MAXIMIZING VALUE—OVERLOOKED PRE-TRANSACTION PLANNING OPPORTUNITIES IN M&A DEALS

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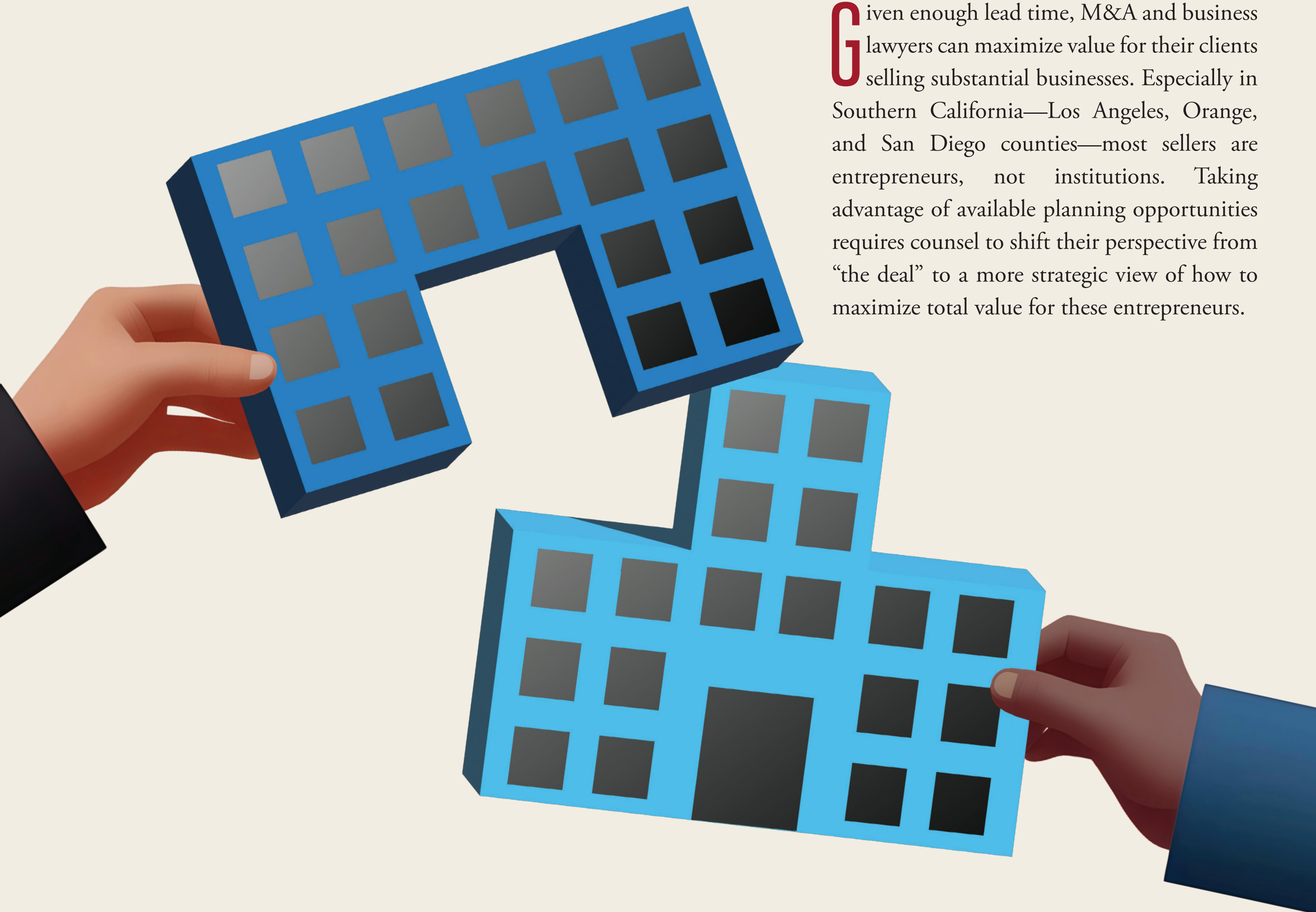


Given enough lead time, M&A and business lawyers can maximize value for their clients selling substantial businesses. Especially in Southern California—Los Angeles, Orange, and San Diego counties—most sellers are entrepreneurs, not institutions. Taking advantage of available planning opportunities requires counsel to shift their perspective from "the deal" to a more strategic view of how to maximize total value for these entrepreneurs.

This article focuses on how, given a set transaction price, much more value can be delivered to the sellers by focusing on the big picture—maximizing the value of the deal to them by capitalizing on some often overlooked planning opportunities.

