Jan 28, 2021

Categories:

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Rollover Equity Transactions 2021

During the 21st century, financial buyers such as private equity sponsors (PE firms) have dramatically increased their participation in the merger and acquisition (M&A) marketplace. PE firms generally acquire "portfolio" companies with the intention of holding them for three to seven years and selling them for what they hope will be a substantial return on their investors' money. Other financial buyers such as family offices (investment arms of wealthy individuals or families) and loose confederations of investors may anticipate longer holding periods. Most financial buyers are seeking companies with strong management teams, and routinely encourage some of the target company's equity owners, particularly members of the management team who are critical to the future growth and success of the business (referred to in this article as "rollover participants"), to "roll over" a portion of their equity. Post-acquisition, rollover participants hold a non-controlling equity position in the target company or have exchanged their target company equity for equity in the buyer's larger acquisition vehicle.

This article addresses key tax and business issues facing those target owners participating in the rollover of some or all of their target company equity into buyer equity (referred to in this article as "rollover equity transactions"). Although the article is primarily written from the perspective of rollover participants, the issues discussed are relevant to investment bankers and PE firms and can serve as an issues checklist for navigating through the rollover equity aspects of a typical M&A transaction.

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Our experience representing sellers prior to the outbreak of COVID-19 was that financial buyers generally included rollover equity as part of their transaction structure. In a sellers' market, PE firms sometimes looked for ways to differentiate themselves from their 7,000+ peers. Assuming deal flow picks up during 2021, these factors should result in the return of favorable deal terms for sellers and continued creativity on the part of PE firms in structuring attractive rollover equity arrangements.

As an example of creative rollover equity planning, an ACG Capital Connection speaker mentioned that her PE firm had recently closed a deal where the PE firm matched each rollover equity share with an option to acquire an additional share, effectively creating an opportunity for rollover participants to achieve a "2 for 1" return on their equity rollover. Assuming that COVID-19 will continue to have an impact on the willingness of investors and lenders to commit funds, we expect that the role of rollover equity as a part of the deal financing package will continue to increase during 2021. For example, we handled a recent transaction that included not only a slice of traditional rollover equity where the management team was expected to hold their buyer equity alongside the buyers, but also an additional slice of rollover equity that was subject to puts-calls at regular intervals over several years. This rollover equity would be redeemed at its then-fair market value, assuming the management team member remained employed, but if the management team member ceased to be employed (including because of death or disability), the equity was subject to a below-FMV buyback.

We also expect to see a continuing interest in earn-outs and other creative financing arrangements. During the second half of 2020, these arrangements helped to move deals forward during a period of uncertainty, particularly with respect to the participation of lenders. The economic uncertainties associated with COVID-19

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made it difficult to forecast the future performance of target companies and as a result, to accurately price transactions. In many ways, earn-outs and rollover equity are similar in terms of how they function from an economic standpoint (both incentivize performance by tying payment to the future success of the target company). We expect both rollover equity and earn-outs to continue playing a significant role in the structuring of M&A transactions during 2021 and beyond.

The financial stakes can be significant for rollover participants. Holders of target company equity are often asked to roll over in the neighborhood of 20% of a target company's enterprise value, which represents a meaningful investment in the ongoing business and in a leveraged buy-out, represent a significant percent of the overall equity committed to a transaction. Rollover participants should seek legal and tax professionals with the experience and expertise to help them navigate their way through the many tax and business issues associated with the structuring and negotiation of an M&A transaction involving rollover equity.

What drives the popularity of equity rollover transactions?

The popularity of rollover transactions can be attributed to a combination of factors. Foremost, PE firms perceive that having the management team roll over a meaningful share of their target company equity is a powerful way to align the management team's interests with those of the PE owners. Rollover equity often represents a critical part of the overall deal consideration, particularly where the deal is aggressively priced (increasing the importance of "soft" money consideration), or where there is a substantial valuation gap between seller and buyer. Rollover equity functions as a component seller financing, reducing the PE firm's upfront equity investment. Participating in rollover equity often appeals to the target company's management team because it gives them an opportunity to share in the future success of their employer. For that reason, the use of rollover equity is often desired by both buyer and seller. As noted in the previous section, we have seen an increased use of rollover equity in creative financing structures developed in response to the reluctance of investors and

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lenders to commit funds in light of the uncertainties brought on by the COVID-19 pandemic.

How are rollover equity transactions typically structured?

The typical rollover transaction involves participants receiving between 8% and 40% of their deal consideration in equity rather than cash. The average historically ranged around 20%. After closing of the transaction, rollover participants may continue to own target company equity, or more likely, they will own equity in the target company's holding company that holds the target on a stand-alone basis or equity in a holding company that owns the target company and other portfolio companies. The rollover transaction itself may be structured as an exchange of target company equity for buyer equity, an exchange of target company assets for buyer equity, a partial target equity sale, a merger, a contribution of target company assets to a newly formed operating entity or an equity investment in the buyer. A large majority of equity rollover transactions are structured to allow for participants to roll over their equity on a tax-deferred basis.

From the economic perspective, the inclusion of rollover equity in a deal is similar to including an earn-out component in the deal's purchase consideration. In both cases, the success of the ownership right rests on the future success of the target company or the buyer's combined portfolio companies. A difference between the earn-outs and rollovers, however, is that an earn-out formula usually pays out over several years if earnings targets are met or exceeded, but the ownership of rollover equity generally only translates into more dollars in the participant's pocket if and when the target company is resold. Rollover equity often ranks *pari passu* with equity purchased by a PE firm's fund, but in some deals it is junior to a class of preferred stock held by the PE firm's investors. Generally, none of the equity owners have a put right or other voluntary exit opportunity until the resale of the portfolio company occurs after several years. But we have recently seen deals where rollover equity included not only equity intended to be held until the occurrence of a subsequent sale process but also equity that was subject to puts and calls after several years and that essentially

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served as a way for the buyer to add a seller financing component to the purchase consideration.

Rollover participants are often in a good position to judge whether a continuing bet on the target company's success makes good investment sense, taking into account whether the purchase price for the target company is attractive, the quality of the going-forward management team, the PE firm's track record for implementing successful business plans and portfolio company sales, the PE firm's plans for add-on acquisitions or other capital infusions to fund growth, and last, but certainly not least, the rollover participants upfront cash in the deal. Of course, in some cases the management team will be expected to roll over a substantial amount of equity in order to help make the liquidity event happen for the target company's investors, regardless of how the management team feels about keeping skin in the game.

Some transactions with rollovers will also include the roll over of bonus rights (e.g., phantom equity rights) and unexercised options. Potential rollover participants should consider early in the sale process how these equity rights will be handled (cashed out or rolled over?).

Lately, we have seen a number of partial recapitalization transactions involving the acquisition by a PE firm of a non-controlling stake in a target company. In those transactions, the goal of the PE firm is generally not to eventually acquire a 100% interest in the target but instead to maintain a large non-controlling position and eventually trigger a sale process. But when viewing partial recapitalizations in the overall M&A marketplace, the buyer's anticipated exit strategy will vary considerably depending on the source of its funds (e.g., PE fund versus family office with a longer investment time horizon).

Participation in a rollover transaction should be viewed as an equity investment in the ongoing business.

Members of the target company's management team who agree to rollover equity are making the equivalent of a non-controlling equity investment in the buyer. These potential participants should certainly consider undertaking some level of financial and legal due

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diligence, focusing on the buyer's track record, the PE firm's proposed business plan for the target company, the PE firm's proposed debt and equity structure for the leveraged buy-out, and other tangible and intangible factors. If the target company is a platform acquisition for the PE firm, a legitimate question is what the PE firm's plans are for expansion through add-on acquisitions or other capital infusions. If the target company is being purchased as an add-on to an existing platform portfolio company, then looking at the financial and business performance and prospects of the portfolio company make good investment sense. One way of looking at how to approach this issue is to ask what level of due diligence the participants would undertake if they were making a cash investment in the buyer equal to the value of their anticipated rollover equity piece. All of this is said with the understanding that the degree of attention to seller due diligence is likely to vary depending on whether the overall purchase price is perceived as being strong or merely acceptable, along with taking into account the percentage of overall deal consideration being folded into the equity rollover.

Ideally, "due diligence" of potential buyers should be undertaken early in the sale process. If the process isn't a formal brokered sale process, potential rollover participants should make every effort to complete as much of their due diligence of the buyer as possible prior to executing a nonbinding letter of intent. If the target company is participating in a formal sales process, potential rollover participant due diligence should also ideally be undertaken prior to soliciting letters of intent and certainly prior to going exclusive with one potential buyer. One potentially useful approach is to develop a list of due diligence questions to ask interested parties to respond to in connection with their indications of interest. Also, potential rollover participants should consider addressing critical governance and ownership deal points in the letter of intent. Once a letter of intent is signed, it can become substantially more difficult to successfully negotiate governance and ownership deal points, particularly if the purchase consideration is attractive to the target company's investors. In other words, when you are well paid for 80% of your equity and your investors are being entirely bought out while management is expected to roll over a substantial percentage

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of their equity, it not only becomes more painful to walk away from the deal over issues associated with the 20% rollover equity piece or management's employment terms going-forward, but it also can create potential conflicts between the target company's investors and management team.

As mentioned in the previous paragraph, the interests of the management team and other investors of a target company can fall out of alignment if management is expected to roll over a substantial percentage of their equity as an incentive to make the company a success for the buyer, with management's outlook on the overall transaction is colored by the terms of its going-forward employment and equity compensation terms, versus owners of the target company who just want to cash out of their investment at an attractive price. For these reasons, either prior to commencement of a sale process or early in the process when diverging interests are noted, the target company's management or counsel may decide that it makes sense to employ separate counsel to represent the management team's, and less often the rollover participants', interests. Separate counsel won't be employed in many deals, leaving it to company counsel to run interference with respect to rollover equity, employment and equity compensation documents and negotiations. From a conflicts standpoint, company counsel should consider making it clear in its engagement letter that counsel represents the company and not individual rollover participants or management team members.[1]

What "due diligence" should potential rollover participants undertake with respect to the potential buyer?

Where the target business will operate on a standalone basis post-acquisition, the equity and debt structure of the buyer and the position of the rollover participants in the buyer's capitalization and governance structure (from the viewpoint of being non-controlling investors) are usual due diligence concerns for potential rollover participants. If the target company is an add-on acquisition, then the rollover participants' due diligence should include a meaningful review of the buyer's platform company, particularly if the rollover participants are exchanging target company equity for equity in the platform company.

