

Rollover Equity in Partnership Acquisitions:

TAX PLANNING CONSIDERATIONS FOR PRIVATE EQUITY SPONSORS

By: Jeffery R. Schaffart, Nicholas E. Bjornson, and Nicole R. Konen | Tax, Mergers & Acquisitions, & Private Equity Practice Groups

Introduction

Acquiring a pass-through target (such as an LLC or partnership) presents a fundamentally different and far more flexible tax landscape than acquiring a C corporation. Structuring for both a tax basis step-up on the cash consideration and tax deferral on the rollover equity—the portion of the consideration paid in equity of the go-forward entity—is often possible.

Unlike in a C corporation acquisition—where double taxation rules often make achieving a tax basis step-up too costly—sponsors in a partnership acquisition generally do not face the same structural trade-off between seller tax deferral and buyer asset basis creation.

Under Internal Revenue Code (IRC) §721, rolling sellers can contribute target LLC units to a buyer partnership on a tax-deferred basis. In many common roll-up structures, including transactions governed by Revenue Ruling (Rev. Rul.) 99-6, the buyer may simultaneously obtain an inside asset basis step-up in the purchased operating assets while the seller receives tax-deferred rollover treatment on the contributed equity.

Partnership tax law draws a distinction between inside basis—the partnership's own tax basis in its assets—and outside basis—a partner's tax basis in their partnership interest. Most of the planning opportunities (and traps) discussed below turn on which of these two basis figures is adjusted, and when.

For many sponsors, this ability to achieve both outcomes in a single transaction is one of the principal reasons partnership acquisition platforms remain the preferred structure for private equity roll-up strategies.

However, maximizing these benefits requires careful navigation of debt allocations, disguised sale rules, Section 704(c) allocations, and Section 751 hot asset ordinary-income traps.

PARTNERSHIP TARGET ROLLOVER DYNAMICS

Seller Nonrecognition	IRC §721 tax-deferred rollover
Buyer Inside Asset Basis Step-Up	IRC §743(b) adjustment, or Rev. Rul. 99-6 deemed asset purchase
Core Structural Watchouts	IRC §707 disguised sales, IRC §752 debt shifts, IRC §704(c) allocations, IRC §751 hot assets

A primary advantage of partnership acquisition structures is that tax basis step-ups extend well beyond the initial deal. With a valid Section 754 election in place, subsequent transfers, redemptions, and secondary purchases of partnership interests generate partner-specific basis adjustments under Section 743(b). These adjustments unlock ongoing depreciation and amortization deductions throughout the sponsor's holding period, preserving and monetizing tax attributes long after the original transaction closes.

Key Structuring Models for Partnership Rollovers

When acquiring a partnership target, sponsors typically utilize one of four core transaction mechanics.

1. Two-Tier Roll-Up Model: Combining Rev. Rul. 99-6 and Section 721

In many bolt-on and platform roll-up acquisitions, the buyer partnership (“HoldCo,” the sponsor-controlled entity formed to acquire and hold the target) acquires 100% of the target LLC interests using a combination of cash consideration and HoldCo rollover equity.

This structure often produces one of the most favorable tax outcomes available in private equity acquisitions because separate tax consequences arise at two different levels of the transaction.

Target Tier: Rev. Rul. 99-6

Because HoldCo becomes the sole owner of the target LLC, the target ceases to be treated as a partnership and becomes a disregarded entity for federal income tax purposes.

Under Rev. Rul. 99-6 (Situation 2), HoldCo is treated as directly purchasing the target's underlying assets rather than merely purchasing partnership interests. As a result, HoldCo generally receives a direct Section 1012 cost basis step-up with respect to the acquired operating assets.

HoldCo Tier: Section 721

At the same time, because HoldCo continues to be owned by both the private equity sponsor and the rolling sellers, HoldCo remains a continuing partnership for federal income tax purposes.

