

# STRUCTURE CONSIDERATIONS FOR MERGERS AND ACQUISITIONS

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# COURSE DESCRIPTION

This presentation discusses the various structures that can be used to complete a merger or acquisition. It begins with a brief explanation of the impacts of the recent tax reform legislation on deal structures followed by a more focused discussion on the pros and cons of various structures from both the buyer's perspective and the seller's perspective. It concludes by pointing out some of the key considerations associated with engineering and architecture firms and how these considerations can be incorporated into deal structures to meet both the needs of the buyer and the seller.

# LEARNING OBJECTIVES

- To generally understand the differences between an asset transaction and a stock transaction
- To understand how tax considerations can play a key roll in structuring a deal
- To be able to recognize different ways to bridge the gap between buyers and sellers
- To appreciate the special considerations that apply to engineering and architectural firms as firm growth and owner exit strategies are evaluated

# INTRODUCTION/BACKGROUND

- Important Strategy for Firm Growth and Ownership Transition
- Tax Cuts and Jobs Act—Impact on M & A
- Two Basic Structures—Asset Purchase and Stock Purchase
- Tax Free (deferred) Re-Organizations
- Particular Deal Considerations with the A/E Industry
- Conclusions/Recommendations

# IMPACTS OF TAX REFORM

## Key Provisions

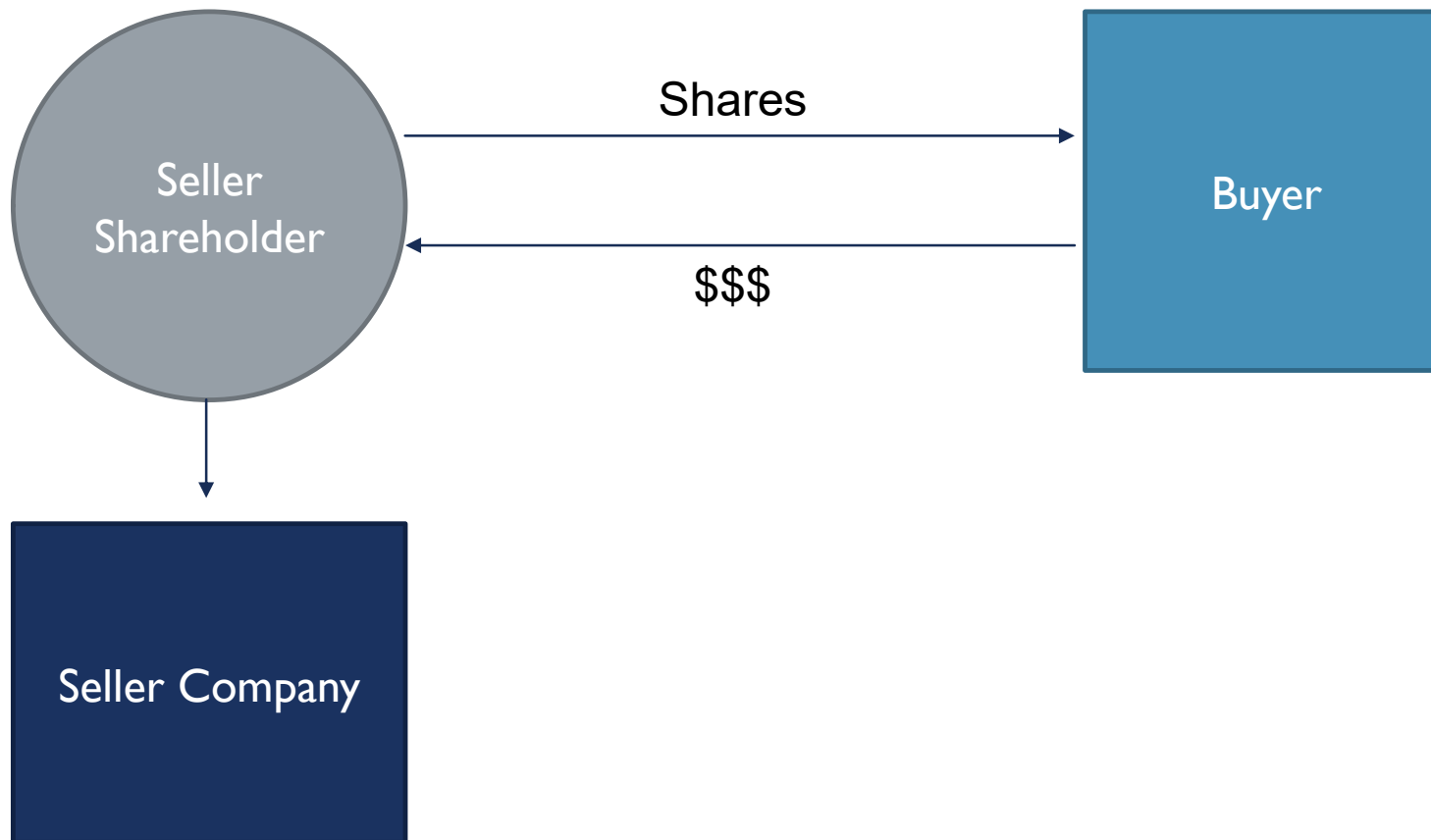
- Reduction of Corporate Tax Rate to 21%
- Elimination of Alternative Minimum Tax for Corporations
- Creation of Qualified Business Income Tax Deduction for Pass Through Entities
  - Different, more restrictive rules for certain “specified service trades or businesses”
  - A/E firms exempt from the different rules
- Changes to Use of Net Operating Losses (no carry backs; carry forward indefinitely, only offset 80% of taxable income)
- 100% Expensing of Tangible Assets (qualified property)
- Also, new rules that apply to foreign subsidiaries and foreign acquisitions

