*martin*wolf
Valuation & Deal Insights
May 16, 2013

Valuation & Deal Insights®
Industry Coverage: IT Services, SaaS, BPO, and IT Supply Chain Services

Understanding "Rollover Equity"

By Chris Covington

We are strong believers in private equity (PE) and in selling owners "rolling over" their equity into a new entity going forward. Some of the absolutely best financial results for our clients have involved the sale of a controlling interest in their companies at a current market valuation to a PE firm followed (often within 36 months) by the sale of the balance of their interest at some multiple of the original valuation. While the seller(s) have probably worked for several more years, the total sales price is significantly larger than what they could have reasonably expected on the initial sale.

There are occasions, however, where selling owners of privately held companies understand neither the mechanisms nor the tax implications of "rollover equity"; this article will touch on some of the essential considerations.

While the "rollover" concept is not difficult to understand – the seller will have a minority interest in a new entity in essentially the same business going forward – the actual form of the transaction and resulting entity can seem unnecessarily complicated, and generally turns on tax considerations.

Keep in mind that the seller desires to pay tax only at the capital gains rate on the portion of the company sold; ideally the seller also wants a structure that will allow for a tax free rollover of its retained equity. The PE buyer, by contrast, is theoretically unconcerned with the purchase price tax consequences to the seller; its interest is in a transaction that will result in a "stepped up" basis in the company assets, so that it will be able to maximize depreciation (and therefore maximize profits) going forward.

So what are the different possible forms of transactions?

- A sale of assets will provide for the step up in basis that the buyer is looking for, but it will mean that the seller (the company) will pay tax on 100% of the purchase price, and the selling individuals will be investing in Newco on an after-tax basis. As a result, a sale of assets is almost always disfavored.

- A sale of a majority of the stock is generally attractive to the selling shareholders – as they are only paying tax on that portion of the company that is in fact changing hands, and generally at a capital gains rate – but the buyer will miss out on a step up in basis.

- If the selling company is an S Corporation, the selling shareholders may be able to sell a portion of their stock and make a 338(h)(10) election. This is attractive in that it is an election made with the IRS that results in treatment as if it were an asset sale: the buyer gets a step up in basis, and the selling shareholders are, of course, required to pay tax on their pro-rata share (that it, it is NOT a tax free rollover). There are a number of limitations to a 338(h)(10) election: among them are that the company must have S status and at least 80% of the company must be sold.

- In a tax-free merger, sellers can get the tax results they want if they are able to effect a tax-free merger, meaning that in a "forward" merger their rollover must be at least 40% of the total deal value and in a "reverse" merger it must be at least 80%. Unfortunately, the PE buyer will not get a step up in its basis, and, combined with the ownership limitations, means that such mergers are generally not favored by PE buyers.

- Most PE buyers will acquire the sellers stock through a holding company, with the expectation that there will be (or perhaps there have already been) add-on acquisitions. The sellers transfer a portion of their stock for a portion of the stock in holding Newco – which transaction should be tax-free – and

then the balance of their stock for agreed to consideration. Unfortunately, under this scenario, there is no step up in basis and the seller must be careful to insure the structure permits it to get the benefits of increased value resulting from additional add-ons.

- Some PE buyers have embraced the use of LLCs for their operating companies, as LLCs (like S Corporations) avoid the double taxation of C Corporations. Accordingly, the selling company's assets are transferred to an LLC on a tax-deferred basis (that is, there is no tax to the sellers), and a portion of the LLC is sold to the buyer. However, to avoid double taxation, the original seller company must have been an S Corporation.

So what does this mean for our sellers?

- First, recognize that rolling over a portion of your equity can be a tremendous opportunity for you. It allows the parties to "bridge" any substantial differences in valuation, and results in buyer and seller having substantially aligned interests going forward. It is as much the formation of a "new partnership" as it is the sale of a controlling interest in a company.

- Second, you should retain a tax adviser early in the process. As noted above, the differing deal structures have significantly different tax implications, and there are a number of sometimes competing considerations: the form of the selling entity (C or S Corporation, LLC and so on); the tax basis in selling entity's assets, stock; the amount of depreciable assets involved, and the most anticipated exit scenario. The competing considerations can, in almost every instance, be accommodated by thoughtful deal structures.

- Third, you should consider appropriate governance provisions that will help you protect your minority interest going forward: Board of Directors participation rights and tag-along rights are just two considerations.