Tax Planning For Private Company Sales

By Jonathan Van Loo • Wood LLP • San Francisco

Tax advisors often complain that when it comes to working on sales and acquisitions, they are usually called in at the last minute. Perhaps most tax advisors in a variety of business settings complain about being left out of the loop, never CCed, the last to know, *etc.* But it might be particularly endemic in M&A deals.

This is ironic since tax considerations can play such a central role in a transaction. Every transactional tax lawyer has a story (or, usually, several) about getting called in at the very last minute because no one bothered to get tax advice earlier. Worse yet, one's corporate colleagues may get irate that "those X!yZMT! tax people" are holding up the deal.

In this light, it may be valuable to try to see things from their perspective. Perhaps the reputation tax advisors have for holding things up is partly earned. We do, after all, have a tendency to myopically focus on the tax issues without appreciating the wider commercial and business context.

Expanding horizons can be a bitter pill. Fortunately, the annual Practicing Law Institute (PLI) *Acquiring or Selling the Privately Held Company* conference provides an excellent way to gain these types of insights and to acquire a new perspective on the role of tax considerations in the larger corporate transaction. It is held every year in San Francisco, New York City and Chicago. This year's conference was co-chaired by Brian C. Miner and David W. Pollak and should soon be available on CD.

Financial Sponsors

In San Francisco, Michael Peterson from the Philadelphia office of Morgan, Lewis & Bockius LLP presented a panel on financial sponsors. Financial sponsors are professional investors that pool capital from outside investors. In the context of M&A deals, financial sponsors are almost always private equity funds, although hedge funds are also active in this space.

The session on financial sponsors addressed one of the questions close to any tax lawyer's heart: debt financing. In today's climate, it is no surprise that acquisitions are smaller (with an average size of approximately $100 million) and involve less leverage than in the past. The days of 90-percent debt financing are long gone. A ratio closer to 60 percent or 50 percent or even lower is more typical.

However, in the short term, there has been a significant increase in the use of leverage driven by investor demand for higher-yield debt. Apparently, debt levels have increased from 50 percent in 2011 to 57 percent in 2012. It remains to be seen if this represents a long-term trend or merely a blip that will disappear with higher interest rates.

A creative way to leverage equity financing is to give equity to management. A typical buy-out of a small company may involve 10-percent to 30-percent management equity financing. From the perspective of the financial sponsor, equity for the management team provides a cheap source of financing while also incentivizing the management team.

Notably, the financial sponsor will fiercely resist any minority shareholder rights or control rights. Instead, the financial sponsor may insist on strong protections for unfettered control over the portfolio company. This is about providing financial incentives for management, not for including management in control of the company.

Participation?

For example, one often sees drag-along rights forcing management to join in any future sale of the company. Another common provision states that, upon separation, the company will have the right to buy back the equity from management at a discount. Financial sponsors also sometimes seek to earn fee income from their portfolio companies.

Although this type of fee income may generate a deduction at the portfolio company level, it can create tax problems for the private equity fund. If a fund were earning ordinary fee income from providing management services to its portfolio companies, it may be regarded as earning income from a U.S. trade or business. Under Code Sec. 875(1), that would cause the foreign partners of the fund to, in turn, be treated as engaged in a U.S. trade or business and as earning a *pro rata* share of "effectively connected income."

As a result, the foreign partners would be required to file U.S. federal income tax returns. That is obviously undesirable. For this and other reasons, there is clearly a need for careful tax planning when earning fee income from portfolio companies. Yet there also appear to be opportunities for tax-efficient structuring.

Sellers never like hold-backs or requirements to leave part of the purchase price in escrow to back up representations and warranties. Representation and warranty insurance, already relatively common in Europe, is becoming more prevalent in U.S. deals. It may even be available for pre-closing tax indemnities. Sellers may be interested to know that, in exchange for a premium that is typically around two percent to three percent of the insured amount, they do not have to leave anything in escrow.

Earn-Outs

In the San Francisco PLI conference session on earn-outs, one of the themes that Sarah Payne of Sullivan & Cromwell LLP emphasized was the need to align the incentives of the buyer and seller. This means that, for practical purposes, lawyers should key the earn-out to a metric that the buyer will be incentivized to maximize. The goal in this context is to tie the earn-out metric over a disputed aspect of the value of the company that the buyer will want to enhance and maximize even if it means paying more to the seller. Otherwise, the buyer will naturally try to game the system by reducing the earn-out metric and therefore reducing the amount it has to pay out.