Unfortunately, many of the opportunities discussed below are not addressed until too late in the process. Sellers and their advisors can be so focused on getting the deal closed that opportunities are missed. A signed letter of intent (LOI) typically signals the beginning of a transaction, but by that time many of the planning opportunities mentioned here are no longer viable. Lead time is required for the most impactful planning.

As one example, it is possible for a business seller to change the state of their residency and thus avoid California income tax on part—or in some cases all—of the sales proceeds. California's top income tax rate is now 14.4%. Given a large enough purchase price, many sellers would appreciate the opportunity of at least considering what they could do to capture such savings.

The potential California savings also depend upon how the sale is structured. For example, if a target S corporation or partnership operates entirely in California and the sale is structured as an asset sale, changing the residency of the owners to another state will save little. That is because, regardless of residency, all California source income is taxed by California. For example, a sale of business real estate located in California will be taxed by California, regardless of the residency of the seller.

However, a different rule applies to sales of intangible assets, such as LLC interests or corporate stock. In that situation, the source of the gain depends on the residency of the individual sellers. As a simple example, if a business is organized as an LLC, the seller can insist on a sale of LLC interests. Although buyers typically want to buy assets, with an LLC taxed as a partnership, a buyer can receive the same "step up" in income tax basis as if they acquired the assets directly. The difference is that if the sellers successfully change their residency prior to the sale, the sale will be sourced to the state of their new residency, not to California.

[G]iven enough lead time, there are a number of planning opportunities that can maximize the value of an M&A deal to sellers.

Is it really possible to change residency from California to another state prior to a sale? With enough time and the proper guidance, it absolutely is. If done properly, it can be accomplished in a matter of months. The challenge is that California is not bound by strict time-based residency guidelines. California ultimately considers both "domicile"—that place a person intends to return to—and a "closer connection" test to determine if someone has really severed their ties to California. There are many cases where taxpayers have tried to claim they "moved" by renting an apartment in Nevada, while leaving expensive primary residences in California available for their use. They lost their residency arguments and paid California tax.

That is why some lead time is required. Assuming a $100,000,000 gain, many sellers would at least appreciate exploring whether a $14,400,000 California tax savings is worth it. Given any close proximity between a California exit and a major liquidity event, you can expect the Franchise Tax Board to audit the transaction. But with the proper planning and implementation, the move can be successful.

Even in cases involving asset sales of flow-through entities such as S corporations and LLCs taxed as partnerships, the authors have seen missed opportunities with residency planning. In some cases, even sophisticated tax advisors don't pay attention to California's source of income rules. If the entity being sold is engaged in a multi-state business, in most cases California applies a "single sales factor" to determine how much of the entity's income is subject to California tax. For example, if California sales only represent 25% of the total sales, California will typically treat only 25% of the sales proceeds as California source. If the owner is a California resident, this is inconsequential—they are taxed on 100% of the flow through income because of their California residency. But even with an asset sale, if they are a nonresident of California at the time of the sale, only 25% of the gain will be taxed by California.

Another overlooked opportunity is the pre-sale shift of value to family members to accomplish wealth transfer objectives. Given that the top estate and gift tax rates are 40%, it frequently makes sense to shift ownership and value from the owners to family members. These shifts are accomplished with trusts that (1) protect the assets for heirs, and (2) allow the grantors to pay the income tax on the trust assets. Normally paying income taxes on assets that don't belong to you doesn't seem like a good idea. But when transferring wealth to avoid a 40% loss of assets, it makes all the sense in the world, because the payment of the trust's income taxes is not considered a taxable gift.

For example, if a parent wants to help their child by paying their child's $50,000 income tax bill, that payment is considered a gift of $50,000. But if that same $50,000 is paid by the parent for the taxes attributable to a "grantor trust"—one on which the parent is liable for the income taxes—it is not a gift. So the opportunity here is to make a pre-sale transfer of interests in a successful and appreciating business when values are relatively lower, and shift the appreciation to trusts created for family members. Even better, in addition to providing asset protection benefits, the trusts can be multi-generational. As long as assets are left in the trust, the trust assets are not included in the taxable estates of the beneficiaries.

Waiting until term sheets are being circulated and draft LOIs negotiated is too

late. Ideally, counsel should be helping their clients anticipate and prepare for a sale well in advance of even approaching investment bankers. Privately held company valuations when there is no buyer on the horizon are not only significantly lower than their exit value, but are typically subject to substantial valuation discounts. For example, a transfer of 10% of a business to trusts created for family members will be subject to both marketability and minority interest discounts. The combination of (1) transfers to trusts at relatively lower values, (2) the appreciation that occurs as a result of a sale transaction, and (3) the payment of all income taxes by the grantors instead of the trust beneficiaries can result in significant value shifts and substantial long term tax savings.

