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WHY DO WE ROLL THIS WAY? TAX DEFERRED TRANSACTIONS IN THE PRIVATE CONTEXT

By

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I. Background

A. For purposes of this outline, a "rollover" is a transaction in which, as part of a larger transaction, an existing equity holder in a target entity accepts equity consideration ("Rollover Equity") in the acquiring entity or a related person rather than cash consideration in whole or in part of its interest in the target. The reasons for rollover transactions are varied and range from purchasers wanting to align interests with a founder or significant member of management who will continue with the business to helping to bridge a price gap.

1. Although the most straightforward way to accomplish the effect of a rollover would be for the equityholders to sell less than all their interest in a target, this is not usually practicable for non-tax reasons, as acquirors have corporate law and financing reasons to create new holding structures. Therefore, this outline focuses on transactions involving an exchange of equity.

2. This outline will generally consider situations where the Rollover Equity represents a minority interest (often a significant minority interest) in the acquiring entity, even though as a percentage of the value of the target the Rollover Equity might represent 20% or more.

3. This outline will not cover all U.S. federal income tax considerations applicable to rolling equity holders and acquirors. In particular, flow-through target entities present fact-specific and difficult issues that should be carefully considered.

B. In the private context, Rollover Equity is illiquid. Therefore, the rolling equityholder generally will prefer to receive the Rollover Equity on a tax-deferred basis. While acquirors would prefer a fully taxable transaction in order to achieve a full stepped-up basis in acquired equity or assets, the present value of this benefit for acquirors is usually far less than the tax cost to the rollover investor. In addition, rollover investors are often key executives or founders needed to execute the target's business plan, so achieving their tax objectives may be important from a relationship perspective.

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[1] The views, opinions, statements, analysis and information contained in this outline are solely the author's and do not necessarily reflect the views of Kirkland & Ellis LLP. This outline (i) does not constitute legal advice, (ii) does not form the basis for the creation of the attorney/client relationship, and (iii) should not be relied upon without seeking specific legal advice with respect to the particular facts and current state of the law applicable to any situation requiring legal advice.

1. Section 61(a)[2]: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived….". Therefore, unless an exception applies, receipt of Rollover Equity in exchange for target equity (or assets) is taxable. In general, rollover transactions can be structured for taxable treatment where desired. Note that if the conditions are met, tax-deferral is not elective and so special structuring may be necessary to achieve taxability. This outline generally will address structures that give rise to some amount of tax deferral for rolling equityholders.

   a. However, taxable rollover transactions might be desirable where:

      i. The selling holders have a built-in loss in their target equity (or assets) – subject to various loss limitations rules that might be applicable in specific circumstances.

      ii. The selling holders have loss carryforwards that might be used against gain recognized in the transaction.

   b. In partially taxable transactions, rolling equityholders generally will desire to maximize basis recovery.

2. The Code provides several exceptions to the recognition rule of Section 61 that are relevant to rollovers. Thematically, the purpose of these exceptions is rooted in a view that a transaction where a business owner retains a sufficiently large equity investment is not the appropriate moment to levy cash tax. E.g.,

   a. <u>Section 351</u>: Tax deferral upon contribution to a corporation of property by one or more persons in exchange for stock in such corporation if immediately after the exchange such person or persons are in Section 368 "control" of the corporation and certain other conditions are met. This is one of the most common tax deferral provisions applicable to rollover transactions. For examples of authorities explaining Section 351's purpose:

      i. <u>Portland Oil Co. v. Commissioner</u>, 109 F.2d 479, 488 (1st Cir.), cert. denied, 310 U.S. 650 (1940). Section 351(a) intended to apply to "certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."

      ii. <u>American Compress & Warehouse Co. v. Bender</u>, 70 F.2d 655, 657 (5th Cir.), cert. denied, 293 U.S. 607 (1934). A Section 351 transaction "lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the

[2] All "Section" references are to the U.S. Internal Revenue Code of 1986, as amended and, as indicated, the Treasury Regulations promulgated thereunder.

transferred property, . . . the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it."

iii. Caruth v. Comm'r, 688 F. Supp. 1129 (N.D. Tex. 1987). "In promulgating these sections [Section 351 and the corporate reorganization provisions], Congress recognized the economic reality that corporate readjustments do not meaningfully change the identity of the person controlling the transferred property."

b. Section 368: "Reorganization" provisions of the Code providing for tax deferral on certain corporate actions that meet a prescribed statutory and regulatory pattern. For rollover transactions, the most relevant provisions are reorganizations described in Section 368(a)(1)(A) (statutory merger), Section 368(a)(2)(D) (forward triangular merger), and Section 368(a)(2)(E) (reverse triangular merger). However, "reorganizations" are seldomly used in the rollover context because of strict statutory and common law requirements that make compliance with provisions difficult in transactions where there is a significant amount of cash. This outline generally will not discuss the reorganization rules, however, the principles behind the exceptions are instructive.[3]

i. Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949). "The essence of a statutory reorganization is a continuance of the proprietary interests in the continuing enterprise under modified corporate form, the transaction being deemed insufficiently closed economically to justify a tax at the time, except in so far as the stockholder gets something in addition to stock or securities in the reorganized company."

ii. Cortland Specialty Co. v Commissioner, 60 F.2d 937 (2d Cir. 1932). "Such statutes vary in the different states particularly in respect to how far the constituent companies may be deemed to survive the creation of the new or modified corporate structure, but we believe that the general purpose of them all has been to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form."

iii. *See also* Bittker & Eustice at 12.00[1]: "The underlying assumption of tax-free exchange provisions generally is that the new property received is substantially a continuation of the old investment. In the case of reorganizations, the assumption is that the new enterprise or the new corporate structure that may hold the corporate assets, and the new stock or securities received in exchange for old stock or securities, are substantially

[3] For detailed discussion of the reorganization provisions of the Code, *see* Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders at Chapter 12 hereinafter "Bittker & Eustice") and Ginsberg, Levin & Rocap, Mergers, Acquisitions & Buyouts (hereinafter, "Ginsberg, Levin & Rocap") at Chapters 6-10.

continuations of, and interests in, the old corporation, still alive but in different form."

c. Section 708: A partnership continues unless it is terminated, and a partnership only terminates if "no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership." The corporate law identity of an entity is not controlling for partnership continuation purposes. Therefore, a transaction involving the acquisition of all or part of a partnership (or its assets) can constitute a continuation even if there is a formation of one or more new entities and an exchange of equity from a corporate law perspective. Very little is required for a partnership to continue.[4]

i. The focus is both on identity of activity as well as at least some identity of partners. *See* Neubecker v. Comm'r, 65 T.C. 577 (1975); Tolmach v. Comm'r, T.C. Memo. 1991-538; Rev. Rul. 66-264, 1966-2 CB 248 (partnership continued when three partners purchased all of the partnership's assets at a judicial sale and continued the business); *see also* Barran v. Comm'r, 334 F.2d 58 (5th Cir. 1964) (sale of operating assets of a partnership treated as sale of partnership interests despite selling entity's retention of land; continuation result unclear); La Rue v. Comm'r, 90 T.C. 465 (1988) (transfer of all of a distressed partnership's assets to another partnership in exchange for an assumption of liabilities treated as a sale of partnership interests); Hatch's Est. v. Comm'r, 198 F.2d 26 (9th Cir. 1952) (similar).