In addition to the challenges in negotiating and drafting an earn-out, the tax issues can present complexities as well as opportunities. Because an earn-out is carefully negotiated, there may be an opportunity to craft tax-favorable provisions, or at least to avoid potential traps. For example, if the sellers are going to continue to be employed at the portfolio company, it may be important to ensure that the earn-out will not be treated as ordinary compensation income.

In the sale of a private company, if the target stock is not traded on an "established securities market" under Code Sec. 453(k)(2)(A), installment sale treatment may be available. Perhaps even more intriguing, it may even be possible to treat an earn-out as an open transaction. Reg. §15A.453-1(d)(2)(iii) specifically provides for open transaction treatment, although it is reserved for "rare and extraordinary cases" when the fair market value of property cannot be determined.

In fact, in the context of sales of private companies, the dividing lines between installment sale versus open or closed transaction treatment seems surprisingly muddled. After all, it is a relatively common transaction. In explicitly excluding equity interests in corporations and partnerships from the definition of an installment sale obligation, Reg. §15A.453-1(c)(1) suggests installment sale treatment is not available when the seller receives equity.

If an installment obligation is equity, it may be nonqualified preferred stock under Code Sec. 351(g)(2) because the issuer may be required to redeem that instrument. And nonqualified preferred generally does not qualify as good stock for purposes of tax-free reorganizations or Code Sec. 351 transactions.

Open Transaction Nirvana

Curiously, some of the old case law stalwarts that permit open transaction treatment were based on earn-outs. In *Burnet v. Logan*, SCt, 2 USTC ¶736, 283 US 404 (1931), the taxpayer sold stock in exchange for what essentially amounted to an earn-out, with payment contingent on the number of tons of iron ore mined. Even though the value of that earn-out right was valued for estate tax purposes, the Supreme Court nevertheless determined that open transaction treatment was appropriate.

Similarly, in *R.T. Marshall Est.*, 20 TC 979, Dec. 19,884 (1953), the court determined that an earn-out payment contingent on the company's dividends and earnings was entitled to open transaction treatment. Open transaction treatment is clearly disfavored by the IRS. Yet a more recent court decision, *E.A. Fisher*, FedCl, 2008-2 USTC ¶50,481, 82 FedCl 780 (2008), noted that the doctrine remains alive. Even more noteworthy, the court suggested a three-factor test for determining if open transaction treatment should be available.

First, is the instrument readily marketable and alienable? Second, is there information on the price of comparable assets? Third, is the value of the instrument dependent on uncertain contingencies? While multi-factor tests can be notoriously ambiguous and difficult to apply, at least this court decision provides a framework to determine if open transaction treatment is appropriate.

Under this test, earn-out obligations may satisfy all three factors for open transaction treatment. First, it is common for restrictions to exist on transferability of earn-out obligations. Second, it is common for there to be limited information on comparable assets because the earn-out depends on a highly specific metric.

Finally, it is common for the earn-out to depend on an uncertain and contingent aspect of the business—an aspect for which the buyer and seller were unable to agree on a value. Interestingly, this suggests that the conditions for open transaction treatment may not be as rare and extraordinary as the IRS has suggested, at least in the context of earn-outs for private companies.

It will be interesting to see if better guidance develops on the proper tax treatment of earn-outs. Indeed, this type of transaction typically is not tax-motivated, but instead is used as a way to bridge the gap between differences in view of the value of the target company. More certainty for such common business realities would be nice.

Conclusion

The PLI conference on private company sales and acquisitions covered a wide range of interesting topics, only some of which are touched upon in this article. Many of these presentations provided an interesting overview of the business and corporate context for these transactions. Tax practitioners will find it valuable to gain a better appreciation of the role played by tax considerations in the wider business and corporate context for M&A deals.

For additional information about the PLI conference, see www.pli.edu *or call (800) 260-4754.*

Article Submission Policy

The M&A Tax Report welcomes the submission of unsolicited articles. Submissions should be 2,000 words or less and use textual citations, rather than footnotes. All submissions should be made via email attachment in either Microsoft Word or WordPerfect format to Robert W. Wood, Editor-in-Chief, at *wood@woodporter.com*. The M&A Tax Report reserves the right to accept, reject, or edit any submitted materials.

TO SUBSCRIBE TO THE M&A TAX REPORT CALL 1-800-638-8437.

Wolters Kluwer
CCH

4025 W. Peterson Ave.
Chicago, IL 60646

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH