



Dealing With the Rollover of the Management Team's Equity and Equity Rights in a Sale Transaction

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A typical part of the sale of a business is the rollover of some equity by the target company's stockholders. In many sale transactions, the management team rolls over a disproportionate share of their equity. Sometimes, participation in the rollover is limited to the management team. For these reasons, it is important to have a good understanding of the business, tax and securities law issues associated with rolling over the management team's equity and equity rights. In particular, the tax consequences associated the rollover of equity and equity rights are different when service provider are involved.

In our regularly updated article [Rollover Equity Transactions](#), we address in greater depth the various business and tax issues associated with structuring transactions involving equity rollovers.

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I. Business Issues

The goal of most financial buyers is to increase the value of their operating companies so that they will have a profitable exit after several years. Most financial buyers believe that a strong performance by the operating company's management team is a critical part of growing the company's value and achieving a profitable exit. Naturally, these financial buyers want to incentivize the operating company's management team to overperform. One way to encourage strong performance is to make sure that the management team has "skin in the game," which translates into making sure that the management team profits along side the financial owner in a successful sale. In some instances, this might mean participating through transaction bonuses. In many cases, "skin in the game" comes in the form of a combination of rollover equity (i.e., the exchange of target company equity for buyer equity) and participation in the buyer's equity compensation plans.

The mix of rollover equity and cash paid to the management team in a target company sale varies widely from deal to deal. As mentioned above, the management team often disproportionately participates in the rollover of target company equity. In many M&A transactions, the target company's investors are cashed out and the equity rollovers are limited to certain management team members. The management team often has mixed feelings about rolling over a significant percentage of their target company equity into buyer equity. There is almost always a desire to take some money off the table during a sale process. But the lure of

participating in a meaningful way in a future exit can be a strong one for the management team. Regardless of how the management team feels about keeping skin in the game, the reality is that for many companies, substantial participation by the management team in the rollover is a critical part of engineering a successful sale process.

In the typical transaction, the management team's equity will be exchanged for buyer equity subject to various restrictions, even if their target company equity was fully vested and unrestricted. The buyer equity issued to the management team often includes a discretionary buy-out (call) right in favor of the employer triggered upon termination of employment, even if the triggering event is termination without cause or death or permanent disability. The redemption price paid in connection with termination for cause or voluntary termination by the management team member is often both substantially below fair market value and paid over time. The redemption price is more likely to be fair market value where the triggering event is termination without cause, resignation for good reason, or death or permanent disability. An employee will rarely have put rights, even upon termination without cause, resignation for good reason, death or permanent disability.

An exception to the usual absence of put rights is the situation where some portion of the buyer equity was intended to function as seller financing, rather than traditional "skin in the game" rollover equity. Where this is the case, there may be put-call rights with respect to a block of rollover equity. The put-call price for this equity might be fixed based on the original sale price or might take into account post-acquisition changes in value. Even where the equity represents additional seller financing, the company still often has the right to redeem the equity at below-FMV if the employee is terminated for cause, and in some cases, even where the triggering event is death or disability. The buy-sell terms for rollover equity can be a complicated mix of triggers, pricing and payment terms where the equity serves multiple functions.

One or more members of the management team may be represented on the portfolio company's board, but this is usually more a reflection of their management role than their equity

ownership. Buyers often establish equity rights plans with participation that may extend to senior management who participated in the rollover. In addition to participating in equity plans, management team members may participate in performance or transaction bonus arrangements that are included in employment or separate agreements.

It sometimes makes sense for the management team to have separate legal representation in a sale process, particularly where the management team's deal terms are significantly different than those of the target company's other investors (e.g., the management team rolls over equity and enters into post-sale compensation arrangements while investors are cashed out).

In addition to those issues that are specific to management team members, there are a number of business and tax issues that are common to all rollover participants. Those issues are discussed in detail in [Rollover Equity Transactions](#).

II. A Primer on the Taxation of Equity Compensation for M&A Participants

The general tax aspects of structuring the rollover of target company equity into buyer equity in an M&A transaction are addressed in [Rollover Equity Transactions](#). The complicated tax issues that are specific to the management team arise from the fact that the Internal Revenue Code often treats service provider's equity differently than equity held by investors. The reason for this distinction is that when equity or equity rights are issued to or held by a service provider, there is a separate set of rules that determine when that "relationship" triggers compensation income to the service provider and a deductible compensation payment for the employer.

A. Section 83 primer for M&A transactions.

Section 83 addresses the tax consequences associated with the transfer of property to employees and other service providers, including the issuance of equity and equity rights, even when the service provider pays full fare for the equity or equity rights. It is

important to keep in mind Section 83's basic rules when considering the tax consequences of rolling over equity and equity rights in an M&A transaction. In general, when an employer issues equity to a service provider, the excess of fair market value (subject to any applicable valuation discounts) ("FMV") over the amount paid for the equity is taxable compensation, unless the equity is nonvested. If equity is nonvested when issued, the later vesting of the equity triggers taxable compensation equal to the FMV of the equity at the time of vesting. Options and stock appreciation rights are not generally taxable when issued. But the issuance of vested equity upon the exercise of an option triggers taxable compensation equal to the difference between the option exercise price and the FMV of the equity issued upon exercise.