ii. Treasury Regulations under Section 708 confirm that partnerships can be combined and divided on a tax-deferred basis, and in identifying surviving partnerships identity of ownership/size of activity is important. Treasury Regulations Sections 1.708-1(c), (d)..

iii. An entity that is a "continuation" of another partnership generally inherits that partnership's tax history and elections and each party to such a transaction should be aware of the consequences to it (good and bad) of this result.

d. Section 721: Tax deferral upon contribution to a partnership of property in exchange for an interest in the partnership. Ability to achieve deferral through a contribution to a partnership is more flexible than a contribution to a corporation, and where practicable commonly used in rollover transactions.

i. Pre-enactment of Subchapter K, courts found that contributions to partnerships did not even give rise to a realization event. *See, e.g.*, Archbald v. Comm'r, 27 B.T.A. 837 (1933) ("That the

[4] For a good discussion of continuation authorities *see*, Gall, Phillip, "Nothing from Something", TAXES, Vol. 95 No. 3 (March 2017).

contribution of individual property to a newly organized partnership operates to shift its title from the individual and to change the nature of his interest is clear. But it does not follow that such change is itself the realization of gain or loss. On the contrary, the investment is now more fettered than before, as it is bound with others in the joint enterprise. Although a transformation in title has occurred, there has been no exchange of property for other and different property, but only a further venturing of the old investment in a new project with the hope of added income in the future." [Citations omitted].)

ii. Ability to defer recognition of gain on a contribution to a partnership is subject to limitations, including to "disguised sale" rules (Section 707), "hot asset" provisions (Section 751), certain considerations related to assumption of liabilities (Section 752), and rules designed to limit ability of parties to shift gain among each other (anti-mixing bowl rules of Section 704(c)(1)(B) and Section 737).

II. C Corporation Target

<u>Example 1</u>: T is a private company organized in the United States and taxed as a C corporation. T's sole shareholders are individuals A and B, each of whom are United States citizens. F, a private equity fund, wishes to acquire T for cash, but wishes B to have an ongoing continuing Rollover Equity interest in the T business of 10%.

A. Section 351 Transaction; Corporate Acquiror

1. <u>Example 1a</u>. F forms Newco, Inc., a C corporation organized in the United States, and contributes $X cash to Newco, Inc. Newco, Inc. borrows $Y cash. A transfers its T stock to Newco, Inc. in exchange for cash. B transfers its T stock to Newco, Inc. in exchange for cash and 10% of Newco, Inc.'s stock as Rollover Equity.

a. Section 351(a), Section 351(b). F and B have transferred property (cash and T stock, respectively) to a corporation (Newco, Inc.) in exchange for stock, and F and B are in "control" (within the meaning of Section 368(c)) of Newco, Inc. immediately after the transaction. However, B must recognize gain equal to the lesser of the amount of gain realized in all of its T stock and the amount of cash received. Therefore, B may not achieve complete deferral in respect of the portion of its T stock exchanged for Rollover Equity.

i. Note that Section 368(c) requires 80% of the vote plus 80% of each other class of stock for control.

ii. Note the non-qualified preferred stock ("NQP") rules of Section 351(g) that treat certain "debt-like" preferred as taxable boot.[5]

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[5] These rules are generally beyond the scope of this outline.

iii. Section 358(a)(1). B will have a carryover basis in its Newco, Inc. stock, decreased by the amount of cash received and increased by the amount of gain recognized.

iv. Section 1223(1). B will have a tacked holding period in its Newco, Inc. stock that includes the holding period of its T shares.

b. This transaction may not achieve F's goals either as F typically needs a more complex holding structure to achieve its financing and non-tax goals.

2. Example 1b. Same as Example 1a, except F forms Holdings, Inc. with one class of common stock, which forms and wholly owns Intermediate, Inc., which forms and wholly owns Newco, Inc. F contributes $X of cash to Holdings, Inc. (further contributed down the chain to Newco, Inc.) in exchange for stock in Holdings, Inc. Newco, Inc. borrows $Y cash. A transfers its T stock to Newco, Inc. in exchange for cash. B transfers some of its T stock to Holdings, Inc. in exchange for 10% of Holdings, Inc. stock as Rollover Equity. It transfers the remainder of its T stock Newco, Inc. in exchange for cash. Holdings Inc. will contribute the T stock down the chain to Newco Inc., in part to facilitate the pledge of the stock under the Newco, Inc. debt.

a. Market generally bifurcates the transaction into a Section 351 transfer at Holdings, Inc., followed by successive Section 351 transfers of the T stock received by Holdings, Inc. in the contribution, and a separate cash purchase of the remaining stock by Newco, Inc.. *See* Ginsberg, Levin & Rocap at ¶¶ 903, 1403; cf. Rev. Rul. 2003-51, 2003-1 C.B. 938; Rev. Rul. 84-44 1984-1 C.B. 105; Rev. Rul. 84-71, 1984-1 C.B. 106. This transaction maximizes B's deferral with respect to its T stock exchanged for Rollover Equity and also achieves F's non-tax structural goals.

i. It is not necessary for Intermediate, Inc. or Newco, Inc. to issue additional shares of stock.

(A) Lessinger v. Comm'r, 872 F.2d 519 (2d Cir. 1989) ("We agree, however, with the Tax Court's ultimate conclusion that the exchange requirements of section 351 are met where a sole stockholder transfers property to a wholly-owned corporation even though no stock or securities are issued therefor. Issuance of new stock in this situation would be a meaningless gesture."); Jackson v. Comm'r, 708 F.2d 1402, 1405 (9th Cir. 1983) (same); Comm'r v. Morgan, 288 F.2d 676, 680 (3d Cir.), cert. denied, 368 U.S. 836 (1961); cf. Rev. Rul. 73-473, 1973-2 C.B. 115.

(B) If stock is not issued, the basis of Intermediate's/Newco's existing shares of stock is likely increased by the basis of the contributed property under Section 358, and the holding period of existing shares stock may be split. *See* Bittker & Eustice at ¶ 313. Note that there many circumstances where separate and identified blocks of stock may be useful, so actual issuance of stock could be helpful.

b. Order of steps generally thought to be respected under "Esmark" principles. Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988) (in rebutting the Commissioner's proposed application of the step transaction doctrine: "No route was more 'direct' than the others. Each route required two steps, and each step involved two of three interested parties. Each route left petitioner, petitioner's shareholders, and the purchaser in the same relative positions. Faced with this choice, petitioner chose the path expected to result in the least tax.").

c. Note that, in general, acquisition of T may also be accomplished by reverse subsidiary merger, which is generally treated as a stock purchase for U.S. federal income tax purposes. Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 79-273, 1979-2 C.B. 125; Rev. Rul. 90-95, 1995-2 C.B. 67; Ginsberg, Levin & Rocap, at ¶ 202.

