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## Teaching Founders to Roll Over: Deal Structures that Bridge the Valuation Gap

### *The tax tail should never wag the deal dog.*

But in private equity, tax structures can significantly affect deal price and portfolio company returns. This is especially true in “rollover” transactions, where the private equity fund (PEF) encourages the founders (Fs) to leave part of their target company (T) stock in the deal. Rollovers not only help align the Fs’ interests with those of the PEF, they also bridge valuation and transaction financing gaps.

Fs often insist on a tax-deferred rollover – meaning they pay no tax on their retained equity until it is sold in the future. At the same time, PEFs generally favor transaction structures that permit them to increase (or step up) the basis in T’s assets by the amount of the deal price.

This is because portfolio company cash flows and PEF returns can be enhanced by the ability to amortize and deduct purchase price against T’s future profits. Unfortunately, deal structures that permit Fs to reinvest equity on a tax-deferred basis can limit the PEF’s ability to step up the tax basis of T’s assets.

### Why Simple Asset or Stock Purchases Often Don’t Work

The most PEF-favorable deal structure for getting a step-up in the tax basis of T’s assets (and limiting liability exposure) is an asset acquisition.

However, an asset deal (including a taxable “forward” subsidiary merger) normally requires the Fs to pay tax on 100% of the deal consideration (taxed at one level if T is an S corporation, and “double-taxed” if T is a closely held C corporation). It also requires Fs to reinvest in the acquiring company on an after-tax basis.

On the other hand, the easiest way for Fs to defer tax is to have the PEF purchase only a portion of their stock. This may minimize Fs’ tax, but it also will deny the PEF any step-up in T’s

assets. Generally, the tax basis of T’s assets is not stepped up in a stock purchase (including those accomplished by way of a taxable “reverse” subsidiary merger).

In a relatively popular deal structure, the parties can make a “338(h)(10)” election and treat the purchase as if it were a taxable asset purchase. This election permits the PEF to benefit from a step-up in T’s assets. To qualify, T must be an S corporation, and the PEF must form an acquisition corporation to acquire at least 80% of T’s stock.

However, contrary to popular belief, a 338(h)(10) transaction does not permit tax-free rollovers of F equity. Fs are required to pay tax on their pro rata share of the gain realized by T on its deemed asset sale. Also, the election is not available if the PEF wants to purchase and hold its investment in T through a partnership or LLC entity.

Finally, leveraged acquisitions of T stock (a common acquisition technique) can affect the 80% stock purchase requirement and invalidate the parties’ 338(h)(10) election.

### Taking the Target and Founders as You Find Them

No one structure fits every deal. As noted, the optimal tax structure depends on many factors:

- Whether T is a C corporation, S corporation, or an LLC, and the magnitude of the desired F equity reinvestment or rollover.
- The relationship among deal price, tax basis in T’s assets, Fs’ stock basis, and losses that can shelter T’s tax on an asset sale.
- The nature of T’s assets (e.g., depreciable equipment or amortizable goodwill) and the present value of future tax write-offs available to shelter tax on T’s operating profits.

- Whether special “antichurning” rules apply, and if so, their effect on PEF’s ability to benefit from a step-up in T’s assets.
- The desire for tax-efficient dividends or distributions of refinancing proceeds, and the most likely type of exit scenario (e.g., sale or IPO).

Depending on how these factors weigh into the choice of transaction structure, if the Fs’ rollover is small and the PEF’s tax benefit from the basis step-up is significant, the Fs might be willing to reinvest on an after-tax basis, provided they receive a bonus to pay their capital gains taxes on the rollover and perhaps options or other equity inducements. However, each of these solutions may involve taxable ordinary income to the Fs.

## Alternative Deal Structures for Equity Rollovers

### Tax-Free Merger

T can be merged into a newly formed subsidiary of an acquisition corporation on a tax-deferred basis if the transaction qualifies as a “reorganization” for tax purposes. Among other requirements, the Fs must receive a significant amount of stock.

In a forward merger, the stock generally must equal 40% or more of the total deal value the Fs receive. In a reverse merger, the stock generally must equal at least 80%. In addition, the Fs will be taxed immediately on cash received (limited to total gain), notwithstanding its common reference as a “tax-free” merger.

Importantly, parties are denied any step-up in the tax basis of T’s assets in a tax-free merger, despite the tax cost to the Fs on cash received. As a result, mergers are not as common in PEF-sponsored transactions as in strategic acquisitions.

### Holding Company Structures

It is common for PEFs to acquire company stock through a holding company, usually with the plan to make add-on acquisitions through separate subsidiaries. However,

Fs typically desire equity in the ultimate parent company if there is a prospect for value accretion from future add-ons.

If, as in a simple stock purchase, the PEF is willing to forgo any step-up in T’s assets, the PEF can form a new holding corporation (Holdco) and capitalize it with all or a portion of the deal cash. Simultaneously, the Fs contribute a portion of their T stock to Holdco in exchange for the agreed percentage of Holdco’s stock.

Finally, either directly or by way of a taxable reverse merger, Holdco purchases the balance of T’s stock. There are multiple variations, including two-tier and three-tier structures that can be tailored to fit specific deal requirements.

### LLC “Drop-Down”: The “Best” Compromise?

A growing number of PEFs are considering the tax benefits of owning portfolio companies in LLC form – primarily given the ability to distribute debt refinancing proceeds and sell the companies’ assets without the “double” tax impact incurred by C corporations.

“Blocker” corporations are used by many PEFs to allow investment in LLCs without creating tax problems for tax-exempt and foreign investors. But LLC acquisition structures also present one of the few ways to accomplish a tax-deferred founder equity rollover, while allowing the PEF to obtain the tax benefits of an asset purchase or 338(h)(10) transaction.

If T is a C or an S corporation, and an asset deal or 338(h)(10) transaction is unacceptable, and if the PEF desires the future tax advantages of operating the portfolio company in the form of an LLC, then T’s assets and business can be transferred to an LLC on a tax-deferred basis. This can be done in exchange for T’s receipt of all the equity in the new LLC. The PEF can then purchase the desired portion of the LLC’s equity directly from T.

The balance of the LLC’s equity will be retained by T (which will remain 100% owned by the Fs). For tax purposes, this type of transaction is treated as an asset

purchase, with the PEF treated as if it had purchased an undivided interest in T’s assets. To avoid “double” taxation to the Fs on their receipt of the cash, T must be an S corporation.

If a conveyance of T’s assets (including contracts and intellectual property) would be problematic, the same tax result afforded by the “drop-down” transaction can be accomplished by a so-called S corporation “inversion” transaction.

Under that structure, the Fs create a new S corporation, contribute their T stock to the new corporation on a tax-deferred basis, make a “QSUB election” for T, and then convert T to an LLC. The PEF then purchases LLC equity just as it would have in a “drop-down” transaction.

## Getting What You Pay For

Private equity funds should be familiar with alternative transaction structures, and to win over sellers and minimize transaction delays, be prepared to address tax structure as early in the process as the letter-of-intent phase.

The right balance between founder tax consequences and fund tax benefits depends on the type of T company, the nature of T’s assets, and the specific deal drivers and terms, among other factors. A PEF will significantly enhance its returns with proper planning to maximize deductions and minimize taxes on portfolio company exits.

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