# THE BASIC STRUCTURES

## Forms of Business Entities:

- Corporation
- Limited Liability Company
- Partnership
- Limited Partnership
- Sole Proprietor

# STOCK PURCHASE





# STOCK PURCHASE - SELLER'S PERSPECTIVE

## ADVANTAGES

- Liabilities of the Company Carry Forward to the Buyer to the Shareholders' Benefit (except those assumed by contract)
- Simple Transaction—Selling Equity
- No or Fewer Assignments (unless contractual) or Third-Party Consents
- Shareholders (Equity Owners) pay single tax-Capital Gain- equal to realized value minus the adjusted basis times the applicable rate (15% or 20%)
- Generally no sales/use tax since acquiring intangible asset (stock)
- Can Structure to be Tax Free (deferred) to be explained later
- BOD/Shareholder approval generally not necessary

## DISADVANTAGES

- Primary Disadvantage to Seller is inability to retain tax attributes of the Company (ie., NOL carry forward)

# STOCK PURCHASE - BUYER'S PERSPECTIVE

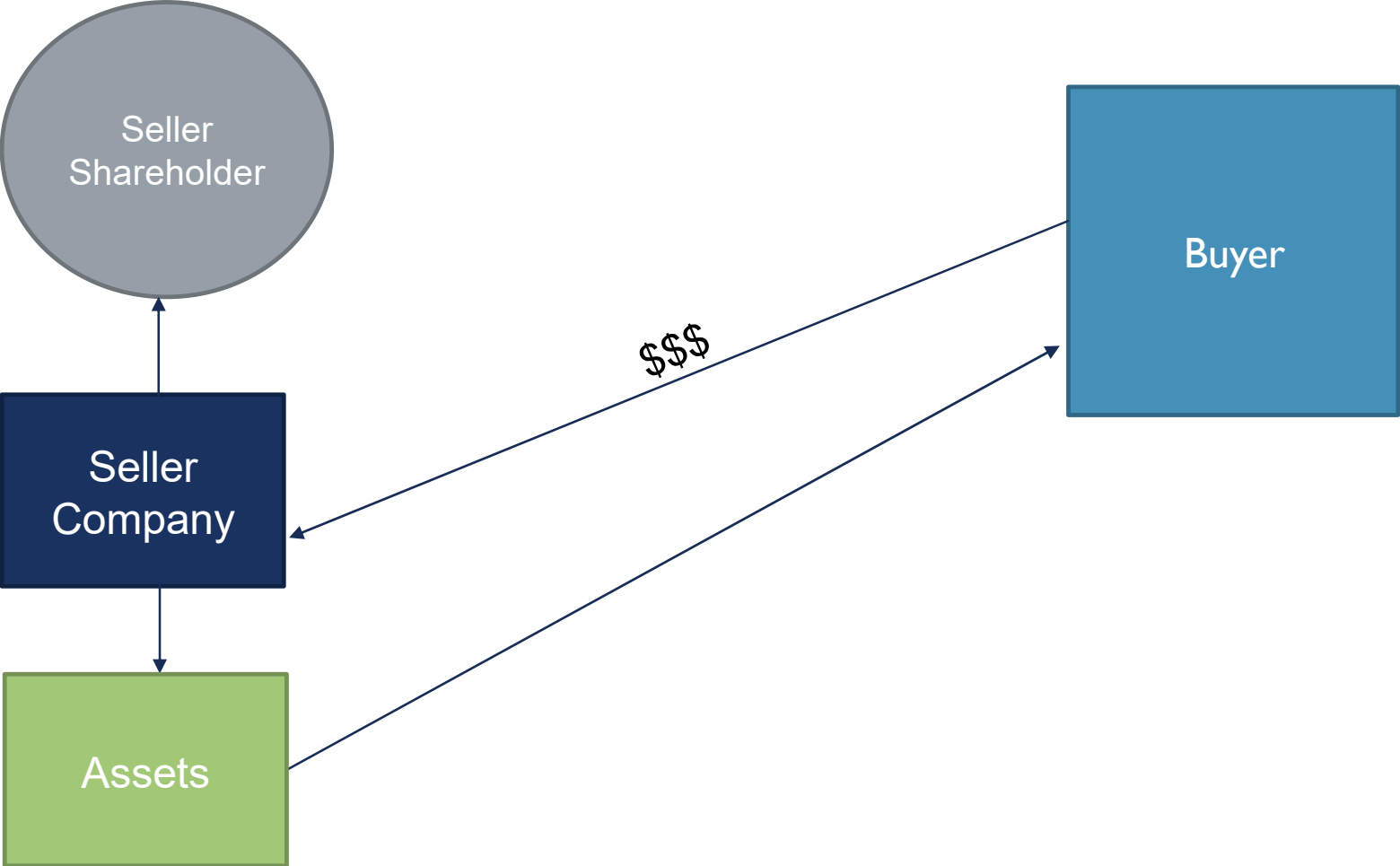
## ADVANTAGES

- Simple Transaction –equity purchase, less disruption with clients and employees
- No or few assignments or third-party consents
- No shareholder/BOD approval generally required from Seller
- Generally no sales/use tax
- May be able to take advantage of Company tax attributes such as NOL carry forward

## DISADVANTAGES

- Buyer takes on all liabilities (past and unknown) of the Company (can mitigate with contractual indemnities)
- Buyer cannot get “stepped up” basis in the assets; rather buyer assumes basis (book value) of assets at sale; Buyer cannot take full advantage of 100% expensing of certain assets

# ASSET PURCHASE



# ASSET PURCHASE – SELLER’S PERSPECTIVE

## ADVANTAGES

- May retain cash in the Company, certain accounts, and A/R
- Can continue operation of the Company and maintain the tax attributes (such as NOL carry forwards)

## DISADVANTAGES

- Can be complex and time consuming because of the transfer requirements of each asset
- Requires assignments and 3rd party consents
- Liabilities of Company stay with Seller (subject to transfers by agreement)
- If Seller is Corporation: Double tax
  - a. Corporate tax on sale of assets (21%) (doesn't matter on character)
  - b. Individual income tax on distribution to shareholders (different if in liquidation)
- If Seller is LLC or disregarded, then tax will depend on character of assets sold
  - a. Ordinary Income Tax for certain items
  - b. Capital gains for intangibles
- Sales/Use taxes will apply