3. Example 1c. Assume in Example 1b, Holdings, Inc. is the parent of an old and cold consolidated group acquiring T as an add-on, and F does not contribute any cash or other assets to Holdings in connection with the transaction. Newco, Inc. funds the acquisition with a borrowing on its line of credit. Section 351 does not apply because B (as sole contributor) is not in Section 368(c) control of Holdings, Inc. immediately after the contribution of T stock in exchange for Holdings, Inc. stock. The lack of deferral may affect B's willingness to accept Rollover Equity.

a. Potential solutions:

i. *"Double Dummy" or "Top Hat"*: F forms Holdings II, Inc. to which it contributes all of its Holdings, Inc. stock at the same time as B contributes its T stock to Holdings II, Inc., in each case in exchange for Holdings II stock. In this case, F and B would both be treated as contributing property to a corporation in exchange for equity in a Section 351 transaction.

(A) If it is impracticable for F to contribute the Holdings, Inc. stock (e.g., because there is a dispersed shareholder base), it is possible for F to accomplish the transaction through merger. Rev. Rul. 67-448, 1967-2 C.B. 144; Rev. Rul. 73-427; Rev. Rul. 78-250, 1978-1 C.B. 83; Rev. Rul. 79-273, 1979-2 C.B. 125. *See also*, Ginsberg, Levin & Rocap at ¶ 904.6.

ii. *Partnership*. F forms New P, a U.S. entity taxed as a partnership, to which it contributes all of its Holdings, Inc. stock at the same time as B contributes its T stock to New P in a transaction described in Section 721; New P contributes such T stock to Holdings, Inc. in exchange for Holdings, Inc. equity (see below in Part III).

iii. *Contribution by F in Exchange for Voting Stock*. F does contribute some amount of cash to Holdings in exchange for voting stock. *But see* accommodation transfer authorities: Treasury Regulation 1.351-1(a)(1)(ii) ("Stock will not be treated as issued for property if it is issued for property which is of relatively small value in comparison to the value of the stock already owned (or to be received for services) by the person who transferred such property and the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property"); Rev. Proc. 77-37, 1977-2 C.B. 568 (for ruling purposes, amount not relatively small if it is at least 10% of the value of the stock already owned by transferor).

iv. See below in Example 8c for other potentially possible, but complex, structures.

4. Example 1d. Assume the same facts as in Example 1b, some of the consideration paid to each of A and B is a 2 year note payable by, in the alternative, Holdings, Inc. or Intermediate, Inc. Alternatively, some of the consideration is an earnout payable by Newco, Inc.

a. Receipt of note/right to earnout not eligible for non-recognition. However, A may receive deferral (though not an ongoing equity interest) under the installment method of reporting under Section 453 in respect of the note consideration, subject to meeting the conditions and a potential interest charge under Section 453A. The installment method applies (unless election to the contrary) if at least one payment in a transaction is due after the close of the taxable year in which the disposition occurs. Section 453(b). *See* rules under Treasury Regulation Section 15a.453-1.[6] B may similarly receive deferral. However, a note, if issued by Holdings, Inc. would constitute "boot", which might limit duration of B's deferral on the rollover T stock under Section 351(b). Therefore, B would prefer any note to be issued by Intermediate, Inc. or Newco, Inc. (it would also be structurally senior to any debt at Holdings, Inc., which might provide non-tax benefits to B). The credit facility at Newco, Inc. might limit Intermediate, Inc.'s or Newco, Inc.'s practical ability to issue such a note. B could insist on another corporation between Intermediate and Holdings as issuer.

b. Recovery of basis under the installment method may not be beneficial, as basis must be allocated to the installments (or potential installments) as described in the Treasury Regulations promulgated under Section 453. Some ordinary income will accrue to sellers either as stated interest or imputed interest under Section 1274 or Section 483.

[6] In general, detailed installment method considerations are beyond the scope of this outline. For a more detailed discussion of the installment method, *see* Ginsberg, Levin & Rocap at ¶¶ 203.4, 302.2.

5. <u>Example 1e</u>. Assume that as a requirement of the transaction, F requires B to subject its Rollover Equity to vesting conditions tied to B's future employment.

    a. B should make an election under Section 83(b) of the Code or risk appreciation being taxed as compensation. See Rev. Rul. 2007-49, 2007-2 C.B.. 237.

    b. Other compensation related topics (e.g. waivers and deferrals of otherwise compensatory amounts) are beyond the scope of this outline.

6. In all transactions involving Section 351, the parties should consider the impact of typical purchase price adjustment mechanics on deferral (e.g., for net debt, working capital, etc.).

    a. Depending on expecting timing of adjustment, do installment sale rules apply?

    b. Treatment of any cash adjustment: (a) additional cash proceeds for stock sold to Newco, Inc. for cash or (b) boot with respect to the contribution of T stock in the rollover? Structure and contractual language should be carefully considered.

B. Intersection of Subchapter K and Subchapter C – C Corporation Target, Partnership Acquiror. Parties may wish for a holding entity taxed as a partnership, as partnerships facilitate a more flexible sharing of economics and governance and permit the issuance of "profits interests" as incentive equity.

1. <u>Example 2a</u>. Same facts as Example 1b, except F forms New P, a U.S. entity taxed as a partnership for U.S. federal income tax purposes and contributes $X of cash to New P. New P forms Holdings, Inc., and contributes such cash to Holdings, Inc. in exchange for stock in Holdings, Inc. A transfers its T stock to Newco, Inc. in exchange for cash. B transfers some of its T stock to New P in exchange for units representing 10% of the capital and profits in New P as Rollover Equity. It transfers the remainder of its T stock Newco, Inc. in exchange for cash. New P transfers the T stock received to Holdings, Inc. in exchange for shares in Holdings, Inc., and stock is further contributed down the chain.

    a. Contribution to New P is described in Section 721(a). B has transferred T stock to New P in exchange for a partnership interest in New P.

        i. B takes a carryover basis in its New P Units (Section 722) and a tacked holding period (Section 1223). B will have a Section 704(b) capital account in New P equal to the value of its Rollover Equity. The contributed T stock is Section 704(c) property with respect to B.

        ii. New P takes a carryover basis (Section 723) and a tacked holding period (Section 1223) in the T stock received.

b. New P's contribution to Holdings, Inc. is described in Section 351(a). New P has transferred T stock to Holdings, Inc. in exchange for Holdings, Inc. stock and is in Section 368(c) "control" of Holdings, Inc.

i. New P takes a carryover basis and tacked holding period in the Holdings, Inc. stock received as described above.

(A) In general, such stock is property of the partnership. Gain or loss is allocated to the partners, subject to Section 704(c)'s "built-in-gain" rules, which allocates gain (or loss) with respect to such stock to the contributing partner up to the amount of such built-in-gain (or loss) at the time of contribution. Treasury Regulation Section 1.704-3.

(B) Even though issuance of stock not required, as described above, issuing stock and specifically identifying it may be helpful to later identify which shares have Section 704(c) "built-in-gain" that is allocable to B. Treasury Regulation 1.704-4(d).

ii. Holdings, Inc. takes a carryover basis and tacked holding period in T stock as described above.

iii. F is likely to structure sale of the portfolio company as a sale of stock of Holdings, Inc. and any gain recognized will pass through to New P's members (including B) and be allocated to them pursuant to the terms of the New P operating agreement, subject to Section 704(c).

