Tax Management Portfolio: Private Equity Funds

Description

Tax Management Portfolio, *Private Equity Funds*, No. 735-4th, addresses the full range of U.S. tax issues that arise in the representation of private equity funds. The purpose of this Portfolio is to provide a source of guidance to tax practitioners who regularly advise private equity funds and their investors. It includes a description of basic fund prototypes, a discussion of common economic terms and variations thereon, and a comprehensive summary of the principal U.S. tax objectives of the general partner, the fund manager, and the various categories of investors in a typical fund.

Private equity funds are investment vehicles that pool capital in privately-owned businesses at various stages of development. A recurring theme in this Portfolio is that very few fund structures produce optimal tax consequences to every participant or, for that matter, any single participant. Fund structures instead resolve inherent conflicts by compromise, allowing investors with similar and conflicting tax objectives to coexist within a single fund or fund family.

This Portfolio may be cited as Fargo, Ravichandran, and Davis, 735-4th T.M., *Private Equity Funds*.

This Bloomberg Tax Portfolio is not intended to provide legal, accounting, or tax advice for any purpose and does not apply to any particular person or factual situation. Neither the author nor the publisher assumes responsibility for the reader's reliance on information or opinions expressed in it, and the reader is encouraged to verify all items by reviewing the original sources.

Authors

Christopher K. Fargo
Arvind Ravichandran

and

Andrew T. Davis
Cravath, Swaine & Moore LLP New York, NY

Christopher K. Fargo, J.D., Columbia University; B.A. Boston College; member of the Tax Section of the New York State Bar Association and the Tax Review; admitted to practice in New York.

Arvind Ravichandran, J.D. Columbia University; B.A. Columbia University; member of the Executive Committee of the Tax Section of the New York State Bar Association, Tax Forum and various advisory Boards; admitted to practice in New York.

Andrew T. Davis, J.D. Stanford Law School; L.L.M. New York University School of Law; B.A. Princeton University; member of the Corporate Tax Committee of the American Bar Association and Tax Section of the New York State Bar Association; admitted to practice in New York.

The authors would like to acknowledge the extraordinary assistance of their past and present colleagues at Cravath, Swaine & Moore LLP in preparing this Portfolio.

This Portfolio revises and supersedes 735-3rd T.M., Private Equity Funds. Portfolio 735-3rd T.M. should be discarded.

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

Chapter XIV. Selected M&A Issues for Private Equity Funds

A. Rollovers

Private equity dispositions of portfolio companies often include a rollover, where the selling fund retains a direct or indirect interest in the company, for a variety of reasons. First, the fund may desire to monetize only a portion of its investment. Second, a rollover reduces the amount of cash the buyer needs for the acquisition. Third, the structure allows a fund family that has invested across multiple funds to sell equity held by a fund nearing the end of its life while retaining the stake held by younger funds. Rollovers are particularly common for continuation funds, where the general partner (GP) and some limited partners (LPs) desire to continue their investment in the portfolio company in a new fund.

Rollovers are also common in private equity acquisitions. The acquirer fund may desire that target management maintain its equity to incentivize performance, particularly in early-stage companies or those that depend on key personnel.

This section identifies common tax planning considerations in structuring rollovers, focusing primarily on acquisitions of partnership targets. The target's key objective is generally to ensure that the rollover is tax-free, and that only sellers who receive cash pay taxes on the acquisition. The acquirer generally desires a basis step-up for any amount it acquires for cash.

1. Continuation vs. Merger —

Where the target is a partnership and the acquirer seeks to preserve flow-through taxation, a key question is whether to structure the acquisition as a continuation of the target partnership or as a partnership merger.

In the simplest form of a rollover, the buyer acquires only a portion of the target equity for cash and leaves the remaining interests outstanding. The target partnership continues its existence and the buyer steps into the shoes of the sellers as a partner.

This simple rollover may not be desirable from a financing, corporate-governance, or other non-tax perspective. For example, in a leveraged buyout, lenders often require that the borrower be wholly owned by a parent guarantor that can pledge all of the borrower's equity.[1077] Avoiding direct management ownership can also simplify governance, especially as to a future disposition of the portfolio company.

1077 *See* Scott W. Dolson, *Equity Rollovers in M&A Transactions* , Frost Brown Todd (July 26, 2018).

If a simple rollover is not desirable, the purchaser may use a passthrough entity to acquire *all* of the interests in the target for cash and partnership interests in the acquiring entity. The form of this transaction (i.e., equity purchase or merger) is generally governed by non-tax concerns.

The form does not affect whether the transaction results in the continuation of the target partnership for tax purposes. That determination depends on whether the acquiring entity was a partnership prior to the transaction, and if so, what percentage of the combined entity is owned by the former partners of the target. Where the acquiring entity is a disregarded entity

Bloomberg Law® © 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

(DRE) that becomes a partnership upon the issuance of interests to target equity holders, the transaction generally results in a continuation of the target.[1078] Where the acquiring entity is a pre-existing partnership, the transaction generally results in a continuation of the target if the former partners of target hold more than 50% of the combined partnership.[1079]

1078 *See* §708. The precise characterization of the exchange of target interests for acquirer interests—or whether an exchange has occurred at all for tax purposes—is not clear. The transaction could be treated as either a tax-free recapitalization of the target partnership interests or an exchange solely for purposes of qualifying for nonrecognition treatment under §721. *See* Rev. Rul. 84-52, Rev. Rul. 66-264; Phillip Gall, *Nothing from Something: Partnership Continuations under Code Section 708(a),* 95 Taxes 167, 171–73 (2017).

1079 *See* §708(b)(2)(A); Reg. §1.708-1(c)(1).

If the transaction does not result in a continuation of the target, it will generally be treated as an assets-over merger.[1080] In an assets-over merger, the target is treated as contributing all of its assets to the acquiring partnership in exchange for acquiring partnership interests (generally tax-free under §721), then distributing the acquirer interests to its partners in complete liquidation (generally tax-free under §731).[1081]

1080 *See* Reg. §1.708-1(c)(3)(i).

1081 The regulations also permit an assets-up transaction, in which the target distributes its assets to its partners, who then contribute the assets to the acquiring partnership. *See* Reg. §1.708-1(c)(3)(ii). However, a taxpayer must specifically plan into this form.

