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The fiscal cliff, higher taxes and family businesses:

What midsize corporate lawyers need to know

By Roy Strom

For lawyers such as Mitchell Roth who represent wealthy people and the small businesses they own, late nights at the end of the year more often involve working — not hitting holiday parties.

Family businesses wrap up tax and estate planning and other legal matters right around the end of the year, said Roth, chairman of 82-lawyer Much Shelist's management committee.

Last year, though, work overwhelmed year-end partying even more than usual, he said.

"Post-Thanksgiving and through December, it's really busy for us," Roth said. "You never really know how crazy it's going to be until you get there."

Fueling business owners' race to their lawyers' office: A set of low tax rates set to fall off the table as part of the year-end "fiscal cliff" negotiations in Washington, D.C.

Consider an aging, wealthy individual hoping to shed assets before the estate tax bites them at death. Lawyers said many clients matching that description rushed to give away up to $5.12 million without paying taxes on it. If they waited until this year, the impending fiscal cliff would mean they could only shovel $1 million to their children or grandchildren without paying Uncle Sam.

And business owners on the fence about selling their company saw last year as a good time to jump into action, too.

Owners expected the tax they pay on selling a business, known as the capital gains rate, to jump from 15 percent in 2012 to as high as roughly 29 percent this year. The difference, for every $1 million in profit, could roughly amount to $140,000.

"That's why people were racing to give away their money and hurry up with selling their businesses," Roth said.

Those incentives make it obvious why many lawyers spent a lot of time with family business owners as lawmakers slowly walked off the fiscal cliff at the start of 2013 — only before paving a three-month extension under their own feet.

The fiscal cliff magnified the ongoing debate about how the country should begin to trim its $16 trillion-plus debt load. Many of the provisions involved in December's negotiations directly impacted small- and medium-size, closely held family businesses. For lawyers at midsize law firms who make a living representing those types of companies, the ramifications of the fiscal cliff and the budget negotiations set for later this year are huge.

Depending on the results, business owners' calculus will change when considering whether to pass their business to the next generation or cash out with a sale. And if a large number of their clients choose the latter option, midsize corporate law practices could suffer.

"You can argue that if the small business is gobbled up, there will be less legal work for firms of our size," said Ed Josephson, a partner at 68-lawyer Chuhak & Tecson who represents companies mostly ranging from $5 million to $50 million in annual sales.

"But the small business has been gobbled up for years, right? The corner drugstore's gone. The corner grocery store's gone. And there are still lawyers in this space."

The financial picture

As a lawyer who represents small and family business owners in the sale of their companies, Joshua Klein attends conferences where dealmakers often talk about a pipeline — as in the number of mergers and acquisitions they see on the horizon.

At the beginning of 2012, Klein, a partner at 161-lawyer Neal, Gerber & Eisenberg, said he heard private equity managers and venture capital investors talk about the pipeline as if it was drying up.

"Everyone said the first quarter was really slow in 2012 — people really just weren't making deals," Klein said.

This kind of talk was not necessarily new. U.S. deal volume slid in the previous five quarters leading up to the end of 2012, said mergermarket, an M&A tracker. And things only got worse in the first quarter of last year — it registered as the third-worst quarter since 2004, mergermarket said.

Dealmakers had good reason for continued apprehension.

The amount of M&A deals roughly tracks attitudes about the economy. At the time, statistics suggested a morbid market.

January through March of last year were the 36th, 37th and 38th consecutive months of U.S.

(From left to right) Neal Gerber & Eisenberg partners Eric Mann and Joshua Klein work in the firm's Family Office Counsel practice. The practice, formalized late last year, represents high-net worth families who Mann said need help navigating uncertainty around the U.S. tax code. Photo by Ben Speckmann.

unemployment above 8 percent. The economy grew that quarter by 1.9 percent — well off the 3 percent growth from three months prior, the Bureau of Economic Analysis said. Things looked bleak.

But the questions posed to a panel of M&A advisers that Klein attended around that time seemed to ignore the gloom many might have expected.

"The question to the panel was, 'Will there be this mad rush of deals at the end of the year?' " Klein said. "And I think people felt there will be a busy M&A season from April to the end of the year."

They believed that, Klein said, because they expected tax hikes to take a chunk of profits from private businesses that would be sold after the year ended. And to a large extent, they were right. Deals flourished at the end of the year.

Mergermarket says $737 billion worth of deals occurred in the fourth quarter of 2012, the most since $849 billion in the third quarter of 2007. The last quarter of last year saw a 52 percent boost in deals from the three months prior.