Under Section 83, equity is "vested" when it is "substantially vested," and "nonvested" when it is "substantially nonvested," in each case as defined in Treasury Regulation § 1.83-3(b). Treasury Regulation § 1.83-3(b) provides that property is substantially nonvested when it is subject to a substantial risk of forfeiture and is nontransferable, and is substantially vested when it is either transferable or not subject to a substantial risk of forfeiture. It is important to understand that not all vesting requirements, buy-back rights and terms or other contractual features governing replacement equity will rise to the level of a "substantial risk of forfeiture" for purposes of Section 83. A risk of forfeiture generally exists only if the recipient's continuing right to equity is conditioned upon the future performance of substantial services or upon the occurrence of a condition if the possibility of forfeiture is substantial. Equity is not subject to forfeiture if the employer is required to pay fair market value for the equity. Equity is transferable if the holder can transfer any interest in the property, but only if the transferee is not subject to a substantial risk of forfeiture.

Section 83 doesn't treat the holder of nonvested stock or a nonvested LLC capital interest as the owner of the equity for tax purposes unless the recipient makes a Section 83(b) election. Prior to vesting, any distributions with respect to nonvested equity are treated as taxable compensation.

If a Section 83(b) election is timely made, the FMV of the equity in excess of any amount paid will be taxable compensation to the service provider. If no Section 83(b) election is made, then the fair market value (net of any tax basis) will be compensation when the equity vests or is transferable. If nonvested equity is sold, the net sales proceeds will be treated as taxable compensation. The employer is generally entitled to a corresponding deduction for compensation paid when a recipient is taxed under Section 83's rules.

Under Section 83, vesting requirements tied to continued employment, along with any other vesting requirements associated with an executive's (i.e., a service provider's) rollover equity, will generally cause equity to be categorized as nonvested equity, so long as the equity is nontransferable. If nonvested stock or an LLC capital interest vests upon a change in control, that event will trigger taxable compensation under Sections 83 at the then-FMV of the equity in excess of any amount paid for the equity, unless a Section 83(b) election was made when the equity was issued, even if the equity is then exchanged in a tax-free exchange for buyer equity.

If the recipient of nonvested equity makes a timely Section 83(b) election, the recipient is then treated as the owner of the equity for tax purposes and the holding period commences for capital gains purposes. Any Section 83(b) election must be made by the recipient within 30 days after receipt of the equity. The making of the Section 83(b) election will trigger a deemed payment of taxable compensation to the service provider equal to the then-FMV of the equity in excess of any amount paid for the equity. If nonvested stock is ultimately forfeited or redeemed at a discount, the recipient can only deduct as a capital loss the amount by which the payment for the stock exceeds any redemption proceeds. The decision whether or not to make the election requires balancing the negative (immediate compensation income equal to the difference between the fair market value of the equity and any amount paid, subject to valuation discounts) and the positive (after the election is made, the holder is treated as the owner of a capital asset and the later sale of the equity will qualify for long-term capital gains treatment after 12 months). In many cases, the value of the equity

at the time of grant will be much lower than when the equity vests. Typically, it makes sense for founders of a start-up business who are issued stock subject to a vesting schedule to make the Section 83(b) election. In most cases, a low valuation placed on founders stock for Section 83(b) purposes can be justified based on a start-up's capitalization (which often includes an overhang of preferred stock and debt) and absence of earnings. Finally, it isn't unusual for employers to require that recipients of incentive equity made the Section 83(b) election.

The taxation of nonqualified stock options (NSOs) is addressed in Treasury Regulation § 1.83-7. In many cases, NSOs cannot be exercised until the occurrence of a change in control event and the equity issued upon exercise is immediately cashed out in the M&A transaction (or the options are cashed out in conjunction with the M&A transaction). The exercise of the NSOs in exchange for vested equity is treated as a compensation event, subject to applicable withholding and deductible by the employer. If nonvested equity is issued upon exercise of an option, the fair market value of the equity, subject to discounts, will be taxed as compensation in the first tax year in which the employee's rights in the equity are transferable or are not subject to a substantial risk of forfeiture. Payments made to cash out options held by LLC members will be treated as guaranteed payments.^[1]

The basic Section 83 rules outlined in the preceding paragraphs are clarified in Revenue Ruling 2007-49 for purposes of the issuance of nonvested stock issued in taxable and tax-free exchanges. If vested stock is "rolled over" in a transaction where the participants continue to hold their original target company equity, but post-transaction, new restrictions are placed on the equity, the IRS ruled that there is no "transfer" for Section 83 purposes, so that new vesting requirements have no tax effect on the characterization of the equity as vested equity for Section 83 purposes. But if vested stock is exchanged in a Section 368 tax-free reorganization for nonvested buyer stock, the replacement stock is treated under Revenue Ruling 2007-49 as being transferred in connection with the performance of services. As a result, the replacement stock is subject to Section 83. Revenue Ruling 2007-49 provides that the "amount paid" for the stock received in the exchange is the fair

market value of the exchanged target company stock. As a result, the rollover participant will not be required to report any taxable compensation in connection with making a Section 83(b) election with respect to equity transferred to the rollover participant in the exchange.

Note that Revenue Ruling 2007-49 confirms the importance of understanding when the IRS takes the position that compensatory equity has been “transferred” to a service provider in a taxable or nontaxable exchange.

The most important aspect of Revenue Ruling 2007-49 is the confirmation that the exchange of vested stock for nonvested stock in a tax-free reorganization or taxable exchange is treated as a new issuance of nonvested stock for Section 83 purposes, resulting in the necessity of making the Section 83(b) election. If the Section 83(b) election isn't made, the then-FMV of the replacement stock will be taxable compensation (net of any tax basis the holder has in the stock) when the stock vests. **Further, note that the Section 83(b) election should generally be made when vested equity is exchanged for nonvested LLC capital interests in a taxable or nontaxable exchange.** We believe that the principles outlined in Revenue Ruling 2007-49 apply equally to the exchange of vested LLC capital interests for nonvested LLC capital interests.