A continuation and an assets-over merger should both be tax-free to the extent of the rollover. But the specific form does have implications for other tax planning objectives.

2. Special Issues for Management Rollovers —

A management rollover is generally subject to the same considerations described above as any other rollover. But if management holds its interests in the portfolio company through an aggregator partnership (a management feeder), additional complexities often arise.[1082]

1082 Management feeders are used for tax and non-tax purposes. One common tax purpose is to manage the issue that a partner cannot also be an employee of the same partnership. *See* Rev. Rul. 69-184. A common non-tax purpose is to concentrate administrative matters with respect to management compensation in an entity outside the portfolio company.

Where a DRE is used to acquire a target held directly by management, introducing a management feeder into the rollover structure can complicate the partnership continuation analysis. None of the historic partners of the target partnership will be partners of the acquiring entity (assuming only management rolls over). However, it may be possible to order the transaction steps such that the management feeder is treated, at least briefly, as a partner in the target before the acquisition, potentially allowing the acquirer to be treated as a continuation of the target partnership.[1083]

1083 *See* Scott W. Dolson, *Dealing With the Rollover of the Management Team's Equity and Equity Rights in a Sale Transaction* , Frost Brown Todd (Jan. 27, 2021).

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

3. Treatment of Cash in Partnership Transactions —

In the case of a continuation transaction, sellers are treated as directly selling the relevant portion of their interests to the buyer. Sellers may treat cash received in an assets-over merger in the same way, so long as the transaction agreement designates consideration accordingly.

Practice Note: In the absence of this rule, cash consideration would be received in the transfer of assets to the acquirer by the target partnership, which would be treated as a §707 disguised sale of such assets by the target partnership. If the assets are appreciated, the disguised sale would result in gain allocations to *all* target partners (regardless of who receives the cash).

Where the acquirer is a pre-existing partnership, there is some uncertainty whether the parties can take the position that Rev. Rul. 99-6 (Situation 1) applies instead of the partnership merger rules. The revenue ruling provides the treatment for a transaction in which one partner acquires all interests held by other partners. That situation aligns with the second step of a partnership acquisition in which (i) rolling partners contribute their interests to an acquiring partnership under §721, then (ii) the acquiring partnership, now a partner in the target, buys the remaining target interests for cash.

If Rev. Rul. 99-6 is applied, the acquiring partnership would be treated as directly purchasing assets from the selling target partners for cash, with the selling partners asymmetrically treated as selling partnership interests. With respect to the target interests contributed to the acquiring partnership in the §721 exchange, the acquiring partnership would be treated as receiving a liquidating distribution from the target partnership of the rollover partners' share of the target's assets.

Note that, because a partner has a unified basis in its partnership interest, target partners who roll a portion of their interests and sell the remainder will offset a pro rata portion of their basis against the cash consideration received. In other words, it is generally not possible to designate high basis interests as the interests sold, even if the partnership's books and records permit the identification of separate interests.[1084]

[1084] *See* Rev. Rul. 84-53.

If a partnership interest is sold for cash, a concern for the seller partner is whether it will get capital gain treatment. While a sale of a partnership interest should be treated as a sale of a capital asset generating capital gain, §751 (often referred to as the "hot asset" rules) can recharacterize some or all of the gain as ordinary income (or income taxed at the 25% rate applicable to real estate depreciation) based on the nature of the underlying assets of the partnership. On a sale of a partnership interest, Form 8308 must be filed by the partnership to report the impact of any hot assets on the seller's treatment of the sales proceeds.

Partners have different holding periods for portions of their interest acquired at different times but, similar to the treatment of basis, they cannot designate only their long-term interests as the interests sold.[1085] The holding period of the interests sold for purposes of determining whether the transfer is eligible for long-term capital gains treatment is split.[1086] In general, this split reflects relative fair market value at the time of acquisition in the case of capital interest, and fair market value at the time of disposal in the case of profits interests.[1087]

[1085] *See* Reg. §1.1223-3(c)(2)(ii). This restriction does not apply to interests in publicly traded partnerships. Reg. §1.1223-3(c)(2)(i).

[1086] *See* Reg. §1.1223-3; *see also* 718 T.M., *Partnerships — Disposition of Partnership Interests or Partnership Business; Partnership Termination.*

[1087] *See* Reg. §1.1223-3(b).

Bloomberg Law®

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

The use of leverage to fund cash consideration often gives rise to additional tax issues. In a continuation transaction, the main tax issue is managing the allocation of liabilities. Standing alone, the incurrence of leverage and subsequent distribution will frequently not be taxable to partners — this is because the borrowing will increase each target partner's outside basis, which can permit a tax-free distribution under §731(a).[1088] The subsequent acquisition by acquiror, however, may cause the basis associated with that leverage to be reallocated. For instance, if acquiror purchases equity from one or more partners, the liabilities associated with the purchased interest will be deemed assumed by acquiror, resulting in additional sale gain for the selling partner.[1089] Similarly, if acquiror contributes cash to the target for additional equity, that may result in a reallocation of liabilities treated as a deemed distribution to the other partners.[1090] Practically, these deemed movements and assumptions of liabilities predominantly govern the treatment of the transaction.[1091]

1088 §752(a). Any cash distributed will reduce the recipient's outside basis. §732.

1089 §752(d).

1090 §752(b).

1091 This issue can often be managed by careful application of the §752 liability allocation rules, particularly the allocation of Tier 3 liabilities. For instance, it may be possible to allocate a disproportionate amount of nonrecourse liabilities to the non-acquiror partners under the additional method of Reg. §1.752-3(a)(3), with the goal of reducing the amount of liabilities deemed assumed under §752(d) or the amount of the deemed distribution under §752(b).

In a merger transaction, the treatment of cash funded by leverage turns on whether the target or acquirer is the borrower. If the acquirer is the borrower, the debt-funded cash should be treated the same as other cash consideration (*i.e.*, qualify as additional cash consideration for the purchased equity). In contrast, if the target is the borrower, the transaction would generally be treated as a disguised sale, since the loan is not a qualified liability.[1092] In this case, whether target partners recognize gain will be determined under the rules for debt-financed disguised sales.[1093]

1092 *See* Reg. §1.707-5(a)(6). 1093 *See* Reg. §1.707-5.

