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How to Structure Tax-Free Rollovers in Add-On Acquisitions

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Private equity sponsors should tailor add-on acquisitions to their particular portfolio companies, in order to achieve the most tax advantageous results—one size does not fit all, says Isaac Grossman of Morrison Cohen.

Anxiety over tariffs and general market uncertainties have slowed the overall M&A deal flow. Nonetheless, private equity buyers continue to move forward, particularly with add-on acquisitions.

In aiming to generate exponential growth for their portfolio companies, private equity funds often employ an M&A-focused growth strategy characterized by effecting numerous add-on acquisitions. One of the key aspects of most add-on acquisitions is the use of rollover equity. To incentivize sellers to continue to focus on the performance of the target business after its sale, many buyers require sellers to roll over a significant amount of their proceeds – which generally ranges from 20% to 30% of the equity value of the business – into the acquiring entity. From the seller's perspective, an important feature of this structure is the ability to defer taxes on the portion of the rolled equity consideration. For convenience, this is generally referred to as a "tax-free" rollover.

While this strategy has become a common part of the M&A playbook for PE-backed buyers, as is often the case, when making a tax-free rollover work, the devil in the details. There are many different structures that PE funds use for their acquisition vehicles, and to a large extent these structures dictate whether and how sellers can roll over. Of course, there is no perfect solution that solves every potential problem. Each model offers advantages and disadvantages. However, having a working knowledge of whether and how tax-free rollovers can be effected in each structure is critical to taking a deal from concept to reaching a successful closing and an eventual exit.

Below we discuss three structures commonly used by private equity sponsors and the methods of achieving tax-deferred rollover (and potential difficulties) associated with each structure. These models are intended to serve as

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introductory guidelines for the uninitiated, but specific tax and corporate advice is required in each deal to ensure the desired outcome.

Three Common Structures

The three most common structures used by private equity sponsors for businesses are as follows:

(i) the "pass-through" model—a pass-through parent entity with pass-through subsidiaries, such as wholly owned limited liability companies;
(ii) the "hybrid" model—a pass-through parent entity, such as a partnership or domestic limited liability company, holding all the equity of a corporation; and
(iii) the "corporate" model—a corporate parent company with either corporate or pass-through subsidiaries.

Each of the models has its own nuances regarding tax-free rollovers, particularly when dealing with smaller add-on acquisitions.

The Pass-Through Model

This is the easiest model to provide tax-free rollover equity. As a general rule, contributions of property made to a partnership in exchange solely for partnership equity are tax-deferred. There is one major complication due to the built-in gain (i.e., fair value over tax basis) that often arises with respect to the contributed property. Under IRC §704(c), the built-in gain or loss must be traced to the contributing partner and will often result in a disproportionate amount of income being allocated to the contributing partner reflecting that built-in gain. For this reason, it is imperative for sellers that they receive tax distributions to cover the taxes on that income allocation. However, buyers are often reluctant to provide cash from post-closing operations to effectively fund a pre-closing liability. Moreover, buyers often refuse to permit non-pro rata cash distributions for any reason (albeit logical). There are a variety of solutions to this conundrum, including grossed up tax distributions for the non-contributing partners and catch-up payments upon liquidation by the contributing partners, but a detailed summary of those solutions is beyond the scope of this article.

The Hybrid Model

The hybrid model has a pass-through parent entity at the top of its structure holding equity of a corporation. As noted above, contributions made to a partnership in exchange solely for partnership equity are generally tax deferred. The §704(c) issue mentioned above is less egregious in the hybrid model because the corporation blocks current income, and §704(c) issues are deferred generally until exit. The difficulties with tax-free rollovers in this hybrid structure arise due to the sensitivities of most PE fund investors. In asset acquisitions or acquisitions of pass-through entities, the contributed property by the seller will be an undivided interest in the target's business assets or a pass-through equity interest in the target, both of which can generate momentary business activity and active business income. Many PE fund investors are sensitive to even an instant of ownership of these operational business assets. As a result, tax-free rollovers with hybrid models may need to be structured either (i) by sellers rolling over into the subsidiary corporation and subsequently "flipping" equity of the corporation into the pass-through parent entity in exchange for equity of the parent, or (ii) by requiring sellers to contribute the rollover assets/equity into a blocker corporation and then having sellers contribute the equity of that blocker corporation into the pass-through parent entity.

The Corporate Model

The corporate model requires the most planning regarding tax-free rollover transactions. There are two basic alternatives: the contribution alternative and the reorganization alternative. The reorganization alternative only works for stock acquisitions. The simplest version of the reorganization alternative is to merge the target into a disregarded LLC subsidiary of the corporate parent in exchange for shares of the corporate parent and cash. However, to qualify as a tax-free reorganization, there are several key requirements: for example, the value of the corporate parent equity must be approximately 45-50% of the total consideration. In contrast, the contribution alternative works for both stock and asset acquisitions. However, it requires that the PE fund and existing owners must also contribute cash/property to the corporation alongside the rolling sellers. Moreover, the PE funds' and existing owners' contributions must be meaningful—say, at least 10% of the existing value of the equity. For those add-ons funded by operational cash and/or debt, where further equity contributions are unnecessary, this alternative is often unavailable. If the add-on is particularly important, but these alternatives are not easily applicable, a more drastic approach – such as adding a new holding company above the corporate parent entity—may be used to qualify the transaction as a tax-free contribution rollover.

Choosing a Model

There are a number of considerations to take into account when assessing which model is most appropriate in a given acquisition. For example, the corporate model offers protection for foreign or tax-exempt PE investors from ECI (Effectively Connected Income), UBTI (Unrelated Business Taxable Income), and direct tax filings. It also offers a relatively low tax rate on retained, undistributed earnings available to grow the business. The hybrid model offers some of the protections of the corporate model described above, but also provides the ability to incentivize management through issuing profits interests, an instrument that only works for pass-through entities and not corporations. The pass-through model offers US domestic investors the ability to avoid a double tax on earnings and provides the next buyer with the ability to get a step up in the tax basis of the assets of the business.

There is no single solution that threads every needle; as experienced M&A practitioners know, every deal is different. But while one size does not fit all, fortunately, there are solutions that can be tailored to fit every set of circumstances with sound legal advice.

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