The rollover equity issued to sellers generally qualifies for tax-deferred nonrecognition treatment under IRC §721(a).

Why Sponsors Like This Structure

Unlike many corporate transactions, this structure can simultaneously deliver:

- **A direct inside asset basis step-up for the buyer.**
- **Tax-deferred rollover treatment for the seller.**
- **Continued seller alignment through rollover equity.**
- **A scalable acquisition platform for future add-on acquisitions.**

For that reason, Rev. Rul. 99-6 structures frequently serve as the foundation of private-equity buy-and-build platforms and bolt-on acquisitions.

2. Direct Partnership-to-Partnership Rollover (IRC §721)

Sellers contribute a portion of their target LLC or partnership interests to the post-closing TopCo or HoldCo partnership in exchange for rollover equity units.

Seller Effect: Tax-deferred treatment under IRC §721(a) on the rollover portion.

Buyer Effect: The buyer generally takes a carryover basis in the contributed interests under IRC §723, while a valid §754 election may create buyer-specific inside asset basis adjustments under IRC §743(b).

This structure is particularly common where the sponsor wishes to preserve the existing partnership entity while still creating buyer-specific tax benefits.

3. Recapitalization / Debt-Financed Redemption Mechanics

The target partnership borrows funds directly and uses loan proceeds to redeem exiting partners for cash while rolling partners retain their ownership interests.

Advantage: Preserves the underlying partnership entity without requiring assignment of contracts, permits, licenses, or operating arrangements.

Watchout: Debt allocation mechanics under IRC §752 must be carefully modeled to avoid deemed cash distributions that exceed basis and trigger gain under IRC §731.

4. Bifurcated Asset Purchase + Partnership Contribution

The buyer partnership purchases a portion of target assets for cash and receives the remaining portion through a Section 721 rollover transaction.

Advantage: Creates a direct Section 1012 cost basis step-up on the purchased portion of assets while preserving rollover treatment on the contributed portion.

This structure is particularly useful when parties seek to maximize basis creation while preserving meaningful seller rollover participation.

Sponsor Takeaway: The economic value of a tax basis step-up is not defined by the size of the gross step-up number. It is defined by the buyer's ability to convert that basis into current or near-term tax savings. Sponsors should model Section 163(j) interest expense limitations and income projections alongside the step-up.

Four Critical Tax Traps in Partnership Rollovers

1. Disguised Sales (IRC §707(a)(2)(B))

When a seller receives both cash consideration and rollover equity in the same transaction, the IRS may recharacterize part of the rollover as a taxable disguised sale.

The Risk: If debt proceeds or cash distributions paid to a rolling seller within two years of the contribution are sufficiently linked to the rollover transaction, the IRS may treat a portion of the intended Section 721 contribution as a taxable sale.

In plain terms: If a seller receives cash alongside or shortly after an equity rollover, the IRS may treat part of the rollover itself as a taxable cash sale—meaning the seller loses tax deferral and owes tax immediately.

Sponsor Mitigation: Structure pre-closing distributions under recognized safe harbors, including the debt-financed distribution rules of Treasury Regulation (Treas. Reg.) §1.707-5(b) or ordinary operating cash flow distributions.

Sponsor Takeaway: Build disguised sale analysis into the deal model before letter of intent (LOI) economics become fixed. Waiting until definitive documentation frequently limits planning flexibility.

2. Debt Shifts and Basis Reduction (IRC §752 / §731)

In leveraged private equity acquisitions, legacy partnership debt is frequently paid off or refinanced at closing.

The Risk: A reduction in a rolling partner's share of partnership liabilities is treated as a deemed cash distribution under IRC §752(b). If the deemed distribution exceeds the partner's remaining tax basis, immediate taxable gain may arise under IRC §731, even though the rollover was intended to be tax deferred.

In plain terms: When a target partnership's debt is paid off or refinanced at closing, a rolling seller's share of that debt drops. Tax law treats that debt relief as a cash payout—and if that "cash" exceeds the seller's basis, it triggers an immediate tax bill, even if they didn't receive an actual dollar.