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Potential rollover participants should look beyond the dollars and carefully consider what their life will be like with the PE firm post-closing when weighing the relative merits of several offers. There are many PE firms competing for deals, and each PE firm will have a different approach for handling rollover participants and the governance of portfolio companies. Most PE firms have adopted a hands-off approach, relying for the most part on the portfolio company's management team. Some PE firms are heavily involved in operational decision making. In most cases, the PE firm shows up for quarterly or monthly board meetings so long as management is achieving the expected financial performance. Some PE firms will go so far as to place an executive at the portfolio company for the purpose of observing day-to-day operations. Sometimes portfolio executives are involved in day-to-day operations and decision making.

Regardless of the PE firm's governance style, the management must accept the reality that when control is held by a PE firm, rollover participants have traded control of their business for a non-controlling equity stake and involvement in the target company's ongoing management. PE firms usually reserve to themselves the decision of if and when their portfolio companies will be sold and whether or not to engage in add-on transactions. Typically, PE firms do involve senior management in their planning process, but the ultimate decision usually rests with the PE firm. Important planning takeaways for rollover participants include "knowing thyself" (i.e., what kind of a partner will the rollover participant make?) and remembering the adage that a person should choose partners wisely.

One risk associated with rolling over equity into the buyer's entity is the possibility that the buyer's enterprise value is difficult to verify or inflated. This issue comes up when the target company is an add-on transaction, and the issuer of the rollover equity is the combined business. Rollover participants should review the buyer's financial information and see whether there is support for the valuation of the buyer and its equity, and make sure they understand the company's equity and debt structure.

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Rollover participants should consider whether they personally like the PE firm's owners and ask themselves whether they believe the PE firm will make a good partner and contribute to the future success of the business. Questions that rollover participants should ask the PE firm upfront might include:

- What role does the PE firm see itself playing in the target company's operations post-acquisition?
- How often do PE firm personnel visit their portfolio companies?
- Will the PE firm place an executive on the premises?
- What are the reporting obligations of management to the PE firm?
- What role does the PE firm play in its portfolio company's day-to-day management and decision making?
- How often will the portfolio company executives meet with its PE owners (quarterly or monthly board meetings)?
- What experience and resources will the PE firm deploy to assist management in achieving a desired successful exit?
- Given the PE firm's strategy and plans for the target company, is the management team in place that can support plans for expected growth?
- What is the PE firm's track record with its other acquisitions?
- What does the PE firm say about its business plan and exit strategy for the target company?
- If the PE firm's strategy is a sale in the "short" term, does this fit with the rollover participants' long-term plans for the business?
- What tools does the PE firm use in terms of equity or non-equity compensation to incentivize the management team?
- Does the PE firm anticipate adding additional members to the management team?

In advance of inking a deal, rollover participants should carefully review all management fees, transaction fees, other compensation payments and any affiliate arrangements that might siphon off the target company's profits. LLC agreements, other governance

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agreements, employment agreements, restrictive covenant agreements, incentive equity and bonus plans and any other agreements relating to the ownership of rollover equity and the governance of the target company on a going-forward basis should also be carefully reviewed. Potential rollover participants should not only carefully review but also thoughtfully negotiate any transaction, equity or employment agreements that will affect them post-closing. As part of the acquisition process, rollover participants should consider interviewing management of the PE firm's current and former portfolio companies to get a better feel of how the PE firm handles works with and "treats" management.

The due diligence process outlined above works best where the target company is being sold for the first time. If the target company is already owned by a PE firm or family office, the portfolio company's management and rollover participants will likely have little say from a contractual standpoint in connection with recapitalizations, including the timing of a sale process or the choice of a buyer. Nevertheless, the cooperation of the management team is often a critical element in a successful sale process. A PE firm often includes senior-level management in the sale process and makes an effort to ensure that the management team has a financial incentive to cooperate with a smile. This approach may not always filter down to the entire management team or in situations when the PE firm is selling the business to a strategic buyer looking to eliminate personnel redundancies.

Some aspects of the "due diligence" process discussed above also applies when the transaction is a partial recapitalization LBO, where a PE firm acquires a non-controlling equity position in the target company. In most cases, a PE firm will participate in a partial recapitalization where it is agreed that the PE firm has a contractual right to trigger an exit after five years or so, typically by putting the company in a sale process. Also, even where a PE firm does not hold a controlling interest in the target company post-transaction, there is a likelihood it will have significant contractual governance rights set out in an LLC agreement or other contract, most likely in the form of board participation and a list of actions that cannot be undertaken without the PE investors' approval. For these reasons,

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the “know your partner” concepts outlined above can have equal application in these partial recapitalization transactions.

How rollover equity typically fits into the buyer’s equity structure

The economic features of transactions with rollover equity have gradually evolved over the past decade as competition among buyers for good companies has heated up. Several years ago, the typical rollover equity currency was common equity subordinated to preferred equity issued to the PE firm’s investors. In recent years, common stock for all participants has become more typical, although some deals use participating or straight preferred equity. The same common and preferred equity classes are utilized if the entity issuing the rollover equity is an LLC. The incentive equity issued to management and employees is typically a class of voting or nonvoting common equity. Rollover participants should carefully review the buyer entity’s capitalization and debt features in connection with negotiating their deal.

The sale documents typically include provisions that require rollover participants to bear their share of purchase price adjustments and indemnity obligations.

The use of debt in M&A transactions

The typical acquisition by a financial buyer is structured as a leveraged buyout (LBO), with the senior and subordinated debt pieces usually adding up to 60% to 70% of the overall purchase consideration. When the transaction is structured as an LBO, rollover participants should take time to study the buyer’s post-acquisition pro forma balance sheet. Generally, the rollover participants’ share of equity will be higher when the deal is highly leveraged, and correspondingly, the buyer will commit less equity. When a financial buyer’s ownership of a portfolio company fails, this often occurs because the operating company’s cash flow isn’t sufficient to cover the debt expense and the buyer isn’t willing to commit sufficient additional capital to avoid action by the lenders. Of course, the attraction of an LBO is that it often funds a large up-front cash payment for the target company owners. The operating company’s debt must be repaid before equity owners share in the

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upside when the second sale occurs. For potential rollover participants, a way of viewing LBO debt is that participants are not only providing a significant equity piece but are also indirectly responsible for a share of the LBO debt.

Another important point to keep in mind is that when rollover participants are anticipating holding LLC rollover equity in a pass-through entity, they should confirm is that the LLC agreement (or LP agreement) provides for a tax distribution. Rollover participants should ask if the LBO debt documents will permit the tax distribution in the absence of the occurrence of an event of default. Typically, the LBO loan documents are circulated after a letter of intent is signed and are signed-off on by the PE firm, so including a requirement in the letter of intent that the PE firm obtain financing where the lender will permit tax distributions in the absence of a loan default will help protect rollover participants. When the operating company is highly leveraged, rollover participants could find themselves subject to phantom income (profits allocated to them on a Schedule K-1 in the absence of a mandatory tax distribution). Obviously, the tax distribution isn't an issue if rollover participants hold C corporation stock.

Typical governance issues facing rollover participants as non-controlling owners

Here are some of the key issues facing rollover participants in their post-acquisition role as non-controlling owners:

Mandatory tax distributions – The inclusion of a mandatory tax distribution is critical to non-controlling owners of a pass-through LLC (or LP) who don't have any control over whether permissive distributions will be approved by management.

No involuntary additional capital contributions – A non-controlling owner doesn't want to be forced to make involuntary capital contributions.

No involuntary loans or personal guarantees – A non-controlling owner doesn't want to be forced to make loans to the company or have an open-ended requirement to guarantee company obligations.

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Understanding the potential for dilution – A non-controlling owner benefits from pre-emptive rights (the right to participate on a pro rata basis in equity issuances) and an understanding of when and how dilution can occur. Typical exceptions to pre-emptive rights include the issuance of equity compensation and equity in connection with acquisitions.

Board representation – Depending on the percentage of equity represented by the rollover participants' holdings, rollover participants may have board representation (in addition to a seat for a rollover participant continuing as the company's president/CEO) or board observer rights. In many cases, board representation for rollover participants is tied to the fact that it is often the target company's management team that roll over their equity, and financial buyers often include executives on the portfolio company's board.

Governance issues and management fiduciary duties – The buyer entity's governance documents, particularly when the entity is an LLC, often require owners to waive the fiduciary duties of care and loyalty otherwise applicable to the financial buyer's board representatives or managers. In many cases, the LLC agreement will go further to provide that the financial buyer and its representatives are permitted to approve decisions that further their interests rather than making decisions based on what is best for the LLC (or for that matter, the equity holders generally). Here is a situation where rollover participants need to use whatever leverage they have in early stages of the sale process and, with the help of experienced counsel, to make sure that at the very least the financial owner doesn't have the right to undertake conflict of interest transactions without obtaining non-controlling owner approval. The other aspect of this issue is the need to review carefully the agreements being put into place when the deal closes, such as management services agreements or other similar arrangements that provide for payments to the financial buyer or its affiliates.

A reality associated with being a minority owners (rollover participant) in a deal with a financial buyer is that situations could arise post-sale where the interests of the majority financial buyer

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and minority rollover participants are not aligned, and in those situations the rollover participants will not have a meaningful say (at least in terms of how the governing agreements work) in decisions regarding capital transactions. For example, the financial buyer often drives the decision making on issues such as whether to add or replace key executives, whether to undertake add-on transactions or restructurings, and whether and when to enter a sale process and the terms of the sale. A further reality is that the rollover participants may have little say in whether there is a required rollover component to the subsequent sale of their company and whether they will be required to participate in the sale.

Depending on the business, there can be the additional risk that the PE firm will sell its portfolio company to a strategic buyer that could replace the management team or have goals that don't align with the portfolio company's management team. These risks should be recognized going into the initial sale process. An offsetting reality is that in spite of the rights stacked up in favor of the majority financial owner, it is often difficult or impossible for the financial buyer to act without at least the cooperation of the management team (i.e., often the rollover participants), if not the active assent of the management team, which gives them a practical if not legal seat at the table in terms of the governance of the operating company.

