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OUTLOOK

What We Learned From 2013 Deals: Proceeds Are Still King

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The year 2013 was a busy year for restaurant deals that ended with a flurry of transactions in the public and private markets and the entire franchise industry. The year also included a significant number of consolidation transactions. Small operators were swallowed up by the larger operators, particularly among the chain restaurants, and large operators were acquired by even larger companies.

This past year saw early franchisees (particularly in the Applebee's system and QSR segments) selling to newer and larger companies, many of which were private equity or private equity-sponsored companies. We even saw a financial company (normally a sponsor) become an operator. In summary, the big guys got bigger.

What did these acquisitions teach us about legal structure and tax issues? A number of issues stood out for us this year as we represented a number of sellers. Hopefully, the following reflections will be helpful to people and companies who are looking to sell or acquire in the restaurant space in 2014.

1. Understand your structure and where the various assets are owned. The assets to be sold are often in a number of different entities. It is important to have a clear understanding of the balance sheets and particularly which entities hold intellectual property and goodwill. All of these entities should be part of the seller group. When assets are in several different entities, the way the purchase price is allocated among the entities needs to be guided by a real understanding of tax implications based on such issues as basis, unused losses, state tax and unused credits.

2. A seller needs to understand the scope of its liabilities. What do you have to pay off at closing? What are potential prepayment penalties? What are the expenses of the sale? What are the contingent liabilities such as gift cards, lawsuits, employment matters, vendor contracts (particularly vendor contracts)? It is important these liabilities be provided for separately, especially if they are related to prepayment penalties and buyouts of contract obligations. It is very likely some of these payments may be deducted as ordinary expenses instead of offsetting capital gains.

3. Allocation of purchase price among the various asset classes can be more of an art than a science. Different types of buyers have different allocation needs. It has been my experience that financial buyers are not as concerned about the allocation of the purchase price among the classes of assets as are operators who want faster depreciation. It is important the allocations be detailed by restaurant and entity. Look at each type of asset and how you can maximize tax savings and avoid ordinary income. Parties sometimes overlook allocating to leasehold interests or franchise rights as opposed to goodwill or other intangibles. Also, if real estate is sold, sellers must understand some of the depreciation is recaptured at a higher rate than capital gains. The purchase price allocation should be addressed early on in the selling process.

4. A new tax wrinkle in deals is the new 3.8% tax imposed on high-income taxpayers on certain passive income. This may definitely have an effect on the selling price process, particularly if the real estate is not sold and is leased to the buyer. This 3.8% tax is imposed on rental income on real estate retained by a seller and leased to the buyer.

5. Besides not negotiating an effective allocation of purchase price, ignoring the effect of state taxes can be costly. If units are in multiple states, transaction terms may have different consequences in different states. For example, the State of Florida imposes sales tax on rental income; some states have income tax while other states impose high state income tax rates. Appropriate allocation of purchase price to states with lower tax rates can be a meaningful opportunity. More states also are trying to force or trace taxable income to individuals that have changed residences. Consider these factors in your structure.

6. Another idea is the use of tax deferred like-kind exchanges and not just for real estate. Franchise rights, furniture, fixtures and equipment all can be rolled over to utilize the advantage of a like-kind exchange. So if you are selling three QSR burger stores and you wish to get into a pizza concept (which seems to be the trend), if you are careful and you properly allocate, you can accomplish a tax-deferred like-kind exchange along the way.

7. Allocation of payments to employees on a sale is often overlooked. These should be carefully thought out and treated in such way as to create an ordinary deduction for severance or deferred compensation. One of things I like to

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see is giving employees a profits interest early on and, if the sale price of the assets exceeds a certain specified amount, allowing employees to collect a share of that price.

8. Liquidate the entity. This is often overlooked once a transaction has been completed and distributions are made to shareholders. In some situations, the entity liquidation is needed to generate a capital loss, and this should be done in the same year in order for capital losses to be matched to capital gains.

2013 was a great year for deals and deal makers, and we learned a lot. But after-tax proceeds from a sale are still king.

*** Rick Gibson, partner, contributed to this article.*

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