Revenue Ruling 2007-49 doesn't address the holding period issue for the replacement buyer equity. In a tax-free exchange, the rollover participant's holding period for target company equity will usually tacks onto the holding period of replacement stock in a tax-free reorganization. The same rule might apply in Situation 2 addressed in Revenue Ruling 2007-49, but the need to make a Section 83(b) election suggests that the IRS could take the position that the holding period begins when the replacement stock is issued. This is the case because if the buyer equity is treated as having been transferred to the rollover participant, thereby necessitating a Section 83(b) election, why wouldn't the holding period for the buyer equity start when the election is made? Nevertheless, we believe that the holding period for the original target company equity should be tacked onto the holding period for the replacement buyer equity in this situation, regardless of the IRS'

characterization of the replacement buyer equity as having been transferred to the rollover participant under Revenue Ruling 2007-49.

Revenue Ruling 2007-49 addresses the tax impact of imposing new vesting requirements on the rollover participants' stock, but fails to address the potential impact of imposing new restrictions on rollover stock on the qualification of the transaction as a Section 368 tax-free reorganization. In order to qualify as a tax-free reorganization, a certain percentage of the consideration received in the exchange must be paid in the form of acquiror stock (the continuity of interest requirement). The percentage varies based on type of reorganization, but a floor of at least around 40% applies to a straight merger of the target company into the acquiror (an "A" reorganization), and the percentage of continuity of interest (COI) required increases from there with the other types of tax-free reorganizations. As far back as 2005, the IRS and Treasury announced in the preamble to final continuity of interest (COI) regulations that they were continuing to consider the appropriate treatment of nonvested stock in determining the level of COI (i.e., whether or not the nonvested stock are outstanding and can count toward COI). Surprisingly, no subsequent IRS statements or authority has surfaced on this topic.

Most commentators believe that where a Section 83(b) election is made and the stock is treated as being issued and owned for Section 83 tax purposes, this result should also apply for purposes of determining COI. But at this time, there is no definitive authority on the issue to rely upon. So, if the amount of nonvested stock could tip the COI scales based on the type of reorganization, it seems to be an open question whether there would be substantial authority to support an opinion that the transaction qualifies as a tax-free reorganization, although the scales do seem to tip in favor of newly imposed restrictions not adversely affecting COI. The water is muddied if no Section 83(b) election is made (which should almost never be the case unless the election is botched) or stock that is counted towards COI is subsequently forfeited (query should you re-run the COI analysis excluding the forfeited stock or counting the forfeited stock as non-stock consideration?).

The take-away from the discussion above is that the parties to a tax-free reorganization which includes the imposition of new vesting requirements on the management team should be aware that there are tax consequences associated with those vesting requirements. A safe approach is to consult tax advisors if a transaction includes equity issued to service providers.

Finally, if a rollover transaction involves the issuance of an LLC interest to a service provider, there is a risk that the IRS might characterize any additional equity issued to a service provider as taxable compensation under Section 61.[\[2\]](#)

B. A primer on LLC capital and profits interests for M&A transactions.

A “profits interest” is an LLC interest issued to a service provider that meets the requirements of Revenue Procedure 93-27. That Revenue Procedure defines a profits interest as one where, on the date it is issued to a service provider, if the issuer were sold for its fair market value, and the proceeds run through the LLC agreement’s distribution waterfall, the holder of the interest would not share in the distribution. There are a couple of other requirements under Revenue Ruling 93-27 for qualifying as a profits interest, including the requirement that the service provider not transfer the interest within two years after its issuance date (see the discussion in Section II.C. below. The feature of a profit interest include that the recipient isn’t taxed (as compensation) upon receipt, the recipient immediately is treated as a partner for federal income tax purposes, including the ability to receive long-term capital gains passed through by the LLC. A nonvested profits interest is afforded the same tax treatment as a vested profits interest if it meets the requirements of both Revenue Procedure 93-27 and Revenue Procedure 2001-43. Most tax practitioners believe that it makes sense to file a protective Section 83(b) election when a service provider is issued a nonvested profits interest. LLC interests that are not profits interests are capital interests and are treated as being subject to Section 83’s rules for vested and nonvested stock.

C. Are there any tax consequences triggered by transferring an LLC profits interest within two years after its issuance (i.e., thereby failing one of Revenue Procedure 93-27's requirements)?

Most service providers who are issued vested or nonvested LLC profits interests rely on Revenue Procedures 93-27 and 2001-43 for the favorable tax treatment associated with those LLC interests. Profits interests are not taxed upon receipt by a service provider and the service provider is treated as the owner of the interest as of the date of issuance, so once 12 months has passed, the service provider can benefit from capital gains rates when the interest is sold (subject to the potential application of Section 1061's three year holding period requirements). However, Revenue Procedure 93-27 excludes from the scope of a "profits interest," interest that are transferred within two years of receipt. In the world of M&A transactions, circumstances regularly arise where employees are issued profits interests and then participate in a sale event within two years. So, a pertinent question is how those profits interests should be treated when the sale occurs during the two-year period after issuance.

During the past 20 years, there is little evidence in published tax authorities that the IRS has attempted to strictly interpret and vigorously enforce Revenue Procedure 93-27's two-year qualification requirement. In 2005, the IRS issued proposed regulations that would have entirely replaced Revenue Procedures 93-27 and 2001-47, but those regulations have not been issued in final form. Most tax practitioners take the position that an LLC interest still qualifies as a profits interest from the date of issuance through the sale in situations where a service provider is compelled to participate in a sale transaction during the first two years after issuance. This treatment does appear to be appropriate in situations where the sale transaction wasn't part of a planned disposition when the LLC interest was originally issued.