# ASSET PURCHASE - BUYER'S PERSPECTIVE

## ADVANTAGES

- Avoids assuming past liabilities of Seller Company
- Can Get “Stepped Up” basis for assets purchased
- Can take full advantage of 100% expense rule
- Can “choose” assets to be purchased

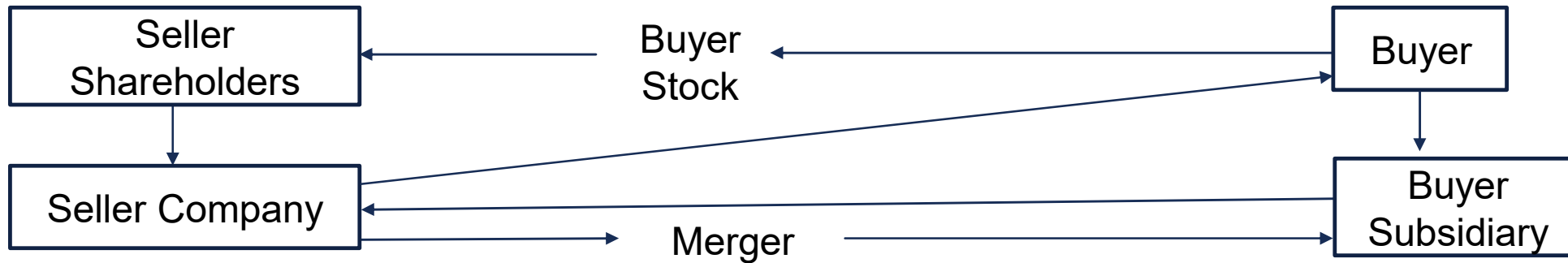
## DISADVANTAGES

- Can be complex and Time consuming
- Need assignments and 3rd party consents (some assets may be difficult to transfer)
- Sales/Use taxes will apply
- Cannot assume tax attributes of Seller Company

# TAX FREE (DEFERRED) ACQUISITIONS PRE-REQUISITES

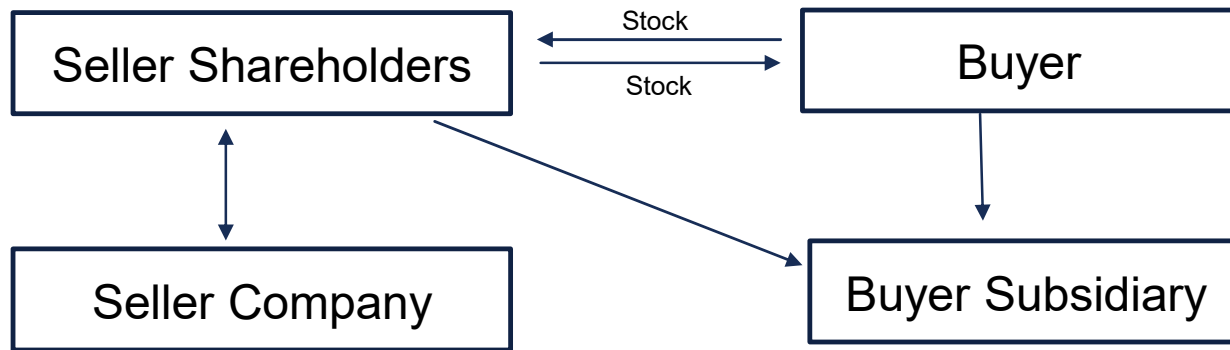
- Must be “Corporations” involved in the transaction
- Must have “Continuity of Business” Business of Seller must continue after the transaction
- Must have “Continuity of Interest”
- A substantial number of Seller shareholders must continue as shareholders of the Buyer
- 40% of the deal consideration needs to be stock of the Buyer
- Non-stock consideration (boot) is taxable

