

Structuring Acquisitions of Family-Owned Businesses: Valuation, Due Diligence, Deal Structure, Operational Transition, and More

WEDNESDAY, MAY 6, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Will Chuchawat, Partner, **Sheppard Mullin**, Los Angeles

Kenneth W. Clingen, Partner, **Clingen Callow & McLean**, Lisle, Ill.

Brett D. Koeller, Shareholder, **Godfrey & Kahn**, Milwaukee

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.



STRUCTURING ACQUISITIONS OF FAMILY-OWNED BUSINESSES



General Outline Of Topics

1. Counseling Prior to Sale
2. Preparing for Sale
3. Key Role of LOIs; Rollovers and Co-Investments; Earnouts
4. Estate Planning and Tax Considerations

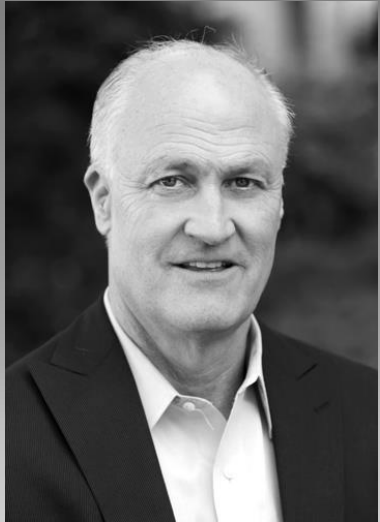
Speaker Info



Will Chuchawat
wchuchawat@sheppardmullin.com

- Will Chuchawat is the Managing Partner of the M&A Practice. He is the former Head of the A&D Team and former Head of the Life Sciences Team.
- He does M&A, all day, every day.
- Mr. Chuchawat has done **hundreds** of deals in healthcare, life sciences, consumer, A&D, TMT, industrials, financial services, manufacturing, food and beverage and other industries.
- Mr. Chuchawat has been consistently recognized as one of the best attorneys in the country, including:
 - ❖ Named one of *Law360's* Top Attorneys in the Nation Under 40.
 - ❖ *The M&A Advisor* named him as one of the "40 Under 40" in the West, which includes: AK, AZ, CA, CO, HI, ID, KS, ND, NE, NM, NV, OR, OK, SD, TX, UT, WA, and WY. *The M&A Advisor* made their selections from a pool of not just attorneys, but everyone in the M&A and turnaround space, which included private equity professionals, bankers, consultants, accountants, money managers, etc.
 - ❖ The *Daily Journal* named him one of the top 20 attorneys under 40 in California.
 - ❖ *The Recorder* named him one of the 50 Lawyers on the Fast Track in California.
 - ❖ The *LA Business Journal* named him one of the Most Influential Minority Lawyers.
 - ❖ *Legal 500*, Mergers and Acquisitions 2015-2020
 - ❖ *Super Lawyers*, Rising Star, 2012-2020

Speaker Info



Kenneth W. Clingen
clingen@ccmlawyer.com

- Kenneth W. Clingen serves as general counsel to several family owned and privately owned business entities in a variety of industries, including manufacturing, distribution, technology, financial services, and professional services. He uses his audit and accounting background to counsel clients in forging solutions that properly balance legal and business concerns.
- Illinois Super Lawyer 2013-2020 Business and Corporate Law.
- Regularly presents on local and national level.
- Representative Transactions:
 - ❖ Advised in sale of acoustic research and hearing aid manufacturer to strategic buyer.
 - ❖ Advised private equity firm on multiple loan transactions to “land bank” lender for housing developers.
 - ❖ Counseled personal care products company in strategic acquisition and related financing involving multiple credit facilities.
 - ❖ Created Family business entities, including limited liability companies and limited partnerships as vehicles for preserving and transferring family wealth.
 - ❖ Advised on sales and gifts of family business interests in connection with estate and succession planning for high net worth and ultra-high net worth families.
 - ❖ Negotiated private placements for investors in multi-tenant apartments, distribution warehouses, retail shopping centers, and related commercial, retail and industrial real estate.
 - ❖ Negotiated Master Service Agreements with Fortune 500 companies for technical outsourcing and licensing agreements.
 - ❖ Assisted manufacturing clients on sales terms and conditions on large dollar purchase orders; assisted in counselling clients and negotiating with purchasers over warranty and indemnity issues involving manufacturer’s products to avoid litigation.

Speaker Info



Brett Koeller
bkoeller@gklaw.com

- Brett Koeller is the Co-Chair of Godfrey & Kahn's Corporate Law Practice Group, which includes M&A, Private Equity & Venture Capital, Securities, Emerging Companies and Private & Family-Owned Businesses.
- He focuses on buy-and-sell side acquisitions, debt and equity financings and general business law issues, acting as outside general counsel for privately-held clients across a variety of industries.
- Mr. Koeller serves on the Board of Directors of the Potosi Brewing Company, which supports the Potosi Foundation, a non-profit 501(c)(3) organization with a mission to spur economic opportunity and support historical and educational initiatives.
- Mr. Koeller has been recognized by:
 - ❖ Wisconsin Rising Star (2011-2016).
 - ❖ Wisconsin Super Lawyer (2018).
 - ❖ The Best Lawyers in America (Corporate Law, Mergers and Acquisitions Law, 2018-present).



Family-Owned Businesses Drive the U.S. Economy

1. Family-owned business does not mean small, unsophisticated or provincial – see Walmart, Cargill, SC Johnson, etc.
2. U.S. Statistics (approx.; see www.score.org)
 - ❖ 65% of GDP
 - ❖ 60% of workers
 - ❖ 80% of new hires

But Challenges Staying Family-Owned

- 30% of family businesses last into G2



- 12% of family businesses last into G3



(April 2015 *Harvard Business Review*)

Challenges Staying Family-Owned

1. Succession Planning -- 58% of businesses have a succession plan
... but most are “informal”

(PWC's 2019 U.S. Family Business Survey)

2. Growth vs. Lifestyle objectives
3. Access to capital
4. “Active” vs. “Passive” owner splintering
5. Illiquid net worth
6. Access to / Attractiveness to Outside Talent
 - ❖ May want equity
 - ❖ Fear of losing out to blind loyalty

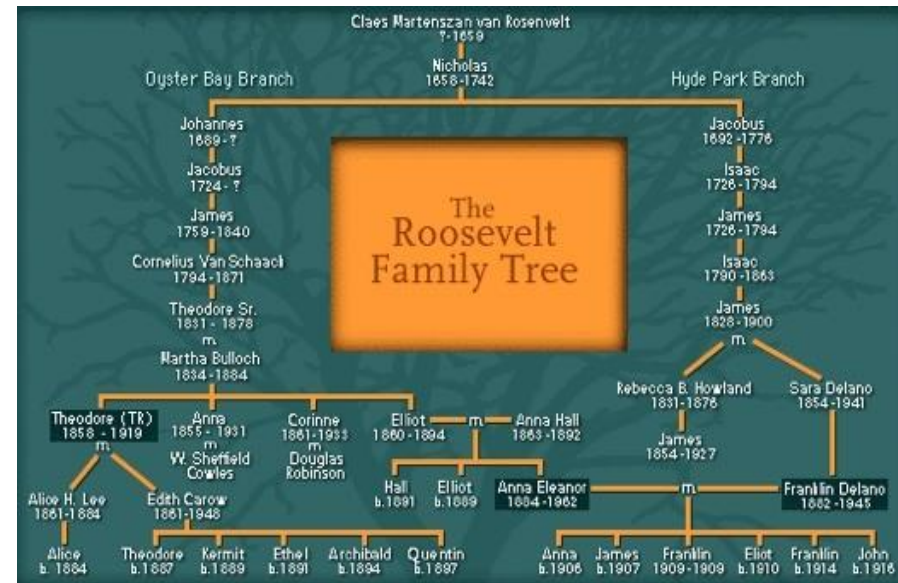


To be honest, the only thing that's keeping you alive is the thought of your cousins taking over the running of your business.



Common (Attempted) Cures to the Challenges

1. Cultivate Advisory Board and other Outside Advisors
2. Supplement talent with non-family management
3. The Hyde Park Roosevelts buy-out the Oyster Bay Roosevelts
4. Adopt (and adhere to) Family “Constitutions” – often includes a mission statement, rules around joining the family business, etc.
5. ESOPs
6. Voting trusts; estate planning trusts
7. Sell to a third party



What Does it Mean to Entertain a Sale?

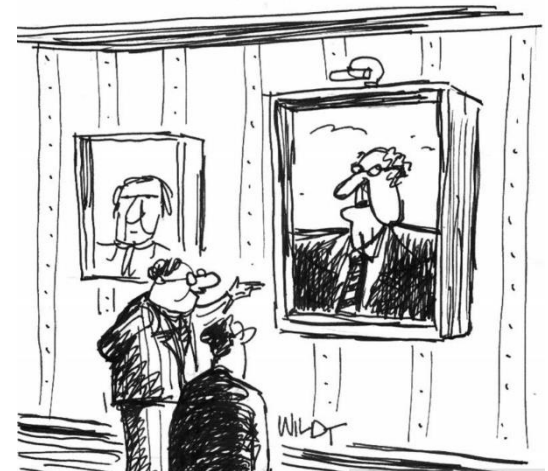


"That's a great question. Come to think of it, I'm not sure what it is I'm trying to sell you."

What Does it Mean to Entertain a Sale?

1. Market Conditions
2. Valuation
3. Timing
4. Confidentiality Considerations
5. Cost

"The company's founder was a man of few words, but apparently 'buy' and 'sell' were all he needed."



Market Conditions



The End

Market Conditions

- A seller-favorable and robust seller's market from approx. 2012-March 2020



Market Conditions (cont'd)

- Now?



