Tax-Free Rollovers in Private M&A Transactions: LLC Asset vs. Stock Drop-Down (with Examples)

By: Philip J. Delano, J. Conrad Garcia & John M. Paris, Jr.

11.23.2020

Companies with a history of consistent revenue growth and adjusted EBITDA make attractive acquisition targets for strategic and private equity buyers. Unlike a strategic buyer, which may have on hand a management team capable of operating a target company after the purchase, private equity buyers often focus on buying growing profitable companies with excellent management teams whom the fund wants to keep in place to operate the target after the purchase. This is especially true when the fund wants that management team to manage the target as a ?platform? company used by the fund to acquire other companies in the same industry.

Creating an ideal acquisition structure that can result in tax savings to both the acquiring fund and the owners of the target is a key consideration for both buyers and sellers. To encourage management teams reviewing their sales options to choose to sell to a private equity fund rather than a strategic buyer, those funds often structure their purchase offers to offer the target?s owners a mix of cash and a continuing stake in the newly organized selling entity after the sale. This technique allows the management teams the chance at the proverbial ?second bite at the apple? (i.e., sellers can grow the business further and receive a second payoff on a future sale of the business at the end of the private equity fund cycle). If that structure allows the target owners to receive equity in the platform company on a tax-free basis, the private equity fund offers can become especially compelling. Tax-free rollovers marry these goals of retaining a strong management team and maximizing tax benefits.

<u>What exactly is a tax-free rollover?</u>

A rollover refers to a scenario where the seller(s) of an entity retain a portion of their equity in the acquired business that would otherwise be subject to purchase in a traditional acquisition?essentially rolling over equity in their existing business to a newly-formed entity that will operate the same business under buyer?s control after closing. Generally, this structure allows investment in the buyer on a tax deferred basis with proper tax planning, effectively deferring a portion of the gain realized on the sale of the target company until a later sale by the buyer. After the decision has been made to pursue an equity rollover, there are multiple ways to structure the transaction.