2. <u>Example 2b</u>. Same transaction as Example 2a, but instead of first transferring T stock to the New P, B transfers some of its T stock to Holdings, Inc. in exchange for 20% of the stock in Holdings, Inc., and then immediately transfers such Holdings, Inc. stock to New P in exchange for units in New P representing 20% of the capital and profits in New P. It transfers the remainder of its T stock Newco, Inc. in exchange for cash. F might prefer this structure for reasons unrelated to U.S. taxation. It also permits a clean identification of Rollover Equity within New P.

a. Each of New P and B have made contributions to Holdings, Inc. in exchange for equity as generally described in Section 351(a). However, is the requirement that the contributors have Section 368(c) control immediately after the exchange met?

i. Transfers among members of the control group are permitted. Rev. Rul. 79-174, 1979-1 C.B. 145, citing Treasury Regulation Section 1.351-1(b) Ex. 1. New P is a transferor to Holdings, Inc. *Compare*, Rev. Rul. 79-70, 1979-1 C.B. 144.

ii. Cf. Rev. Rul. 2003-51, 2003-1 C.B. 938 (Section 351 exchanges found to exist where transferor contributed property in exchange for an amount of stock in corporation Z constituting control and, pursuant to a binding commitment, the transferor transfers the stock of Z so received to corporation Y simultaneously with the transfer of assets by the third party to Y in exchange for an aggregate amount of stock constituting control of Y). Note that the second transfer described in the ruling is to a corporation rather than a partnership.

b. B has transferred Holdings, Inc. stock to New P in exchange for an equity interest in New P as described in Section 721(a). Same consequences as described in Example 2a.

c. Section 704(c) property is clearly identified without need for Treasury Regulation Section of 1.704-4(d) tracing.

3. Example 2c. Same transaction as Example 2a, but New P contributes the cash it receives from P to Holdings Inc. in exchange for plain vanilla evergreen preferred stock (no put or call rights) with a market yield. Any upside above that yield is paid in respect of the common stock issued in respect of the transferred T stock. F might like this structure, as on a future exit there might be more items of long-term capital gain to allocate to F.

   a. Character and holding period of property (e.g., long term or short term) is determined at the partnership level. Consider whether this could maximize long-term capital gain on a future sale, including for purposes of Section 1061.

   b. Valuation and sizing important.

C. Intersection of Subchapter C and Subchapter K – C Corporation Target, Partnership Seller.

Example 3. Assume same facts as Example 1, except A and B are equal partners in partnership AB which owns 100% of the stock of T.[7] AB acquired the T stock for cash more than 1 year ago. Assume further that AB has no other assets or liabilities. F wishes to acquire T, and wishes B (but not A) to have a continuing equity interest in the T business of 10%.

1. Example 3a. F forms Holdings, Inc., and contributes $X cash to Holdings, Inc. in exchange for stock. Holdings, Inc. forms and wholly owns Intermediate, Inc., which forms and wholly owns Newco, Inc., in each case, contributing the cash received from F. Newco, Inc. borrows $Y cash. AB transfers some of its T stock to Holdings, Inc. in exchange for 10% of Holdings, Inc. stock. AB transfers the remainder of its T stock Newco, Inc. in exchange for cash. AB liquidates, distributing 50% of its value in cash to A and 50% of its value in the Holdings, Inc. stock (as Rollover Equity) and the balance in cash to B.

   a. Consequences of the transaction are recognized at the AB level. Therefore, gain recognized by AB under Section 1001 is allocated to A

[7] Note that this structure is commonly seen where there is a private equity-sponsored target. The examples below are simplified for illustrative purposes.

and B pursuant to the terms of the AB operating agreement unless AB can get comfortable that it can specially allocate ("stuff") a disproportionate amount of recognized gain to A (subject to Section 704(c)). Law is unclear, and therefore rollovers are seldom structured this way. Instead, one of the structures below is typically used.

b. Each of A and B's basis in AB equity will be adjusted upwards under Section 705 for gain recognized and allocated to them. On liquidation of AB, B's basis in its distributed Rollover Equity will be equal to its adjusted basis in AB, less the amount of cash received. Section 732(b). A and B will each recognize gain upon the liquidation in AB equal to the difference between the cash received and their basis in AB immediately prior to the distribution or loss equal to the excess of their basis over the sum of the cash and the basis to the partner of any T stock received. Section 732(a).

   i. B will ultimately get the benefit of a capital loss to offset the timing detriment, but practical timing issues and loss limitations may give rise to a non-optimal result for B.

   ii. AB's operating agreement should be carefully examined to determine whether the disproportionate distribution of consideration types is contractually permitted.

2. Example 3b. Same as Example 3a, except as a first step, AB liquidates, distributing 50% of the T stock to each of A and B.[8] Transaction proceeds as described above in Example 1b.

   a. No gain or loss recognized by either A or B in the liquidation. Section 731(a). Each of A and B take a basis in their T stock received equal to their respective bases in AB. Section 732(b). No gain or loss recognized by AB. Section 731(b).

   b. In the subsequent acquisition steps each of A and B have the same results they would have had in Example 1b.

   c. Similar result to B if only B's interest is liquidated by a distribution of T stock and AB remains a partnership (e.g., if there is a third partner, C; any gain recognized by AB on the retained T stock allocated between A and C pursuant to AB's operating agreement).

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8 Because in this example, AB is a two person partnership for tax purposes, the same result could be achieved by redeeming either A or B completely from AB in exchange for T stock, if permitted by the operating agreement of the entity. Rev. Rul. 99-6 1999-1 CB 432. If any of the T stock constitutes property previously contributed by either partner within 7 years, that block of T stock should be distributed to the contributing partner to avoid application of anti-mixing bowl rules of Section 737 and Section 704(c)(1)(B). *See* Section 737(d)(1); Section 704(c)(1)(B); Treasury Regulation Section 1.704-4; Treasury Regulation Section 1.737-2(d).

3. Example 3c. Same as Example 3a, except as a first step, AB distributes T stock with a value equal to the agreed value of the Rollover Equity to B. B contributes the T stock so received to Holdings, Inc. in exchange for Rollover Equity as described in as described above in Example 1b. AB sells the remaining T stock to Newco for cash.

   a. No gain or loss recognized by AB or B on partial distribution of T stock. Section 731(a). B takes a basis in its distributed T stock equal to the lesser of its basis in AB and AB's basis in the distributed T stock. Section 732(a). B's basis in AB is reduced, but not below zero, by the basis to B of the T stock distributed. Section 733. If AB has a Section 754 election in place, it is possible that the basis of the remaining shares of T in AB's hands would be adjusted under Section 734. A detailed analysis of all implications under Subchapter K is beyond the scope of this outline.

      i. Many operating agreements provide for built-in-gain on distributed property to be allocated pursuant to "forced" allocation provisions designed to align capital accounts with distribution priorities. How this built in gain should be booked to the partners' capital accounts for Section 704(b) purposes in respect of distributed shares in cases like Example 3c is not entirely clear, and while it is possible that such gain could be specially allocated to B, this is not certain. It is possible that instead such gain should be allocated in proportion to the partners' economic arrangements as described in the partnership agreement. *See, e.g..*, New York State Bar Association Tax Section, "Report on Section 704(b)" (October 10, 2024) (asking for guidance on this situation).

      ii. In the absence of such a special allocation, the tax results to A and B may be distorted from a timing perspective if B is only allocated its 50% share of the built-in gain in the distributed T stock for capital account purposes. *See id*. at IV.B.4. It is arguably more consistent with each partner's interest in the partnership to make such a special allocation.

   b. B's contribution to Holdings, Inc. of the T shares distributed to it in exchange for Rollover Equity should qualify for deferral under Section 351 as described above in the Example 1 alternatives.

   c. AB will recognize gain or loss equal to the difference between the cash received on its disposition of remaining T stock and its adjusted basis in its T stock. Section 1001. This gain should be allocated between A and B pursuant to the operating agreement of AB, taking into account the effect of B's partial redemption from AB, including any special allocation of the gain. Consider how the consequences of any purchase price adjustment mechanic should be allocated if such adjustment is received by AB and paid to both partners.

   d. A and B should recognize gain or loss in their AB partnership interests on the distribution of cash in liquidation of AB as described in Section 731.