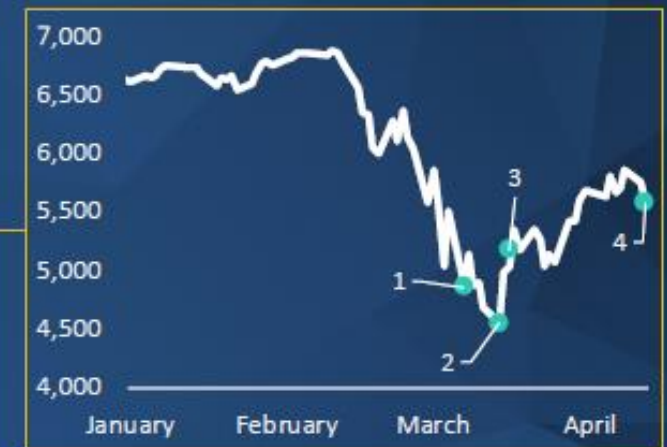
Market Conditions

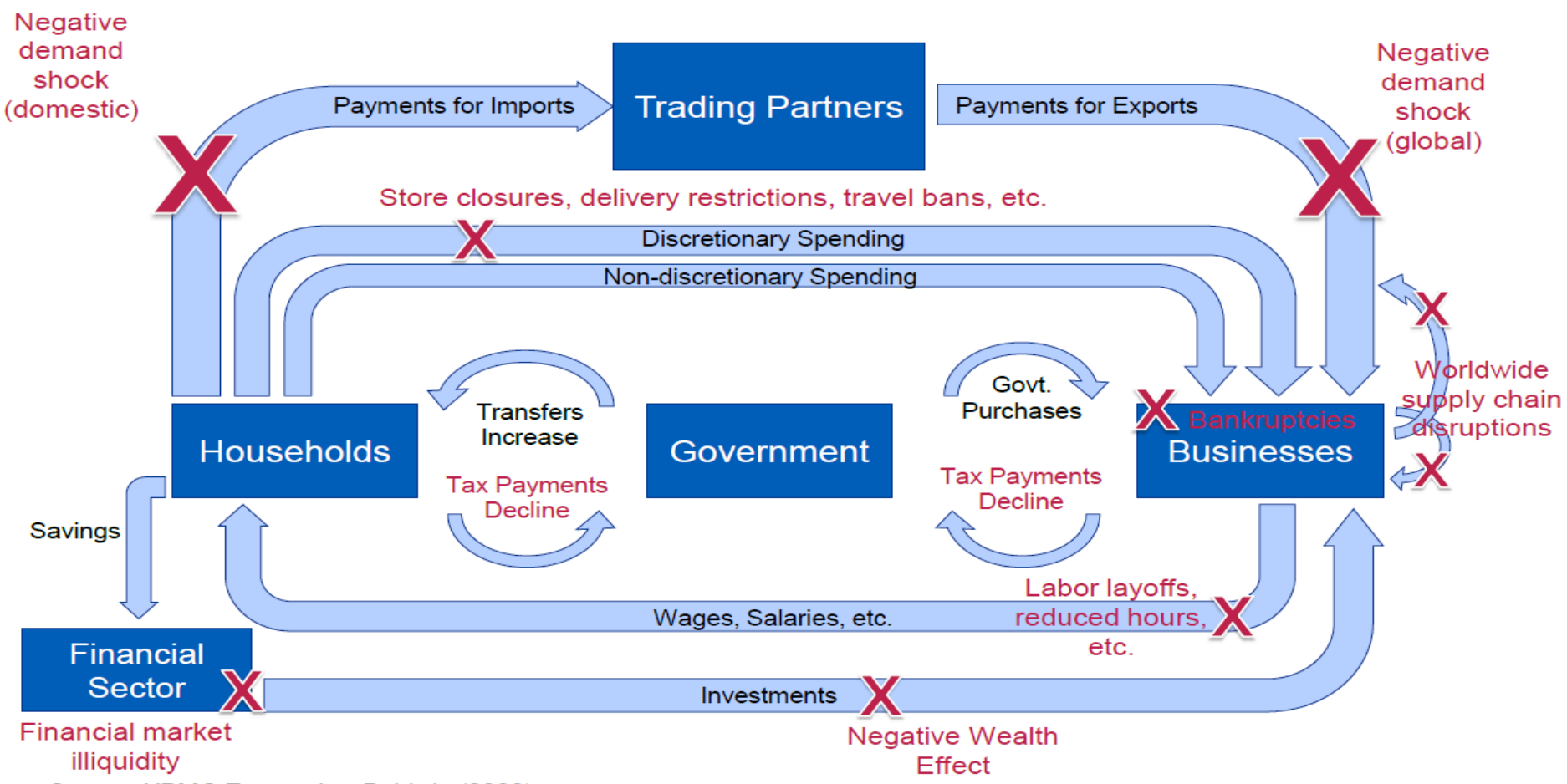
US public markets

S&P 500 TR index fell 55.5% from 2007-2009. The index was down 19% from February 19 to April 21, 2020. Early government intervention has eased some fears, for now.



1. 3/15/20 - Fed cuts rate target to 0%; pledges \$700B in asset purchases
2. 3/23/20 - Fed announces unlimited QE
3. 3/25/20 - Senate approves \$2T stimulus package
4. 4/21/20 - Senate approves \$480B extra stimulus





Source: KPMG Economics, Baldwin (2020)

Market Conditions

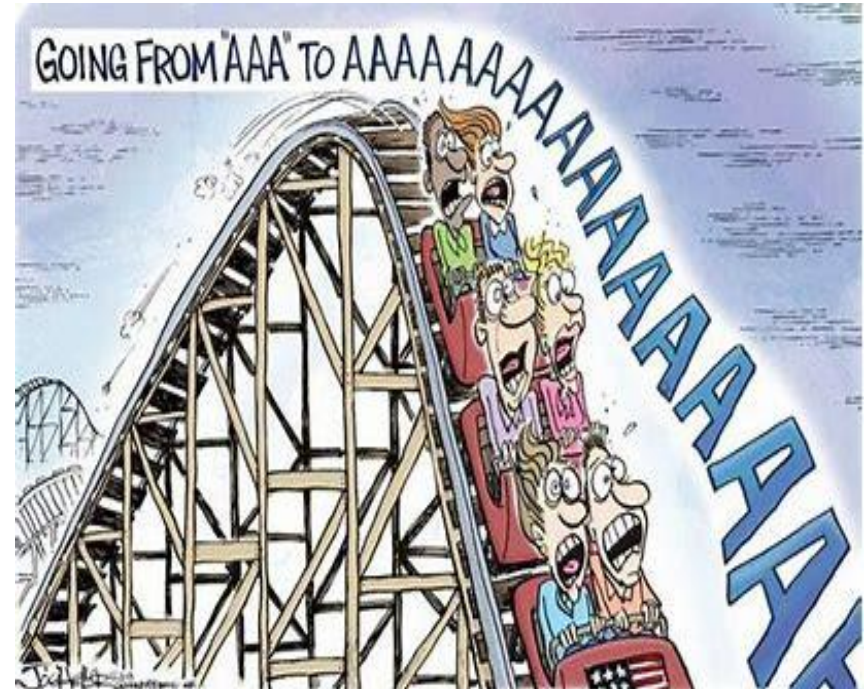
Market Conditions

Exit activity falls precipitously during periods of market uncertainty, as valuations are in flux and company growth trajectories are difficult to assess...



Market Conditions

1. Reduced activity
2. Strategic buyers
3. International buyers
4. PEGs
5. Troubled deals
6. Seller participation
 - Lower multiples
 - Seller paper
 - Earnouts
7. ESOPs



Valuation

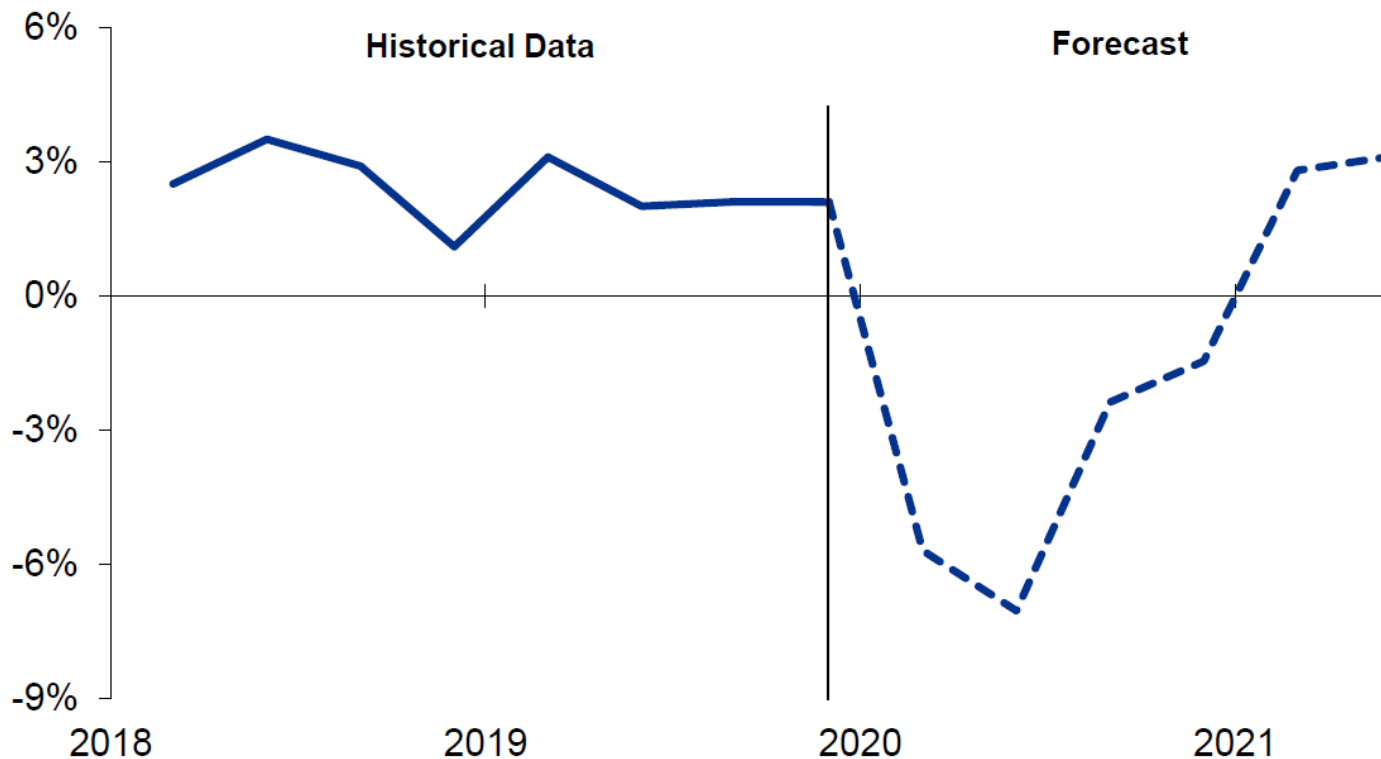
Bridging owner's concept of business value with market realities