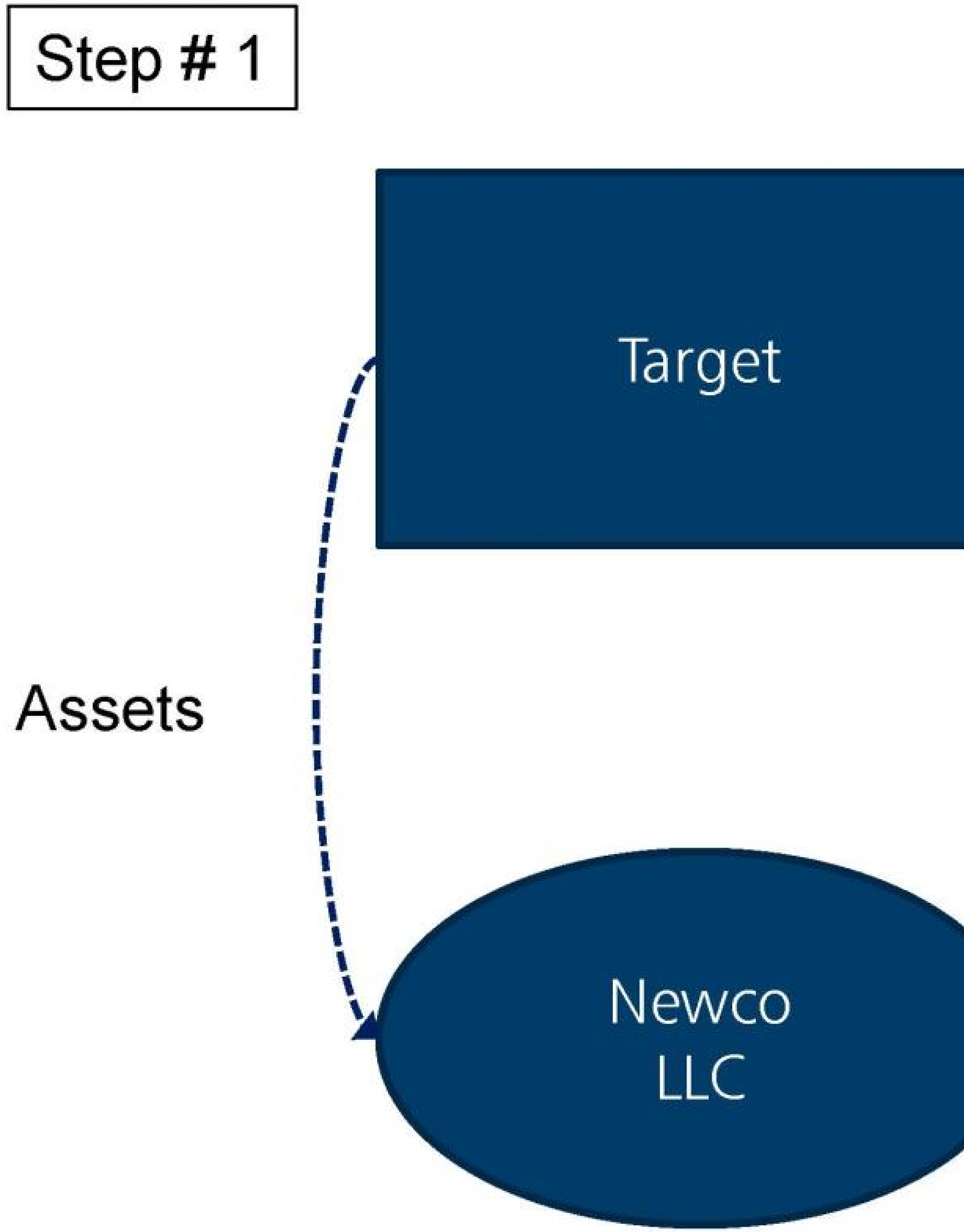
LLC drop-down structure overview

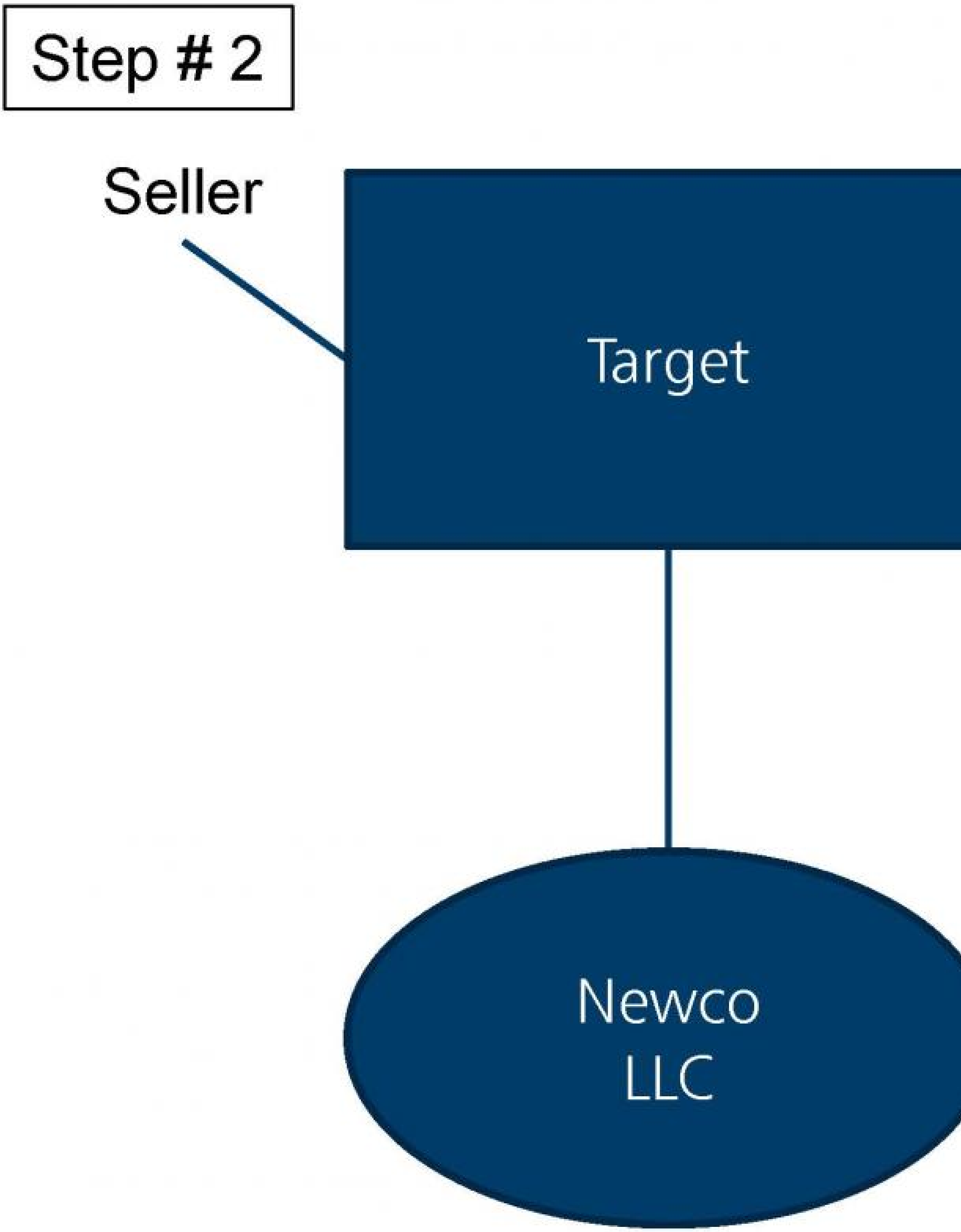
One popular method to achieve tax-deferral is the drop-down LLC structure. This transaction can be effected by first contributing the assets or the stock of the target company into a newly-formed subsidiary of the target company or seller, respectively. These two variations both achieve tax deferral treatment but differ in that the asset drop-down may require additional consents or novations to transfer some or all of the target?s assets. The LLC drop-down structure can be used if the target entity is either a C Corporation or an S Corporation. Partnerships may also utilize this structure, but additional considerations that are outside the scope of this article must be addressed.

The LLC drop-down structure provides two primary tax benefits: stepped-up basis in the target entity?s assets and tax deferral to the seller(s) on their rollover equity. A basis step-up is desirable to buyers, because it allows them to take higher tax deductions for depreciation and amortization on their newly acquired assets (assuming no anti-churning rules apply). The tax deferral similarly favors sellers, allowing them to defer the capital gains taxes on their rollover equity until a follow-on sale, often providing several additional years of deferral. In addition, C Corporations can avoid double taxation by using the drop-down structure for the roll over equity that is kept in the C Corporation.

The Asset drop-down structure

Scenario 1: In an asset drop-down, the target entity (Target) forms a new limited liability company (Newco) and contributes the Target?s assets to Newco in exchange for a 100% interest in Newco. The Target then sells a significant portion of its interest (say, 80%, the ?Controlling Interest?) in Newco to buyer in exchange for cash. The seller retains the remaining 20% of Newco. The purchase of the interest in Newco is covered by Revenue Ruling 99-5. The seller will only recognize gain on the percentage of assets deemed sold. Any assets retained by Newco are deemed contributed by Target on a tax-deferred basis in exchange for the membership interest in Newco.