Supermajority voting rights – Rollover participants who will have a substantial stake in the portfolio company should at least attempt to negotiate for supermajority voting rights on key decisions. In most cases, buyers will not be willing to grant the rollover participants a meaningful vote on matters other than perhaps consent rights in connection with a conflict transaction involving the PE firm. Key issues that could be the subject of a supermajority consent requirement include: (i) amending organizational/governing documents such as LLC agreements; (ii) making non-pro rata distributions not authorized in the governing documents; (iii) redeeming equity except as contemplated in governing documents; (iv) the dissolution or liquidation of the buyer entity; (v) consent rights with respect to asset purchases or sales exceeding agreed-upon thresholds; and (vi) recapitalizations, including a sale process.

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Sponsor fees – PE firms typically receive an equity interest equal to a 20% carried interest (profits interest) in the operating company, and in addition, a support and services or other management fee equal to 1.5% to 2% of committed capital. There may be other fees, including directors' fees, acquisition and disposition fees, and monitoring fees. Rollover participants should carefully review a PE firm's fee structure to confirm that the fee structure is market. Obviously, if there are aspects of the fee structure that are atypical or excessive, this should be addressed during negotiations.

Information and inspection rights – Rollover participants usually have a right to periodic financial statements and typical equity holder information rights. Careful attention should be paid to any restrictions on those rights set out in the LLC operating agreement or a separate stockholders' agreement.

PE firm (portfolio company) repurchase rights upon termination of employment – Most rollover equity is subject to repurchase rights upon termination of employment. In most deals, the repurchase right is based on some reasonable fair market value calculation where the equity holder is terminated without cause, dies, suffers a permanent disability or retires, but the terms of the repurchase should be carefully reviewed. We have seen a number of deals where the buy-back price is below FMV where an employee quits without good reason or is terminated for cause. We also see situations where rollover participants with fully vested target company equity are expected as rollover participants to exchange that equity for nonvested buyer equity. If a rollover participant intends to retire within a five or six-year time frame, he or she should consider negotiating for a limitation on the time period where quitting work triggers a below FMV buy-back. Also, careful attention should be paid to payment terms. If the repurchase of equity will be over time, rollover participants should negotiate for an acceleration of payment if a recapitalization or events of default (to be negotiated) occur.

Put and call rights – Very few deals include rollover participant put rights, and when they are included in a deal, the triggers are usually termination without cause, death or disability. If there is a put right

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triggered upon the termination of employment without "Cause" or quitting for "Good Reason," the redemption price is usually set at current fair market value. It is more common to include a call right triggered by termination of employment for "Cause" or resigning from employment. The redemption amount payable upon the exercise of a call right in this situation is often less than fair market value. In most cases, there is be a call right triggered by any event triggering termination of employment.

Although it is difficult in one sense to argue with a below fair market value call right if a rollover participant is terminated for "Cause" or resigns prior to the passage of some reasonable period of time, it is often the case that a rollover participant is in a sense unfairly penalized where the equity rolled over is fully vested at the time of the rollover and effectively is turned into equity subject to additional restrictions under the terms of the applicable LLC agreement or stockholders agreement. If a rollover participant is nearing retirement age or otherwise expects not to remain with the target company through the next sale process, consideration should be given to negotiating for an exception to any below-FMV purchase price triggered upon a voluntary termination of employment when a mutually-agreed upon time has passed after the initial acquisition.

We see transactions that include puts and calls with respect to some percentage of the equity rolled over in the deal. These puts and calls are generally time based rather than event based and serve as an element of seller financing in the transaction. Undoubtedly, the advent of COVID-19 has spurred parties to find more creative ways to finance deals. Increasing the amount of rollover equity and structuring the redemption from time to time of a portion of this rollover equity gives the parties additional tools to finance the acquisition. From the seller's perspective, additional rollover equity introduces additional risk, but can help make a deal happen and in some cases can potentially increase the overall deal consideration.

Expect several layers of restrictive covenants – In addition to any restrictive covenants (non-competition, non-solicitation and confidentiality covenants, and in some cases non-disparagement

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and IP assignment clauses) entered into in connection with a sale transaction, rollover participants are often required to enter into a second set of overlapping restrictive covenants as part of joining in as a party to an LLC agreement or shareholders agreement governing their rollover equity investment. If additional restrictive covenants are included in a rollover participant's employment agreement and option agreement, there could be, and often are, four separate sets of covenants restricting a rollover participant. Rollover participants should consider whether each of these restrictive covenants make sense. If passive investors are included among the rollover participants, it may be reasonable question to ask whether they should be subject to restrictive covenants beyond those applicable to selling investors. When the PE firm's investors sell their interest in the target company several years down the road, it is likely that they will not be required to execute restrictive covenants, in contrast to the treatment of management and rollover participants. To the extent that rollover participants negotiate the scope or exceptions to their restrictive covenants, they should make sure that these provisions apply across all of their restrictive covenants.

Registration rights – Many PE firms include the granting of securities (demand and/or piggyback) registration rights in their investor documents.

Additional noteworthy LLC or shareholders agreement clauses – Most rollover equity will be subject through the terms of LLC agreements or shareholder agreements to rights of first refusal or first offer clauses, drag-along (forced sale) clauses in favor of the majority owners, and tag-along (co-sale) clauses for the rollover participant's benefit.

Rollover déjà vu – Management holders of rollover equity understand they could be "asked" again to roll equity to the owner when the PE firm sells the target company. This result is likely if the purchaser is another PE's firm's investors. Although this situation isn't usually addressed in the initial rollover arrangement, it may be difficult for the management team to avoid rolling over again if they want to maintain their role with the portfolio company. The same result could apply to other equity or bonus compensation

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arrangements (e.g., options).

Tax Aspects – Structuring Rollover Transactions

Most sellers prefer stock sales or transactions structured to maximize tax deferral (unless the equity is being sold at a loss), most buyers would prefer fully taxable asset purchases, which permits a complete step-up in the tax basis of the target company's assets for future depreciation and goodwill amortization write-off purposes. Equity rollovers are usually structured to allow participants to defer taxes on the rollover piece of their sale compensation. Deferring taxes isn't the same as "tax-free." When the target company is resold by the PE firm, rollover participants will finally be taxed on their rolled over equity, unless they rollover again. Tax deferral isn't always possible and isn't always part of the deal structure. Where a tax-free rollover isn't included in the deal, participants are essentially investing after-tax dollars to purchase buyer equity. A seller-friendly M&A environment usually translates into buyers who are willing to cooperate in structuring a tax-deferred rollover.

The most common ways for structuring rollovers are outlined below. Obviously, the structure varies from deal to deal based on the parties' respective tax-related identities (i.e., C corporation, S corporation or pass-through LLC), the entity selected through which to operate the acquired business (e.g., C corporation or pass-through LLC), and the relative size of the parties.

Structuring taxable rollovers

A fully taxable rollover transaction generally involves the taxable purchase of 100% of a target company's assets or stock, followed by the rollover participants' reinvestment in the buyer's equity on an after-tax basis. A taxable rollover transaction might also involve a stock or asset exchange where the transaction fails to qualify as a Section 351 or Section 721 exchange, or taxable merger or other taxable reorganization where a portion of the purchase consideration is buyer equity. Deals may be structured to include taxable equity rollovers in situations where the sale would trigger tax losses for the rollover participants, the terms of the deal or tax

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characteristics of the parties make a tax-deferred rollover difficult or impossible, or a taxable rollover is buyer demand.

The rollover-related tax issues are generally straightforward in a fully taxable transaction. The key non-tax issues discussed in this article are applicable to rollover participants acquiring their rollover equity on an after-tax basis.

A buyer purchasing target company stock may desire to make a Section 336(e) or Section 338(h)(10) election to step up the target company's basis in its assets. These elections won't be possible if the sale transaction includes a nontaxable rollover of more than 20% of the target company's stock. There is a risk that the IRS could recharacterize a transaction structured as a purchase of 100% of the target company's stock for cash, followed by a sale by the buyer of some equity to the target company's management team, as a Section 351 exchange. If this were to occur in a situation where the "rollover" in the deemed Section 351 exchange aggregated more than 20% of the target company's stock, the purchase of the target company's stock would not qualify as a Section 338(h)(10) purchase or a Section 336(e) disposition.

Rollovers involving Section 1202 qualified small business stock (QSBS)

Ensuring that participants can roll over equity tax-free is a critical concern in most M&A transactions involving rollover equity. Occasionally, however, rollover participants have met the qualification requirements for the Section 1202 gain exclusion, which can dramatically affect the target stockholders' priorities.

Generally, structuring a transaction so that equity is rolled over on a tax-free basis is a high priority for rollover participants. But priorities do change when rollover participants hold QSBS, because by triggering a taxable sale of their QSBS (assuming they have satisfied the five-year holding period requirement), these stockholders can both avoid tax on the sale and receive a step up in tax basis in any replacement equity received in the rollover transaction.[2] Often, triggering a taxable sale is an important planning goal for target stockholders (including rollover participants) who have met all of Section 1202's eligibility requirements.

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Section 1202 background information.

Section 1202 provides an above-the-line exclusion from taxable income on gain from the sale of QSBS, subject to certain limitations. [3] To qualify for Section 1202's gain exclusion, stockholders must have held QSBS for at least five years. Stockholders with a holding period of less than five years who sell their QSBS (or roll it over in a taxable rollover) have the option under Section 1045 of preserving their Section 1202 gain exclusion by purchasing new QSBS with the sale proceeds. If the combined holding period for the original QSBS and replacement QSBS is over five years, the holder can claim the Section 1202 gain exclusion when the replacement QSBS is sold. In all cases, triggering a taxable sale of QSBS is required to claim Section 1202's gain exclusion. By triggering a taxable sale and claiming Section 1202's gain exclusion, target company stockholders being cashed-out can take advantage of Section 1202's generous benefits. Likewise, rollover participants can first claim the Section 1202 gain exclusion with respect to the sale of their original QSBS and then be treated as having purchased the replacement buyer equity with a stepped-up fair market value tax basis (generally higher than their historical tax basis in the target company equity). The fully taxable rollover can be structured with an all cash transaction, followed by the purchase of buyer equity by the rollover participants or through a taxable exchange of target company QSBS for buyer equity (which may or may not itself be QSBS).