Timing

Real GDP

% Change, Annual Rate



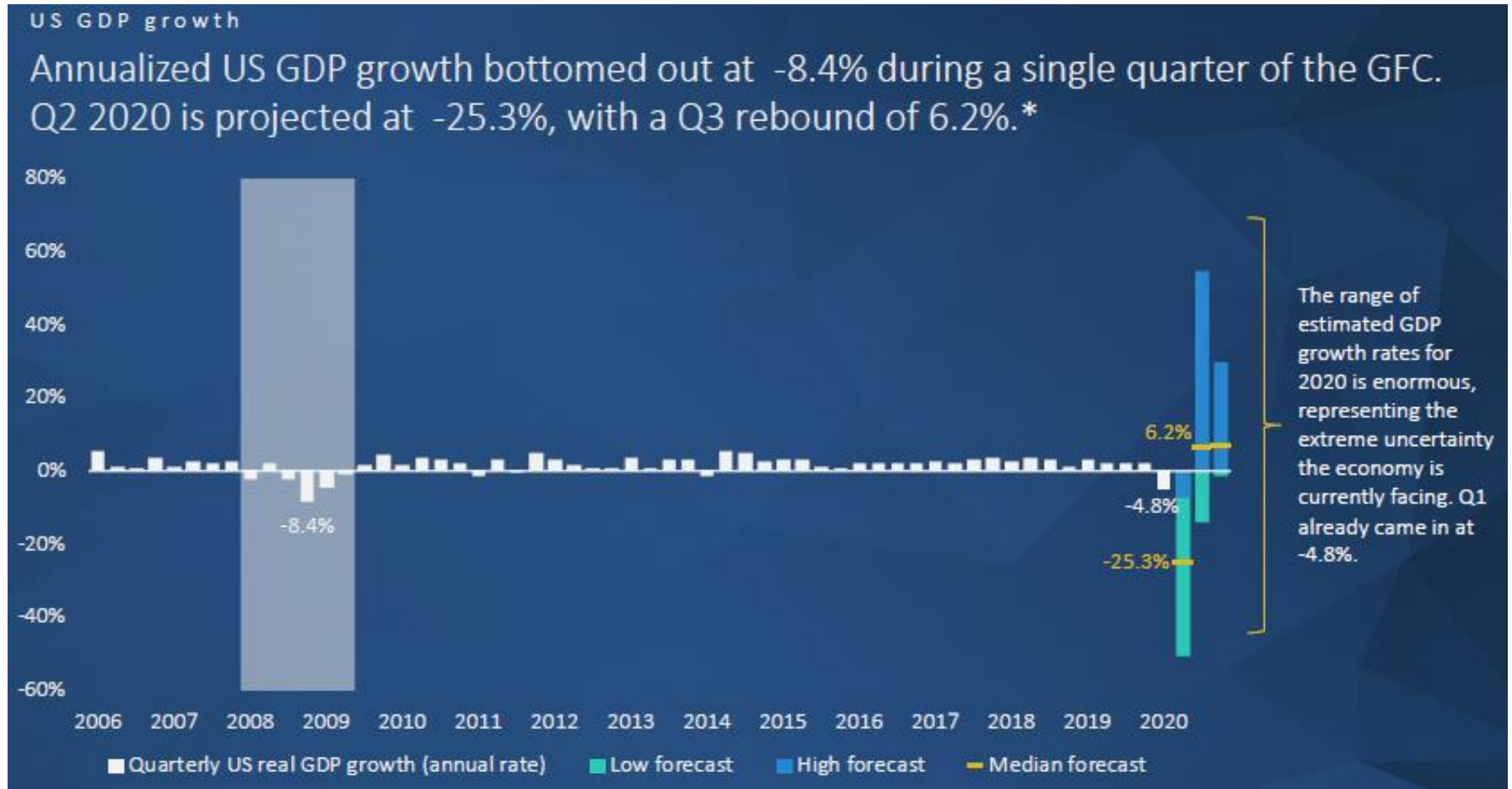
Note: Forecasts are inherently time sensitive and projections are dated as of March 31, 2020.

Source: KPMG Economics, BEA, Macroeconomic Advisors by IHS Markit, Haver Analytics, Eichenbaum, et al., 2020



© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

Timing



Timing



Timing

- Timing
 - M&A activity and valuation premiums/discounts run in cycles
 - “Strong” businesses usually sell in any market
 - Consider specific industries
 - Businesses stumble; competition increases
 - Things change
 - “It’s a Balancing Act”
 - Personal and family goals of the seller



Confidentiality Considerations

- Confidentiality
 - NDAs



“Upset at you for breaching the non-compete? Of course not.”



Cost



Cost

Estate Planning Opportunities – Is it Too Late?

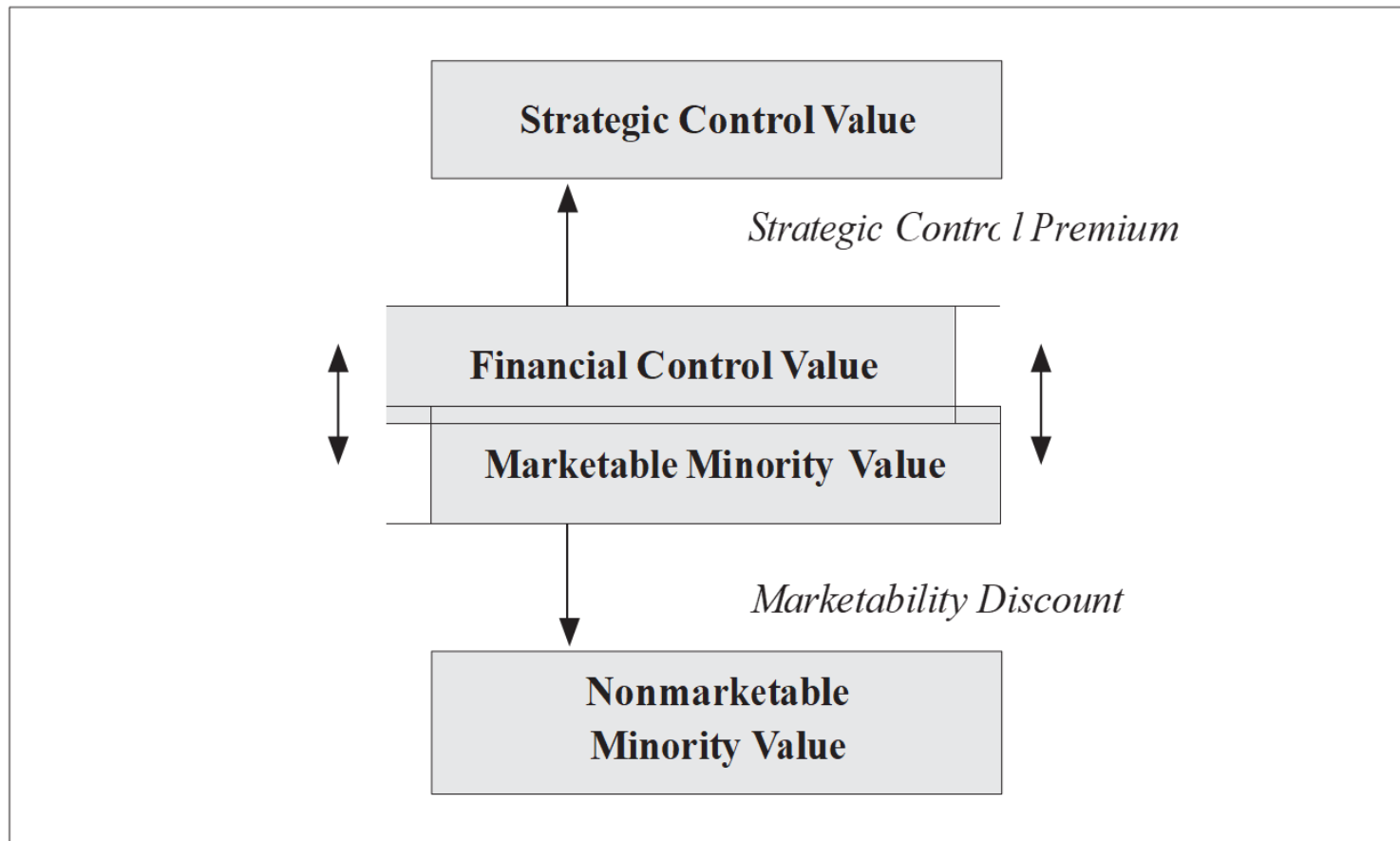
Favorable Planning Environment

- Depressed Valuations due to COVID-19 economic fallout
- Historically Low Applicable Federal Rates
 - Short Term .25%
 - Mid Term .58%
 - Long Term 1.15%
- Historically Large Gift Exemption that sunsets 1/1/26
 - 2020 exemption is \$11.58 million

Estate Planning Opportunities – Is it Too Late?

Valuation Discounts and Subsequent Events

Levels of Value



Estate Planning Opportunities – Is it Too Late?

Valuation Discounts

- **Minority Interest**
 - A minority interest discount reflects the fact that an interest in an enterprise is worth less when, either by operation of law or because of the terms of an agreement, the holder of the interest does not possess all of the requisite elements of control, including the sharing in profits and losses; managing and controlling assets; being paid salary; admitting new participants; withdrawing from the entity; assigning the interest; dissolving the entity; instituting legal proceedings to resolve conflicts among participants; controlling day-to-day or long-range managerial decisions; affecting future earnings; controlling efforts for growth potential; establishing executive compensation; compelling a liquidation to reach entity assets; demanding full and timely financial information; and pledging an interest in the entity for a loan.
- **Lack of Marketability**
 - A Discount for Lack of Marketability (DLOM) is “an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.” Given two identical business interests, a higher price will be paid by investors in the market for the business interest that can be converted to cash most rapidly, without risk of loss in value. A primary concern driving this price reduction is that, over the uncertain time frame required to complete the sale, the final sale price becomes less certain and with it a decline in value is quite possible. Accordingly, a prudent buyer would want a discount for acquiring such an interest to protect against value loss in a future sale scenario. – **Discount for Lack of Marketability, Job Aid for IRS Valuation Professionals**, www.irs.gov/Businesses/Valuation-of-Assets
 - **DLOM applied after any discount for minority interest.**

Valuation Opportunities – Is it Too Late? Subsequent Events

- How do post-transaction events impact the value of the subject asset?
- Subsequent events in hindsight appear appropriate to the value as of the valuation date in applying the willing buyer/willing seller valuation standard.
 - Post-transaction sale, merger, or business announcement.
 - How are post valuation events included and weighted?
- Chief Counsel Advice 201939002
 - IRS concluded that in valuing a gift of publicly traded stock to a GRAT, the announcement of a merger shortly after the gift must be factored into the valuation.

Valuation Opportunities – Is it Too Late?

- IRS Rationale:

- In applying the willing buyer and willing seller standard for valuation, a willing buyer and seller are presumed to have reasonable knowledge of relevant facts affecting the value of the property at issue, even if the facts are unknown to the actual owner.
- Both parties are presumed to have made a reasonable investigation of the relevant facts, including those facts that a reasonable buyer or seller would uncover during the course of negotiations over the purchase price of the property. Moreover, a hypothetical willing buyer is presumed to be “reasonably informed” and “prudent” and to have asked the hypothetical willing seller for information that is not publicly available.
- While publicly traded stock is generally valued based on the average of the highest and lowest selling price on the day of the transfer, if such prices do not represent the fair market value then a modification of the value is required.

Valuation Opportunities – Is it Too Late?

- IRS Cites Case Precedent:
 - Silverman v. Commissioner, T.C. Memo. 1974-285, aff'd, 538 F.2d 927 (2d Cir. 1976), cert. denied, 431 U.S. 938 (1977), the petitioners gifted shares of preferred stock while in the process of reorganizing with the intent to go public. The Tax Court rejected the expert testimony presented by the petitioners because the expert failed to take into account the circumstances of the future public sale.
 - Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999), aff'g 108 T.C. 244 (1997), transfer of shares was undertaken in stock of a corporation after an investment firm had located a purchaser for the corporation, a merger agreement had been entered into, and a tender offer was underway. The court concluded that the shares were transferred after the shares had ripened from an interest in a viable corporation into a fixed right to receive cash and the merger was “practically certain” to go through, and therefore applied the assignment of income doctrine to tax the transferor on the gain from the tender offer exchange that occurred after the transfer.