4. Basis Step-Ups in Partnership Transactions —

The buyer of a partnership portfolio company usually expects to receive a basis step-up in the assets of the company to the extent of any cash consideration. Tax basis is typically a valuable asset that generates amortization deductions or reduces gain on asset sales, and thus represents additional transaction value. Understanding the path to and amount of any basis step-up, as well as any incremental costs to generate it, is relevant in determining the purchase price. Accordingly, this technical tax issue is often the subject of business negotiations rather than merely a lawyers' point.

a. Forms of Basis Step-Up —

The first type of basis step-up in the partnership context is personal to the purchaser (Individual Basis). Individual Basis arises under §743 where a partnership interest is purchased for cash and the target partnership has made a §754 election.[1094] Under §743(b), the purchaser's outside basis in the acquired interest is pushed down to the purchaser's proportionate share of partnership's assets. Thus, only the purchasing partner takes the incremental basis into account for future deductions and asset sales.

1094 *See* 714 T.M., *Partnerships — Allocation of Liabilities; Basis Rules.*

Bloomberg Law®

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

The second type of basis step-up attaches to all of the partnership's assets and is shared among all the partners (Common Basis). Common Basis is often created as a result of the cash consideration in an assets-over merger or a partnership distribution that gives rise to a basis step-up under §734(b). Because the benefits of this basis are generally shared among all the partners, it is necessary to rely on §704(c) to attempt to specially allocate the tax effects of the Common Basis to the appropriate partners. The §704(c) rules permit multiple tax allocation methods, and even allow different methods to be applied to different properties, which allows significant flexibility.[1095] However, certain §704(c) methods may not permit the full benefit of the Common Basis to be allocated to the purchasing partner.[1096] In addition, §704(c) is often indirect—the tax allocations follow from other items in the partnership rather than purchased asset basis.

1095 *See* Arvind Ravichandran, *Should We Repeal Section 704(c)?,* Tax Forum No. 732 (2023) (overview of different Section 704(c) methods and practical effects).

1096 In particular, the traditional method's allocations are restricted by the ceiling rule. Reg. §1.704-3(b)(1).

There are other differences between Individual Basis and Common Basis, including that: (i) §743 basis is generally treated as a fresh purchase, giving rise to a new depreciation period, whereas it is possible to retain the existing depreciation period under the §704(c) rules; (ii) §743(b) adjustments are not taken into account in calculating partnership-level taxable income for purposes of applying the §163(j) limitations;[1097] and (iii) §743(b) adjustments are generally not subject to the anti-churning rules, whereas certain forms of Common Basis are.[1098]

1097 *See* Reg. §1.163(j)-6(d)(2), §1.163(j)-6(o)(6). Although the partner must take the effect of the basis adjustment into account, it will do so at the partner level and can thus use income from sources outside the partnership to offset any additional deductions attributable to the basis adjustment.

1098 For further discussion of anti-churning rules, see XIV.A.4.c., below. The anti-churning rules can occasionally come as a surprise where there is substantial rollover because relatedness is tested at a 20% threshold immediately *after* the transaction.

b. Transaction Structures —

In a continuation transaction where none of the cash consideration is attributable to target-level borrowing, the purchaser's step-up is Individual Basis. However, where target-level borrowing is involved, sellers may be treated as recognizing gain on the distribution of cash from the target under §731, giving rise to Common Basis.

In an assets-over merger, the step-up is generally Common Basis.[1099] If the parties designate specific interests as sold under the merger rules, the purchase price for the units attaches to the assets of the target. This occurs because, at the conclusion of the merger, the acquiring partnership is treated as receiving a liquidating distribution of assets from the target with respect to the purchased target interests, and the acquiring partnership's basis in the assets is determined under §732(b).[1100] If the cash consideration is instead treated as a disguised sale, the acquiring partnership's basis in the assets is determined under §1012. In either case, it is necessary to rely on §704(c) to allocate this basis step-up to the purchaser if desired.[1101]

1099 The same is true for transactions treated under Rev. Rul. 99-6 (Situation 1) in which the acquirer takes a purchased basis in the assets under §1012.

1100 *See* Reg. §1.708-1(c)(4), 1.708-1(c)(5) *Ex.* 5.

1101 The deemed transfer of the target's assets to the acquirer in exchange for partnership interests should produce a new §704(c) layer pursuant to which such allocations can be made.

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

c. Anti-Churning Rules —

In acquisitions of partnership targets, buyers should be wary of the potential that the §197(f)(9) anti-churning rules could disallow the benefits of a basis step-up. These rules generally disallow taxpayers from amortizing §197 intangibles (e.g., goodwill and going concern value) acquired from a business that existed prior to August 11, 1993, in a transaction in which the buyer and seller are related.[1102] Relatedness is tested both immediately before and immediately after the acquisition, and thus overlap between the target's and acquirer's owners before and after the transaction is relevant.[1103] However, for basis step-ups that result from adjustments under §732(b), §734(b), or §743(b), special rules may allow the parties to structure around anti-churning concerns using the transaction forms described above.[1104] These rules test relatedness at the partner level — so, for example, the anti-churning rules will not apply to a §743(b) adjustment so long as the purchaser is not related to the seller.

1102 The buyer and the seller are related for purposes of §197 if they have a relationship described in §267(b) or §707(b), applying a 20% instead of a 50% threshold, or if they are engaged in trades or businesses under common control as defined in §41(f)(1). §197(f)(9)(C). For further discussion, see 533 T.M., *Amortization of Intangibles.*

1103 §197(f)(9)(C)(ii); Reg. §1.197-2(h)(6)(ii).

1104 Reg. §1.197-2(g)(3), §1.197-2(h)(12). *See* Michael P. Spiro, *Tax-Deferred Management Rollovers in Acquisitions of Pass-Through Entities,* 110 J. of Tax'n 345, 347–51 (2009).

5. Rollup into Corporate Acquirer —

Purchasers generally desire to maintain the passthrough status of partnership targets. As discussed above, Subchapter K provides substantial flexibility to structure a tax-free rollover in a partnership acquisition. However, where the acquirer seeks to integrate the target with an existing business held in a corporation, achieving a tax-free rollover can be more difficult.