Step # 1
Target
Assets
Newco
LLC

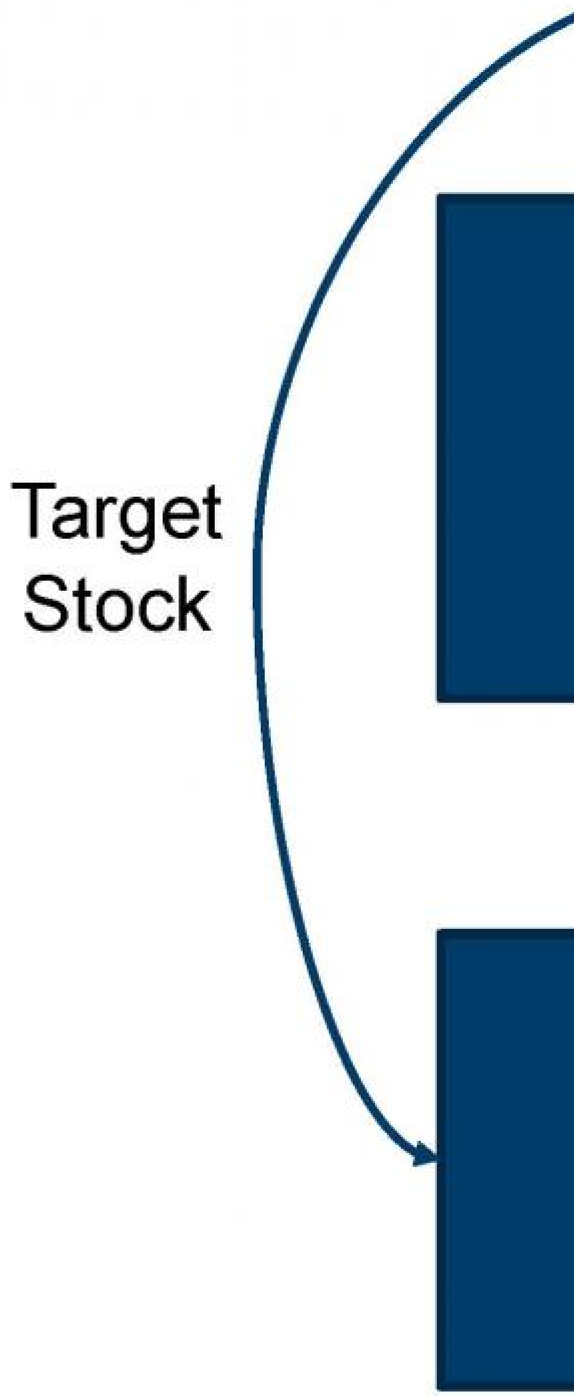


The Stock drop-down / LLC conversion structure

A stock drop-down structure is preferable if certain assets are difficult to transfer due to legal or other restrictions. These could include contracts, licenses, or intellectual property that would require third party consents or novations to transfer to a new entity. Also, unlike an asset drop-down, Target retains its federal employer identification number (EIN), which may ease the administrative burden in the transaction.