There may be a practical reason for the lack of effort by the IRS to run down LLC interests that fail Revenue Procedure 93-27's two-year holding requirements. If Revenue Procedure 93-27 doesn't apply, resulting in a vested profits interest being taxable at the time of issuance, the reality is that based on pre-1993 caselaw, the

profits interest most likely has little or no value (particularly assuming that the interest is valued on a liquidation basis), resulting in little or no incentive for the IRS to pursue a recharacterization of the LLC interest as a taxable interest under Section 83 rather than “profits interest” subject to Revenue Procedure 93-27. The IRS might have more interest where the interest was nonvested when issued and sole and no protective Section 83(b) election was filed. In that instance, the IRS could argue that all of the consideration received upon sale of the interest is taxable compensation. Of course, in that situation the employer should have a corresponding deduction, which perhaps further dampens the IRS’ enforcement efforts. *We believe that the prudent approach from a planning standpoint is to file a protective Section 83(b) election whenever a nonvested profits interest is being issued.*

D. A Section 409A primer for M&A transactions.

Section 409A was enacted as an effort to address perceived abuses regarding the inclusion of nonqualified deferred compensation in income. The provision restricts the ability of employer and employee to control the timing of receipt and inclusion of nonqualified deferred compensation in income. As enacted, however, the provision’s reach is well beyond dealing with manipulation of the timing of compensation payments. As enacted, Section 409A’s extensive scope, complicated functioning and draconian penalties basically dictates a review by Section 409A specialists of almost any compensation arrangements or M&A transactions involving nonqualified deferred compensation.

For the most part, a current grant of equity or equity rights (e.g., options and stock appreciation rights) is excluded from the scope of Section 409A, but it is important when structuring rollover transactions to specifically confirm the exclusion of Section 409A’s application with respect to the handling of each type of equity and equity rights involved in the rollover. Restricted stock units and various types of phantom equity awards and transaction bonus arrangements are not exempt from Section 409A, and any effort in connection with the M&A transaction to change their terms or defer payment probably presents a Section 409A issue and must be

vett ed accordingly.

III. Tax Aspects of Management Team's Rollover of Various Equity Interests and Equity Rights

Beyond the basic tax issues discussed in [Rollover Equity Transactions](#) and addressed the primer on equity compensation taxation in the preceding section, the rollover of equity and equity rights by the management team will implicate the specific tax issues governed by Sections 83 and 409A, and other sections discussed below. While many companies have a simple capitalization structure and uncomplicated equity and bonus compensation arrangement, many venture backed companies have elaborate ownership and compensation arrangements.

The discussion below assumes that LLC equity and equity rights were issued by an LLC taxed as a partnership. Also, the various references to the treatment of LLC equity and equity rights will also apply generally to equity and equity rights issued by limited partnerships (LPs), general partnerships and joint ventures (taxed as partnerships).

A. Taxable exchange of vested target company stock for vested buyer equity (stock or LLC interests).

A taxable rollover of vested stock (either vested stock or stock with respect to which a Section 83(b) election was made) in exchange for vested buyer stock will generally trigger capital gain recognition under Section 1001.[\[3\]](#)

B. Taxable exchange of vested stock for nonvested equity (stock or LLC capital interests).

A taxable rollover of vested stock (either vested stock or stock with respect to which a Section 83(b) election was timely made) in exchange for nonvested buyer stock will generally trigger gain recognition under Section 1001, with the gain taxable at capital gains rates.

Revenue Ruling 2007-49, Situation 3 provides that nonvested buyer stock issued in a taxable exchange for vested target company stock

is treated as having been transferred in connection with the performance of services and is subject to Section 83. For this reason, the recipient of nonvested buyer stock should file a timely Section 83(b) election. Because the recipient of the nonvested buyer stock recognized gain equal to the fair market value of the buyer equity in the exchange, there should be no additional compensation income triggered in connection with the making of the Section 83(b) election.

If a service provider is issued nonvested equity and fails to make a timely Section 83(b) election, any subsequent distributions or deemed (pursuant to Section 83's rules) or actual gain with respect to the sale of the nonvested equity will be treated as compensation income.

C. Taxable exchanges of nonvested stock for vested equity (stock or LLC interests).

A taxable rollover of nonvested stock or a nonvested LLC capital interest in exchange for vested buyer equity will be treated as a transfer of the target company equity and trigger compensation income under Section 83's rules.

When nonvested equity is exchanged for vested equity, an amount equal to the fair market value of the equity received in the exchange (subject to applicable valuation discounts), will be taxed as compensation to the rollover participant. The math in these taxable exchanges doesn't always work well for employees who are required to pay taxes in connection with an actual or deemed sale of their target company equity, while at the same time asked to participate in the rollover with respect to some or all of their target company equity. This is particularly true where there is a deemed sale of nonvested target company equity triggering compensation income, subject to both income and employment taxes. This result occurs if the transaction involves a taxable or nontaxable exchange of nonvested equity for vested equity, the exercise of an option or the exchange of an option for vested equity. It may make sense to exclude certain employees from a rollover transaction if participation will have a negative impact, particularly where the numbers result in the service provider needing to come out of

pocket to pay taxes.

If the equity received in exchange for nonvested equity is itself nonvested equity, Treasury Regulation § 1.83-1(b)(3) provides that the exchange is nontaxable and the nonvested equity received in the exchange is thereafter subject to the rules of Section 83. A Section 83(b) election could be made with respect to the equity received in the exchange, but this would trigger treatment of the then-FMV of the equity as taxable compensation.

The discussion below assumes that the exchange of target company equity for rollover equity will be a tax-free exchange (most likely under Sections 351, 368 or 721). The discussion also assumes that the IRS would consider the equity and equity rights received in each situation discussed below as having been transferred in connection with the performance of services, and thus subject to Section 83.