4. Example 3d. Assume F structured its acquisition using a holding partnership, New P, but otherwise as described in Examples 2a or 2b. As mentioned above, this is a common structure and generally should achieve deferral for B.

   a. Could New P be treated as a continuation of AB under Section 708?

      i. Better answer is no in both situations. In Example 2b, New P never has any direct interest in the assets or business of AB, even though it will indirectly own all the stock of T and there is some partner overlap. The separate existence of Holdings, Inc., etc., should be respected. Moline Properties v. Comm'r, 319 U.S. 436 (1943). In Example 2a, the transitory ownership of T stock by New P should not cause AB to continue.

      ii. If F has any concerns on this account:

         (A) Transaction could be structured to preserve the existence of AB, e.g., through purchase price adjustment/contingent asset or liability items as authorities suggest that very little is required to continue a partnership. *See* Baker Commodities v. Comm'r, 415 F.2d 519 (9th Cir. 1969) (partnership was deemed to continue because there was no evidence of a final distribution of partnership assets); Harbor Cove Marina Partners P'ship v. Comm'r, 123 T.C. 64, (2004) (mere retention of cash was sufficient for partnership continuation); Foxman v. Comm'r, 41 T.C. 535 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965) (partnership continues even if its only assets are notes receivable and its business activities are generally limited to actions related thereto); Robert M. Kane, Jr., "Partnership Terminations: When Does Something Become Nothing?", 160 TAX NOTES 1683 (Sept. 17, 2018); Sara B. Zablotney, "A Rose by Any Other Name Will Cost You More: Form, Substance, and Business Transactions under Subchapter K", TAXES, Vol. 90 No. 3 (March 2020). *But see* Rev. Rul. 66-264 and Barran v. Comm'r, *supra*.

         (B) Alternatively, if there are good non-tax reasons, consider holding Rollover Equity through a separate aggregator partnership.

   b. Same considerations as described in Examples 2a and 2b otherwise apply.

III. Flow-Through Target

Example 4: T is a private company organized in the United States and taxed as a partnership. T's sole members and unitholders are individuals A and B who each own 50% of the capital and profits in T unless otherwise indicated. F, a private equity fund, wishes to acquire T for cash, but wishes B to have an ongoing continuing Rollover Equity interest in the T business of 10%.

A. Partnership Target; Flow-through Acquiror

1. Example 4a. F forms Newco LLC, a limited liability company organized in the United States and initially disregarded.[9] F contributes $X cash to Newco LLC. Newco LLC borrows $Y cash. A transfers its T units to Newco LLC in exchange for cash. B transfers its T units to Newco LLC in exchange for cash and units representing 10% of Newco LLC's capital and profits as Rollover Equity.

   a. It is relatively common for F to structure its investment in T through one or more "blocker corporations." This structuring generally does not implicate the rollover structure for B, though both F and B may wish to negotiate terms of a future transaction (e.g., F may wish to be able to sell its blocker corporation stock on the same terms as the sale of Newco LLC equity, and B may wish to capture the benefit of any future step up on the sale of its Rollover equity from a future buyer). Note there are certain circumstances where F is in the same circumstances as B and desires to rollover (e.g. to address a valuation gap or in a "continuation fund" structure) that are more complex.

   b. Application of continuation authorities under Section 708 versus Rul. 99-6 situation 2 principles.

      i. Continuation result is likely as the transaction is in substance the same as if F purchased partnership interests in T from A and B for cash, with B continuing as a partner in respect of 10% of Newco LLC. Bias in the partnership tax law is to continuation. *See, e.g.*, Gall, *supra* at 195; New York State Bar Association, Report No. 1432, "Report on Partnership Terminations Following the Tax Cuts and Jobs Act" (January 2020), Zablotney, *supra*, at III; Tijana Dvornic, "Formless Partnership Transactions and Deemed Transfers: Connecting the Dots and Completing the Picture," TAXES, Vol. 102, No. 3 (March, 2024). Note that if both A and B roll over, this result is even clearer.

      ii. F achieves a step-up under Section 743 in respect of the assets attributable to its purchased partnership interests (potentially characterized as a "disguised sale of partnership interests" under Section 707 principles).

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[9] In reality, F is likely to form a stack of disregarded entities to facilitate its holding and financing structure. This should not change the result.

(A) F likely prefers a Section 743 step-up as all of the available step-up is specific to F. In contrast, in a transaction structured as a Rev. Rul. 99-6 transaction, T would be treated as if it liquidated, distributing its assets to A and B, and immediately thereafter, F would be treated as acquiring a portion of the assets from A and B respectively, and then F and B each would be treated as contributing assets to Newco LLC. In that case the step-up generated from F's purchase would be "common basis" and to achieve the effect of a step-up F would need to insist on the "remedial method" under Section 704(c) to achieve the full benefit attributable to its investment.

(B) A Section 743 step-up also alleviates "anti-churning" concerns under Section 197 regarding amortization of intangibles for F, if relevant. See Treasury Regulation Section 1.197-2(g)(3) (increase in basis of a section 197 intangible treated as a separate intangible); Treasury Regulation Section 1.197-2(h)(12)(v). For further discussion of the anti-churning rules in the context of partnership transactions, see Ginsberg, Levin & Rocap at ¶ 403.4; Romina Weiss, "Enough Anti-Churning: It's Time to Make Butter", THE PARTNERSHIP TAX PRACTICE SERIES: PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES (hereinafter, the PARTNERSHIP TAX SERIES"), Chapter 52 (2024, Reprinted from THE PARTNERSHIP TAX PRACTICE SERIES 2014). A detailed discussion of the anti-churning rules is beyond the scope of this outline.

iii. Each of A and B recognize gain or loss from a sale of partnership interests (or disguised sale of partnership interests) under Section 741. This gain is generally capital, subject to the application of the "hot asset" rules of Section 751. B is generally treated as if nothing happened with respect to its Rollover Equity, even though from a non-tax perspective B actually exchanges its interests.

(A) A and B care about the allocation of consideration among T's assets for purposes of Section 755 because amounts allocated to "hot assets" give rise to a character difference.