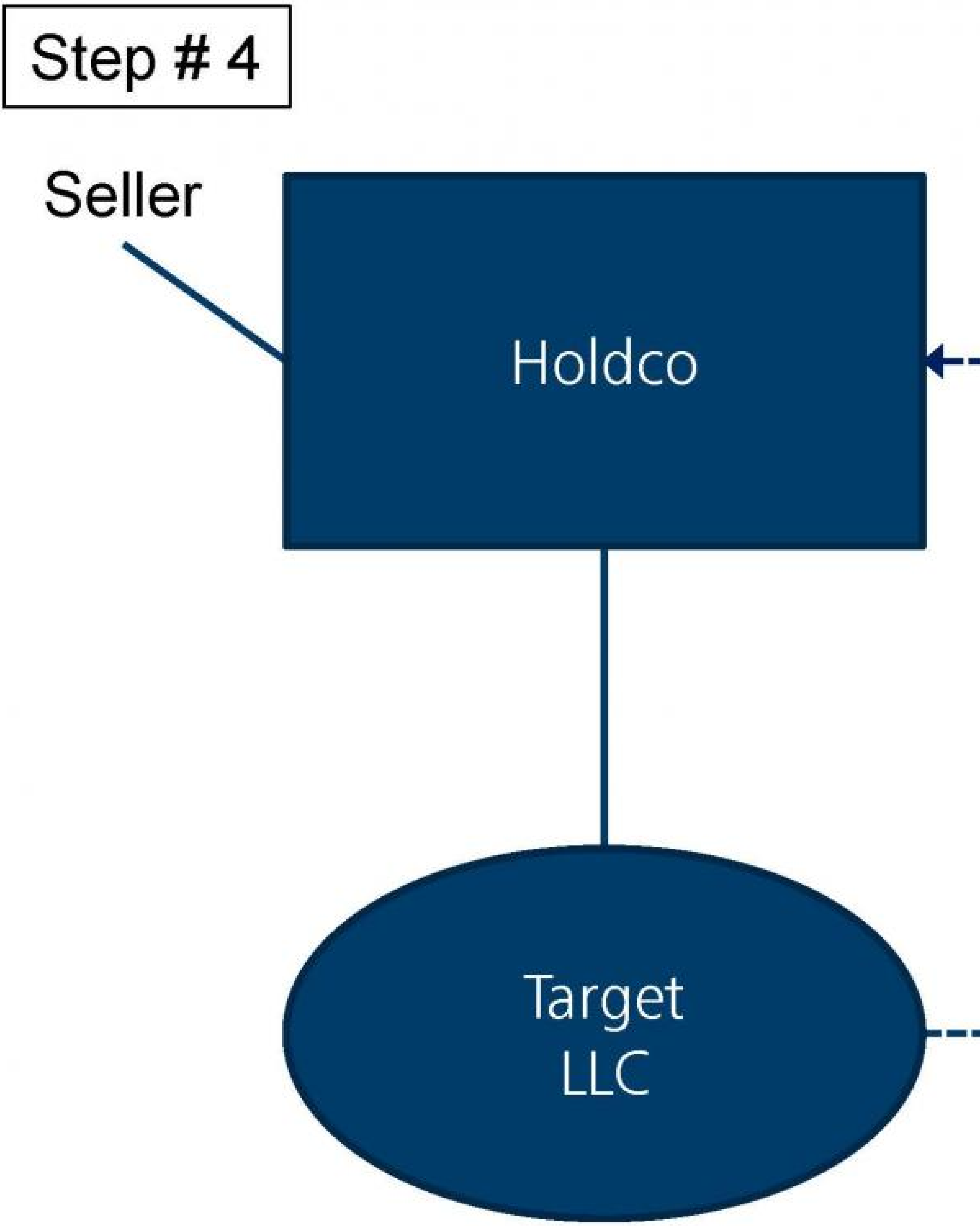
Scenario 2: In a stock drop down, also known as an S Corporation inversion, instead of Target forming a new limited liability company and contributing Target?s assets, seller forms a new S Corporation holding company (Holdco). Seller contributes the stock of Target to Holdco, tax deferred, in exchange for Holdco?s stock. Second, Holdco elects S status, and Target elects qualified subchapter S subsidiary (QSub) status, effective as of the date Target was contributed to Holdco. As a result, Holdco owns Target. The tax treatment for the formation of the S Corporation Holdco and Target?s QSub election are covered by Revenue Ruling 2008-18. As a third step, Target converts to an LLC under state law the next day. Finally, just as in the asset drop-down, the buyer purchases the Controlling Interest in Target from Holdco in exchange for cash, a transaction covered by Revenue Ruling 99-5.