While it is easy to trigger a taxable exchange when exchanging QSBS for buyer stock by avoiding satisfying Section 351's control requirements or purposefully failing the Section 368 reorganization requirements, it is more difficult to avoid a tax-free exchange where QSBS is exchanged for an LLC interest (Section 721's requirements don't include Section 351's 80% control requirement). Where buyer LLC interests are involved, the best approach might be to structure and document the QSBS rollover as a taxable sale of 100% of the QSBS, followed by a reinvestment of purchase consideration in buyer LLC interests.

Considering planning alternatives.

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Two situations where a tax-free rollover of some QSBS might be desirable are (i) where the aggregate sales proceeds attributable to the rollover equity would exceed the rollover participant's Section 1202 gain exclusion cap (generally $10 million), or (ii) where the rollover participant's aggregate Section 1202 gain exclusion is well below the cap and the rollover involves the exchange of target company QSBS for the buyer's QSBS in a tax-free exchange (i.e., Section 351 exchange or Section 368 reorganization). With respect to the second situation, the rollover participant might want to roll over target company QSBS for buyer QSBS in a tax-free transaction because it defers gain and opens the door for the possibility that the QSBS will further appreciate, allowing the holder to claim a greater Section 1202 gain exclusion.[4] If the original exchange was a taxable transaction followed by a reinvestment in QSBS, a subsequent sale of the replacement QSBS won't have the benefit of a taking of the original QSBS's holding period, which opens the door to the possibility that the holder won't have satisfied the five-year holding period requirement when the replacement QSBS is sold. On the flip side, there is always the risk that the stock will lose its QSBS status after the exchange or that the tax laws will change, resulting in the rollover participant losing the opportunity to take advantage of any Section 1202 gain exclusion.

Some Section 1202 rules to keep in mind during the planning process.

Target stockholders sporting a five-year holding period for their QSBS should keep several Section 1202 rules in mind during the sale process:

- In order to take advantage of Section 1202's gain exclusion, QSBS must be sold. A sale can be structured as a sale or redemption for cash, or a taxable exchange of QSBS for buyer equity or other property.
- If target company QSBS is exchanged for buyer QSBS in a Section 351 exchange or Section 368 reorganization, the replacement QSBS will include the holding period for the original QSBS.

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- If target company QSBS is exchanged for buyer non-QSBS in a Section 351 exchange or Section 368 reorganization, when the replacement non-QSBS is sold, if the rollover participant has a five year holding period for the replacement non-QSBS (for this purpose taking into account the holding period for the original QSBS and the holding period for the replacement stock), the rollover participant will be able to claim the Section 1202 gain exclusion in an amount equal to the gain deferred at the time of the exchange of buyer non-QSBS for the target company QSBS Additional gain would be taxable at capital gains rates. Section 1202(h)(4)(D) provides that the Section 1202 rules with respect to a Section 351 exchange apply only if the corporation issuing stock (either QSBS or non-QSBS) to the rollover participants controls the target company within the meaning of Section 368(c) immediately after the exchange.
- It appears that if target company QSBS is exchanged for buyer QSBS in a tax-free exchange, a subsequent loss of QSBS status for the buyer stock would cause the rollover participant to lose the opportunity to claim any Section 1202 gain exclusion. This result appears to be the case in spite of the fact that in connection with a taxable exchange of QSBS coupled with a Section 1045 election—or a taxable sale of target company QSBS followed by a reinvestment of the proceeds in buyer QSBS coupled with a Section 1045 election—Section 1045 provides that the buyer only needs to satisfy the active business requirement under Section 1202(c)(2) for a period of six months after the exchange.
- Finally, the exchange of QSBS for buyer LLC (a partnership for tax purposes) interests may be a tax-free exchange under Section 721, but the exchange will end the stock's QSBS status, and the rollover participant won't be able to claim the Section 1202 gain exclusion with respect to the buyer LLC interests received in the exchange.

Planning objectives shift when target company stockholders lack a five-year holding period for QSBS.

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One obvious strategy when target stockholders don't have a five-year holding period for QSBS is to postpone the closing of a sale until the five-year holding period requirement has been satisfied. If postponing the sale is not possible, then target company stockholders can consider the following planning options:

- Selling target company QSBS and rolling the proceeds over into buyer QSBS. This strategy works whether the rollover is taxable or tax-free under Section 351 or Section 368. If the rollover is taxable, the rollover participant will need to make an election for under Section 1045 in connection with the rollover. All of the target company stockholders holding QSBS can reinvest their sale proceeds in QSBS and make an election to defer gain under Section 1045.
- Exchanging target company QSBS for buyer non-QSBS in a tax-free exchange under Section 351 or tax-free reorganization under Section 368. When the replacement non-QSBS is sold, if the rollover participant has a five-year holding period for the replacement non-QSBS, taking into account the holding period for the original QSBS, the rollover participant will be able to claim the Section 1202 gain exclusion in an amount equal to the gain deferred at the time of the exchange of buyer non-QSBS for the target company QSBS, and additional gain would be taxable at capital gains rates.

Confirm and document satisfaction of Section 1202's eligibility requirements, and Section 1045's requirements, if applicable.

In addition to having an understanding of how QSBS is treated in rollover transactions and the M&A sale process generally, potential rollover participants should determine whether their equity is, in fact, QSBS and the date on which their original QSBS holding period commenced for purposes of Section 1202's five-year holding period requirement. Finally, rollover participants, along with any target company stockholders claiming Section 1202's gain exclusion or rolling over proceeds under Section 1045, should make sure they have fully documented their satisfaction of each of Section 1202's eligibility requirements and Section 1045's requirements, as

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applicable.

Structuring tax-deferred rollovers

A tax-free (deferred) rollover involves the deferral of taxes on the portion of the rollover participants' equity rolled over into the buyer's entity. The cash portion of the transaction consideration will be fully taxable. The tax on the rollover portion of the equity is deferred until the next sale of the target company.

If "vesting" is imposed on rollover equity, requiring the rollover participant's continued participation in management, the rollover participant's retained equity could potentially be characterized as compensatory equity and therefore would not qualify for tax-free rollover treatment. A possible alternative to introducing a "vesting" concept into the transaction structure would be an agreement between the rollover participants and buyer to a purchase price adjustment (which might include equity forfeitures or buy-backs) if certain triggering events occur. The rollover equity would be fully vested at the time of issuance.

Purchasing less than 100% of the target company's equity (C corporation, S corporation or LLC target)

The most straightforward way of effecting a tax-deferred rollover transaction (albeit one that isn't frequently used because of the buyer's concern over contingent liabilities of the target business) is for the buyer to purchase less than 100% of the target company's equity. Generally, buyers prefer structuring transactions that allow for a basis step-up. An asset purchase not only accomplishes the desired basis step up but usually allows the buyer to avoid the target entity's unknown liabilities and unwanted obligations. A buyer's concern about target company liabilities and obligations can often be mitigated (but not eliminated) through relying on due diligence and the rollover participants' indemnification obligations. In some deals, however, regulatory issues or concerns over third party approvals may override these issues and point toward choosing a stock acquisition.

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If the target company is a corporation, a stock purchase will not automatically trigger an inside basis step-up to reflect the consideration paid for the rollover participants' stock. This reduces the post-acquisition value of the company to the extent of the lost tax write-offs. If the target company is an S corporation that has been taking advantage of its pass-through tax treatment, the purchase of stock by an ineligible shareholder (e.g., a PE firm's fund taxed as a partnership) would trigger the termination of the S election. An 80% to 100% purchase of an S corporation's stock can be treated as an asset purchase if the parties make a Section 338(h)(10) or Section 336(e) election. But the portion of stock rolled over by the rollover participants is not tax-deferred, as 100% of the target company's assets are treated as having been sold, including the percentage representing the rollover participants' rollover equity piece.

The Section 338(h)(10) or Section 336(e) elections won't be available if more than 20% of the target company's equity is rolled over in the transaction. The potential impact of the Section 318 constructive ownership rules on satisfying the 80% purchase requirement should be considered where a PE fund owning the target company has one or more common investors with a PE fund owning the buyer.

If the target company is an LLC taxed as a partnership, the sale of LLC equity by the rollover participants will generally be entitled to tax-free sale treatment under Section 741, but a portion of the sales proceeds may trigger ordinary income if the target company holds Section 751 "hot assets," such as appreciated inventory, receivables or depreciated equipment. If a selling rollover participant has a long-term holding period for his LLC equity, he will be entitled to long-term capital gains treatment even if the LLC holds capital assets with a short-term holding period, subject to the potential application of Section 1061 for holders of carried interests. But if the rollover participants have contributed cash to the LLC or leveraged the LLC during the 12 months preceding the sale, a portion of the sales proceeds may be short-term under the Section 1223 rules. A step-up can be achieved by making a Section 754 election to step up the basis of a pro rata share of the target LLC's assets under Section 743.

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In some cases, the first step will be a recapitalization of an LLC's outstanding equity interests into several classes of preferred and common equity, with an eye towards the classes of equity to be purchased by the buyer and retained by the target company's rollover participants. Buyers may use blocker corporations to hold some of their target company equity if the buyer's fund includes tax-exempt or foreign investors.

Utilizing a corporate holding company formation structure (C or S corporation target)

The holding company formation structure works in a transaction where the target company is a C or S corporation, the buyer is acquiring target company stock, and the rollover equity is intended to be an interest both in the holding company (which may hold both the target company and one or more other PE firm portfolio companies).

The transaction involves the formation of a newco C corporation (holdco). The target company shareholders contribute target company stock in exchange for holdco stock and the buyer contributes stock or assets to holdco in exchange for holdco stock. The cash contributed by the PE firm is distributed to the target company shareholders.

The transaction fits within a tax-free exchange under Section 351, except for the cash "boot" distributed to the target company shareholders.

In a variation of the holding company formation structure that addresses the issue of non-pro rata participation in the rollover, the buyer first purchases target company equity from those shareholders not participating in the rollover and contribute the purchased stock to holdco. The rollover participants contribute the remaining target company equity to holdco, or their "contribution" is effected through a merger of the target company into a holdco acquisition subsidiary.

One tax issue associated with this holding company formation structure is that the transaction triggers no basis step-up in the target company's assets.

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Utilizing an LLC holding company formation structure (C or S corporation target)

Here the buyer forms an LLC holding company and contributes cash to the holding company in exchange for the agreed-upon post-closing equity interest. The rollover participants then contribute a portion of their target stock to the holdco LLC in exchange for LLC units. Using the capital contributed by the PE fund and outside financing holdco LLC then merges a transitory merger subsidiary with the target and cashes out the remaining target shareholders.