Sponsor Mitigation: To prevent a rolling partner's share of liabilities from dropping to zero upon refinancing, sponsors should consider maintaining partner nonrecourse debt allocations under Treas. Reg. §1.752-3 to preserve tax basis.

3. Section 704(c) Built-In Gain Allocations

The Risk: Because rolling partners frequently contribute assets or partnership interests with built-in appreciation, IRC §704(c) mandates that built-in gain be allocated back to the contributing partner as the underlying assets are depreciated, amortized, or sold.

In plain terms: If a seller rolls over an asset that has already increased in value, the tax bill on that pre-contribution gain follows them personally—it cannot be shifted to the new investors. The specific IRC §704(c) allocation method chosen in the partnership agreement determines how quickly and in what amounts that tax bill comes due over time.

Method Selection Matters

Sponsors and sellers should address the applicable IRC §704(c) method early in negotiations:

- **Traditional Method**
- **Traditional Method with Curative Allocations**
- **Remedial Method**

The Remedial Method generally provides the greatest ability to align tax depreciation deductions with economic depreciation, benefiting sponsor cash-tax projections while accelerating corresponding taxable income to contributing sellers.

Sponsor Takeaway: The IRC §704(c) method should be negotiated during LOI discussions rather than deferred to operating agreement drafting.

4. Section 751 Hot Assets (Ordinary Income Trap)

Sponsors should identify IRC §751 exposure during diligence and address tax character expectations before purchase-price economics become fixed.

The Risk: Even in a deal that generally yields capital gain treatment, IRC §751(a) recharacterizes a portion of the seller's gain as ordinary income to the extent it is attributable to partnership "hot assets"—specifically unrealized receivables, inventory, and Section 1245/1250 depreciation recapture.

In plain terms: Even if the overall deal qualifies for lower capital gains tax rates, any portion of the seller's gain tied to unpaid invoices, inventory, or past equipment depreciation gets taxed at higher ordinary income rates. This unexpected tax rate jump can significantly shrink a seller's after-tax proceeds,

Management Equity and Profits Interests Alignment

A distinct advantage of partnership acquisition structures is the ability to issue profits interests to management.

Tax-Free Grant: Under Revenue Procedure (Rev. Proc.) 93-27 and Rev. Proc. 2001-43, management may generally receive profits interests without immediate taxation if structured appropriately and subject to applicable requirements.

Section 83(b) Protective Elections: Recipients should generally file protective Section 83(b) elections within 30 days to maximize future capital-gain treatment on appreciation.

For sponsors, profits interests often provide an efficient mechanism for aligning management incentives without requiring substantial up-front capital investment by executives.

Key Takeaways for Sponsors

- **Leverage Dual Tax Benefits:** Use IRC §721 for tax-deferred seller rollovers while securing an inside asset basis step-up via Rev. Rul. 99-6 (in 100% target roll-ups) or an IRC §754/§743(b) election
- **Audit Disguised Sale Mechanics:** Review all transaction cash flows, debt-financed distributions, liability shifts, and reimbursements under IRC §707.
- **Negotiate Section 704(c) Methods Early:** Address allocation methodology during LOI discussions rather than deferring the issue to final operating agreement negotiations.
- **Model Debt Allocations Under IRC §752:** Ensure refinancing and liability shifts do not create unanticipated Section 731 gain recognition for rolling sellers.
- **Identify Section 751 Exposure During Diligence:** Evaluate ordinary-income recharacterization risks before transaction economics become fixed.
- **Ensure Form 8308 Compliance:** Confirm that transaction reporting for IRC §751(a) hot asset exchanges is properly built into post-closing tax compliance schedules.

This alert is intended for educational and informational purposes only and should not be construed as legal, tax, or financial advice. Readers should consult qualified legal and tax advisors regarding their particular facts and circumstances.