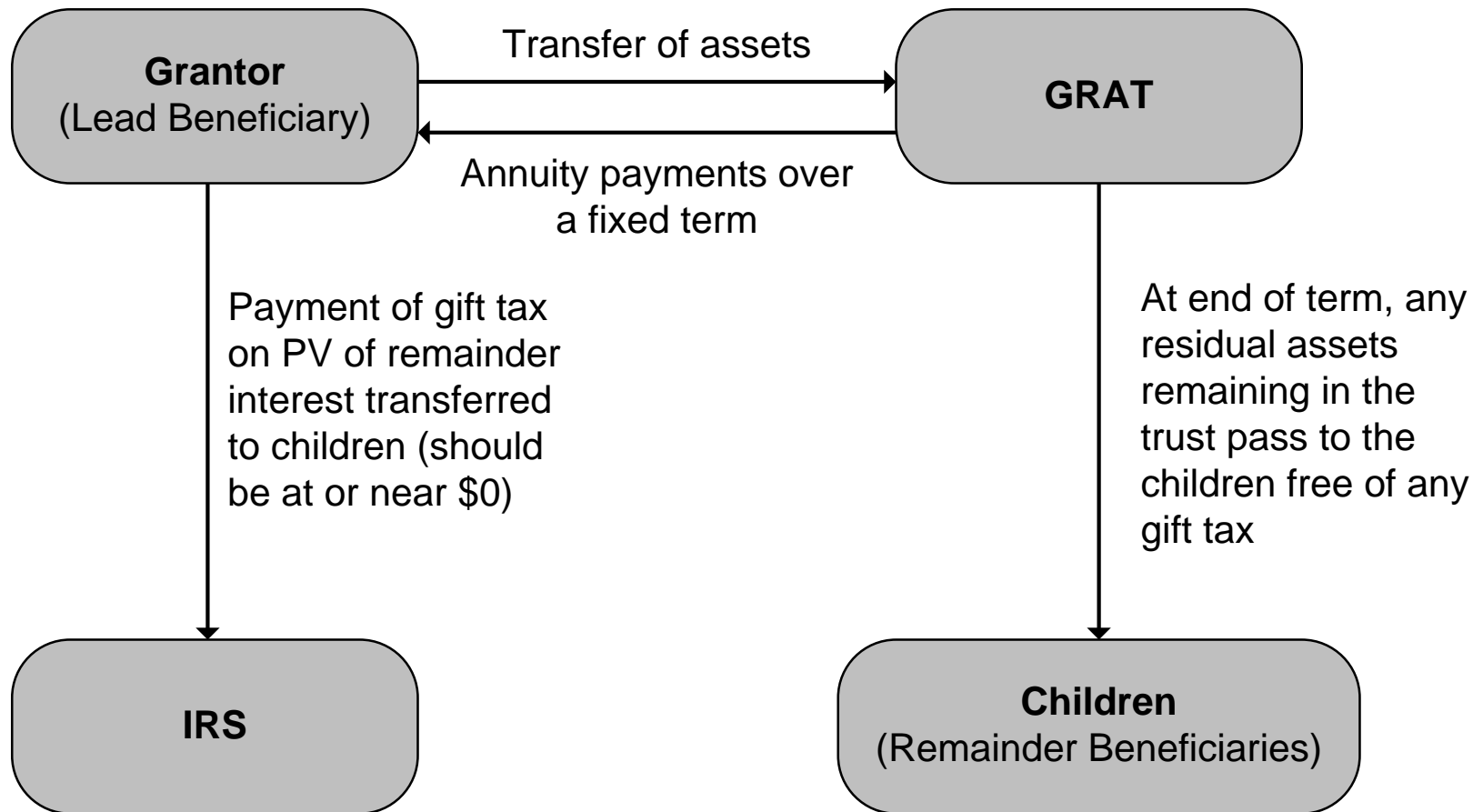
Valuation Opportunities – Is it Too Late?

- Planning to Avoid Result in CCA 201939002
 - CCA does not specify the time period between the valuation and the merger announcement.
 - Start Early!
- The most critical element is time. The longer the time between the valuation date and a subsequent transaction, the greater the risk the transaction will not close. Ideally, valuation is performed prior to:
 - Formalizing any “book”
 - Term sheet
 - Transaction Agreement
 - Contingencies in the Transaction Agreement

Estate Planning Opportunities – Grantor Retained Annuity Trust (GRAT)

- Split-interest trust
- Grantor retains an annuity interest for a term of years.
- Assets remaining at the end of the annuity term pass to the remainder beneficiaries, typically the grantor's children.
- Taxable gift is the value of the property transferred to the trust less the present value of the lead annuity interest retained by the grantor.
- Value of the annuity interest can be set equal to the full value of the property transferred – a “zeroed-out GRAT” resulting in no taxable gift.
- Grantors may desire to create a GRAT with a minimal taxable gift to start the statute of limitations and to avoid a possible argument that the GRAT has no substance because the grantor didn't transfer any value.

Estate Planning Opportunities – Grantor Retained Annuity Trust (GRAT)



Grantor Retained Annuity Trust (GRAT) – Planning with GRATS

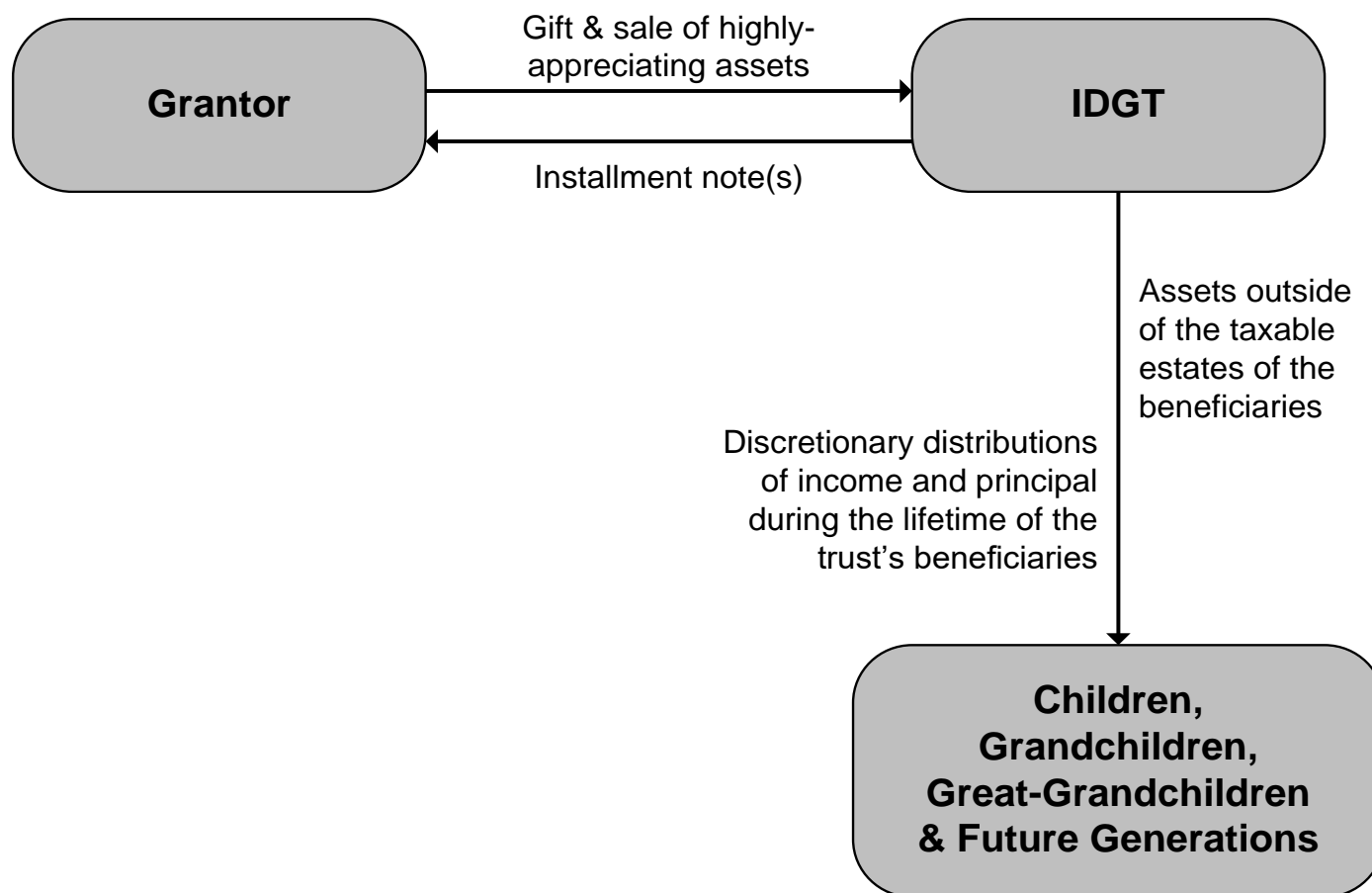
- Interest Rate arbitrage
 - If GRAT assets produce a return in excess of the IRC § 7520 rate, property remaining in the GRAT at the end of its term transferred tax-free to the remainder beneficiary.
 - GRATs are generally most favorable when the IRC § 7520 rate is low. The lower this rate is, the easier it is for trust returns to exceed it and produce tax-free transfers.
 - Closely owned business interests valued with appropriate discounts (nonmarketable minority interest) capable of high appreciation will maximize arbitrage.
- Grantor must survive the term of the trust.
 - If the grantor dies prematurely, the full value of the trust assets are generally included in the grantor's estate.
 - Mitigate mortality risk by creating cascading short term GRATs.

Estate Planning Opportunities – Sale to Grantor Trust (IDGT)

- Sales to an intentionally defective grantor trust (IDGT) are completed transfers for gift and estate tax purposes, but are ignored for income tax purposes. Grantor is taxed on all trust income, but the transferred assets are removed from the grantor's estate.
- IDGT Mechanics:
 - Grantor creates an irrevocable trust for the benefit of his or her descendants.
 - Grantor “seeds” the trust by gifting assets having at least one-ninth the value of the assets to be sold to the trust to avoid the argument that the grantor has retained an income interest in the trust assets under IRC § 2036.
 - Grantor allocates generation-skipping transfer tax (GSTT) exemption to the trust to cover the amount of the seed money gift.
 - Grantor sells assets to the trust that are expected to increase rapidly in value and receives an installment note in exchange.
 - Equity sale price is equal to the full fair market value of the property sold – no taxable gift on the sale.
 - Valuation discounts may reduce the selling price.
 - The interest rate is equal to the AFR tied to the maturity date of the note.

Estate Planning Opportunities – Sale to Grantor Trust (IDGT)

- Diagram of Sale to IDGT:



Estate Planning Opportunities – Sale to Grantor Trust (IDGT)

- Sale to IDGT – Risks
 - No tax basis step up for any appreciation between the sale date and the grantor's date of death. Advisor must assess value of loss of basis step up against estate tax exposure.
 - If the sale is not properly structured, it could be treated as a gift with a retained income interest under IRC § 2036.
 - Note must be a bona fide debt
 - Note payments must adhere to note terms
 - Valuation understatement does not qualify for “bona fide sale” exemption of 2036, which can result in a taxable gift
 - Payment of IDGT's income tax by the grantor may create cash flow problem because of grantor obligation to pay tax on IDGT income without receiving cash to pay tax.
 - Possible to avoid this issue by granting the trustee the power to toggle off grantor trust status.