The portion of the cash consideration that is funded by third-party debt will likely be treated as a redemption of target company stock. If any of the selling shareholders who receive cash are also rollover participants, the distribution could be treated as a dividend to the extent of the target company's earnings and profits, provided the distribution fails to qualify for sale and exchange treatment under Section 302.

Having an LLC holding company post-acquisition should provide some welcome flexibility in structuring add-on transactions and equity compensation arrangements.

Utilizing an LLC "drop-down" structure to effect asset acquisitions (C or S corporation target)

In some cases, a buyer may be operating a business in corporate form, but the holding company formation structure won't work for various reasons (e.g., the deal doesn't merit forming a holding company size-wise) or the buyer wants to operate the business as a pass-through LLC. In those cases, the parties may utilize a "drop-down" LLC structure. First, the target company forms an LLC subsidiary. Second, the target company contributes assets wanted by the buyer into its wholly-owned (and disregarded for tax purposes) subsidiary LLC. Finally, the buyer either purchases a majority interest in newco LLC's equity from the target company, or alternatively, the buyer contributes cash to newco LLC in exchange for newco LLC equity. The cash is immediately distributed to the target company.

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The purchase or issuance of newco LLC equity will be treated as a formation of a partnership under Section 721 coupled with a sale by the target company of the equity interest held post-transaction by the buyer. The rules discussed above regarding the possible impact of "hot assets" in a sale of a partnership interest will be applicable here, as the transaction includes the sale of those "hot assets" generating ordinary income. Also, if the target company has a short-term holding period for any of its capital assets, the transaction will include short-term capital gain on the deemed sale of those assets. Newco LLC will receive a tax basis step up in portion of assets deemed to be purchased and a new holding period will commence in the purchased assets. Newco LLC will have a carryover basis and holding period in the portion of assets deemed purchased. It is possible to structure the transaction as an installment sale under Section 453 if the payments are spread over more than one year, but the contributing rollover participant will be taxed on all the gain associated with the Section 751 hot assets at the time of contribution, regardless of whether payments for those assets are deferred into subsequent years.

The drop-down structure is particularly useful where the rollover participant's entity is operated through an S corporation and the buyer is an ineligible shareholder (typical for a PE firm buyer with investments through funds operated in partnership form). The rollover participants' S corporation will continue post-transaction as an equity owner holding rollover equity. The LLC drop-down transaction structure allows the parties to take advantage post-transaction of the often-favorable pass-through tax treatment afforded LLC owners. In some cases, financial buyers may employ a "blocker" corporation if the ultimate owners are foreign investors or tax-exempt investors trying to avoid a pass-through of active trade or business income (which generates UBIT for tax-exempt shareholders).

Utilizing an LLC "drop-down" structure to effect asset acquisitions (LLC target)

Where the target company is an LLC, a transaction may be structured with the first step being the target's formation of a new LLC subsidiary. Newco is capitalized with several classes of

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common and preferred equity, asset, liabilities, and contracts included in the deal are dropped down into newco LLC, and the buyer acquires equity in newco. The transaction is treated as an asset purchase for tax purposes, followed by the formation of a new partnership for tax purposes. The buyer may use a blocker corporation if some of its fund investors are tax-exempt or foreign investors.

Debt financing at the LLC level may cause part of the acquisition to be taxed as a redemption or other distribution, which would generate a tax basis adjustment inside the partnership which would likely be shared by the LLC's owners (rather than a tax basis adjustment generated by the equity purchase, which belongs to the purchaser).

If the acquisition of a target LLC's equity isn't treated as an asset purchase for tax purposes (i.e., the target LLC isn't a disregarded entity or 100% of the target LLC's interests aren't being purchased), the buyer should consider whether a Section 754 election should be made to trigger a deemed step-up in the inside tax basis of the target LLC's assets.

Where the transaction involves a partial purchase and partial contribution of assets to an LLC taxed as a partnership, and the contributed assets are appreciated, there will be a book-tax disparity. Section 704(c) will cause the target company's owners to bear the tax burden associated with the contributed assets' book-tax disparity when the assets are eventually sold. Attention should be paid to the choice of Section 704(b) allocation method selected in the LLC agreement. Two of the most common allocation methods endorsed by the Section 704(c) regulations are the traditional method and the remedial method. If the traditional method is selected, target company owners may end up with relatively more depreciation and the buyer with relatively less depreciation than would be the case if depreciation were allocated pro rata with the relative aggregate tax basis of the parties in the contributed assets. If the remedial method is selected, the buyer's allocation of depreciation is increased to match what the buyer would have been allocated if the target company owners' assets had been contributed with a tax basis equal to their fair market value. This

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increased depreciation allocation is generated at the expense of the target company owners. Careful consideration should be given to whether the choice of allocation method is stated in the LLC agreement or left to the manager's discretion.

It isn't unusual for the target company's owners to be divided into those who will and those who won't participate in the rollover transaction, as well as whether owners will either roll over all or only a portion of their equity. How this affects the ability to structure a tax-free rollover depends on the tax identities of the target and buyer and the structure of the sale transaction. If the target company is an LLC taxed as a partnership and the transaction is an asset sale, it may be possible to specially allocate gain on the sale among the target's owners to account for who is rolling over and who is being cashed out in the transaction. If the LLC interests are being sold, the exchange versus sale can be accomplished at the individual target owner level. If the target is an S corporation and the transaction an asset sale, the S corporation will need to continue as an equity owner in the rollover transaction. Depending on the goals of the S corporation shareholders, it may be possible to take some of the target shareholders out through pre-transaction redemptions. If S or C corporation stock is being exchanged for acquiror equity, then the sorting out of continuing and existing target shareholders can be accomplished as part of Section 351 exchange transactions. Rollover participants and their counsel must drive this planning and structuring process, as the buyer's tax goals are not necessarily aligned with those of the rollover participants.

Utilizing a partial rollover and partial interest purchase to effect a purchase of LLC membership interests (LLC target)

There are a couple of approaches to select from if the parties want to structure a transaction to include the purchase of a target company's LLC interests and the rollover of target company equity by members of the management team and/or other rollover participants.

First, the buyer can simply purchase target company membership interests. If the target company is an LLC taxed as a partnership, the parties can make sure that the target partnership has filed or

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will file an election under Section 754 to step up the inside basis of the LLC's assets for purposes of future allocations of depreciation and amortization of the target LLC's assets. In other words, if 80% of the target company's assets are purchased for $100 and the inside basis of the target LLC's assets is $10, then upon making the Section 754 election, the buyer would have a $100 basis in its 80% LLC interest and the LLC would maintain a set of books showing the LLC has a $100 basis in the buyer's 80% indirect ownership of the LLC's assets. The target LLC's owners would be treated as selling their LLC interests in the transaction, with a portion of the gain generally treated as a sale of a capital asset under Section 741 and a portion as a sale of "hot assets" (e.g., depreciated property, inventory and account receivables) that are according ordinary income treatment. The portion of the LLC interests not purchased would remain in the hands of the target LLC's owners without triggering any taxable transaction.

Second, if the buyer wants to create a holding company to acquire the target company (i.e., the target company ends up as a 100% disregarded LLC owned by the new holding company), then the buyer can form the LLC and the target LLC owners can contribute LLC equity to that new holding company LLC, to the extent that those owners are participating in an equity rollover. The balance of the target LLC interests would be purchased by the new holding company. The same tax consequences outlined above would generally apply here also. The contribution of the target LLC interests to the new LLC holding company (structured to be taxed as a partnership) would be a tax-free contribution of assets to a partnership and issuance of equity interests in exchange under Section 721.

In either scenario, a tax issue that will need to be addressed in the LLC agreement is the allocation method to be selected by the parties for Section 704(b) purposes. Typically, contributors of appreciated property to a partner (here the rollover participants) would want the regulatory tax provisions dealing with Section 704(c) in the LLC agreement to provide that the LLC will use the "traditional" allocation method, while buyers would want the LLC to use the "remedial" method of allocation.

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Utilizing an F reorganization (S corporation target)

An example of where an F reorganization (mere change in identity or form) comes in handy is where the target is an S corporation, the parties want the target company to continue in existence for state law purposes, the buyer wants a basis step-up for the portion of the target's assets that it is purchasing for cash, the parties want tax-deferred treatment for the rollover equity portion of the deal, and, most importantly for making the transaction work, each target shareholder will roll over a pro rata portion of target equity into the buyer. In some deals, the buyer agrees to make the target shareholders whole the any tax differential between the asset sale and a stock sale.

The typical F reorganization is accomplished by first forming a new corporation (holdco) that becomes the historic S corporation for tax purposes in the F reorganization, second having the target shareholders contribute their target company stock to holdco, third making a Qsub election for the target corporation (now a subsidiary of holdco), and fourth, the target Qsub (subsidiary) is converted into an LLC under state conversion or merger statutes. When the dust settles, the target is a disregarded LLC for federal income tax purposes. The buyer then purchases the desired percentage of the target company's assets or a controlling share of its LLC interest for cash and the sales proceeds ae distributed to holdco's (formerly the target company's) shareholders. Tax issues that need to be addressed include ordinary income recapture and the possible impact of the disguised sale provisions in a leveraged acquisition.

The F reorganization structure permits the parties to avoid transferring the target company's assets and contracts to a new LLC prior to the sale transaction, which is often desirable from a business standpoint. If an asset transfer isn't a problem, the parties can just avoid the F reorganization steps by having the target S corporation transfer assets into a newco LLC and sell a portion of its membership interest, or sell assets directly to a buyer newco LLC.

After the sale transaction is completed, the buyer will now have an S corporation member (the rollover participant) of its operating

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company LLC. If the seller was in business prior to 1993, the transaction will often be structured so that the target LLC is a partnership at the time of the sale of a membership interest to the buyer. If the target company is a tax partnership rather than a disregarded LLC, the sale of the interest, coupled with a Section 754 election, will avoid the potential application of the Section 197 anti-churning rules. If the target is a disregarded entity for tax purposes, the transaction is treated as a straight sale of assets by the S corporation seller, followed by the formation of a partnership by the S corporation seller and the buyer, with both treated as contributing assets to the new tax partnership. If the target is a partnership for tax purposes, the transaction is treated as a combination of a taxable distribution from the partnership to the S corporation seller and a purchase of the S corporation seller's equity interest in the downstream LLC. In either cash, the rollover equity piece, whether it is 20% or 51% or more in a partial recapitalization, will be rolled over on a tax deferred basis.