A direct transfer of target interests to the acquirer corporation will generally not be tax-free under §351 because the transferors will not control the acquirer.[1105] One possibility is to have the sellers transfer interests into an acquirer partnership that wholly owns the corporation, and then have the acquirer partnership contribute the target interests to the corporation. However, the acquirer partnership will momentarily be engaged in the target's U.S. trade or business, introducing concerns for tax-exempt and foreign investors.[1106] Alternatively, it may be possible to preserve the target partnership below the acquiring corporation by having the rollover partners simply retain their partnership interests, but this effectively creates an Up-C structure with its own complications.[1107] Another possibility is to form a new corporation to which the existing acquiring corporation and the target partnership are transferred in a §351 transaction. Both acquiring shareholders and target partners would be transferors, so the transaction should meet the control test. Alternatively, if the acquiring corporation needs a capital infusion from its fund owner, the fund could contribute that capital simultaneously with the contribution by the target holders to the acquirer. The fund's historic ownership of the acquirer will generally count towards the stock held by the transferors in the control test.[1108]

1105 For a similar reason, it is not generally possible to incorporate the target and immediately transfer it tax-free to the acquirer, since the transferors in the first step will immediately lose control of the corporation and will not be in control of the transferee corporation. *See Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976).

1106 For further discussion of foreign and tax-exempt investors, see VIII., above.

1107 For further discussion of Up-C structures, see XIV.B.5., below.

1108 This option is subject to an anti-abuse rule that prevents existing shareholders from being included in the control group when they contribute "property which is of relatively small value in comparison to the value of the stock already owned." Reg. §1.351-1(a)(1)(ii).

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

a. Boot Within Gain —

If target partners contribute their interests to a corporate acquirer in exchange for both cash and stock in a §351 transaction, they will recognize any gain realized in the transaction to the extent of the cash boot received.[1109] In other words, the transferor must recognize the aggregate gain on all interests transferred (up to the amount of cash).[1110]

1109 §351(b). For further discussion, see 758 T.M., *Transfers to Controlled Corporations: In General.*

1110 By contrast, if the target partners had exchanged their target interests in exchange for cash and interests in an acquirer *partnership,* the transaction would be bifurcated into a partial taxable sale and a partial §721 exchange, and gain would be triggered only with respect to the deemed sold portion of the target interests. Reg. §1.707-3(a)(2) (treating transfer of money by a partnership to a contributing partner as a sale in whole or in part).

To avoid this result, the target partners could contribute a portion of their target interests to the acquiring corporation in a §351 exchange with no boot, and then sell their remaining target interests to a corporate subsidiary of the acquirer. This separates the cash sale from the §351 transaction, isolating the gain to the sold interests. Generally, this produces a similar result to a partnership rollover with cash consideration, as discussed in XIV.A.3., above.

b. Basis in Target's Assets —

The target partnership will terminate if it becomes wholly owned by a corporate acquirer.[1111] The corporate acquirer will generally take a stepped-up basis in the portion of the assets attributable to any cash purchase and a carryover basis in the assets attributable to the interests contributed tax-free.[1112] As is the case with partnership acquirers, the potential application of the anti-churning rules should be analyzed to ensure the basis step-up can be fully utilized.[1113]

1111 *See* Rev. Rul. 99-6, Rev. Rul. 84-111.

1112 The mechanics of the basis step-up are not well defined, and depend on the form of the transaction and order of the steps. Additionally, if the transaction is structured as an integrated §351 exchange for stock and cash, the boot within gain rule may increase the rollover partners' gain (compared to the bifurcated §351 and sale described above) and therefore result in a greater basis step-up.

1113 For further discussion, see XIV.A.4.c., above.

6. C Corporation Targets —

In the context of private equity rollover transactions, it is generally not possible to obtain an asset basis step-up in a C corporation acquisition.[1114] The primary tax planning objective is achieving a tax-free rollover for target shareholders.

1114 A §336(e) or §338(h)(10) election typically will not be available, either because the target will not be a member of a consolidated group or more than 20% of the target stock will be rolled rather than purchased. For further discussion of these elections, see 788 T.M., *Stock Purchases Treated as Asset Acquisitions — Section 338.*

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

a. Partnership Acquiring Entity —

Target shareholders can easily achieve a tax-free rollover into a partnership acquirer because §721 does not have a control requirement, unlike §351.[1115] If a rollover shareholder receives cash and acquirer partnership interests, the transaction would be bifurcated into a partial taxable sale and a partial §721 exchange of each acquired share.[1116]

1115 The transfer must still comply with investment company rules of §721(b), but it is unusual for those rules to be relevant to private companies.

1116 Reg. §1.707-3(a)(2). There is no equivalent to the boot within gain rule of §351.

If the acquirer is a passthrough portfolio company, the acquisition may result in tax inefficiencies because part of the business will be subject to corporate tax and part will not. The acquiring portfolio company may instead have the target contribute its assets to the acquirer and retain the C corporation as a holding vehicle (similar to a Blocker) for the rollover shareholders.

b. Corporate Acquiring Entity —

If the acquirer is a corporation, a tax-free rollover can be accomplished under §351 or §368. The former can be challenging because the transferors are unlikely to meet the 80% control requirement without focused structuring. Likewise, §368 may not be available unless there is a substantial rollover.[1117] In either case, any cash consideration will be subject to the boot within gain rules.

1117 For further discussion of §368, see 750 T.M., *Corporate Overview.*

If the acquirer is a corporate portfolio company, the shareholders could transfer the target stock to a fund partnership entity that holds the acquirer and then have the partnership contribute the target to the acquirer. The first step should qualify under §721, and the second should qualify under §351.[1118]

1118 *See* PLR 201810005.

c. Additional Matters

(1) Deemed Dividends to Partnerships —

When a fund partnership acquires a corporate target, and the acquisition includes post-closing cash payments (e.g., purchase price adjustments, earnouts, indemnity escrows) to rollover shareholders in respect of stock contributed to the acquirer, there is a risk that the payments might first be treated as dividends paid by the target to the acquirer, and then as acquisition consideration paid by the acquirer to the shareholders.[1119] The dividend income would generally be allocated to all of the acquirer's partners, resulting in phantom income for the fund investors (who do not receive corresponding cash payments).[1120]

1119 *See Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) (holding that a transaction related to a prior transaction maintains the character of the prior transaction); *see also* 562 T.M., *Capital Assets — Related Issues.*

1120 Taxpayers may attempt to take the position the dividend income is allocated solely to the rollover transferors, but the basis for this position is not clear.