Another commonly overlooked opportunity is a strategic review of the business. Every business has a unique set of value drivers. Whatever those key value drivers are, they can typically be captured for the seller's benefit with enough time and planning. For example, we've experienced situations where a business is operating in a unique, leased facility. Due to zoning and land use issues, it would be inordinately expensive for them to move. Under those circumstances, it makes sense to approach landlords and negotiate lease extensions or options as early as possible. If the situation isn't addressed until the time of sale, a difficult landlord could stand in the way of a closing, or at least make it much more expensive.

Another example is key employees. A good management team—especially one capable of running the business without the owner—adds immense value to a business. The time to implement "golden handcuffs"—for example, deferred compensation and bonus plans—is before the business is marketed. Other possible areas include a strategic review of intellectual property rights and licenses, supplier contracts, major customer contracts, and any other area that adds unique value to the business. The aim is to make sure the business has locked up the vital pieces of the business that make it valuable before any sale is negotiated.

In the authors' experience, the earlier anticipated due diligence items are reviewed, the more smoothly the ultimate sale closes. We have seen many situations where, at the last minute, there were unexecuted lease extensions, missing S corporation elections, incorrect lien filings, unexpected transfer restrictions, and similar items which, while fixable, take precious time to address and can hold up closings. Our philosophy is that time is the enemy of closing any deal. The more potential issues are addressed before a buyer even appears, the better.

Another opportunity is using qualified small business stock (QSBS) benefits. (For an explanation of the QSBS rules, see the March 2024 issue of *Orange County Lawyer*). In the case of C corporation stock acquired after September 27, 2010, taxpayers may exclude up to 100% of eligible gain under Code Section 1202(a)(4). If there is sufficient time, the gain exclusion can be "multiplied" by setting up trusts in advance of the sale. Thoroughly documenting qualification for QSBS treatment should be undertaken as part of this process.

The QSBS benefit requires a stock sale. It can be utilized to a lesser extent in an asset sale by a C corporation (there would be a corporate level tax on the sale, but the shareholder tax paid on liquidation of the C corporation can be mitigated). Where QSBS treatment is not available and a C corporation asset sale is involved, consideration should be given to allocating as much of the purchase price as possible to individual goodwill.

If goodwill is a corporate asset, it is subject to the same double tax as any other asset sold by a C corporation. However, if goodwill is allocated to the shareholders—by virtue of their knowledge of customers, their personal relationships with customers, and other factors—the portion of the purchase price allocated to personal goodwill will be subject to capital gains tax only at the shareholder level. The tax treatment to the buyer is the same with corporate or personal goodwill—the buyer can amortize the goodwill over fifteen years.

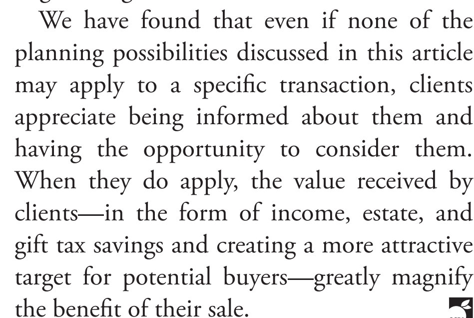
Everyone who has ever participated in significant M&A transactions knows that once the LOI is signed, the deal rarely improves for the seller. For that reason, it is important that all of a client's advisors—bankers, CPAs, and legal counsel—work together cooperatively prior to going to market. Each party has specialized expertise.

If the bankers are made aware of the potential for QSBS treatment, they can factor that into their consideration of how to market the business. That discussion should occur enough in advance of a transaction so that, for example, counsel doesn't waste time and money setting up multiple trusts to magnify the QSBS exemption, only to learn the banker feels a stock sale isn't possible. Instead, the personal goodwill planning, residency planning, and other opportunities in this article can be discussed to see if they can be used to increase the owner's value.

For example, if the banker believes buyers will require the seller's involvement in the business post-sale, depending on the buyer's requirements, a change in residence out of California may not be possible. But if the seller negotiates in advance so that, for example, their physical presence in California to help the buyer is limited to just a few months each year, they can end up with 14.4% more in their pocket.

For that reason, the entire team should be involved in the pre-transaction planning and LOI negotiations. It is much easier to make it clear that the seller is not willing to spend more than a few months a year in California up front than to sign the LOI, then make this ask later. Similarly, understanding whether an allocation of sales consideration to personal goodwill will be a worthwhile benefit for your client is important. If it is included in the LOI from the beginning, it is much more likely to survive a challenge than if someone proposes it in the middle of negotiating deal documents.

We have found that even if none of the planning possibilities discussed in this article may apply to a specific transaction, clients appreciate being informed about them and having the opportunity to consider them. When they do apply, the value received by clients—in the form of income, estate, and gift tax savings and creating a more attractive target for potential buyers—greatly magnify the benefit of their sale.



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