D. Tax-free exchanges of vested stock for vested stock.

A management team's exchange of vested target company stock for vested buyer stock in a tax-free exchange doesn't present any additional tax issues. See the discussion in [Rollover Equity Transactions](#) for an outline of the basic tax consequences associated with structuring tax-free equity exchanges in rollover transactions.

E. Tax-free exchanges of vested stock for nonvested equity (stock or LLC interests).

If a service provider exchanges vested target company stock in a tax-free exchange for nonvested buyer equity, the service provider will not recognize any gain on the exchange. *But the IRS in Situation 2 in Revenue Ruling 2007-49 confirms that the service provider should make a Section 83(b) election with respect to the nonvested equity received in the taxable exchange.* Rollover participants will be able to indicate on the Section 83(b) election form that the amount paid for buyer equity equals its fair market value, so that the filing of the election shouldn't trigger any taxable compensation.

F. Tax-free exchanges of nonvested stock for vested stock.

If nonvested stock is exchanged for vested stock tax-free under Sections 351 or 368, Section 83 provides that the fair market value (which is subject to discounting) of the vested stock will be treated as taxable compensation paid to the rollover participant. This unfavorable tax result occurs if a rollover participant's original nonvested stock vests upon a change in control, even if the newly-vested stock is exchanged for replacement nonvested stock. See the discussion in "Tax-free exchange of nonvested target company stock for nonvested buyer stock" below for a discussion of modifying a change in control vesting trigger.

G. Tax-free exchanges of nonvested stock for nonvested stock.

Section 83(g) provides that if nonvested stock is exchanged for nonvested stock (i.e., subject to restrictions and conditions substantially similar to those to which the property given in such exchange was subject), so long as the exchange is governed by Sections 354, 355, 356 or 1036 (which covers the various ways stock can be exchanged tax free in transactions such as Section 351 exchanges and Section 368 reorganizations), then the exchange won't trigger taxation under Section 83(a), and the nonvested stock received in the exchange is treated as property to which Section 83(a) applies.

Typically, in a tax-free exchange or reorganization transaction that falls within the scope of Sections 354, 355, 356 or 1036, the holding period of the original stock tacks onto the holding period for replacement stock. But under Section 83(a), a taxpayer's holding period for nonvested stock doesn't commence until the restrictions are lifted. So, in this situation, the taxpayer won't have a holding period for either the original stock or the replacement stock. Based on the phrase in Section 83(g) to the effect that "the nonvested stock received in the exchange is treated as property to which subsection (a) [Section 83(a)] applies", it seems that this can be interpreted to permit the rollover participant to make a Section 83(b) election for the replacement buyer stock. Of course, making this election would trigger compensation income equal to the fair market value of the replacement buyer stock. If no Section 83(b)

election is made, the fair market value of the equity would be taxable compensation when the restrictions lapse or the equity is transferred (or transferable).

Vesting triggered on the occurrence of a change in control is often a second vesting trigger, usually in conjunction with performance and/or time vesting. For a variety of reasons, the parties to M&A transactions often want employees to waive or modify the change-in-control vesting trigger associated with their nonvested equity. In particular, where the management team is expected to roll over a substantial percentage or all of their target company equity into buyer equity, the waiver or amendment of a change in control vesting trigger can allow for the deferral of what otherwise could be significant compensation event occurring in a situation where the holder of the nonvested stock wouldn't be benefiting from a substantial liquidity event.

Rollover participants who are considering exchanging nonvested equity for nonvested equity should carefully review all of the contracts that will govern their replacement nonvested equity so that they fully understand at what point their equity will be vested within the meaning of Treasury Regulation § 1.83-3(b). Rollover participants will be treated as having been paid compensation equal to the fair market value of their stock when it vests under Section 83. If the equity becomes vested at a point other than upon the occurrence of a liquidity event, the employer will have a withholding obligation and the rollover participant may be forced to come out-of-pocket to cover the tax obligations. When a stockholder has a put right at fair market value, it will generally cause the stock to vest for Section 83 purposes, because a put right will be considered constructive receipt of payment for tax purposes, whether or not the holder exercises the right. Finally, if a rollover participant's stock certificate doesn't have a legend evidencing transfer restrictions, the stock will be deemed to be transferable and taxable for Section 83 purposes.^[4]

[The following sections address LLC interests, but also apply to LP interests.](#)

H. Taxable exchanges of vested LLC interests for vested LLC interests.

Gain recognition under Section 741 at capital gains rates will generally apply to a taxable rollover of a vested LLC capital or profits interest for an LLC capital or profits interest, subject to taxation of “hot assets” at ordinary income rates pursuant to Section 751.

I. Taxable exchanges of vested LLC interests for nonvested LLC interests.

Gain recognition under Section 741 at capital gains rates will generally apply to a taxable rollover of a vested LLC capital or profits interest for an LLC capital or profits interest, subject to taxation of “hot assets” at ordinary income rates pursuant to Section 751.

Revenue Ruling 2007-49, Situation 3 provides that nonvested buyer stock issued in a taxable exchange for vested target company stock is treated as having been transferred in connection with the performance of services and is subject to Section 83. We believe that this ruling would also apply to LLC capital interests. For this reason, the recipient of a nonvested LLC interests should file a timely Section 83(b) election. Because the recipient of the nonvested LLC interest recognized gain equal to the fair market value of the buyer equity in the exchange, there should be no additional compensation income triggered in connection with the making of the Section 83(b) election.

J. Tax-free exchanges of vested LLC capital interests for vested LLC capital interests.

The exchange of a vested target company capital interest for a buyer vested capital interest in a tax-free exchange under Section 721 doesn't present any tax issues unique to the status of the rollover participant as a management team member. The same tax analysis applicable to whether the exchange of original LLC capital interests for replacement LLC capital interests generally applies when a management team member is the rollover participant. See [Rollover Equity Transactions](#).