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

(2) Dividend Treatment for Rollover Shareholders —

In certain situations, cash consideration can be treated as dividend income to rollover shareholders in acquisitions of corporate targets. The two scenarios described below can arise regardless of whether the fund uses a partnership or corporate acquirer.

(a) Redemptions by the Target —

The first situation arises when a fund effects the cash consideration through a reverse subsidiary merger funded in part with cash borrowed by the merger subsidiary.[1121] Because the merger subsidiary is transitory, and the target will become liable for the debt, the borrowed cash is treated as paid directly by the target to its shareholders. Accordingly, the transaction is partially recharacterized as a redemption by the target to the extent of the borrowing.[1122]

1121 For further discussion of reverse subsidiary mergers, see 770 T.M., *Structuring Corporate Acquisitions — Tax Aspects.*

1122 *See* Rev. Rul. 78-250; FSA 200126001 (Oct. 8, 1999).

The redemption is tested under §302 for potential dividend treatment.[1123] Non-rollover sellers will generally receive sale treatment due to the termination of their interests in the target.[1124] However, depending on the extent of their retained indirect interest in the target through the acquirer entity, the rollover shareholders may be required to treat the cash as a §301 distribution, and thus as a dividend to the extent of the target's earnings and profits.[1125]

1123 For further discussion, see 767 T.M., *Redemptions.*

1124 *See* §302(b)(3).

1125 The use of a partnership acquirer rather than an acquirer entity can change the outcome of the §302 test, which uses §318(a) attribution rules when calculating the reduction in a shareholder's interest in a corporation. *See* §302(c). There is no minimum threshold for attributing stock owned by a partnership to its partners; in contrast, stock owned by a corporation is not attributed to a shareholder unless the shareholder owns at least 50% of the value of the stock of the corporation. §318(a)(2).

(b) Section 304 —

The second scenario arises under §304(a)(1), which generally applies when the target is acquired by a corporation, and the rollover shareholders collectively own (directly or indirectly) at least 50% of the target before the transaction and at least 50% of the acquirer after the transaction.[1126] Applying §304 is notoriously complex in part due to its attribution rules, which are based on §318, subject to modifications.[1127] If §304(a)(1) applies, target sellers will be deemed to receive the cash in a redemption of stock of the acquirer.[1128] The redemption is tested under §302 for possible treatment as a §301 distribution, with the reduction-in-interest tests of §302 determined with reference to each seller's (direct or constructive)

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

ownership of the target before and after the transaction.1129 If §301 treatment applies, the amount constituting a dividend is determined with reference to the earnings and profits of both the acquirer and the target.[1130]

[1126] For further discussion of §304, see 768 T.M., *Stock Sales Subject to Section 304.*
[1127] For purposes of the 50% ownership test that triggers the application of §304, the threshold for attribution between shareholders and corporations is lowered from 50% to 5%. *See* §304(c)(3)(B).
[1128] Note that §304 does not apply to cash that is attributable to target-level borrowing. Stock purchased with such cash is treated as redeemed by the target, rather than purchased by the acquiring corporation, and §304 only applies to stock treated as acquired by another corporation. As discussed above, however, that cash would still be tested for dividend treatment.
[1129] §304(b)(1). For purposes of applying the §318(a) rules when testing the redemption under §302(b), §304 removes the 50% ownership threshold for attribution between shareholders and corporations. §304(b)(1).[1130] §304(b)(2).

7. S Corporation Targets —

Transactions involving S corporation targets raise innumerable tax issues.

A fund cannot be an S corporation shareholder.[1131] Accordingly, if a fund purchases a partial interest, the S election would terminate, which the rollover shareholders may not desire. One solution is a pre-closing reorganization under §368(a)(1)(F), in which the S corporation shareholders contribute the target into a new S corporation, then convert the target into a qualified subchapter S subsidiary, and subsequently into an LLC, which is treated as a disregarded entity for tax purposes. The new parent is the S corporation successor to the target.[1132] After the reorganization, the fund purchases interests in the LLC and attains a basis step-up in the target assets.[1133]

[1131] *See* §1361(b)(1)(B).

[1132] *See* Rev. Rul. 2008-18.

[1133] The step-up is conveyed either under Rev. Rul. 99-5 (Situation 1) or §743(b), depending on whether the LLC is a disregarded entity or a partnership before the acquisition. In both cases, the step-up does not depend on the target's S corporation status (unlike in a stock purchase with a §338(h)(10) election). S corporation rollovers are prone to §197 anti-churning issues, which may be solved through a §743(b) adjustment. This can be accomplished by making the LLC a partnership rather than a disregarded entity before the purchase by having a small interest held by an individual or a regarded entity.

The new S corporation's gain on the sale will pass through to its shareholders pro rata based upon the relative ownership interests, even if the proceeds are not distributed pro rata. Further, rollover shareholders of the successor S corporation will not have the same flexibility as direct investors in the LLC with respect to dispositions or exits, which may create complications. For example, any distribution of LLC units to a single S corporation shareholder will trigger §311 gain that is shared by all shareholders.

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

B. Miscellaneous Issues

1. Earnouts —

Funds frequently employ earnouts in portfolio company acquisitions. An earnout is generally additional purchase price that is contingent on future events.[1134] Earnouts can achieve similar goals to rollovers by diminishing the amount of up-front cash needed to fund the acquisition and incentivizing seller-employees. They can also be used to bridge valuation gaps across contingencies (e.g., pharmaceutical milestones).

1134 The type of contingency varies widely, from hitting sales targets to attaining government approvals.

Sellers generally receive capital gains treatment on earnout payments and report the payments as they are received under the installment method federal rates.[1135] Buyers generally receive additional basis in the target (or the target's assets, depending on the transaction structure) as the earnout payments are made.