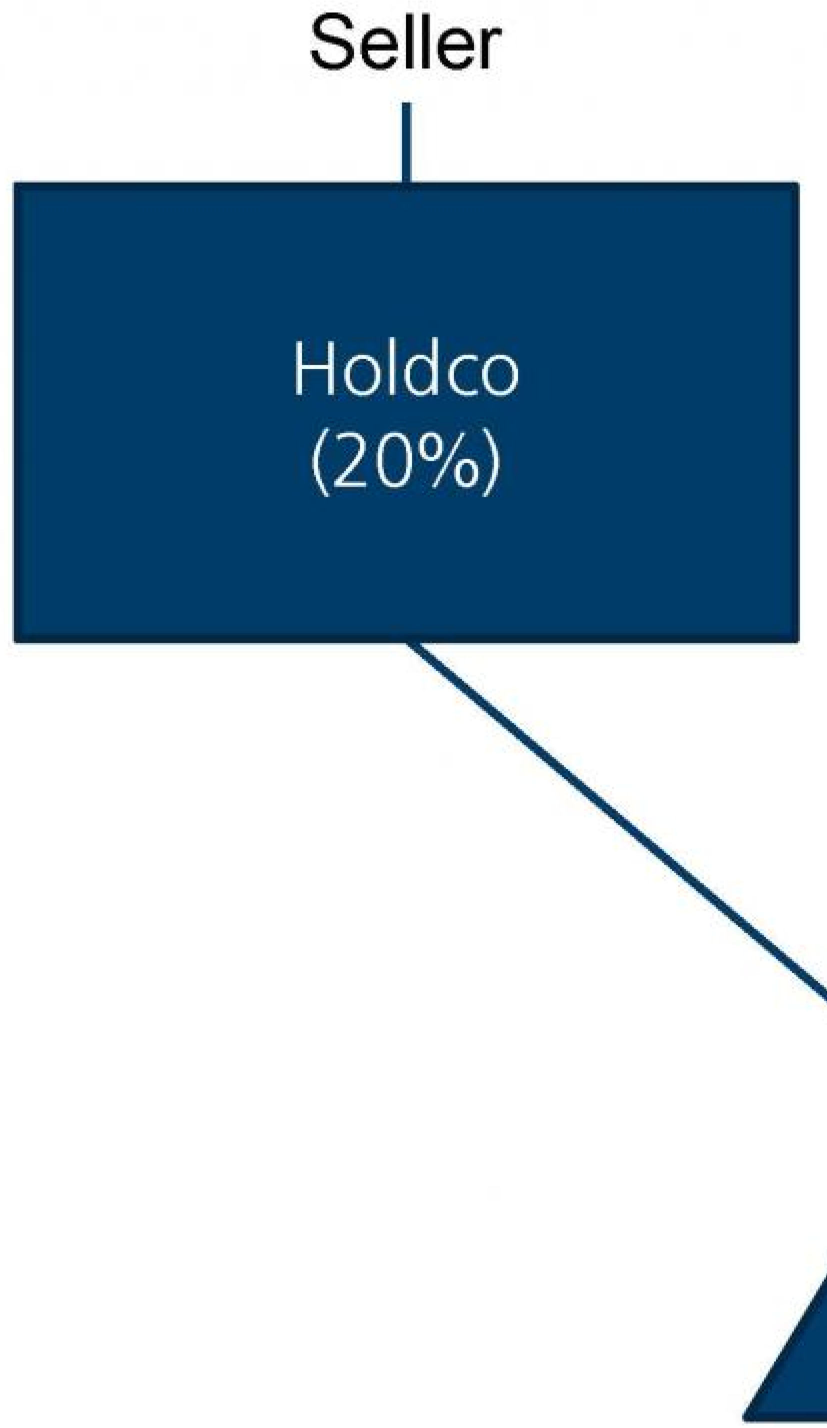
Step # 1



Step # 2

- QSub election for Target made effective as of date Target contributed to Holdco.
- **Rev. Rul. 2008-18** covers tax treatment of new S corporation formation and QSUB election.


Step # 4
Seller
Holdco
Target
LLC



The result in both drop-down structures ends with seller retaining a minority stake and buyer holding a controlling interest in Target. Seller?s equity interest will remain tax-deferred until an eventual sale, and buyer receives a favorable step-up in basis.

For any questions relating to the sale of your business, or structuring a tax-free rollover, please contact the authors of this article.

Related People

- Philip J. Delano ? 804.420.6057 ? pdelano@williamsmullen.com
- J. Conrad Garcia ? 804.420.6910 ? cgarcia@williamsmullen.com
- John M. Paris, Jr. ? 757.473.5308 ? jparis@williamsmullen.com

Related Services

- Mergers & Acquisitions
- Tax Law
- Corporate