Estate Planning Opportunities – Charitable Opportunities

- **Charitable Remainder Trusts**

- Split interest trust with one or more individuals having a beneficial interest in the trust prior to its termination, with one or more charities receiving the remainder interest in the trust, and with the donor receiving an income or estate tax charitable deduction for a portion of the value of the property transferred to the trust.
 - **CRAT** is a charitable remainder trust in which the noncharitable beneficiary receives at least annually an annuity interest in the property transferred in trust remaining balance of the trust passes to charity at the end of the annuity interest.
 - Noncharitable annuity interest must be stated as a sum certain or as a fraction or percentage of the net fair market value (“FMV”) of the property transferred to the trust.
 - **CRUT** is a charitable remainder trust in that the noncharitable beneficiary receives at least annually a fixed percentage of the net FMV of the trust assets, as valued annually.
- Low interest rate environment (low 7520 rate) disfavors CRT’s

Estate Planning Opportunities – Charitable Opportunities

- **Charitable Lead Trust**

- Split interest trust with an income interest paid to one or more charitable beneficiaries, and the remainder interest either reverting to grantor or paid to one or more noncharitable beneficiaries at the termination of the trust.
- Low interest rate environment (low 7520 rate) favors CLT's, because it lowers valuation of remainder interest, reducing taxable portion of any gift.

Properly Preparing the Business for Sale

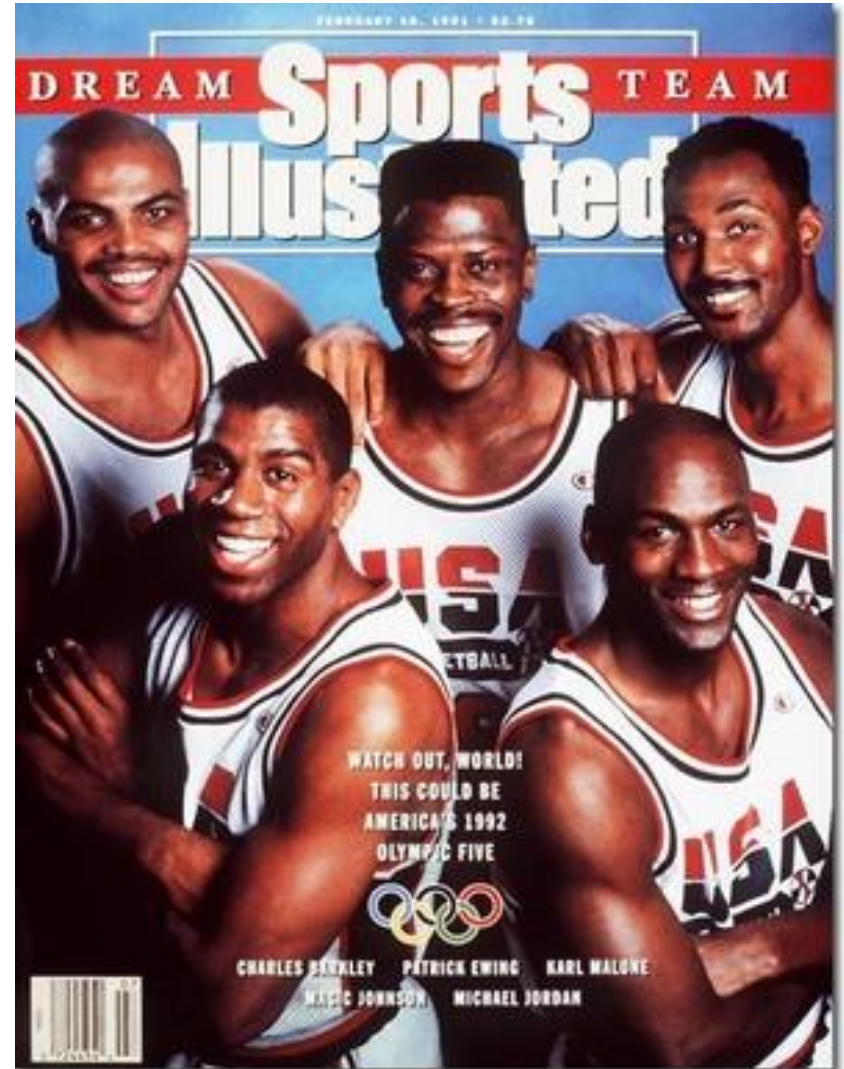
1. Team
2. Adjusted EBITDA
3. Housekeeping Matters



"Heck, no, I'm not thinking of leaving. That said, I do feel it's probably wise to have an exit strategy in place."

Team: Assembling a “Dream Team”

- Deal Lawyer
- Investment Banker
- Accountant
- Key Management



Deal Lawyer

- More than a lawyer, a business advisor
- Finds solutions, not obstacles
 - “Thinks outside the box”
 - Creative
- Practical, business approach
 - Willing to devote the time to understand the client’s goals
 - Willing to devote the time to understand the client’s business and industry
 - Listens well and asks good questions
- Judgment

Deal Lawyer

- “Hands-on approach”
- Personality
- Competence and Expertise
- Experienced in the particular areas needed
- Reputation
- Capacity
- Fee sensitivity
- Relationships with other professionals
 - Works well in teams

Investment Banker

- Exclusive financial advisor to buyer or seller throughout the process
- **Makes a market**
- Prepares all offering documents/memoranda
- Designs and implements process to solicit, coordinate and evaluate proposals from all appropriate parties (buyers, sellers and financing sources)
- Performs financial and strategic analysis necessary to facilitate the proper and timely integration of financial, tax and merger and acquisition aspects of any transaction
- Seeks to maximize results, not just \$\$\$

Investment Banker

- Negotiates transactions
- Assists with documentation and closing
- Works closely with client's other advisors (legal and accounting) in consummating the transaction
- Ensures maintenance of confidentiality
- "Navigate through the morass"
- Buffers management and ownership to allow them to continue to run their business throughout the process

Accountant

- Quality of Earnings Report (“QofE”)
 - Determine the add-backs to earnings so the transaction price will be higher
 - Find and fix accounting issues in advance before buyers do
 - Helps to promote an efficient transaction
 - Control the process
 - Establish working capital target
 - Credibility and support

Key Management

- A sale is a second job
- Locking down key management, who may not have robust equity incentives
- Post-closing life for them



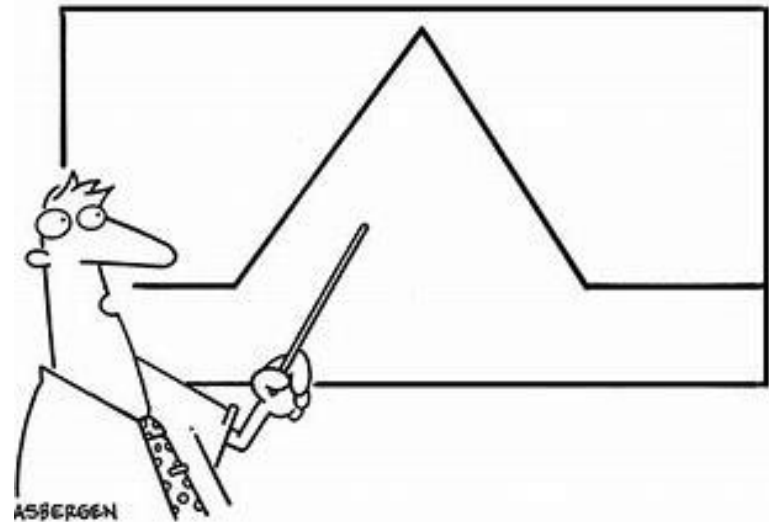
Adjusted EBITDA

- Common adjustments to EBITDA
 - Owner compensation
 - Other benefits and perquisites
 - Adding expense for underinvestment in IT, CFO function, etc.
- QofE
 - GAAP vs. Seller's historical financial accounting practices
 - Working capital sensitivities
 - Inventory and timing differences

Properly Preparing the Business for Sale

Housekeeping Matters

dy Glasbergen / glasbergen.com



"When preparation and opportunity collide, it causes a seismic upheaval and that's how mountains of money are made!"

Housekeeping Matters



“Right, moving on to the housekeeping...”

Housekeeping Matters

- Financial Statements (including whether audited financial statements are appropriate for current fiscal year)
 - QofE
 - Working capital adjustment and typical soft-spots
 - Impact on RWI underwriting
- Organizational Records
 - S-Corp
 - Stock Records
 - Articles
 - By-laws
 - LLC agreements
 - Shareholder agreements

The Overlooked LOI

1. Offers the ability to look-forward and avoid missteps which cost time, money and other opportunities
2. May be a once-in-a-lifetime transaction for client
3. Common misconceptions and missteps

❖ An LOI will “Just bog things down”

“Everyone’s getting along so well”

“This is such a favorable deal, we don’t want to do anything that might ‘rock the boat’”

“Let’s just go straight to the definitive agreements”

“Let’s lock everyone in a room to hammer this out”



“Just to get the negotiation off on the right foot, I don’t intend to concede anything.”

The Overlooked LOI (contd)



- ❖ A one-off sale with no “sanity check” on valuation
 - The country club or peer group valuation
 - Value-add of an investment banker or other financial advisor
 - Protect against oversharing with buyer, overpreparing and pride
- ❖ Not specifying structure of the sale – and tax implications to seller, e.g. dual taxation, ordinary income recapture, etc.
- ❖ Overlooking the finer details around payment mechanisms other than cash at the closing – issues to consider with use of seller notes and buyer equity
 - Seller Notes:
 - Subordinated?
 - Senior to some (e.g., buyer distributions on equity or management fees if in default)
 - Secured and/or guaranteed?
 - Appropriately priced?
 - Adequate cross-defaults?

The Overlooked LOI

- Buyer Equity:
 - Pari passu* with buyer's equity?
 - Pre- or post- transaction %
 - Preemptive rights?
 - Veto on insider dealing, etc.?
 - Capital calls?
 - Tag-along rights?
 - Ability to be dragged into non-price terms
 - Sufficient buyer reps/warranties *and* diligence?
- ❖ Punting on the \$\$, duration and / or exclusiveness of escrows, holdbacks and set-off
- ❖ Ability to insist upon RWI as buyer's sole (or primary) source of recovery
- ❖ Failure to parallel track the negotiation of management's post-closing terms – avoiding future tri-party negotiations
 - On the whole, family-owned businesses tend to underweight equity incentives in executive compensation
 - This can result in a buyer emphasis on retention and stay bonus agreements
 - Consider deductibility of the compensation deduction and noncompetes
- ❖ Underestimating buyer's NWC benchmark expectations

Earnouts: Resurgent?

1. Consideration in an M&A transaction payable to seller which is contingent upon the future performance of the target business and/or based on the achievement of certain milestones
2. Utilization of earnouts tends to track economic cycles ... the transition between a bull and bear market – expectations have not been reset
3. Generally structured as payment(s) contingent on satisfying future milestones, such as:
 - ❖ Financial: EBITDA, Revenue, Net Income
 - ❖ Non-Financial: Regulatory Approval, Increase in New Customers



Earnouts: Resurgent?