The typical acquisition will be structured with a combination of buyer capital and target LLC debt. The selling S corporation will receive a distribution from its downstream LLC and purchase consideration from the buyer for the target's LLC interest.

Utilizing tax-free reorganizations (C or S corporation target)

If structured properly, tax-free reorganizations allow selling shareholders to defer taxes on all or a substantial portion of the sales proceeds. Rollover participants must take a substantial portion of their consideration in the form of buyer equity. In most cases, the percentage of equity being rolled over won't qualify the transaction for tax-free reorganization treatment. 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 (i.e., 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 target into the acquiror (an "A" reorganization), and the percentage of continuity of interest (COI) required goes up from there with different reorganization types. Final COI regulations were issued in 2005.

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These regulations provide that COI can be lost if the stock of the issuing corporation is redeemed by the issuing corporation in connection with the reorganization. The COI regulations should be carefully reviewed if other contractual features are tied to the acquiror's stock, including for example, "put" and "call" provisions. Also, the IRS and Treasury announced in the preamble to the COI regulations that they were continuing to consider the appropriate treatment of restricted shares in determining the level of COI (i.e., whether or not the restricted shares are outstanding and can count toward COI).

Buyers considering using tax-free reorganizations must weigh the benefits associated with using their stock as purchase consideration against the loss of the tax basis step-up for the portion of the transaction involving buyer equity. With respect to the target company's unknown liabilities, the availability of the assets for stock "C" reorganization is helpful, but the requirement that the target assets be exchanged solely for voting stock of the acquiror or parent usually disqualifies the C reorganization. Tax-free reorganizations are much more common where the transaction involves a publicly-traded strategic buyer.

Avoiding tax traps

The drafting details of LLC agreements are beyond the scope of this article but can have a significant impact on rollover participants.

Advisors structuring rollover transactions must be familiar with the technical tax rules for achieving tax-free treatment under Sections 351, 368 and 721.[5] There are also various potential tax traps to be avoided.

For example, if a target business was in existence on or before August 10, 1993, and the rollover participants will own more than 20% of the equity post-transaction, the target's goodwill and going concern value may not be amortizable under Section 197 due to the "anti-churning rules." A typical fix in a partial recapitalization (acquisition of a minority interest in an operating business by a financial buyer) or equity rollover involving an LLC taxed as a partnership is to structure the transaction to involve the purchase of a partnership interest coupled with a Section 754 election, which

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provides an effective workaround for the anti-churning rules. In some cases, it will be necessary to add a partner (LLC member) prior to the sale transaction so that the sale fits the sale of partnership interest coupled with Section 754 election structure. This two-step transaction may be of particular use where the target company restructures through an F reorganization followed by conversion of the operating company to a disregarded LLC prior to the sale transaction.

If the target company has been operating as an LLC taxed as a partnership, the business cannot be converted into a corporation for the purpose of engaging in a tax-free reorganization. The likely result of conversion in anticipation of a merger transaction would be the IRS' invocation of the "step transaction" doctrine, which would transform the hoped-for tax-free reorganization into a taxable sale transaction, regardless of how much of the consideration was in the form of acquirer stock.

If the rollover is structured as a deemed sale of assets, whether due to a Section 338(h)(10) election or sale of interests in a disregarded entity, success-based fees (e.g., investment banker fees) may need to be capitalized and treated as a reduction of the amount realized on the sale, as opposed to generating an ordinary deduction.[6]

The provisions in an LLC agreement dealing with the partnership audit rules can be another source of concern for rollover participants. Under the new audit rules, tax audits and litigation are generally conducted at the partnership level under the auspices of a "partnership representative." There are several issues that need to be addressed in the LLC agreement, including what information and consent rights the owners have versus management and the partnership representative, and whether any resulting tax liabilities will be "pushed out" to the owners or paid at the partnership level.

The terms of an LLC agreement can impact the allocation of net income to rollover participants during the target company's post-sale operating years

Where the buying entity is an LLC, an important issue is the LLC agreement's terms governing post-sale tax allocations. Unfavorably drafted tax allocation provisions can act to accelerate the allocation of taxable income to rollover participants, which blunts the benefits

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associated with the deferral of taxes on the built-in gain (i.e., the gain associated with the equity or assets rolled over in the sale transaction).

The tax allocation provisions in an LLC agreement can be structured in several different ways to accommodate both the business goals of the owners and the requirements of Section 704(c) that tax allocations have "substantial economic effect." One drafting method commonly seen in today's agreements is to provide that the annual general tax allocations are made among the owners based on a deemed sale of the LLC's assets, followed by a liquidation of the LLC. Once this calculation is made, taxable income and tax losses are allocated, to the extent possible, to bring the owners' capital accounts in line with their anticipated share of the LLC's liquidation proceeds. Further, these LLC agreements often include allocation provisions addressing the working of Section 704(c), in conjunction with the allocation rules found at the Section 704(b) Treasury Regulations, that permit the controlling owners to make tax allocations that accelerate the narrowing of the book and tax difference associated with rollover participants' built-in gains in the years immediately following the sale.

The goal of the rollover participants should be to defer as much as possible the imposition of taxes on the built-in rollover gain until the second sale occurs. One step the rollover participants should take is to demand that allocations be made using the "traditional" method rather than other methods, such as the "remedial" method. Another step would be to provide for a general allocation on a per-unit basis rather than any method involving deemed asset sales. The selection of the allocation method is often dependent both on the tax sophistication of the parties and the market for businesses.

The PE firm owners generally would want provisions in the LLC agreement that basically narrow the tax and book gap associated with the rollover as soon as possible, as this would have the effect of incrementally reducing the non-rollover participants' taxable income. But in a seller-friendly M&A market, PE firms may be willing to give rollover participants the benefit of the most favorable tax treatment with respect to preserving their tax deferral.

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Using "contribution agreements" rather than "purchase agreements" in rollover transactions

Best practices dictate the use of a transaction agreement titled "contribution agreement" rather than titled "purchase agreement," if the parties intend for the rollover equity to be tax-deferred for the rollover participants. Characterizing the transaction form as a stock or asset purchase invites an IRS agent's argument that the form of the transaction dictates tax treatment. Using a contribution agreement makes sure that the form of the transaction is one where the default is tax-free treatment (subject to dealing with cash boot). It also makes sense in the contribution agreement to describe in some detail the tax aspects of the transaction, including an acknowledgment by the buyer and rollover participants that the transaction involves, at least in part, a tax-free rollover. At a minimum, a purchase agreement should clearly state that the rollover equity piece of the transaction is governed by Section 351 or Section 721 and intended by the parties to constitute a tax-free exchange, rather than a purchase of equity.

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

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 with the rollover of equity and equity rights are different when service providers are involved.

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

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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 alongside the financial owner in a successful sale. 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

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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, 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 from 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).

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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.

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) 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. By contrast, property 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

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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

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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 make a 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.[7]

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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 new restrictions are placed on the equity post-transaction, 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.

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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 tack 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 it 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 stocks are outstanding and can count toward COI). Surprisingly, no subsequent IRS statements or authority has surfaced on this topic.

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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 takeaway 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.[8]

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

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the discussion in Section II.C. below. The features of a profits interest include that the recipient isn't taxed (as compensation) upon receipt and 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.

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," interests 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

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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-hear 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.*

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. Section 409A's extensive scope, complicated functioning and draconian

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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 vetted accordingly.

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

Beyond the basic tax issues discussed elsewhere in this article, and in particular, addressed in 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).

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

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for vested buyer stock will generally trigger capital gain recognition under Section 1001.[9]

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.

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

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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.

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 general discussion of structuring with tax-free exchanges for an outline of the basic tax consequences associated with structuring tax-free equity exchanges in rollover transactions.

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

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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 should not trigger any taxable compensation.

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 exchanges of nonvested target company stock for nonvested buyer stock" below for a discussion of modifying a change in control vesting trigger.

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

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period for nonvested stock does not 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

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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.[10]

The following sections address LLC interests, but also apply to LP interests.

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.

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.

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

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The exchange of a vested target company capital interest for a buyer vested capital interest in a tax-free exchange under Section 721 does not 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.

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.

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.

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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 represents compensation paid by the buyer. These same principles could apply in situations where service providers involved in rollover transactions exchange either stock for stock or LLC interests for LLC interests.

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 is 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,[11] 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.

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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 therefore 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.

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.

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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 provisions.

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, therefore, 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

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transaction.

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.[12]

If the recipient fails to make a timely Section 83(b) election with respect to any restricted LLC interest received 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.

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.

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 does not 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

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(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 (i.e., 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

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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.

Exchange of stock appreciation rights (SARs) for SARs.

A 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.

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 does not 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

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place by the buyer.

Securities law issues associated with the management team's participation in a rollover transaction

A sale transaction where the rollover participant retains target company equity, 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 his/her 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

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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 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.

What Potential Rollover Participants Need to Know About Blocker Corporations

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What are "blocker corporations"?

Blocker corporations are corporations that effectively "block" taxable income at the corporate level for U.S. federal, state and local income tax purposes. When a PE firm structures an LBO transaction, some PE investors, generally tax-exempt and foreign investors, will invest directly or indirectly in portfolio company equity through one or more newly formed Delaware C corporations (the blocker corporation). The right of tax-exempt and foreign investors to use blocker corporations and provisions protecting the economic rights of tax-exempt and foreign investors are often spelled out in a PE firm's fund documents and limited partnership agreement.

Why are "blocker corporations" used when a PE fund invests in a U.S. based business taxed as a partnership for federal income tax purposes?

Taxable income passed through on a Schedule K-1 by a portfolio company generally falls into the category of income "effectively connected with a U.S. trade or business" for foreign investors and unrelated business taxable income (UBTI) for U.S. tax-exempt investors. Foreign investors want to avoid being allocated effectively connected income because exposure to an allocation of that income subjects them to a U.S. income tax filing requirement and potentially to U.S. federal income and withholding taxes. Tax-exempt investors want to avoid being allocated income that is UBTI because that income will subject the otherwise tax-exempt investor to U.S. excise taxes. So, neither foreign nor tax-exempt investors want to hold directly an equity interest in a U.S. business taxed as a partnership. Hence the use of a U.S. C corporation as a "blocker corporation" to block the flow-through of income on a Schedule K-1 at the corporate level.