1135 *See* §453; Temp. Reg. §15a.453-1(c). If an earnout has total unstated interest, a portion of each installment payment will be recharacterized as interest (deductible by buyer and ordinary income for sellers). *See* §483(a); Reg. §1.483-2(a). Where sellers are employees, the earnout should be scrutinized to ensure it can be properly characterized as sale proceeds rather than compensation, particularly if contingent on continued employment. For further discussion, see 566 T.M., *Tax Consequences of Contingent Payment Transactions.*

However, if one or more of the sellers will continue to provide services to the company, it is possible the amount will be considered compensation for services that is taxed as ordinary income. While this situation will not generally apply to investors in a fund, this situation may arise where some of the sellers were also employed by, or consultants to, the company.

The determination of whether there is compensation is based on all the facts and circumstances. Factors that favor ordinary income tax treatment are: (i) whether the earnout is conditioned, in whole or in part, on future services; and (ii) whether the seller's employment term is aligned to the earnout period.[1136] Factors that favor capital gains tax treatment are: (i) whether the seller's post-closing employment compensation is at or close to market; (ii) the proportionality of earnouts;[1137] and (iii) the buyer's earnout obligation if seller's employment is terminated, wherein a buyer's obligation to make payments notwithstanding a termination more heavily favors capital gains treatment).[1138]

1136 *See, e.g., Lane Processing Trust v. United States*, 25 F.3d 662 (8th Cir. 1994) (holding payments made to employee-owners were considered compensation because the payments were tied to employment and the amounts paid were based on each employee's job classification and length of employment, among other factors); *Estate of Morris v. Commissioner*, 46 T.C.M. 993 (1983) (holding payments to the sole shareholder of an acquired corporation for consultation services most resembled compensation and should be treated as such, even though the payments enabled the buyer to retain a valuable customer list).

1137 For example, if all sellers receive the earnout based on their proportionate equity interests, but the earnout is tied to the performance of services by a minority set of owners, then that more heavily favors capital gains treatment.

1138 See, e.g., R.J. Reynolds Tobacco Company v. United States, 149 F. Supp. 889 (Ct. Cl. 1957) (holding payments proportionate to employee-shareholders' ownership percentage were not taxable as compensation because: (i) they were proportionate to equity ownership; (ii) they would be considered "unreasonable" if treated as compensation because the employees already earned market-rate salaries; and (iii) the company's long-standing treatment of the payments as related to ownership was approved by its advisors in accordance with best practices).

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

In a typical earnout, payments are contingent on target metrics, and are usually paid from target revenues. In an exit-based earnout, however, the contingency is the fund's subsequent sale of the company (or other liquidity event, such as an initial public offering (IPO)).[1139] Exit-based earnouts are paid using cash received by the fund in the liquidity event, rather than with the target's cash. This payment should generally offset a portion of the fund's capital gain recognized upon the exit.

[1139] *See* Kacy R. Joy, *Making the Most on the Sale of Your Business — An Owner's Tax Considerations on Earnouts,* Frost Brown Todd (June 29, 2020). For example, an exit-based earnout may entitle the target sellers to a portion of future sale proceeds in excess of an agreed-upon threshold, subject to a cap.

Where the target is a partnership, an exit-based earnout may cause the fund to recognize more ordinary income from the investment than a traditional earnout. Traditional earnouts typically result in payments to sellers (and corresponding basis step-ups) relatively soon after the fund's investment, allowing it to offset ordinary operating income from the target with incremental deductions from the stepped-up basis. An exit-based earnout is generally not paid until the fund sells all or most of its interest in the target, so the fund will not have incremental deductions over the life of the investment.

2. Blocker Exits —

A key commercial point in any acquisition of a partnership held through a Blocker is how the buyer will acquire the blocked interests. The buyer could purchase the partnership interests directly from the Blocker, just as it does the unblocked interests, which would convey a full asset basis step-up to the buyer.[1140] This is rarely the best answer because the present value of the step-up to the buyer, which generates tax benefits typically realized over 15 years,[1141] is often significantly below the Blocker's corporate tax liability on the sale (unless the Blocker has net operating losses (NOLs) or other tax attributes).

[1140] This would arise under §743(b) (assuming a §754 election is in effect) or Rev. Rul. 99-6, depending on whether the partnership remains in existence for tax purposes after the purchase.

[1141] Purchase price allocable to goodwill and certain intangibles may be amortized over 15 years pursuant to §197(a).

Accordingly, funds typically dispose of blocked investments by selling the Blocker shares. The fund must address who bears the implicit cost of using the Blocker (i.e., any purchase price reduction because of the foregone basis step-up on the blocked interests). This may be negotiated at the inception of the fund (or co-investment). Often the costs are shared among all sellers—that is, each investor receives the same per-unit price regardless of whether it held through a Blocker. In other cases, the costs are allocated solely to the blocked investors by reducing their share of the proceeds. This approach can be challenging to administer because the buyer may not identify a specific price reduction, so the fund and blocked investors must agree on a methodology to determine the cost of the Blocker.

3. Seller Recourse —

Historically, a common feature of private M&A transactions has been a general pre-closing tax indemnity, pursuant to which the sellers indemnified the buyer for any taxes relating to the operation of the business before closing. The sellers would typically negotiate for control of any tax returns or proceedings related to indemnified taxes.

Pre-closing tax indemnities often require sellers and buyers to be enmeshed long after the transaction because tax matters may take several years to be raised and resolved. This is particularly inconvenient in transactions involving fund sellers. From a buyer's perspective, it can be difficult to identify a fund entity that will be in existence and creditworthy for the life of the indemnity. While in principle this issue could be mitigated by placing a portion of the transaction proceeds into escrow as security for sellers' indemnification obligations, this is usually inconsistent with fund requirements to distribute cash at the end of life, and with the limited partner's (LP's) expectations.

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

a. Representation and Warranty Insurance —

Market practice has significantly evolved with the popularization of representation and warranty insurance (RWI). Under an RWI policy, an insurer agrees to reimburse an insured for losses incurred as a result of any breach of representation or warranty under the relevant purchase agreement. In addition, most RWI policies now cover pre-closing taxes of the target through a standalone definition reminiscent of a pre-closing tax indemnity.