Those numbers track large companies, which midsize lawyers do not typically represent. But they also track the midsize clients — valued up to $250 million — that Klein represents. He said the uptick of corporate sales occurred in his practice as well.

"People typically like year-end deals, but they were never massively relevant from a tax standpoint ... and this definitely made 2012 unique in that there was a tax incentive to get deals finished by the end of the year," Klein said.

Meanwhile, as Klein and other M&A partners at midsize firms rushed to help clients sell their companies, other midsize corporate lawyers hurried to help them hand out their cash.

"I think it was one of the busiest year-ends I've had in my professional practice," said Jonathan Michael, a shareholder at Burke, Warren, MacKay & Serritella who handles business and wealth succession planning.

Michael's heavy workload came from clients who wanted to pass on some of their wealth to the next generation at a more friendly 2012 estate tax, which hits assets at a person's death.

As part of the fiscal cliff, the definition of wealthy — the people the estate tax applies to — would drop from an estate valued at $5.12 million to $1 million. In addition, the tax rate would jump from 35 percent to 55 percent.

President Barack Obama proposed setting a 45 percent tax on any estate worth more than $3.5 million. The amount someone could give away without paying taxes — called a tax-free gifting exemption — was also set to drop to $1 million from $5.12 million.

"Clients saw it as they needed to act," Michael said.

"I anticipated I'd be busy. And we're still busy. We have a lot of follow-up work stemming out of the work done at the end of the year. And I expect we'll continue to be busy, although the transactions may be a little different in nature."

Is the tax tail wagging the dog?

Michael expects to be busy this year, in part, because much of the fears about higher taxes that led to his booming year-end still exist: The result of the fiscal cliff negotiations left many unanswered questions about long-term tax rates for midsize companies.

Uncertainty around the tax code may find a resolution soon, as lawmakers are scheduled to negotiate a deal to stave off deep cuts in defense and other government spending.

For now, though, the uncertainty creates a form of paralysis that also existed prior to the fiscal cliff. Lawyers said they counsel clients not to base business decisions around expectations of future tax revisions.

"You never want to have the tax tail wag the dog," Michael said. "Don't do something strictly for the tax benefit."

While that advice sounds simple, it can prove difficult to determine when the tax tail wags the dog and when the tax tail makes the dog worthwhile. In other words, when does a business deal — say, selling a company — make sense because of a tax incentive as opposed to the deal's underlying value?

Klein, from Neal, Gerber & Eisenberg, represented a company facing this question last year.

He went through a nearly eight-month process with a client looking to sell a business to a private equity firm. Throughout negotiations, Dec. 31 always served as a deal-or-no-deal date: If the buyer could not close a deal by the end of the year, Klein's client would not make the sale in January.

The client took that stance to save on taxes it expected would increase this year. But setting a deadline for a deal can also make a company appear desperate and willing to settle for a bad deal, Klein said.

For example, if selling a business in December instead of January saved $1 million in taxes, a buyer could theoretically lower the price by $999,999 and the seller might still take the deal. After all, the seller still gets a good deal, saving $1 on taxes.

So, when the potential buyer of Klein's client started lowering its offer in early November, he said it may have been trying to get a piece of the seller's tax savings. Rather than cave to the pressure, though, Klein said the company stood its ground and walked away from the deal.

"They were not a desperate company," he said. "And that deal fell apart because of that."

Instead, the company held onto the business and paid out dividends to owners under the more tax-friendly 2012 regime.

Klein's client executed the strategy they planned — they determined the deal was not worthwhile without the tax savings.

But in some ways, the benefits of the strategy remain unclear. That is because many of the tax hikes expected to occur this year never actually happened.

The tax rate that business owners such as Klein's client pay on selling their companies fell short of climbing to the 29 percent rate some predicted. It went to roughly 24 percent from 15 percent.

And consider the tax-free gifting exemption. Expected to fall from $5.12 million to at least $3.5 million — if not $1 million — it actually rose as part of the last-second fiscal cliff deal reached by Congress. That could arguably have benefited laggards who held out last year because they can now make bigger gifts this year.

The future of these tax breaks will likely be featured in budget negotiations again this year.

"Whenever those are finally resolved, then maybe (business owners) will finally get a clear picture of: 'If I sell, what's the damage?' " Klein said.

Time to fold 'em?

All of this complexity and uncertainty creates a simple question: Does selling a business at some point sound more pleasant, and financially rewarding, than keeping it?

For Josephson at Chuhak & Tecson, answering that question requires understanding two subjects: The relationship small business owners have with their companies and the tax structure those companies employ.