(B) It is possible that the IRS would treat the transaction as including an exchange described under Section 721 notwithstanding the continuation result. See Rev. Rul. 86-101, 1986-2 C.B. 94; Rev. Rul. 84-52, 1984-1 C.B. 157. This would be most likely in a case where Newco LLC is a different entity type or organized in a different state than T.

iv. Amount realized for purposes of gain and step-up will in part relate to liability relief under Section 752. Treatment of debt financed proceeds to be negotiated and considered.

(A) If possible, B prefers an ordering/transaction structure where the debt is incurred after F becomes a partner and B receives proceeds under Section 731 in partial redemption of its interest, as this structure arguably maximizes B's basis recovery. Any distribution in excess of B's basis may give rise to a basis adjustment under Section 734 that is "common" to the partners. This result is less beneficial to F.

(B) F prefers a borrowing that precedes, or is simultaneous with, its investment such that its portion of the debt-financed proceeds are treated as consideration that gives rise to basis under Section 743 for F.

c. <u>Example 4(b)</u>. Same facts as Example 4a except Newco LLC has more than one member when organized and funded by F (e.g., because F is comprised of parallel funds.)

i. It is possible that the partnership merger rules under Treasury Regulation Section 1.708-1(c) could apply. A transaction is treated as a partnership merger "if two or more partnerships merge or consolidate". In that case, the resulting partnership is treated as a continuation of the merging partnership the members of which own an interest of more than 50% in the capital and profits of the resulting partnership (or in a tie-break situation, the larger partnership). Treasury Regulation Section 1.708-1(c)(1). Under these facts, F owns more than 50% of the combined entities and therefore Newco LLC, and not T, would continue.

(A) In a situation where Newco LLC is funded in connection with the acquisition of the interests in T, Newco LLC does not have independent substance apart from the transaction and therefore the market generally does not apply a merger analysis.

(B) However, if Newco LLC is funded prior to the transaction, especially if its existence crosses a tax year in a manner that necessitates the filing of a separate tax return for Newco LLC, it is possible that the merger rules apply.

ii. Application of the merger rules changes the analysis. In a typical rollover transaction treated as a partnership merger, the merged partnership is treated as contributing all of its assets and liabilities to the resulting partnership in exchange for consideration and then liquidating. "Assets over" form described in Treasury Regulation Section 1.708-1(c)(3)(i).[10]

(A) If this transaction is treated as a partnership merger, T would be treated as contributing its assets and liabilities to Newco LLC in exchange for an interest Newco LLC and cash, followed by a liquidation of T with A receiving cash and B receiving cash and interests in Newco LLC.

(B) It is likely quite beneficial to specify in the transaction documents that A and B's sale of interests in T to Newco LLC for cash is respected as a sale of an interest under Section 741. *See* Treasury Regulation Section 1.708-1(c)(4). This treatment aligns the results for A and B with Example 4a. Otherwise T would be treated as recognizing gain on its deemed transfer of assets under the "disguised sale" regulations of Section 707. This is likely unfavorable to B and may give rise to unfortunate results under the anti-churning rules if applicable. *See, e.g.*, Eric B. Sloan and Dina A. Wisen, "Partnership Mergers and Divisions: A User's Guide," THE PARTNERSHIP TAX SERIES Chapter 264 (2024, Reprinted from THE PARTNERSHIP TAX PRACTICE SERIES 2015).

(1) Access to the treatment described in Treasury Regulation Section 1.708-1(c)(4) requires a specific agreement in the transaction documents. Failing to include is a trap for the unwary, and because the law is unclear in situations like Example 4b, it probably makes sense to include this language if a purchase of interests is the desired result.

(2) However, parties should model the consequences of this election in all transactions that could be treated as a partnership merger, merger transactions as it is not always favorable.

iii. Note that for non-tax purposes it is very common for Example 4-type transactions to involve one or more corporate mergers, though a corporate law merger is not required for any particular tax result. A merger subsidiary might be used to place the debt, e.g., because board members of T do not wish to approve the debt (which will be the on-going business's responsibility) and associated distribution of proceeds. A merger also might be useful

[10] An "assets up" form can apply, but only in situations where the merging partnership actually distributes the assets to its partners in a manner respected for local law purposes. Treasury Regulation Section 1.708-1(c)(3)(ii). This form is seldom used outside the real estate area given the non-tax difficulties inherent in actually distributing assets.

to make sure that all equityholders are cashed out. Unlike in the Subchapter C Context, the direction of a partnership merger for corporate purposes is not relevant to the tax result (though similar structures are often used). The tax timing and characterization of transactions including partnerships and actual mergers under local law is not always clear, but parties often use contractual self-help to bolster reporting. *See* Dvornik, *supra*.

2. Example 4(c): Assume instead that Newco LLC is an old and cold partnership. A transfers its T units to Newco LLC in exchange for cash. B transfers its T units to Newco LLC in exchange for cash and 10% of Newco LLC's capital and profits.

   a. Partnership merger rules of Treasury Regulation Section 1.708-1(c) more clearly apply with the results described above.

   b. Agreement likely should specify that B's transfer of units for cash is treated separate under Treasury Regulation Section 1.708-1(c)(4), otherwise unintended consequences under the disguised sale regulations could apply, though this should be modeled as described above.

   c. Same result if Newco LLC is owned in a multi-tiered structure with several disregarded LLCs and the purchase of interests and the contribution occur at separate levels.

3. In all Example 4 scenarios, there may be a benefit for B to hold their interest through an aggregator partnership (if there are other rollover partners/profits interest partners) or (with some reservations) an S corporation.

   a. If B is or will be a service provider to the business of T, B cannot be both a partner and an employee, and, therefore B will receive all of B's income from Newco LLC, including B's salary (shown as a guaranteed payment) on an IRS Schedule K-1. This will subject B to self-employment tax on B's "salary" and will also limit B's ability to access certain kinds of benefit plans. *See, e.g.*, Renkenmeyer, Campbell & Weaver LLP v. Comm'r, 136 T.C. 137 (2011), Rev. Rul. 69-184, 1969-1 C.B. 256; McKee, Nelson, Whitmire & Brodie, Federal Taxation of Partnerships & Partners at ¶ 14.03[6][b] and [c] (hereinafter, "McKee"). If B is a partner or member of a separate and regarded entity, then they could be treated as an employee of T/Newco LLC post transaction.

   b. Note that there is often a corporate benefit to aggregating smaller holders in an entity, e.g., to enforce drag-along rights on a future transaction, so that an aggregator may be desirable even if the partner/employee distinction is not meaningful to the rolling equityholder. There may be practical benefits to aggregating Rollover Equity separate from incentive equity.