Like any other insurance product, RWI does not eliminate all of the risk. The purchaser of the policy pays a premium (e.g., 2% to 6% of the insured amount), plus certain taxes and fees. The policy has a deductible (called a retention) and is capped at the insured amount.[1142] Insurance carriers may refuse to cover certain risks (*e.g.*, transfer pricing), but the list of uninsurable risks changes frequently and has been shrinking in recent years.

1142 Premium costs and deductibles, as well as which party pays for the policy, may be negotiated in the transaction agreement.

Most importantly, RWI policies exclude risks that the parties had knowledge of as of signing or closing. This means; that risks identified in diligence (i.e., risks that the buyer may be most worried about) are not covered by RWI.; Buyer may seek alternative protection for identified risks (e.g., a purchase price adjustment or a bespoke insurance; policy).

b. Tax Insurance —

Tax insurance is a separate product that provides coverage for tax risks known as of signing or closing (*i.e.,* risks; not covered by RWI). Instead of being based on a representation or warranty, tax insurance compensates for; losses attributable to a covered tax position. The covered position may arise in diligence or in connection with the; M&A transaction. Generally, the position has not been identified by taxing authorities, although insurance may be; obtained in connection with a pending audit.[1143]

1143 Insurers may ask the insured to provide a memorandum or formal opinion supporting the covered tax position (sometimes at a “more likely than not” standard or higher).

4. Partnership Audit Rules and Push-out Elections —

The Bipartisan Budget Act of 2015 (the BBA) fundamentally changed the way that in-scope partnerships were audited.;[1144] The BBA implemented a centralized regime that provides for the conduct of audits at the partnership level through a; designated partnership representative. Any resulting assessment is also implemented at the partnership level, such that;the *partnership* is liable for taxes resulting from an audit. The partnership, however, may elect to push out this liability to;its historic partners for the taxable year under audit, at the cost of a 2% higher interest rate on the underpayment.[1145]

1144 Pub. L. No. 114-74, § 1101(a). For further discussion of the BBA, see 629 T.M., *The Partnership Audit Rules under the Bipartisan Budget Act.* 1145 §6226.

Push-out elections have special importance in the context of partnership acquisitions. Absent a push-out election (or a liquidation of the partnership),[1146] a buyer economically inherits the contingent tax exposures of the former partners (and recalcitrant continuing partners). The election ensures that the correct historic partners bear this exposure without any

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

further involvement from the partnership or the buyer. Accordingly, buyers usually insist on push-out election covenants in partnership acquisitions.

1146 If the IRS determines that a partnership has ceased to exist (e.g., due to a liquidation) before audit liabilities arise, then the partnership is deemed to make a push-out election. §6241(7); Reg. §301.6241-3. *See also* Christian Brause, Eric M. Grosshandler & Alvin Wang, *The BBA's "Cease to Exist" Rule in Partnership M&A Transactions,* Bloomberg Tax (May 16, 2023).

To avoid the 2% interest charge for pushing out, sellers may negotiate for an opportunity for historic partners to pay their shares of the underpayment through alternative procedures before the push-out election is made. Even absent a contractual provision, partnerships often attempt to reach this result before making the election.

5. Up-C Structures —

A common exit strategy for passthrough portfolio companies is an umbrella-partnership C corporation (Up-C) structure. Up-C structures are typically implemented to facilitate an IPO of the business while maintaining the partnership's tax status. In lieu of converting the partnership to a corporation, (i) public investors contribute cash to a new public corporation (PubCo), (ii) PubCo purchases partnership equity from the partnership or historic partners, and (iii) to attain liquidity in the future, historic partners may be granted the option in the future to exchange their retained partnership interests for cash or a corresponding amount of PubCo stock, which can be sold on the market. In the case of historic partners who retained their partnership interest until death, their beneficiaries obtain a step-up in basis for the retained partnership interest, which can then be exchanged for PubCo stock without generating income tax liability.

PubCo's initial purchases of partnership equity from historic partners, as well as the future exchanges by historic partners for liquidity, are taxable to the historic partners, and therefore create tax basis step-ups in the partnership's assets under §743(b) for the benefit of the public company.[1147] A substantial portion (usually 85%) of this tax benefit is then paid over to the exchanging partner under a tax receivable agreement (TRA).

1147 This assumes that the business has appreciated, and the partnership has a §754 election in place.

The remainder of this section discusses a few issues of particular relevance to funds considering an Up-C structure.[1148]

1148 Up-C structures are complex, and a full discussion is beyond the scope of this Portfolio. For further discussion, see 770 T.M., *Structuring Corporate Acquisitions — Tax Aspects.*

a. TRA Attributes —

In the past, TRAs typically covered only §743(b) basis adjustments resulting from an exchange and iterative tax benefits resulting from the TRA payments themselves (i.e., imputed interest and incremental §743(b) basis adjustments). The list of covered tax attributes has expanded significantly, and market practice is constantly evolving. For example, TRAs often cover NOLs inherited by PubCo from fund Blockers merged into it in connection with the IPO. Other transactions that create basis step-ups, such as actual cash distributions from the partnership or deemed cash distributions resulting from the repayment of debt, are also frequently taken into account. Recent TRAs may even cover tax benefits from the partnership's pre-IPO asset basis (i.e., prior to any step-ups from IPO exchanges), though this is less common.

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

b. Consequences of Change in Control —

TRA payments are generally calculated on a "with and without" basis, comparing PubCo's actual tax liability to its hypothetical tax liability had the attributes not been available. Accordingly, public companies that would not owe tax without the TRA attributes generally do not owe TRA payments, which is not uncommon. The present value of the TRA to historic partners is diminished if PubCo is not profitable.

This framework does *not* apply to a change of control of PubCo. Instead, TRA obligations accelerate, becoming immediately due and payable. The TRA calculates the acceleration payment using assumptions that are quite favorable to TRA beneficiaries, including that attributes are deemed used in the first year they become available, even if it is clear that PubCo would not have sufficient taxable income to actually use the attributes in that year. For that reason, acceleration payments inflate the "true" cost of a TRA.