- ❖ Revenue-based metrics are less risky than earnings-based metrics
 - But see competing divisions within buyer
 - See also timing differences for the “sale”
 - If earnings-based:
 - ❑ Can buyer “Cadillac” post-closing IT, facilities, etc.?
 - ❑ How will buyer allocate common overhead?
- ❖ Require target business to operate in the ordinary course (keep key management)
- ❖ Subordinated i.e. equivalent to buyer debt?
- ❖ Seller information rights
- ❖ Acceleration or minimum payout events:
 - Change in management
 - Subsequent change of control
- ❖ Buyer’s obligation to seek to “maximize the earnout”
- ❖ Buyer should face some risk (default interest?) for obfuscation

Rollovers and Re-investments

1. Buyers may require that sellers have some “skin in the game” in the form of equity in the go-forward business, either because buyer needs the **financing help** and/or seeks to **incentivize** seller to keep active
2. “Rollover” is often used interchangeably, but seller should understand whether the equity retained will be taxable or seller will be able to carry-over basis to the new security
3. The retained equity is likely a new security for federal and state securities law purposes
4. See slide ____ above with respect to negotiation points for the go-forward shareholders or operating agreement

Key Tax Issues

Entity Structures and Related Taxation

- The federal income tax status of the business entity will affect the tax consequences associated with the sale of the business.
 - “C” Corporation: Separate taxpayer. Taxable income is taxed at a flat rate of 21%. Distributions of dividends to “C” corporation shareholder are taxed at a rate of up to 20%.
 - “S” Corporation: Income or loss is allocated to the shareholders in accordance with their ownership percentages. Taxable income of “S” corporation taxed to owners at owner’s marginal rate, which for individuals is up to 37% before any QBI deduction.
 - LLC: Income or loss is allocated to the owners of the LLC in accordance with the LLC/Operating agreement, which is respected so long as the allocation has “substantial economic effect” in accordance with Code Section 704(c). Taxable income of LLC is taxed to owners at owner’s marginal rate, which for individuals is up to 37% before any QBI deduction.

Overview of Sale Consequences by Entity

	<u>"C" Corporation</u>	<u>"S" Corporation</u>	<u>Limited Liability Company</u>
Sale of Property	Corporation recognizes gain or loss.	Gain or loss allocated to shareholder; gain increases shareholder's stock basis.	Gain or loss allocated to members. Gain increases member's basis in membership interest.
Distribution of property from entity	Gain or loss recognized by corporation based upon difference between fair market value and basis to the corporation.	Gain or loss allocated to shareholder based upon difference between fair market value and basis to the corporation.	No gain or loss recognized to extent Owner has basis in the asset, subject to exceptions for "hot assets."
Sale of Equity	Generally Capital gain or loss.	Generally capital gain or loss	Ordinary income allocable to unrealized receivables and inventory is ordinary income; remaining gain or loss is generally capital gain or loss.
Distribution of property to owner	Gain or loss recognized by shareholder based upon difference between fair market value of property received and basis of stock owned by shareholder.	Generally no gain or loss recognized because gain or loss allocated on the corporate distribution increases the shareholder's basis in his or her stock.	No gain or loss recognized to extent Owner has basis in the asset, subject to exceptions for "hot assets."

Key Tax Issues

Entity Structures and Related Taxation

- Tax Benefit to one party usually imposes corresponding tax burden on other party
 - Sale of equity
 - Beneficial capital gains treatment to Seller
 - Nondeductible capital transaction for Buyer
 - Sale of Assets
 - Ordinary income treatment on certain asset classes to Seller and potential “double tax” if seller is a “C” corporation
 - Buyer can amortize the purchase price among the various asset classes
- Payments to individual owner for consulting services and non-compete agreements may bridge gap between buyer and seller expectations
- Buyer and Seller need to work together to produce most efficient overall tax structure for transaction
 - One party may be indifferent to tax treatment that will benefit other party
 - Section 338(h)(10) election
 - 2017 Tax Cut and Jobs Act (“2017 Act”) permits full expensing of assets, acquired in an asset acquisition, further enhancing the attractiveness of asset purchase for Buyer.

Key Tax Issues

Form of Transaction

Taxable Purchase of Equity vs. Assets

- What is the Buyer Purchasing?
 - Shares of stock
 - LLC units or membership interest(s)
 - Assets
- How is the Buyer paying the Purchase Price
 - Cash
 - Installment note
 - Buyer's equity interests
 - Assumption of liabilities

Asset Sales

“C” Corporation Tax Issues

- The “Double Tax”
 - Tax Reform Act of 1986 Repealed “General Utilities” and ability of corporations to distribute assets in liquidation without recognizing gain.
 - “C” corporations and certain “S” corporation owners are subject to two levels of income tax if the corporation sells its assets.
 - “C” Corporation is a taxpayer, so it pays taxes on the difference between the purchase price allocated to particular assets and the tax basis of those assets.
 - When the corporation liquidates and distributes proceeds to shareholder, shareholder pays tax based upon the difference between the proceeds and the tax basis of the shareholder in his or her shares.
 - 2017 Tax Act reduced corporate tax rate to 21%, softening impact of “double tax.”

“C” Corporation Tax Issues Mitigating the “Double Tax”

- Stock Sale
 - Seller obtains more favorable tax treatment
 - Buyer, however, prefers asset purchases:
 - Buyer can designate purchased assets and assumed and excluded liabilities
 - Buyer cannot amortize the purchase price of the shares
 - Buyer's after-tax cost of the transaction increases; lost tax benefit equal to the buyer's tax rate multiplied amortization of purchase price discounted to present value.

Mitigating the “Double Tax”

- Allocate purchase price outside the corporate solution
 - Covenants Not to Compete
 - Consulting Agreement
 - Sale of Personal Goodwill

“S” Corporation and LLC Tax Issues – Asset Sales

- “S” Corporation structure generally exposes shareholder to one level of tax.
 - An "S" Corporation that sells its assets will recognize gain with a character based upon the nature of the assets sold (either ordinary income or capital gain) and measured based upon the difference between the purchase price allocable to the particular asset and the "S" Corporation's basis in the asset.
 - The "S" Corporation shareholder does not recognize a second level of tax like his "C" Corporation counterpart, because the "S" Corporation shareholder increases his or her basis in his or her shares by the amount of gain recognized by the "S" Corporation on the sale of the assets.
- LLC Structure
 - LLC is not the taxpayer
 - The LLC member taxpayer recognizes only one level of tax upon the sale and distribution of the LLC assets, as the partnership provisions of the Code govern the sale and distributions.
 - Perhaps the most “tax efficient” because there is only one level of tax and certain events that would be taxable events in an “S” corporation taxation regime are not taxable events in an LLC structure.

“S” Corporation Tax Issues – Built In Gains Tax

- Code Section 1374 imposes a corporate level income tax upon an “S” corporation appreciation in the value of its assets for the period it was a “C” corporation if the “S” corporation converted to “S” status less than five years prior to the date the asset was sold.
 - Gain on the disposal of assets is the unrealized gain on each asset as of the date of the “S” election
 - Amount that would be realized if, at the beginning of the first day of the “S” election, the corporation had remained a “C” corporation and sold its assets at fair market value to a third party (including any assumed debt), less the aggregate adjusted basis of the assets
 - Rate of tax is the highest corporate level rate (currently 21%)
 - Emphasizes the importance of a proper appraisal at the time of the “S” election for an existing “C” corporation.

“S” Corporation Tax Issues – Tax Elections

- A seller generally prefers to structure an acquisition as a stock acquisition because the buyer assumes all liabilities of the target company as a matter of law in a stock acquisition (whereas the seller is left with known and unknown liabilities of the target company not assumed by the buyer in an asset acquisition). Asset acquisitions are also often more complicated and time consuming than stock acquisitions. However, a buyer often prefers to structure an acquisition as an asset acquisition if it would receive a stepped-up basis in the target company's assets. Therefore, the seller may insist that the acquisition is structured as a stock acquisition, but the buyer may want to make a tax election to treat the stock acquisition as an asset acquisition for US federal income tax purposes. The availability of this tax election depends on a variety of factors.
- For certain transactions, a tax election can be made to treat a stock acquisition as an asset acquisition for US federal income tax purposes.

“S” Corporation Tax Issues- Tax Elections – 336(e) Election

- Code Section that permits buyer and seller to characterize a stock purchase as an asset purchase for federal income tax purposes.
- Requirements
 - Election made jointly by target and seller; can be made without Buyer's consent
 - Target must be a domestic corporation or an “S” corporation
 - If parties elect, the transaction is characterized as a sale of assets, and treated as if seller corporation transferred all of its assets and liabilities to purchaser, which in turn allocates the purchase price among the transferred assets.
- Motivations for Election
 - Seller may have contracts that would otherwise need to be assigned (leases)
 - Seller licenses and permits remain in place
 - Buyer desire to amortize purchase price
- Use in private company transactions
 - Primarily used when seller shareholder owns an “S” corporation
 - Seller usually requires a tax “gross up” in order to agree to making election.

“S” Corporation Tax Issues

Section 336(e), 338(h)(10) Election

- Example of Election language in Stock Purchase Agreement:
 - 5.7 Tax Elections. Unless the Purchaser elects otherwise in writing, the Seller shall join with the Purchaser in making (i) an election under Section 338(h)(10) of the Code (and any corresponding elections under state, county, local, foreign or other Tax Laws) (collectively, a “Code Section 338(h)(10) Election”) and (ii) an election under Section 336(e) of the Code (and any corresponding elections under state, county, local, foreign or other Tax Laws) (collectively, a “Code Section 336(e) Election”), in each case, with respect to the purchase and sale of the Shares pursuant to this Agreement (together, the “Tax Elections”). The Purchaser and the Seller shall cooperate in the preparation and execution of all the Tax Returns (including IRS Form 8023) required to make the Tax Elections and shall take such other steps that are necessary to effect the Tax Elections. The Seller shall include any income, gain, loss or deduction of the Tax item resulting from the Tax Elections on its Tax Returns to the extent required by applicable Law. Neither the Purchaser nor the Seller shall take any position contrary to the Tax Elections on any Tax Return or in connection with any audit, assessment, claim, action or other Tax proceeding with any Taxing Governmental Entity.

“S” Corporation Tax Issues

Tax Elections - The 338(h)(10) Election

- Code Section that permits buyer and seller to characterize a stock purchase as an asset purchase for federal income tax purposes.
- Requirements
 - Election must be made jointly by seller and purchaser
 - Target must be a domestic corporation that is a member of an affiliated or consolidated group, or an “S” corporation
 - If parties elect, the transaction is characterized as a sale of assets, and treated as if seller corporation transferred all of its assets and liabilities to purchaser, which in turn allocates the purchase price among the transferred assets.
- Motivations for Election
 - Seller may have contracts that would otherwise need to be assigned (leases)
 - Seller licenses and permits remain in place
 - Buyer desire to amortize purchase price
- Use in private company transactions
 - Primarily used when seller shareholder owns an “S” corporation
 - Seller usually requires a tax “gross up” in order to agree to making election.

“S” Corporation Tax Issues

Section 338(h)(10) Election

- Example of Election language in Stock Purchase Agreement:

Section 338(h)(10) Election: Sellers and Buyer shall join in making an election under Section 338(h)(10) of the Code (and any corresponding equivalent elections under state or local Law) (a “Section 338(h)(10) Election”) with respect to the purchase and sale of the Shares to treat such purchase and sale as a deemed sale of assets for U.S. federal income Tax and state and/or franchise Tax purposes. Except as otherwise provided herein, Sellers shall include in all relevant Tax calculations and filings any income, gain, loss, deduction, or other Tax item resulting from the Section 338(h)(10) Election, including (a) any Tax imposed under Treasury Regulations Section 1.338(h)(10)-1(d)(2), or (b) any state or local Tax imposed. In connection with the Section 338(h)(10) Election (or as soon thereafter as reasonably practicable), the parties shall file all federal, state, local and other forms necessary to make the Section 338(h)(10) Election jointly and shall make any required filings and take any and all other reasonable actions necessary or appropriate to effect the Section 338(h)(10) Election. Sellers shall include in Sellers’ income Tax Returns for the taxable period, which includes the Closing Date, any forms that are required to be so included on account of the Section 338(h)(10) Election. Sellers and Buyer shall cooperate fully, and in good faith, with each other in making the Section 338(h)(10) Election.