Generally, a partial rollover and partial sale of LLC units is structured so that the rollover of target company units is exchanged for buyer

units in a tax-free Section 721 exchange, and the balance of management's target company units are cashed-out along with the other target company owners. If the transaction is structured as a partial rollover and partial sale, with cash received in addition to buyer units, then that "boot" will generally be recharacterized as a part contribution and part sale under Section 707(a)(2)(B)'s "disguised sale" rules, with the contributor recognizing gain or loss to the extent he or she is deemed to have "sold" property to the partnership for the boot.

There is a risk that the IRS would recharacterize any excess equity (i.e., involving a capital shift) received in a rollover transaction involving a service provider as a compensation payment under Section 61.

K. Tax-free exchanges of vested LLC interests for vested stock.

LLC interests (i.e., partnership interests) can be exchanged for corporate stock tax-free if the exchange meets Section 351's requirements. Otherwise, the exchange will be fully taxable and treated as a sale of the LLC interest.

In rollover transactions involving distribution waterfall provisions that may include preferred LLC interests, common LLC interests and profits interests, the allocation of purchase price proceeds among the target company owners, including proceeds in the form of cash or buyer equity, will normally be based on how the proceeds would be distributed if the target company's assets were acquired and the purchase consideration then distributed among the target company's members pursuant to the terms of the LLC agreement.

Under normal circumstances, there won't be any issues under Section 351 with respect to the equity that rollover participants receive in exchange for their LLC interests. Presumably, LLC interests exchanged in connection with the incorporation of a partnership will be valued for exchange purposes based on their liquidation value (as discussed in the preceding paragraph), and the parties will determine the buyer equity each contributor is entitled to receive accordingly. If rollover participants might receive an amount of stock that is disproportionate to the economic rights

associated with their LLC equity (e.g., where a profits interest distribution threshold is ignored), the IRS could characterize a portion of the stock received in the Section 351 exchange as compensation under Treasury Regulation § 1.351-1(b), which provides that where property received is disproportionate to a transferor's prior interest, the transaction will be given tax effect in accordance with its true nature, which might be payment of compensation subject to Sections 61(a)(1) and 83(a). The IRS could also take the position that the issuance of "excess" equity to service providers represent compensation paid by the buyer. These same principles could apply in situations where service providers involved in rollover transactions exchange stock for stock or LLC interests for LLC interests.

L. Tax-free exchanges of nonvested LLC interests for vested stock.

The receipt of vested buyer stock in a Section 351 exchange for a nonvested LLC capital interest will be treated as a transfer for Section 83 purposes, triggering compensation income equal to the difference between the fair market value of the buyer stock and the rollover participant's tax basis in the target company LLC interest. This treatment assumes that no timely Section 83(b) election was made with respect to the nonvested LLC interest.

If the LLC interest is a nonvested profits interest^[5], then for Section 83 purposes, the holder is treated as being the owner of the interest from the date of issuance, and the exchange of the profits interest for vested stock should not be treated as a transfer for Section 83 purposes.

M. Tax-free exchanges of nonvested LLC interests for nonvested stock.

Typically, the transfer of nonvested equity triggers a compensation event under Section 83. But Treasury Regulation § 1.83-1(b)(3) provides that the general rule that a disposition of nonvested equity triggers a compensation event does not apply and no gain is recognized "to the extent that any property received in exchange therefor is substantially non-vested. Instead, section 83 and this section shall apply with respect to such property received (as if it were substituted for the property disposed of)."

See the discussion in “A Section 83 primer for M&A participants” above for a discussion of waiving a change in control vesting provision.

N, Tax-free exchanges of vested LLC capital interests for nonvested LLC capital interests.

An LLC interest can be exchanged for another LLC interest tax-free under Section 721 if the replacement LLC capital interest is issued by a partnership.

Revenue Ruling 2007-49, Situation 3 provides that nonvested buyer stock issued in a taxable exchange for vested target company stock is treated as having been transferred in connection with the performance of services and is subject to Section 83. For this reason, the recipient of nonvested buyer LLC interest should file a timely Section 83(b) election. Because the recipient of the nonvested buyer LLC interest recognized gain equal to the fair market value of the buyer equity in the exchange, there should be no additional compensation income triggered in connection with the making of the Section 83(b) election.

If the recipient fails to make a timely Section 83(b) election, any subsequent deemed or actual gain with respect to the nonvested equity will be treated as compensation income.

There is a risk that the IRS would recharacterize any excess equity (i.e., involving a capital shift) received in a rollover transaction involving a service provider as a compensation payment under Section 61.

O. Tax-free exchanges of nonvested LLC capital interests for vested LLC capital interests.

If a nonvested LLC capital interest (with respect to which no Section 83(b) election was made) is exchanged for a vested LLC capital interest in a Section 721 transaction, then the fair market value (which is subject to discounting) of the vested LLC capital interest will be treated as taxable compensation paid to the rollover participant. This unfavorable tax result occurs if a rollover participant's original nonvested LLC capital interest vests upon the

change in control, even where the newly-vested LLC capital interest then immediately exchanged for a replacement LLC nonvested capital (in that instance, a Section 83(b) election would need to then be made for the replacement buyer nonvested equity received in the exchange).

See the discussion in “A Section 83 primer for M&A participants” above for a discussion of waiving a change in control vesting provision.