B. Disregarded Target; Flow-Through Acquiror

1. Example 5a. Assume the same facts as Example 4, but that T is a disregarded entity wholly-owned by B. F forms Newco LLC, organized in the United States and initially disregarded.[11] F contributes $X cash to Newco LLC. Newco LLC borrows $Y cash. B transfers its T units to Newco LLC in exchange for cash and 10% of Newco LLC's capital and profits as Rollover Equity.

   a. Generally treated as if B contributed all of the assets of T to Newco LLC in exchange for cash and Rollover Equity in Newco LLC as part of a transaction described in part as a contribution described under Section 721 and in part as a "disguised sale" of assets under Section 707. See Treasury Regulation Section 1.707-3(f), Ex. 1. B generally would recognize gain or loss with respect to assets deemed sold under Treasury Regulation Sections 1.707-3 through 1.707-5, provided that it may be able to receive some cash as "preformation capital expenditures" and some amount of debt-financed proceeds to the extent constituting qualifying liabilities or liabilities incurred in lieu thereof. A detailed discussion of the disguised sale rules and the exceptions thereto is beyond the scope of this outline.[12]

      i. If B causes T to actually contribute certain assets and sell others, B may have the opportunity to "cherry pick" and contribute assets that have a larger amount of built in gain in exchange for its interest in Newco LLC if the form is clear, though this is not free from doubt. *See* McKee at ¶ 3.04[4][d].

      ii. However, where the transaction is cast as a contribution of the disregarded entity, transaction should be analyzed as a pro rata sale of a portion of each of AB's assets in exchange for cash and a contribution of a portion of each of T's assets to Newco LLC in exchange for an interest.

   b. Alternatively, this example may be treated as a transaction described in Rev. Rul. 99-5, 1999-1 C.B. 434. The facts of the revenue ruling do not address this situation squarely. However, in interpolating the ruling, the transaction could either be cast as a purchase by F of a pro rata portion of T's assets followed by a contribution by F and T of assets, or as described in the prior paragraph (though an actual separate contribution of assets is not possible).

   c. If a specific asset purchase alternative is desired, as a practical matter the parties should structure the form of the transaction in accordance with the desired result, though this may not be possible for non-tax reasons.

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11 In reality, F is likely to form a stack of disregarded entities to facilitate its holding and financing structure. This should not change the result.

12 For further reading on disguised sales *see* e.g. Mckee at ¶ 14.02; Aaron Nocjar, "Partnership Disguised Sale Rules," THE PARTNERSHIP TAX SERIES, Chapter 234 (2024, Reprinted from 2019).

2. <u>Example 5b</u>. Assume the same facts as Example 5a, except that Newco LLC is an old and cold partnership. This scenario generally should be analyzed under the first alternative above as a disguised sale of assets by B. Similarly, the parties should consider whether another form is more beneficial.

C. Disregarded Target; C Corp Acquiror

1. <u>Example 6a</u>. Assume the same facts as Example 5a, except that F forms Newco, Inc., a C corporation organized in the United States, and contributes $X cash to Newco, Inc. Newco, Inc. borrows $Y cash. B transfers its T units to Newco, Inc. in exchange for cash and 10% of Newco, Inc.'s stock.

a. As a threshold matter, B may wish to continue to hold its interest in T directly so that they may continue to obtain the benefits of flow-through taxation. In this case, Newco, Inc. would purchase an interest in T and B would retain its interest in a transaction described in Rev. Rul. 99-5.

i. This structure is similar to an "UP-C" structure used for some IPOs. See, e.g., Andrew B. Purcell, "The Umbrellas of Subchapter K," THE PARTNERSHIP TAX SERIES, Chapter 286 (2024), for more details on UP-Cs.

b. F should make sure that it has analyzed any anti-churning issues to validate Newco, Inc.'s ability to amortize the step-up and carefully consider the Section 704(c) method selected by AB.

c. B may have reasons to prefer an ongoing corporate structure. E.g., it may simplify B's state filing position and may permit a more tax-efficient grant of profits interests.

2. If the transaction does proceed as described in Example 6a, Section 351 should apply to F and B's contribution to Newco, Inc. B will recognize gain equal to the lesser of its built-in-gain in its T assets and the cash received.

i. B cannot "cherry pick" which assets are treated as contributed and which are treated as purchased. This is true even if T actually contributes assets. Rev. Rul. 68-55, 1968-1 C.B. 140.

ii. B cannot offset any gain recognized by built-in losses.

iii. B should confirm that they will not recognize gain under Section 357(b) or Section 357(c).

b. Newco, Inc. obtains a basis in the T assets that is increased by B's recognized gain. Section 358.

3. <u>Example 6b</u>. Assume the same facts as Example 6a, except that F forms Holdings, Inc., which forms and wholly owns Intermediate, Inc., which forms and wholly owns Newco, Inc., and F contributes $X of cash to Holdings, Inc. (further contributed down the chain to Newco, Inc.). Newco, Inc. borrows $Y cash. B transfers some of its T units to Holdings, Inc. in exchange for 10% of Holdings,

Inc. stock. It transfers the remainder of its T units Newco, Inc. in exchange for cash. Holdings Inc. will contribute the T units down the chain to Newco Inc., in part to facilitate the pledge of the stock under the Newco, Inc. debt.

a. In general, B should get the same result as under Example 1b. Note that since B is transferring interests in a disregarded entity, it cannot "cherry pick" higher built in gain assets for contribution. However, it may be able to use realized losses attributable to the Newco, Inc. deemed purchase of T's assets to offset gain. If B wishes to "cherry pick", then it could attempt to transfer low basis assets to Holdings, Inc. (as a contribution) and high basis assets to Newco, Inc. as a sale. This may not be practically possible for non-tax reasons. F/Holdings, Inc. group obtains the benefit of a "step up" in the purchased portion of T's assets.

b. The purchase price, as determined for tax purposes, should be allocated among the deemed purchased assets in accordance with Section 1060. B has an interest in minimizing the amount of purchase price in excess of basis allocated to assets that will generate ordinary income for B. The considerations for F and T that are applicable to asset purchase price allocations are beyond the scope of this outline.

c. T momentarily has more than one owner. Query whether Rev. Rul. 99-5 applies to treat T as a partnership. Consider whether there is any benefit to causing T to be treated as a partnership.

4. <u>Example 6c</u>. Assume the same facts as Example 6b, except that Holdings, Inc. is an old and cold corporation and F does not contribute any cash or other assets. Similar to Example 1c, Section 351 does not apply to the transaction. Same potential solutions apply.

D. Partnership Target; Corporate Acquiror

1. <u>Example 7a</u>. Assume the facts of Example 1a, except T is an LLC taxed as a partnership.

a. Rev. Rul. 84-111, 1984-2 C.B. 88, situation 3. With respect to B, transaction is respected as a transfer of partnership interests to Newco, Inc. in exchange for stock and cash. A's sale of partnership interests for cash likely respected as well.

i. B's result will be the same as in Example 1a, except its gain recognized will be by reference to its basis in its partnership interest.

ii. T will cease to exist as a partnership.

iii. Parties should confirm that Sections 357(b) and 357(c) do not apply.

b. Rev. Rul. 84-111 provides two other possible forms for incorporating a partnership.

i. Under situation 1, T would contribute all its assets and liabilities to Newco, Inc. in exchange for Newco, Inc. stock and cash and then liquidate, distributing the Newco, Inc. stock and cash to A and B.

(A) While asset transactions can sometimes be difficult for non-tax reasons, if T owns all of its assets through a disregarded entity subsidiary, this could be a feasible transaction. F might like this transaction because it distances F from any involvement in the prior history of T.

(B) However, A and B should consider this transaction carefully as it could distort the timing of gain recognition for A and B. In certain circumstances, this transaction can be more tax advantageous, so A and B should model.

ii. Under situation 2, T liquidates, distributing all of its assets to A and B, subject to T's liabilities, then A and B contribute these assets and liabilities to Newco, Inc. in exchange for Newco, Inc. stock and cash. This transaction can also have advantages under certain circumstances depending on the basis of assets as compared to basis of interests and other factors if it is commercially feasible to accomplish. But again, must be carefully modeled.