Acceleration provisions pose complicated commercial questions if PubCo becomes an acquisition target. An acquirer will typically ask for the TRA (i) to be canceled for no consideration, (ii) to be paid off at a discount to its acceleration payment, reflecting the acquirer's projections as to the value of the attributes, or (iii) to not accelerate and instead continue to pay out on a "with and without" basis. This dynamic should be anticipated when drafting the TRA. The parties should consider the appropriate standards for acceleration (e.g., should it be automatic or at the election of a controlling shareholder?) and amendment (e.g., is the consent of a majority or supermajority of holders needed to accept a haircut?). The more difficult it is to force TRA beneficiaries to accept deferral or haircut of TRA payments, the more leverage that these beneficiaries will have over a potential change-in-control transaction.[1149]

[1149] This leverage is exacerbated if TRA beneficiaries sell their equity in the business prior to the M&A transaction because they have no interest in the transaction other than maximizing TRA payments.

c. Fund Investments in TRAs —

Further complicating these dynamics is the existence of funds that invest in TRA rights. Funds are able to purchase TRA rights at substantial discounts because the payments occur over many years and are difficult for some investors to understand.

The potential for funds or other third parties to acquire TRA rights should be anticipated at the time of drafting. Depending on the acceleration and amendment provisions, these funds may be in a position to extract value in a change of control, and they have no other interest in the M&A transaction because they do not own a stake in the business.

d. Cash Pooling and Other Parity Issues —

A key operating principle for many Up-C structures is that each share of PubCo stock has the same economic entitlement as a unit of the operating partnership. This is because partners exit by exchanging units for an equivalent number of PubCo shares. If the units and shares have unequal values, the exchanges will unintentionally create winners and losers. Maintaining parity is accomplished in part by ensuring that PubCo always has the same number of shares outstanding as the number of partnership units that it owns.

Up-C partnership agreements usually make all tax distributions pro rata to ensure that no party gets a disproportionate share of cash that would disrupt parity. Outside of the Up-C context, partnerships typically manage this concern by treating tax distributions as advances of normal distributions under the waterfall. This may be

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

inadequate in an Up-C because a partner may exchange their partnership units for stock before the advance is recouped, which can create permanent value differences. However, pro rata tax distributions usually pay more cash to PubCo than it needs to satisfy its tax liabilities given that PubCo is subject to tax at a lower rate than most individual holders and typically has less gross income on a per unit basis than other partners as a result of §743(b) and/or §704(c). This excess cash tends to pool at PubCo. To maintain parity, PubCo should distribute the cash to shareholders or reinvest it in the partnership for additional units. In the latter case, the parties will need to effect a partnership unit split or a PubCo reverse-stock split to maintain the 1:1 ratio between PubCo's units in the partnership and its outstanding stock.[1150]

1150 Not all Up-C structures maintain 1:1 parity between PubCo's partnership units and outstanding stock. The primary alternative is adjusting the exchange ratio for partner liquidity exchanges to account for events that would otherwise cause distortions, such as disproportionate distributions or cash pooling.

6. The Capital Shift Problem with Certain Portfolio Investments —

Some portfolio investments entitle the fund to a minimum return in a future sale equal to a fixed multiple of the original investment. If the portfolio company is a corporation, rights of this kind should have no tax consequences to the holder until the triggering event occurs.[1151]

1151 For further discussion, see XI.A.2.f., above.

But the situation is more complicated for investments in partnerships. A partner is generally credited with an opening capital account equal to its initial cash contribution. If the partner is entitled to a fixed multiple of the investment in a sale, however, the failure to credit the opening capital account with the value of this right may understate the size of the partner's actual claim to the partnership assets.

The admission of a new partner is a book-up event.[1152] When a partnership revalues its assets upon the admission, the resulting book gain or loss must be allocated to the book capital accounts of the non-contributing partners in accordance with the economic agreement. This ensures that each partner's capital accounts reflect what they would receive if the partnership were to dispose of all of its assets at fair market value and distribute the proceeds.[1153] Here, however, the right of the fund to participate in proceeds of a future sale of the portfolio company on a disproportionate basis has the effect of shifting book capital from the other partners to the fund, not on the date of sale but on the date of the revaluation. Is this a taxable capital shift?

1152 Reg. §1.704-1(b)(2)(iv)(*f*)(*5*)(*i*).

1153 Reg. §1.704-1(b)(2)(*iv*)(*f*)(*1*); Reg. §1.704-1(b)(2)(*iv*)(*f*)(*2*).

1154 *See* Reg. §1.704-1(b)(2)(iv)(*f*)(2) (capital accounts adjusted to "reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property … would be allocated among the partners if there were a taxable disposition of such property" for fair market value). The liquidation construct under the same regulations understates the value of a profits interest for the same reason.

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service

Assuming the fund's investment is not a taxable event, how should the portfolio company allocate future profits (or gain on sale) to eliminate the disparity? Disproportionately allocating income to the fund until its capital account reflects the agreed multiple seems questionable. First, it would effectively convey a current deduction to the other partners before they incur the related expense. Second, it would not be faithful to the economic agreement, which allocates a higher percentage of the sales proceeds to the fund without regard to the profits of the portfolio company, but only if the sales price falls below the stated multiple.

The portfolio company might instead postpone the special allocation until the year of sale, allocating gross income and/or guaranteed payments to the fund to produce the correct capital account balance. However, this approach also fails to perfectly capture the economic agreement, which envisions a contingent shift of capital to the fund on an uncertain date that may never occur.

Unfortunately, the §704(b) regulations provide no guidance on the proper tax treatment in this case, but depending on the nature of the preferred interests, partnerships commonly postpone disproportionate allocations until the year of sale.[1155]

1155 In 2013, Treasury issued regulations that extended §721 to the exercise of a partnership option. T.D. 9612, 78 Fed. Reg. 7997 (Feb. 5, 2013). These rules provided a clear statement that a capital shift is not a taxable event in every circumstance.

Copyright 2025 Bloomberg Industry Group, Inc. (800-372-1033) www.bloombergindustry.com. Reproduced with permission.

Bloomberg Law®

© 2025 Bloomberg Industry Group, Inc. All Rights Reserved. Terms of Service