# TYPE A REORGANIZATION



- Statutory Merger or Consolidation (State Law)
- Boot Possible – up to 60% of sales price (40% in stock – tax free)
- Sales and use tax still apply
- Selling Shareholders do not have to be treated equally

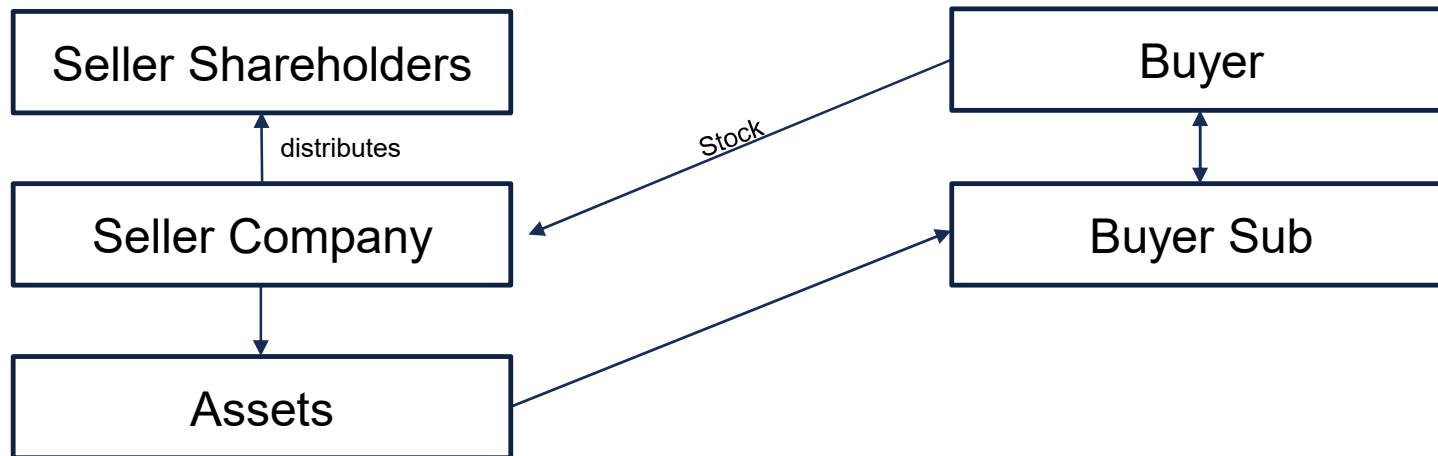
# TYPE B REORGANIZATION



- Seller Shares are transferred to Buyer in exchange for Buyer Stock or Sub Stock
- Buyer must end up controlling Seller Company (80%)
- Boot possible (up to 20%)
- No sales or use tax



# TYPE C REORGANIZATION



- Seller Company's assets are transferred to Buyer Sub in exchange for Buyer Sub Stock or Buyer Parent Stock, but not both
- Seller Company distributes Stock to Seller Shareholders as part of liquidation of Seller Company
- Can use boot up to 20% of consideration
- Buyer does not assume liability
- Sales and use tax applicable

# PARTICULAR DEAL CONSIDERATIONS IN THE A/E INDUSTRY

- Professional Liabilities of Seller
- If Seller to receive Buyer stock, then important due diligence of Buyer necessary
- Continuing Involvement of Founding Owners
- Specific tax considerations of Seller shareholders
- Key Personnel of Seller
- Alignment of business objectives –Buyer and Seller
- Contingent Consideration (Earn-outs, Promissory Notes with possible off sets)

# CONCLUSION RECOMMENDATIONS

- It is important to assess tax consequences of the deal early on.
- Recognize that many options exist to structure a transaction
- Most A/E deals done as an asset purchase, primarily because of the concern regarding contingent liabilities
- Tax impacts of Buyer v. Seller are generally different
- Structure can help parties meet their objectives
- Often, purchase price will be affected by structure of deal
- Should be resolved, if possible, at the Letter of Intent stage

# QUESTIONS?



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