PE investors also favor the use of blocker corporations because when the portfolio company investments held by the blocker corporations are eventually sold, the stockholders will sell their blocker corporation stock instead of having their blocker corporations directly sell the portfolio company investments. In a sale of blocker corporation stock, tax-exempt and foreign investors will generally avoid U.S. income taxes because neither foreign nor tax-exempt investors are subject to U.S. federal income tax on

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capital gains.[13] In contrast, if a blocker corporation sold its portfolio company investment and then liquidated, the blocker corporation would be subject to federal, state and local income taxes. Blocker corporation investors generally negotiate for the right to sell blocker corporation stock when they invest with the PE firm.

So, when a sale process in undertaken with respect to a portfolio company, the PE firm will conduct a sale process that includes the sale of blocker corporation stock by its stockholders and the sale of portfolio company equity by the remaining PE investors and rollover participants. After closing, a buyer presumably has the choice of either liquidating the blocker corporation and take the tax hit associated with a deemed sale of the blocker corporation's assets or holding the blocker corporation stock (and indirectly that portion of the portfolio company's equity). Either way, the buyer won't benefit from the full tax basis step-up otherwise associated with the purchase of a portfolio company's equity (i.e., the typical 15-year amortization of goodwill under Section 179). The portion of the purchase consideration paid for the blocker corporation stock cannot be amortized. For example, if the equity of a portfolio company taxed as a partnership is purchased for $100, and its assets consist solely of goodwill, the buyer will be able to amortize this $100 investment over 15 years. In contrast, if the buyer purchases 80% of the portfolio company's equity directly and 20% indirectly through the purchase of blocker corporation stock, the buyer will be able to amortize only the $80 investment in portfolio company equity. The buyer won't be able to amortize its $20 investment in the blocker corporation's stock. The buyer is worse off in terms of future tax benefits. So, unless a buyer is entirely tax-insensitive (e.g., perhaps a public company that strictly views the purchase in terms of whether it is accretive to earnings?), the buyer will make some adjustment to the purchase price to reflect the loss of future tax benefits.

Most blocker corporations are C corporations domiciled in the United States, so taxable income from an equity investment in an LLC taxed as a partnership passes through on a Schedule K-1 to the blocker corporation, taxes are paid at the corporate level at the current 21% federal income tax rate, and stockholders do not report income and are not taxed unless a taxable distribution is made by

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the blocker corporation to its stockholders. There is the potential for double taxation with blocker corporations if after-tax profits are distributed to stockholders. Non-liquidating distributions made by blocker corporations to foreign investors are generally subject to a 30% U.S. withholding tax, but there are exceptions to double taxation where distributions are made to U.S. tax-exempt investors, non-U.S. governmental entity investors, or non-U.S. investors qualifying for tax-treaty withholding exemptions or reductions. However, the threat of double taxation is generally an empty one because prior to the sale of a portfolio company investment, most distributions from portfolio companies acquired through an LBO will be limited to tax distributions. There generally won't be any excess distributable cash that could potentially be subject to double taxation prior to the sale of the portfolio company.

Foreign corporations are generally not used as blocker corporations to invest in U.S. target companies because foreign owners don't want to expose the foreign corporation to a U.S. tax return filing requirement, along with a potential exposure to U.S. income tax and withholding requirements.[14] Instead, foreign corporations will also make their U.S. equity investments through U.S. based blocker corporations.

Does the use of blocker corporations result in a misalignment between the economic interests of blocker corporation stockholders, on the one hand, and other PE investors and rollover participants, on the other hand?

Generally, the interests of blocker corporation stockholders, on the one hand, and PE investors and rollover participants, on the other hand, are not aligned because in spite of the fact that a buyer might reduce the overall purchase price solely due to the presence of a blocker corporation, blocker corporation stockholders typically share equally in the sale proceeds. Further, it can be argued that the inclusion of the requirement that a buyer purchase blocker corporation stock places foreign and tax-exempt investors in a better tax position than other holders of portfolio company equity. Finally, although it is difficult to quantify, it is possible that the pool of interested buyers is reduced if buyers must purchase blocker corporation stock.

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To summarize, rollover participants (and other PE investors) generally are told that there are the following requirements with respect to blocker corporations: (i) some investors (foreign and tax-exempt investors) will invest through blocker corporations, (ii) when the target company's equity is eventually sold in a sale process three to seven years down the road, the sale process will include the sale of blocker corporation stock, and (iii) blocker corporation investors will share equally (pro rata with the indirect interest in the portfolio company equity) in the sales proceeds, disregarding any differentiation in purchase price paid for the blocker corporation stock. A reasonable question to ask is why PE firms cooperate with the demands of foreign and tax-exempt investors if structuring an LBO with blocker corporations puts other PE investors and rollover participants in a worse position?

A big part of the work of PE firms is attracting investors, and competition for those investors' dollars is intense. A healthy slice of many PE firms' investor pool consists of tax-exempt and foreign investors. For those reasons, PE firms are highly motivated to make investing in their funds attractive to foreign and tax-exempt investors. As a result, PE firms routinely include in their fund documents the blocker corporation provisions discussed above. In some cases, particularly where a non-controlling interest in a business is acquired in a partial recapitalization, the sale of blocker corporation stock is not required but is expected to be pursued on a commercially reasonable "best efforts" basis. Few if any PE agreements require blocker corporation stockholders to shoulder the purchase price haircut imposed by a tax sensitive buyer (e.g., even where the buyer expressly reduces the price paid for the blocker corporation stock because of the loss of future tax benefits [15]). Our experience has been that most PE firms treat these provisions as a non-negotiable aspect of a purchase transaction. Of course, everyone hopes that the future buyer of the portfolio company won't be particularly sensitive and reduce the purchase consideration. But at the end of the day, rollover participants and other PE investors should recognize that their interests are not aligned on these issues with those of the blocker corporation shareholders, and this misalignment generally translates into some economic cost borne by the rollover participants and some PE

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investors.

Is it really necessary for blocker corporation stockholders to sell stock rather than have the blocker corporation sell its equity interest in a portfolio company?

If a PE firm is asked why it is necessary for some PE investors to invest through a blocker corporation, a likely response is a discussion of the problems associated with "effectively connected income," "UBTI" and double taxation. While we agree that blocking effectively connected income and UBTI is necessary, we question whether most blocker corporation stockholders would be subject to double taxation if the blocker corporation sold its equity interest in the portfolio company and then liquidated. If a blocker corporation sells its portfolio company investment, it will be taxed on the sale at the 21% federal corporate tax rate on taxable gain. A subsequent liquidation of the blocker corporation would be treated as a stock sale for federal income tax purposes. Tax-exempt and foreign investors are not generally subject to U.S. federal income tax on the capital gains triggered by a corporate liquidation. So, the net result of a blocker corporation's sale of its portfolio company investment would be to place its stockholders (the tax-exempt and foreign investors) on par with other PE investors and rollover participants in terms of the overall tax burden generated by the sale (e.g., a 21% federal corporate income rate for the blocker corporation and a 20% or 23.8% federal income tax rate for other investors).[16] What PE firms really should be saying to their PE investors and rollover participants is that tax-exempt and foreign investors are accustomed to an overall 0% tax rate for U.S. income tax purposes, and the blocker corporation structure allows these investors to avoid U.S. income taxes. Again, what the PE firms could be saying is that, in reality, the demands of tax-exempt and foreign investors must be met, and blocker corporations help those investors maintain their accustomed favorable tax treatment.

How should PE investors and rollover participants view the issue of blocker corporations?

It is a fact that PE investors investing in a portfolio companies through blocker corporations are afforded special treatment at the

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expense of other investors in portfolio companies. This fact might appear unfair to non-blocker corporation investors and rollover participants, but the difference in tax treatment among the investors is more a result of the way tax-exempt and foreign investors are accorded special favorable treatment under U.S. income tax laws than a result specially engineered through blocker corporations. Blocker corporations preserve the disparity in treatment created by Congress through the Internal Revenue Code – the fact that while most investors will be taxed on their capital gains, foreign investors and tax-exempt investors avoid taxation. For rollover participants, the participation of blocker corporations on the PE firm side of the equation is certainly worth taking note of, but the potential incremental haircut on the sales proceeds received in connection with a future sale of a portfolio company represents just one of numerous economic and business factors that merit close attention when selecting a target company's buyer. Our experience has generally been that the consequences of blocker corporations isn't well understood by sellers, and when the ramifications of blocker corporations are fully explained and considered, the issue seldom rises to the level of a deal breaker for the target company's owners. Rollover participants are usually more focused on the amount of up-front cash, and gauging whether the PE firm will contribute towards a successful future sale of the portfolio company.

Finally, a factor to keep in mind with respect to foreign investors who invest through blocker corporations is that they may be subject to tax in their home jurisdiction on gains from the sale of their blocker corporation stock. For example, when blocker corporation stock held by a Canadian resident is sold, the Canadian investor may escape U.S. federal withholding or income tax liability but will be subject to tax on the gain in Canada. On the other hand, this might not be true for foreign investors residing in tax havens who may not be subject to U.S. federal withholding or income tax or foreign taxation on the sale of the blocker corporation's stock.

Should rollover participants and other non-tax-exempt or foreign investors invest through blocker corporations or should a pass-through portfolio company be converted into a C corporation?

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This question sometimes comes up when rollover participants look at the benefits of blocker corporations for tax-exempt and foreign investors. While the basic choice of entity analysis is beyond the scope of this article, there are a few general thoughts that should be kept in mind. First, if a U.S. taxpayer isn't a tax-exempt investor, there won't be a problem with UBTI, and the investor is already filing a U.S. federal income tax return. When the portfolio company is sold, owning the pass-through LLC interest through a blocker corporation won't significantly decrease an owner's tax liability because the portion of the gain taxed at ordinary income rates under Section 751 (e.g., accounts receivable, appreciated inventory and depreciation recapture) doesn't typically represent a significant percentage of the sale consideration. So, for the U.S. taxpayer, the blocker corporation doesn't generally improve the tax result.