"Selling a business is not easy for many people," Josephson said. "It's as if it's their baby that has grown up and they're being asked to give that up and have someone else shepherd it through."

While the personal connection to a business may make an owner hesitant to sell, Josephson said one tax proposal could cause a drastic shift in small business owner's relationship to their company.

He was talking about a proposal to lower taxes on income from 35 percent to as low as zero on U.S. corporations — large, often investor-owned businesses called "C-corps" in tax lingo.

While that could provide a boon for big companies, Josephson said it would be unfair to small businesses, whose owners typically pay taxes at individual tax rates that now run higher than 40 percent.

"It would make smaller businesses somewhat less competitive," he said.

Eric Mann, a partner at Neal, Gerber & Eisenberg, said he hears a similar sentiment from his family business owner-clients.

"There are a lot of new rules in play that are making it more and more difficult for business owners to succeed," he said.

"And they're burned out. I'm finding more and more that they're burned out and they're either looking to transition (their business) to the next generation or sell it altogether."

Mann said his clients used the tax incentives created by the fiscal cliff as a way to assess their relationship with their businesses. The process often pulled apart the personal feelings his clients have toward their businesses, he said.

"When they look at it from the big picture, they realize: 'The business is one aspect of my life, how does this fit into the rest of it?' " Mann said. "That was an eye-opener."

The paternal feeling some owners feel toward their businesses may delay a sale for four or five years, Mann said. But after the due diligence owners went through because of the fiscal cliff, he expects that process to accelerate to 18 months.

"As you're working with an appraiser, that's where the reflection begins," he said. "And for a lot of people, that was the first time they did that — that they really sat down and thought about: 'What direction is my business heading and where do I see myself in the next five or 10 years?' "

How do law firms adjust?

Mann and Klein work in a new practice group at Neal, Gerber & Eisenberg focused on legal services for "family offices" — the investment arms of wealthy families tasked with managing their money.

The firm formalized the practice group — Mann said it already did a lot of work for family offices — partially because of the acceleration in the area caused by the fiscal cliff and other tax uncertainties.

The practice focuses on what families do with their money before or after they sell their businesses, but families that sell their businesses typically have more money to manage.

Partially because of this practice and also because business owners who sell one business often start or invest in another, Mann said he, like other lawyers at midsize firms that represent wealthy families, will not face a shortage of work if indeed a slew of their business owner-clients cash out soon.

"It's always been very hard to succeed at generation two. And at generation three most family businesses don't exist," he said. "But there is always rock stars coming up."

Lance Rodgers, chairman of the tax and business planning group at 107-lawyer Barack Ferrazzano Kirschbaum & Nagelberg, said midsize law firms still provide the best option for family business owners, regardless of their decision to sell a company or pass it on to the next generation.

"Midsize firms have an advantage over some of your larger conglomerates because you still have lawyers who have those holistic relationships with family businesses and not just someone who's a spoke on the wheel," Rodgers said.

Large law firms, he said, may take a single-minded approach: Save as much on taxes as possible. But they may fail to realize that's not always a business owner's goal.

"You're not dealing with economic units when you're dealing with clients, especially in a family business," Rodgers said.

He gave an example of a 55-year-old client he represented who held no equity in his family business even though he still ran its day-to-day operations. That came about after a large law firm counseled him to get ownership of the business out of his hands as fast as possible to avoid taxes. But rather than being happy about saving money, Rodgers said the client lost his motivation to work.

"He was overadvised to the point that (a lawyer) theoretically was building him the perfect bridge ... but he didn't care whose side the bridge was for," Rodgers said.

"Everybody can be very proud of the structure, but who is it for? It should be for the client."

Roth, from Much Shelist, said he sees no reason why midsize law firms will suffer a lack of clients as a result of tax code revisions. Roth said a long period of growth in the size of all businesses — "You need to be bigger, faster, smarter," he said — resulted in a similar growth in law firms.

"Even closely held businesses today, to be competitive, are looking beyond local," he said.

"And even if you look at law firms 20 years ago, the largest firms were a few hundred. Today, the largest firms are multibillion-dollar organizations in numerous countries. And the midsize shop went from 50 to 100 to 300 to 800. ... So we need to evolve also."

The urgency that the fiscal cliff created showed Roth one way his firm evolved: He closed deals in a 30- to 60-day period around the holidays.

Skipping some holiday social events, staying in the office and working faster occurred all as a result of the fiscal cliff and tougher law firm competition.

"If I can't operate at that speed, I won't get hired," he said. "So yeah, we all change. We all evolve. And that's what it takes to be competitive." ■

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