P. Tax-free exchanges of a nonvested LLC capital interests for a nonvested LLC capital interests.

Typically, the transfer of nonvested equity triggers a compensation event under Section 83’s rules. As discussed above, if the equity is stock and the exchange falls into one of several tax-free exchange or reorganization provisions, the exchange of nonvested stock for nonvested stock is a nontaxable event under Section 83(g). If the equity is a nonvested LLC interest, Treasury Regulation § 1.83-1(b)(3) provides that the general rule that a disposition of nonvested equity triggers a compensation event does not apply and no gain is recognized “to the extent that any property received in exchange therefor is substantially non-vested. Instead, section 83 and this section shall apply with respect to such property received (as if it were substituted for the property disposed of).”

If the rollover participant is holding a nonvested target company LLC capital interest that would vest upon a change in control, see the discussion in “A Section 83 primer for M&A participants” for a discussion of modifying a change in control vesting provision to avoid triggering taxable compensation in connection with the sale transaction.

Q. Tax-free exchanges of LLC profits interests for LLC interests.

An exchange of a target company LLC profits interest for a buyer LLC interest in a transaction governed by Section 721 (i.e., contribution of the LLC interest to an LLC in exchange for an LLC interest) should be tax-free, so long as the same distribution threshold is maintained with respect to the buyer LLC interest

received in the exchange. If the distribution threshold isn't maintained with respect to the exchanged LLC interests, the IRS could take the position that there has been a taxable "capital shift" in favor of the rollover participant that would be treated as taxable compensation.^[6]

If the recipient fails to make a timely Section 83(b) election with respect to any restricted LLC interest receiving in exchange for an unrestricted target company LLC interest, any subsequent deemed or actual gain under Section 83 with respect to the nonvested equity will be treated as compensation income.

R. Exchanges of incentive stock options (ISOs) for ISOs.

New ISOs can be substituted for old ISOs or an old ISO can be assumed without triggering tax recognition if the requirements of Section 424 and Treasury Regulation § 1.424-1 are satisfied.

S. Exchanges of nonqualified stock or LLC options (NSOs) for NSOs.

Exchange of NSOs – The exchange of target company NSOs for buyer NSOs is generally not taxable. Section 83(e) provides that the transfer of an option without a readily ascertainable fair market value doesn't fall within Section 83. In most cases, the receipt of a buyer option in exchange for a target company option won't trigger immediate income recognition and the tax treatment of the buyer option will be thereafter subject to the general treatment of NSOs under Section 83.

NSOs granted with respect to common stock and an exercise price that can never be less than the fair market value of the underlying stock as of the date of grant are generally excluded from the application of Section 409A. Treasury Regulation § 1.409A-1(b)(5)(v)(D) provides that the substitution of one stock right (including options and stock appreciation rights) in a corporate transaction for another stock right generally doesn't trigger taxation under Section 409A.

If a buyer assumes or exchanges in-the-money target company NSOs, the substitution must meet the same requirements as substitution of an ISO under Treasury Regulation § 1.424-1.

Otherwise, the NSO is treated as a new grant and violates Section 409A since the exercise price is less than fair value immediately following the exchange. An exchange of employer NSOs for employer NSOs equal in value in connection with most corporate transactions will not violate Section 409A.

NSOs issued to a participant in a rollover transaction will have the same spread value as existed immediately prior to closing (e.g., if a participant's options have an aggregate spread between the exercise price and fair market value of \$1,000 at the time of the exchange, the replacement options will also have an aggregate \$1,000 spread), but the number of options will be reduced by increasing the per-option spread. This approach has the effect of canceling underwater options and dramatically reducing the number of options in a situation where the options are slightly in the money. Section 409A allows for this deleveraging by permitting the ratio of the exercise price to the fair market value of the stock underlying the NSO received in the exchange to be less than such ratio under the NSO exchanged. The parties should not go overboard in creating too deep a discount as it could trigger taxation under Section 83(e) based on the concept set out in Treasury Regulation § 1.83-7, that an option with too deep of an exercise price discount has an FMV that is readily ascertainable and therefore is subject to taxation under Section 61.

Exchange of options for vested stock or vested LLC capital interests – If vested stock or an LLC capital interest is issued to a rollover participant (who is a service provider) in exchange for options, the rollover participant will recognize compensation income equal to the fair market value of the equity issued in exchange for the options, subject to valuation discounts.

Exchange of options for nonvested stock or nonvested capital interests – If nonvested stock or a nonvested LLC capital interest is issued to a service provider upon exercise of an option, the exercise won't trigger compensation income at the time of the exchange unless the service provider makes a timely Section 83(b) election. Thereafter, Section 83's rules will apply with respect to the taxation of the nonvested stock or nonvested capital interest.

Exchange of options for LLC profits interests – If a profits interest is issued to a rollover participant in exchange for options, the rollover participant won't recognize compensation income so long as the "hurdle" or "distribution threshold" set for the profits interest is based on the enterprise value of the entity issuing the profits interest and each of Revenue Procedure 93-27's requirements are met. The rollover participant will be taxed on the receipt of a vested capital interest under Section 83's rules.

T. Exchange of stock appreciation rights (SARs) for SARs.

An SAR is a right to compensation based on the appreciation in value of a specified number of shares of stock occurring between the date of grant and the date of exercise (or for noncorporate entities, the appreciation in value of a specified number of equity interests).

SARs generally qualify for the same treatment as NSOs under Section 409A. Treasury Regulation § 1.409A-1(b)(5)(v)(D) provides that the substitution of one stock right (including options and stock appreciation rights) in a corporate transaction for another stock right generally does not trigger taxation under Section 409A.

U. Treatment of restricted stock units and other types of phantom equity awards and bonus arrangements that are payable upon the closing of the sale transaction.