“S” Corporation Tax Issues – Section 338(h)(10) Election

- Example of Tax Gross Up Provision:

The Purchase Price shall include an amount equal to the grossed up excess Tax cost to Sellers (for the avoidance of doubt, excluding any interest, penalties and additions that may be imposed with respect to such amount other than interest, penalties and additions imposed as a result of an act or omission of Buyer) resulting from the Section 338(h)(10) Election and the transactions contemplated by this Agreement being treated as a sale of assets as opposed to a sale of stock for Tax purposes, as determined in the following manner (the “Tax Gross-Up Amount”). The Tax Gross-Up Amount shall equal the product of (x) and (y), with (x) equal to the quotient that results when (i) the amount by which (A) the aggregate amount of U.S. federal, state, local and any other Taxes incurred by Seller with respect to the disposition of its Shares pursuant to this Agreement in the manner specified by the Section 338(h)(10) Election, including (1) any Tax imposed on Seller on amounts paid by Buyer pursuant to this Section 2.6(a), (2) any Section 338(h)(10) Transfer Tax and (3) any Taxes imposed on the Company resulting from the Section 338(h)(10) Election, exceeds (B) the aggregate amount of U.S. federal, state, local and any other Taxes that would have been incurred by Seller with respect to the disposition of its Shares pursuant to the Agreement, assuming that no Section 338(h)(10) Election was made, is divided by (ii) the number of Shares held by Seller and with (y) equal to the total number of Shares. The parties agree that the intention of this Section 2.6(a) is to place the most adversely affected Seller in the same net after-Tax position it would have been in had no Section 338(h)(10) Election been made, while also providing each Seller with the same per share amount pursuant to this Section 2.6(a), and the parties shall calculate the Tax Gross-Up Amount consistent with that intention. Notwithstanding anything to the contrary contained herein, no positive tax attributes of Sellers that are unrelated to the transactions contemplated by this Agreement shall be taken into account in the calculation of the Tax Gross-Up Amount.

Selected LLC Tax Issues

- Explosion in LLC Formation means greater number of LLC's in private M&A transactions
- There is no such thing as "LLC" taxation
- LLC's with more than one member are by default taxed as partnerships for federal income tax purposes
- The sale of LLC "units" is not the same as the sale of stock of a corporation
- LLC's are not "taxed the same as S corporations" unless the LLC has elected to be taxed as an "S" corporation
- LLC "Units" are not stock!
 - Sale can generate ordinary income
 - Section 751
 - Ordinary income treatment for partner's interest attributable to unrealized accounts receivable, which includes depreciation recapture) and inventory

Payment of the Purchase Price – Installment Sales

- Many private transactions include “seller financing”
 - Seller finances a portion (or sometimes all) of the purchase price for the transaction
 - Particularly common in management buyout transactions
- Tax Treatment of installment Sales
 - Section 453(b)(1): “the term installment sale” means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.”

Payment of the Purchase Price – Installment Sales

- Installment Sale Reporting
 - Installment payment to Seller consists of three parts:
 - Nontaxable Recovery of basis
 - Gain on sale
 - Interest
 - Treated as ordinary income; if there is no interest, interest will be imputed (Section 483 and 1274)
 - Avoid the problem of imputed interest by providing for interest at the applicable federal rate (AFR) or greater for the applicable term of the debt
 - Calculation of Gain recognized
 - Installment payments multiplied by the gross profit percentage
 - Gross profit percentage is the ratio that the gross profit bears to the total purchase price

Payment of the Purchase Price – Installment Sales

- Important Exceptions to Installment Sale Treatment
 - Section 1245 and 1250 income recapture
 - Seller must report all “recapture income” in the year of sale; any gain in excess of the recapture income is eligible for installment treatment
 - Section 751 income
 - Ordinary income attributable to the partnership sale of inventory and accounts receivable (also includes depreciation recapture)
 - Dealer Dispositions
 - Disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan
 - Disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer’s trade or business
 - Sales of Depreciable Property to Related Parties

Tax Free Reorganizations

“F” Reorganizations

Proposed Transaction Mechanics (F Reorg)

Step 1

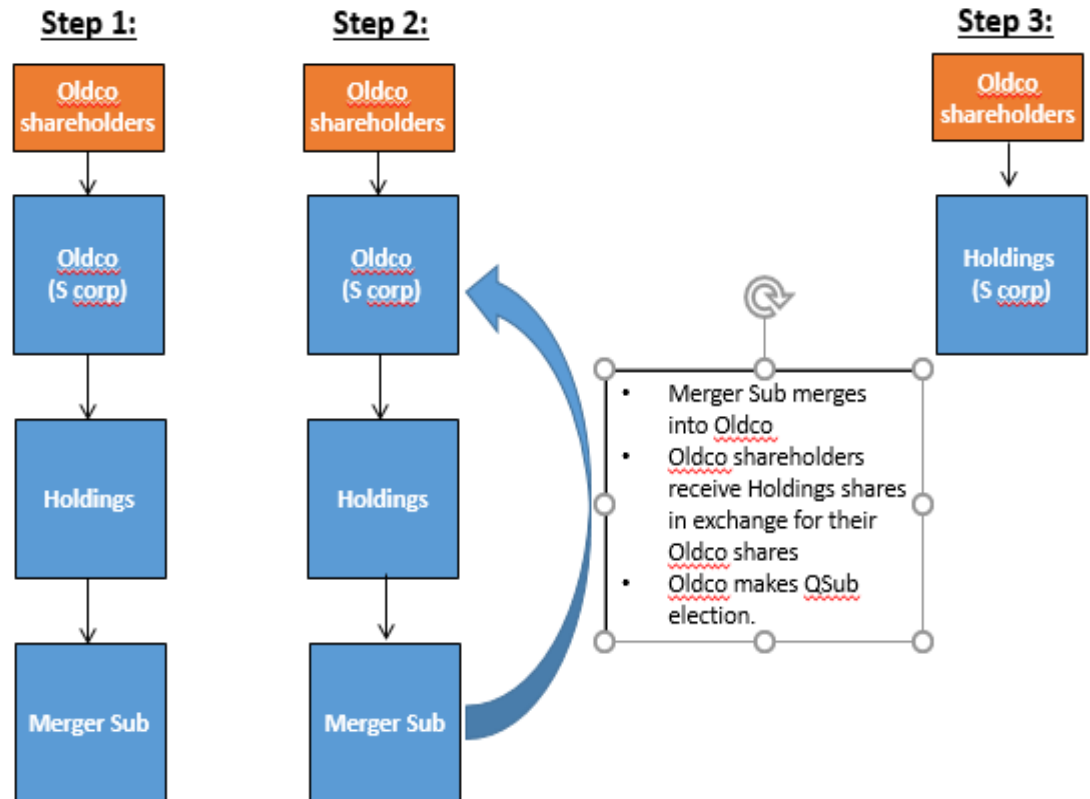
- Oldco, Inc. forms a wholly owned subsidiary, “Holdings”, a corporation, which, in turn, forms a wholly owned subsidiary “Merger Sub”, also a corporation.

Step 2

- Merger Sub merges into Oldco, with Oldco shareholders receiving Holdings shares in exchange for their Oldco shares.

Step 3

- Oldco makes a qualified subchapter S subsidiary (QSub) election.



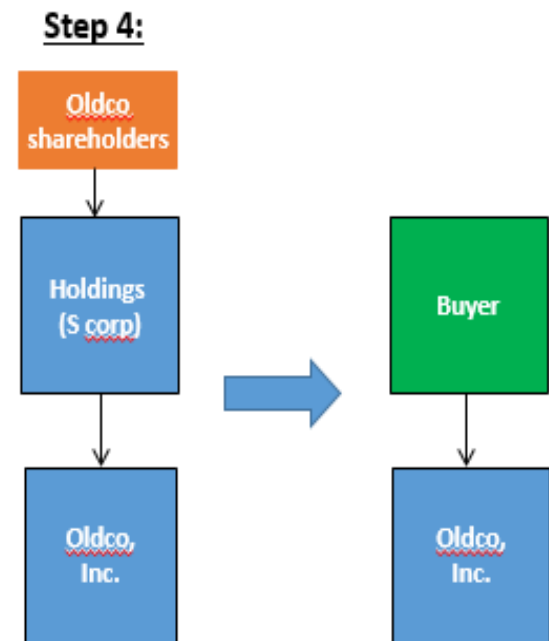
Tax Free Reorganizations

“F” Reorganizations

Proposed Transaction Mechanics (F Reorg) (cont'd)

Step 4

- Buyer would then purchase all of the shares of Oldco, Inc. from Holdings, which is now the sole shareholder of Oldco, Inc.



Tax-Free Acquisitions

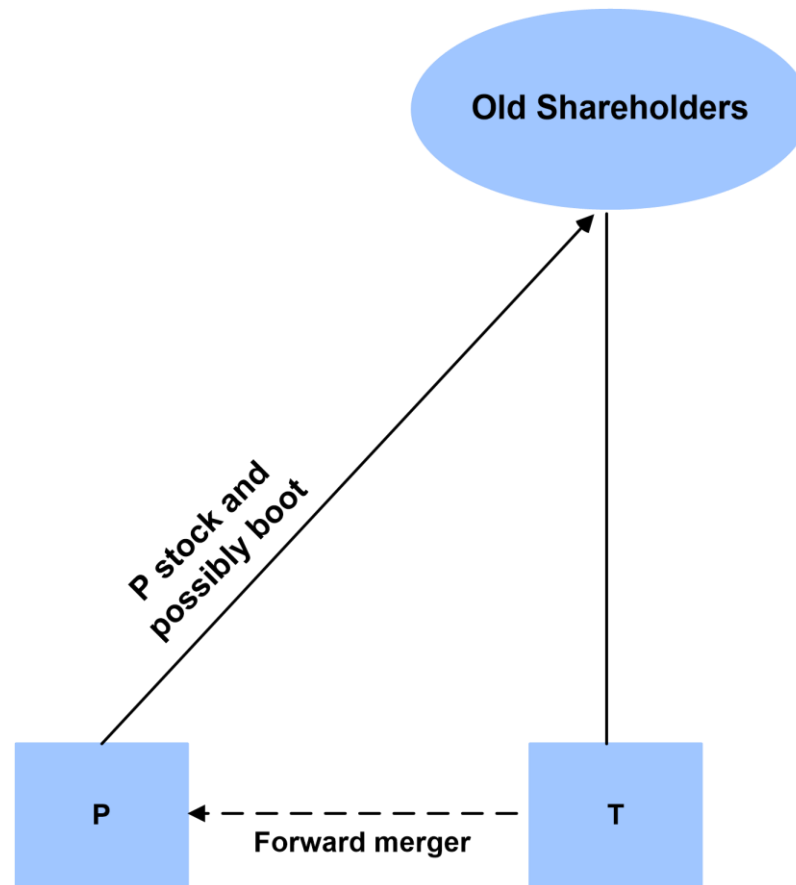
- Introduction
 - Generally, in a tax-free organization there is no gain or loss recognized if stock or securities of a corporation that is a party to a reorganization are exchanged solely for stock or securities in that corporation or another corporation that is a party to the reorganization. In order for a transaction to qualify as a tax-free reorganization under the Code, it must fall within one of the provisions of Section 368(a) (1) of the Code. The principle acquisitive reorganizations are described and diagramed below:

Tax-Free Acquisitions

- Tax-Free Acquisition of Target Assets
 - “A” Reorganization
 - Generally a statutory Merger or Consolidation. P acquires all of the stock of T in exchange for P stock (and possibly boot), pursuant to a statutory merger.
 - Benefits of an “A” Reorganization:
 - No “substantially all” requirement
 - “C” and Forward or reverse triangular merger require the acquisition by P of substantially all of the properties of T.
 - No Requirement to issue voting stock
 - P may pay T consideration other than stock
 - ❖ Cash, other property
 - Only limitation is continuity of interest requirement
 - Disadvantages of “A” Reorganization
 - Inability to pick and choose T liabilities assumed
 - State statute will require approval and appraisal rights for P shareholders
 - Concerns can be alleviated by merging T into LLC owned by P.