Investors and rollover participants should keep in mind that if the portfolio company is a C corporation or a significant percentage of its owners hold their interests through a blocker corporation, a buyer might calculate a significant reduction into the purchase price if it is tax sensitive (i.e., the buyer strongly objects to the loss of future goodwill amortization and prices the deal accordingly). Perhaps one situation where the use of a blocker corporation would be worth pursuing is if there is a reasonable possibility that the blocker corporation's stock could be treated as qualified small business stock (QSBS) for purposes of Section 1202's generous gain exclusion.[17]

Working With Financial Buyers

Earn-out arrangements in sales to financial buyers

PE firms often structure purchase consideration to include both rollover equity and earn-out provisions. Earn-out arrangements make a portion of the overall purchase consideration contingent on the target company meeting negotiated post-closing financial goals. Including an earn-out in a deal may be attractive to a PE firm because it defers payment of a portion of the purchase price, shifts some of the risk of disappointing performance by a business in its

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portfolio to the rollover participants, and may assist in bridging gaps between the rollover participants' and PE firm's estimation of a target's value. As we mentioned in the introduction to this article, we expect both rollover equity and earn-outs to play a significant role in structuring transaction consideration for the foreseeable future as both sellers and buyers may experience difficulties with pricing and financing transactions during and following the COVID-19 crisis. From the rollover participants' standpoint, an earn-out can increase the overall purchase consideration and defer taxes, but most earn-out formulas require good to excellent performance, which, as rollover participants more than anyone can attest, is anything but a sure thing. Rollover participants who are inclined to agree to an earn-out arrangement should consider whether they would be satisfied with the up-front consideration if the earn-out piece is never earned. They should view the operation of the earn-out formula realistically and work to build in whatever protections they can negotiate for to ensure that the new owners will operate the business in a way that favors satisfying the earn-out targets. For example, rollover participants may negotiate for specific covenants that the rollover participants will remain employed and operating the business during the earn-out period and that the earn-out vests in full if the business is sold during the earn-out period.

Rollover participants should negotiate for a covenant from the PE firm that it will not take actions that would adversely affect achieving the maximum earn-out amount. PE firms will try to avoid provisions that are seen to tie their hands in how they manage or operate the target business, but rollover participants may be successful in obtaining favorable covenants if they demand them as a prerequisite for considering an earn-out.

Incentive equity pools established by financial buyers

Many PE firms and other financial buyers establish incentive equity pools for the target company's key management team. The plan usually includes senior executives and sometimes covers a broader range of employees. Like rollover equity, these arrangements are seen to incentivize employees by giving them tangible "skin in the game," which aligns their interests with those of their employer. In

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some industries, making the benefits of an incentive equity pool available to key employees is both customary and required to be competitive in the labor market. PE firms use incentive equity pools both as a retention tool for the target company's employees and as bait for attracting new management blood to their new portfolio companies.

Incentive equity pools generally average about 12.5% of the company's outstanding equity but can range from 5% to 20% of a portfolio company's common equity. Incentive equity includes grants of restricted equity, options or profits interests (used with LLCs). A typical equity plan provides for equity that vests based on a combination of time vesting and performance-based vesting (typically based on an agreed-upon return on investment capital or IRR). Rollover participants and management who leave employment generally forfeit unvested equity and are required to sell their vested equity back to the company.

Incentive equity is almost always common equity that is subordinated to a class of preferred equity (usually held by the PE firm's fund and the rollover participants). In many cases, holders of incentive equity do not expect to receive profit distributions from day-to-day operations but are looking to participate in a liquidity event such as a sale of the company or IPO.

Addressing the tax consequences of an equity incentive plan is always a critical aspect of the planning process. Deferral of compensation income is always a primary goal of participants, but this desire must be weighed against the benefits of incentive equity that allows for favorable capital gains treatment for the proceeds of a liquidity event. Although the detailed business and tax consequences of incentive equity pools are outside the scope of materials focusing on the rollover participants' rollover equity, those consequences should be studied and fully understood by rollover participants, who should take into consideration the terms of the incentive equity plan and whether they will be included in the scope of the plan's participants.

In some deals, participants receiving incentive equity or options will be asked to roll some or all their equity or options when the PE firm

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resells the target company. This may occur whether the governing plans and agreements provide that the sale should be a liquidity event. From the participants' standpoint, it is difficult to plan for these circumstances, particularly when their primary interest when the portfolio company is sold may be staying on with the company (i.e., keeping its new owners happy). The PE firm will want to build flexibility at its discretion into the compensation documents or plan with respect to whether incentive equity and options are cashed out or rolled over in their portfolio company's sale.

Legal representation and disclosure issues in sales to financial buyers

If a target company's ownership includes both management personnel and investors, there may be circumstances where it makes sense for the management team, the investors, or both, to have legal counsel separate from the attorneys representing the target company in the sale transaction. The reason for separate counsel is that in a sale transaction, the interests of these various constituencies may materially differ. It is not unusual, however, for target company counsel, in the interest of moving the deal forward, to handle the review and negotiation of not only the purchase documents, but also the management team's post-sale contracts, with the proviso that management and target company equity owners should consult with their own legal and tax advisors.

If there are non-controlling investors on the sell side of the deal, best practices would include disclosing to them all the material terms of the management team's deal with the target company and/or the buyer post-sale. Focus on full disclosure and addressing concerns of self-dealing or conflict of interest transactions can become a significant concern and sometimes an issue where the management team and/or rollover participants, unlike non-controlling owners, are expected to roll over their equity into the acquirer, enter into new employment arrangements and/or participate in post-sale incentive compensation plans. Full disclosure of the deal terms, the approval by at least majority of the non-controlling investors of the deal terms, and/or structuring the transaction to make available statutory appraisal rights are tools used to address these potential conflict of interest situations.

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Pre-Sale Process Succession Planning for Business Owners

For many rollover participants, the sale to a PE firm is a culmination of a multi-year succession planning process. Meaningful succession planning encompasses tax, business, and estate planning and focuses both on the target company's owners and the business itself. Ideally, the target company's owners should begin considering succession planning issues when they start a new business, and the process should then include periodically revisiting aspects of the plan throughout the lifecycle of the business. Along the way, careful consideration should be given to whether the target company's owners want to maintain a significant management role in their company post-sale. If the target company's owners would rather move on entirely or play a limited role, then they should pay attention early in the lifecycle to the job of developing a management team that can step in to run the business post-sale. Obviously, a strong management team capable of taking the business to the next level not only adds value to the business but almost always makes it a more attractive acquisition target. Other options include selling to a strategic buyer who can bring in its own management team or transferring the business to family, management or employees (e.g., through an ESOP).

For more information, contact Scott Dolson or any attorney on Frost Brown Todd's **QSBS & Tax Planning Services** team.

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[1] Management team members and rollover participants should be asked to acknowledge that company counsel is not representing them individually and they should be put on notice that they should consult with their own tax and legal advisors.

[2] Note that this article focuses on federal income tax consequences. States approach Section 1202 differently, with some states following the federal Section 1202 gain exclusion and other states not following the gain exclusion, thereby subjecting residents to state income taxes on the sale of their QSBS. Of course, some states don't have an income tax or have some other exemption that would apply to the sale of QSBS. Planning should always take into

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consideration any applicable state and local tax issues.

[3] The Section 1202 exclusion for a taxable year is limited to the greater of $10 million or 10 times the stockholder's aggregate basis in the QSBS. The limitation is applied to each issuer of QSBS at the stockholder level. As such, every stockholder of QSBS stock may exclude gain of the greater of $10 million or 10 times the stockholder's basis in an issuing corporation's QSBS, and the limitation is not aggregated with QSBS from other issuers.

[4] If the buyer's equity is QSBS and the transaction is structured to permit a tax-free rollover of original QSBS for replacement QSBS, it still might make sense to restructure and trigger a sale transaction. Deferring gain recognition (and the Section 1202's gain exclusion claim) opens the door to the possibility that there won't be a qualifying sale of the QSBS in the future, or that the replacement stock might decline in value, which would result in the participant foregoing some capital loss when the replacement QSBS is sold – if the original exchange had been taxable, participants claiming Section 1202's gain exclusion would have started with a higher tax basis in the replacement QSBS.

[5] Unless otherwise noted, references to "Section" are to section of the Internal Revenue Code of 1986, as amended.

[6] Chief Counsel Advice 201624021; Treasury Regulation § 1.263(a)-5.

[7] 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.

[8] 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 taxable compensation under Section 61.

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

[10] 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 an uncertificated LLC).

[11]See Revenue Procedures 93-27 and 2001-43.

[12]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.

[13] Gain on the sale of blocker corporation by a foreign investor could be subject to U.S. federal income tax under the FIRPTA rules if the blocker corporation's assets are primarily composed of U.S. real estate at any time during the five-year period preceding the sale.

[14] Foreign corporations are taxed on income allocated to them on a Schedule K-1 as effectively connected income subject to U.S. corporate income tax, along with a 30% "branch profits" tax on the after-tax effectively connected income withdrawn from the U.S. flow-through portfolio company's U.S. business (unless otherwise reinvested in a U.S. business). Also, a sale by a foreign corporation of a U.S. based pass-through entity interest will be subject to unfavorable tax treatment under Section 864(c)(8) of the Internal Revenue Code when contrasted with the tax treatment afforded foreign investors who sell U.S. blocker corporation stock.

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[15] Most letters of intent and purchase agreements are silent about price reductions associated with buyer's loss of tax benefits. Generally, buyers will take this reduction in tax benefits into account when setting the purchase price rather than expressly addressing the reduction through a formula or otherwise. But, of course, silence doesn't mean that the buyer isn't taking the loss of those benefits into consideration.

[16] For the non-corporate taxpayers' portion of the gain may be subject to taxation at ordinary income rates under Section 751. This differential in tax rates doesn't apply when blocker corporation stock is sold or the blocker corporation sells its portfolio company equity.

[17] If all of the requirements of Section 1202 are met, each individual taxpayer might qualify for at least a $10 million gain exclusion with respect to the sale of an issuing corporation's stock. The application of Section 1202 to portfolio company investments and equity rollover arrangements has not been fully explored and certainly represents an interesting opportunity for tax savvy PE firms and venture capitalists. A blocker corporation would need to hold a controlling interest in a corporation to satisfy Section 1202's eligibility requirements. If the operating company is a pass-thru LLC or LP, then it is possible that the threshold might be less than a controlling interest but there are no tax authorities supporting that position.

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