Restricted stock units, phantom equity awards and other bonus arrangements such as transaction bonuses that vest and are payable upon the occurrence of a sale transaction cannot be rolled over because they are not exempt from Section 409A, and are generally subject to taxation under Section 409A if payment is deferred through some form of rollover arrangement. If the arrangement doesn't vest upon a change-in-control or otherwise in connection with the transaction, it should generally be possible to roll the arrangement over into a comparable arrangement put into place by the buyer.

IV. Securities Law Issues Associated With the Management Team's Participation in a Rollover Transaction

If sale transaction where the rollover participant retains target company equity a sale transaction, absent additional facts that would result in a change in the target company should not generally be considered the issuance of equity to the rollover participant requiring compliance with securities laws. Most rollover transactions, however, involve the issuance of buyer equity to rollover participants, and as a result will be considered the issuance of a security to those rollover participants under federal and state securities laws.

In most cases, members of the management team will qualify as "accredited investors, as defined in Rule 501 of Regulation D of the Securities Act of 1933. If the management team's members are accredited investors, a buyer can issue equity to the management team without the necessity of providing information about the buyer and the transaction in any specific format, although the securities laws still require the disclosure of material information in connection with the issuance of a security. If each of the management team members is an accredited investor, the issuance will fall within Rule 506 of Regulation D, which preempts state blue sky securities laws.

Under Regulation D, an accredited investor is an individual who has a net worth of \$1 million or more or an individual with an annual income of \$200,000 (or \$300,000 or greater combined income with your spouse) for the prior two years and who has a reasonable expectation of the same or greater income in the current year. Rule 501 also states that "any director, executive officer, or general partner" of the company selling securities is an accredited investor by default. Further, on August 26, 2020, the SEC issued final rules amending the accredited investor definition.

The SEC added the following new categories of natural persons to the category of accredited investors, including: (i) those who hold certain professional "certifications, designations or other credentials recognized by the Commission," (ii) "knowledgeable

employees” of a private fund who are investing in that fund, (iii) LLCs with \$5MM in assets, and (iv) “family offices” with at least \$5MM in assets under management and their “family clients” (as that term is defined under the Investment Advisors Act). With respect to the professional degrees, the SEC rule establishes an initial list of accepted certifications, to be revised and amended from time to time. The initial list includes: a Licensed General Securities Representative (Series 7); a Licensed Investment Adviser Representative (Series 65); and a Licensed Private Securities Offerings Representative (Series 82). The SEC commented that this approach will give the SEC the flexibility to reevaluate or add certifications, designations or credentials in the future and an avenue for the public to make suggest changes.

In cases where some of the management team members are not accredited investors, it isn’t unusual to exclude those individuals from participating in the rollover. Non-accredited employees often reside in multiple states (so an intrastate offering exemption won’t apply) and the parties to the transaction are sometimes reluctant to provide securities disclosure to employees in connection with the M&A transaction. Parties who find themselves in this situation should explore the availability of the Rule 701 exemption discussed below.

Rule 701, adopted pursuant to Section 3(b) of the Securities Act of 1933, as amended (the “Securities Act”), provides an exemption from the registration requirements of the Securities Act for certain offers and sales of securities made pursuant to the terms of compensatory benefit plans or written contracts relating to compensation by a private company. Rule 701 provides another possible registration exemption for equity issued in connection with rollover transactions. Unlike an all-accredited offering under Rule 506 of Regulation D, Rule 701 doesn’t preempt state blue sky laws, which will necessitate a state-by-state analysis to determine whether each state has a separate exemption that allows the parties to avoid the need to prepare offering materials.

V. Conclusions

Handling an M&A transaction involving an equity rollover by the management team requires the involvement of professionals who not only are experienced dealing with the usual mix of complicated business and tax issues associated with rollovers, but also understand how equity compensation arrangements function in the rollover. We recommend a review of our blog article [Rollover Equity Transactions](#) for a broader discussion of the general tax and legal consequences associated with equity rollovers.

For more information, contact [Scott Dolson](#) or any attorney on Frost Brown Todd's [Private Equity Industry team](#). For more updates like these, please visit Frost Brown Todd's [Private Equity Blog](#).

[1] As part of the 2017 tax act, Congress enacted Section 83(i), which gives eligible private company employees the opportunity to elect to defer for up to five years the recognition of income from stock acquired in connection with the exercise of NSOs or the settlement of restricted stock units (RSUs). The workings of Section 83(i) are not addressed in this article, but its potential application should be kept in mind if a target company has NSOs or RSUs.

[2] The treatment will depend on the type of additional equity being issued. An increase in a rollover participant's capital interest, including by virtue of an increase in the service provider's capital account or other a capital shift in favor of the service provider would likely be treated as as taxable compensation under Section 61.

[3] An exception would be the where the target company stock is qualified small business stock (QSBS) under Section 1202.

[4] Legislative history for Section 83 indicates that, if the risk of forfeitability is not indicated on the stock certificate and a transferee would have no notice of it, then an employee's interest in stock would be considered transferable. S Rept No. 91-552 (PL 91-172) P. 122. Also, note that Example (1) to Treasury Regulation § 1.83-1(f) includes in an example this sentence: "Evidence of this restriction is stamped on the face of E's stock certificates, which are therefore nontransferable (within the meaning of § 1.83-3(d))." If the employer is a limited liability company, a legend on the LLC agreement probably suffices, so long as the employee joins in as a

party to the LLC agreement. Perhaps better still would be the inclusion of a legend on the joinder to the LLC agreement signed by the employee (which stands in for the stock certificate in a uncertificated LLC).

[\[5\]](#) See Revenue Procedures 93-27 and 2001-43.

[\[6\]](#) In other words, as a result of the transaction, the service provider would be entitled to a greater share of proceeds if the LLC's assets were sold after the exchange and the proceeds distributed in liquidation of the LLC than if the same thing occurred immediately prior to the exchange.

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