2. <u>Example 7b</u>. Assume the facts of Example 1b, except T is an LLC taxed as a partnership. In that case B may be able to defer additional gain because the purchase is separated from the contribution. Note that the same 3 scenarios are available in this circumstance and must be modeled and considered.

E. Intersection of Subchapter C and Subchapter K – Flow Through Target, Acquiror is a C Corporation held by a Partnership

1. <u>Example 8a</u>. Assume the same facts as Example 2a except T is a limited liability company taxed as a partnership.

a. This structure works well for B (see consequences to 2a), but F may object to operating assets existing in flow-through form even for an instant due to a technical risk that F's unblocked non-U.S. LPs could have a tax filing obligation (or potentially an issue for sovereigns under Section 892) because of the momentary ownership of a US trade or business. Treasury Regulation Section 1.6012-1(b)(1)(i); Treasury Regulation Section 1.6012-2(g)(1)(i); Treasury Regulation 1.892-5T(d)(3).

i. Some practitioners/sponsors take the view that this "flash ECI" risk is not material and will accept it.

ii. It is not clear that the IRS agrees, and particularly the consequences of a commercial activity for foreign sovereigns can make sponsors very conservative on this point.

b. In addition, parties should confirm that Section 357(b) or (c) does not apply.

2. Example 8b. Assume the same facts as Example 2b, except T is a limited liability company taxed as a partnership.

   a. This structure should work for B (see consequences to 2b), and alleviates F's concerns about the momentary ownership of a US trade or business in flow-through form.

   b. Has the same benefits/risks as 2b.

3. Example 8c. Same facts as Example 8b except Holdings, Inc. is an old and cold C corporation. See Example 1c. Additional potential solutions:

   a. B incorporates the rollover portion of its partnership interest in T into newly formed B Holdings Inc. as a first step. B subsequently contributes all of the stock of B Holdings Inc. to New P in exchange for partnership interests in New P as Rollover Equity. New P contributes such interests to Holdco, Inc. in exchange for stock in Holdco Inc. Newco, Inc. purchases the remaining interests in T for cash.

      i. Subsequent transfer of B Holdings Inc. stock is not to a member of the control group making a contribution to B Holdings Inc. Consider application of the logic of Rev. Rul. 2003-51.

      ii. At a minimum, B Holdings Inc. must remain in the structure for an undefined amount of time.

   b. Newco, Inc. contributes cash to Bidco Inc., a newly formed subsidiary in exchange for stock in Bidco Inc. B contributes its interests in T to Bidco Inc. in exchange for cash and equity in Bidco Inc. B contributes the Bidco Inc. shares to New P in exchange for interests in New P, and New P contributes the shares down to Holdco, Inc. (which are subsequently contributed down the chain to Newco).

      i. Subsequent transfer of Bidco Inc. stock by B is not to a member of the control group making a contribution to Bidco Inc., but rather to Bidco Inc.'s ultimate parent entity. Consider application of the logic of Rev. Rul. 2003-51.

      ii. Bidco Inc. should remain in place for an undefined amount of time.

      iii. Consider substance of transaction.

IV. Special Considerations for S Corporation Targets

A. Special S Corporation Challenges.

1. S corporations may only have qualifying shareholders (basically U.S. individuals and certain kinds of trusts). In addition, S corporations may only have 1 class of stock (meaning that shareholders in an S corporation generally must receive identical economic treatment with respect to each share). Section 1361(b).

2. Because S corporations are flow-through entities, S corporations can sell assets and/or offer a step-up in the asset basis of their assets to a purchaser through a Section 338 election or a Section 336(e) election generally without double tax.[13] This step-up is usually quite valuable for a purchaser.

    a. No tax-deferred rollover is available in a Section 338 election or a Section 336(e) election scenario. The election triggers gain in 100% of the assets.

    b. This is true even if the transaction is otherwise structured in a manner that otherwise might qualify for Section 351 treatment, provided that the transaction otherwise constitutes a "qualified stock purchase" within the meaning of Section 338(d). F must carefully examine its structure if it desires to make a Section 336(e)/Section 338 election and also have some after-tax rollover of T stock.

B. JV structure.

1. A common solution to the "all or nothing" nature of the Section 338 election is a transaction where as a first step, T's assets and liabilities are transferred to an LLC. As a second step, an entity formed by F purchases the desired amount of the LLC's equity.

    a. This transaction can also be accomplished by T's shareholders contributing their T stock to New T, for which they make an S election, and converting T to an LLC under state law in a transaction described in Section 368(a)(1)(F).

    b. This permits F to obtain the effect of a step-up at least with respect to the portion of the assets that it purchases, but for the S corporation shareholders to benefit from deferral. Note that in this transaction, where T becomes a partnership as a result of F's purchase, Rev. Rul. 99-5 applies. F may need to negotiate for the "remedial method" under Section 704(c) in order to obtain the full benefit of the step up, and/or structure as described below. In addition, F should carefully examine whether the anti-

[13] Note that in certain circumstances some built in gain of an S corporation can be subject to corporate tax. See Section 1374. Note that not all states follow the federal treatment and there can be incremental state tax on such asset sales. In addition, there is a character difference between sales of assets (some gain can be ordinary), and sales of S corporation stock (all gain is capital). While beyond the scope of this outline, note that well-advised S corporation sellers ask for a gross-up from buyers to compensate them for these differences.

churning rules of Section 197 would apply to disallow amortization deductions for goodwill.

c. It may be necessary or beneficial for T to become a partnership prior to F's purchase of T. Purchase of a partnership interest would permit F to obtain the benefit of its step up through Section 743. In addition, anti-churning rules generally would not apply to F's step-up.

i. This can be accomplished through, e.g. the contribution of assets held by the shareholders outside the partnership (which sometimes exists), or a distribution of a portion of the receivables (or other assets) to the shareholders, who then contribute such receivables to T some period prior to closing.

ii. Timing of any such partnership formation should be carefully considered.

d. New T obtains the effect of a rollover. However, the rollover is in effect pro-rata among the T shareholders because of the S corporation single class of stock rules (that is the T shareholders must participate pro rata in the on-going ownership of the equity of the LLC).

i. Gain on the sale portion of the transaction is allocated pro rata.

ii. A distribution of the LLC equity would give rise to taxable income under Section 311(b) (also shared pro rata).

iii. This can pose practical difficulties where shareholders are not necessarily aligned in their desires to roll over.

iv. There are limited potential solutions that also permit a step-up, most of which are very complex and change the economics. For one creative solution, see Eric Sloan and James Jennings, "Disproportionate S Corporation Rollovers: Turns Out Lindsey Buckingham Was Right", 181 TAX NOTES FEDERAL 1175 (Nov. 13, 2023).

e. Note that special S corporation rules can affect structure of earnouts and other deferred payments. *See* Ginsberg, Levin & Rocap at ¶ 1108.3.

C. Other corporate structures. S corporation rollovers can proceed in the same manner as rollovers of C corporation stock. However, F will not obtain the benefit of a step-up.