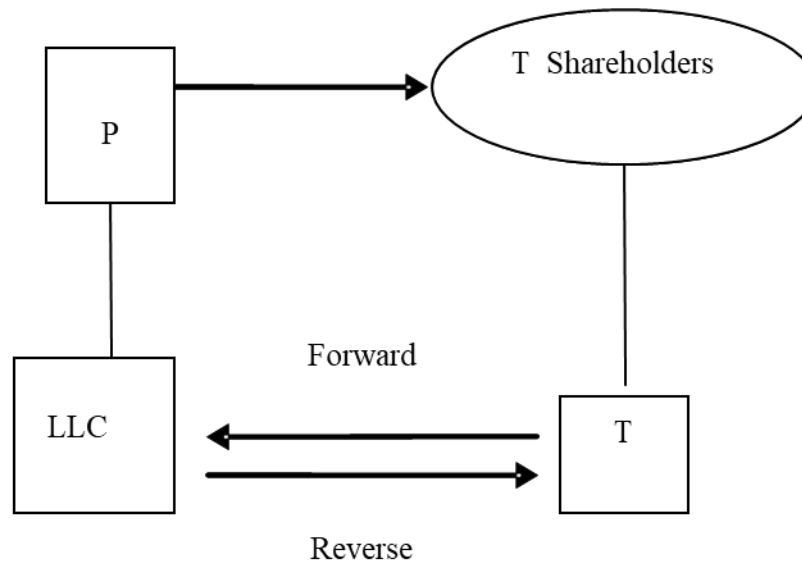
Tax-Free Acquisitions

- Tax-Free Acquisition of Target Assets (cont'd)
Diagram of an “A” Reorganization



Tax-Free Acquisitions

- Tax-Free Acquisition of Target Assets (cont'd)
Use of an “A” Reorganization
 - Treasury Regulations now allow use of disregarded entities to qualify as an “A” reorganization

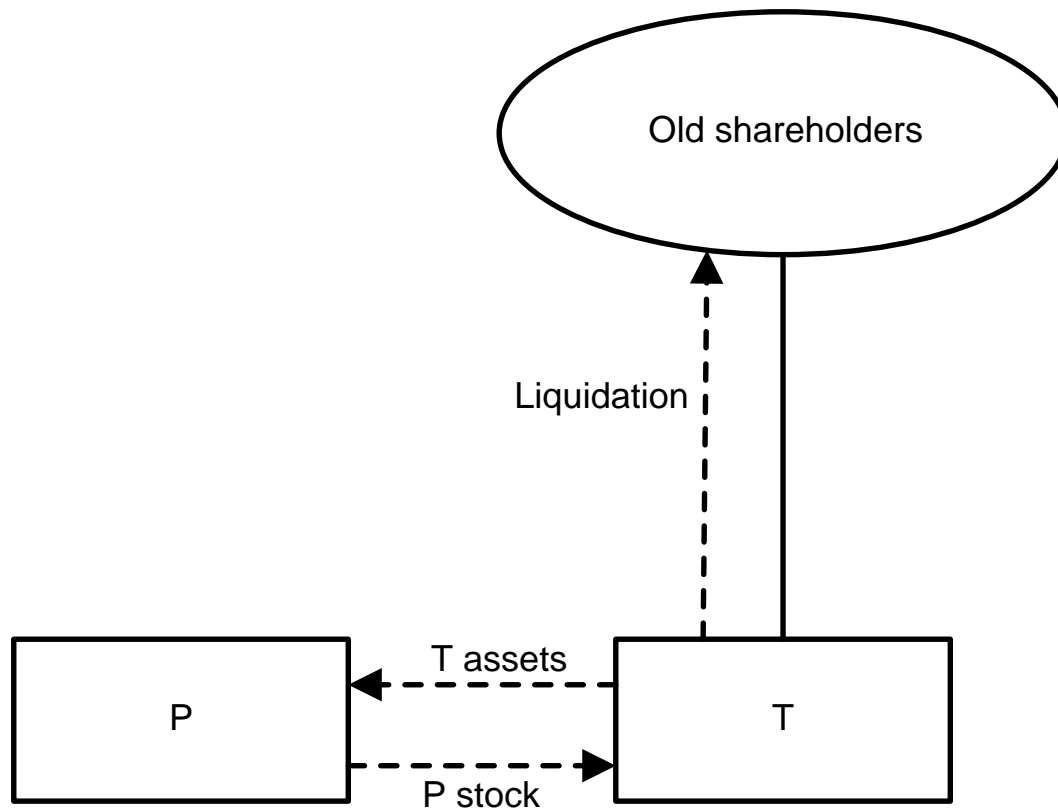


Tax-Free Acquisitions

- Tax-Free Acquisition of Target Assets (cont'd)
 - “C” Reorganization
 - This is a transaction in which P acquires, in exchange *solely* for all or a part of its own or its controlling parent’s voting stock, *substantially all* of the property of T generally followed by T’s distribution of all of its property to T shareholders in accordance with the plan of reorganization.

Tax-Free Acquisitions

- Tax-Free Acquisition of Target Assets (cont'd)
Diagram of “C” Reorganization:



Tax-Free Acquisitions

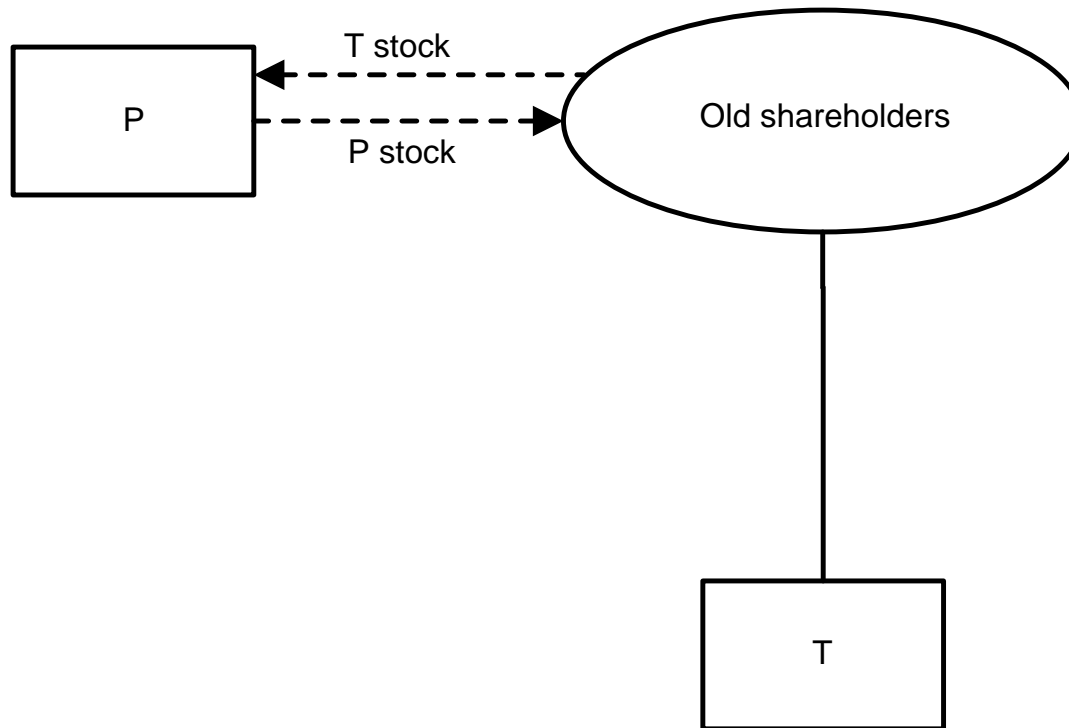
- Tax-Free Acquisition of Target Assets (cont'd)
 - “C” Reorganization
 - Not as flexible as an “A” Reorganization
 - Title to T assets must be transferred to P
 - P must acquire substantially all of T assets
 - T must liquidate
 - Advantage of “C” reorganization
 - P can pick and choose T liabilities to assume
 - Limits appraisal rights to T shareholders, unlike merger

Tax-Free Acquisitions

- Tax-Free Acquisition of Target Stock
 - “B” Reorganization: This is a stock for stock exchange in which P acquires, in exchange *solely* for all or a part of its own or the parent of P’s voting stock, stock of T, if, immediately after the acquisition, P has control of T.

Tax-Free Acquisitions

- Tax-Free Acquisition of Target Stock
Diagram of “B” Reorganization:



Tax-Free Acquisitions

- Tax-Free Acquisition of Target Stock (cont'd)
Use of a “B” Reorganization
 - Alternative ways to accomplish “B” structure:
 - T shareholders exchange stock with P in exchange for P voting stock
 - Merger S of P into T; T shareholders receive voting stock of P in exchange for T stock
 - Reorganizations involving S are referred to as “triangular B reorganizations”

Tax-Free Acquisitions

- Tax-Free Acquisition of Target Stock (cont'd)
 - “B” Reorganization pros and cons
 - Strict compliance with solely for voting stock requirement
 - No requirement that T own substantially all of its historic assets following transaction
 - Permits distribution of T assets to T shareholders prior to the transaction
 - Liabilities of T remain as T liabilities
 - P (or S) succeeds to T liabilities in an “A” reorganization

Q&A

To ask a question from your touchtone phone, press *1.

To exit the queue, press *1 again.

You may also use the Chat function to ask questions, or email questions to **MAlaw@straffordpub.com**

CLE CODE: TLG2DC

Tell us how we did!

Look for our 'Thank You' email (which you should receive within 24 hours) for details and a link to the program survey and attendance attestation.

Not a Passholder Yet?

Try the CLE Individual Annual Pass

- Attend unlimited live webinars in any of our legal practice areas - we produce over 750 advanced live CLE webinars each year
- Get unlimited access to hundreds of recorded webinars
- Get all your CLE credits for one price

Simply respond to the email you will receive after the program and **we will rebate the cost of this webinar from the pass price!**

Did you know that Strafford offers **significant discounts for group participation?**

- Add colleagues to participate with you on the same device for up to 67% off,
OR
- if they'd rather attend on their own device, add additional connections/devices and get 25% off.