The Anatomy of a Planned Gift

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Jeff Pickett
Nathan Daley
Brock Bowden
2010 - 2011

- Develop Business Plan
- Pool Savings
- Quit Mere Wages Jobs
- Launch Super Widgets, LLC (very successful)
2012 - 2013

Super Widgets, LLC

50%
Adam

50%
Zach

- Profits (hooray!)
- Self-employment taxes (ouch!)
★ Saves 2.9% or more on business profits after “reasonable” W-2 salary
2014 - 2015

Super Widgets, LLC

- Hugely popular products
- Revenues, profit margins, market share, etc., through the roof
- Company’s value soars: $20 to $25 million
- Serious buyer initiates negotiations
Proposal: Asset Acquisition
2015

Non-Binding Letter of Intent signed 11/01/15

$15,000,000 cash
$ 5,000,000 PN
$ 5,000,000 Equity

Super Widgets, LLC

- Inside A/B = nearly zero
- Governing Documents = Standard, DIY, member managed
A Financial Turning Point

Income

Time

Point of Sale
What they’re thinking about

• What’s next?
• How much, and is it enough?
• What will I do with my time?
• How do I create Income?
• Taxes?

What they’re not thinking about

• Charitable Giving
• Impact Investing
2015 Pre-LOI

Super Widgets, LLC

50% 50%

1120-S 1120-S

SW-A, LLC★ SW-Z, LLC★

100% 100%

Adam Zach

★ Saves 2.9% or more on business profits after “reasonable” W-2 salary
Reorganizing the LLC

- Amend and restate the LLC’s governing documents
- Prepare for the donation of minority interests to two Donor Advised Funds
- Select the DAF: Fidelity Investments Charitable Gift Fund
Reorganizing the LLC

Amend/restate the LLC’s governing documents

• 100,000 units issued like stock for membership interests, with 50,000 issued to SW-A, LLC and 50,000 issued to SW-Z, LLC.

• Manager-managed; two managers; one manager appointed by each member (SW-A, LLC appoints Adam; SW-Z, LLC appoints Zach).
Reorganizing the LLC

Amend/restate the LLC’s governing documents

• The LLC will pay zero compensation to its managers. This provision enhances the value of units held by minority members by eliminating compensation as a pre-distribution expense. Instead of draining itself via payments of "reasonable compensation," this Company first makes pro-rata distributions to all of its members, and then the S-Corp LLC which is controlled by each manager pays him for all services rendered.
Reorganizing the LLC

Amend/restate the LLC’s governing documents

• The defined term, "Available Funds," imposes a $50K cap on the Company's maximum reserves.

• A specific provision requires the Company to distribute 100% of its "Available Funds" monthly, and “Available Funds” equals nearly all of the LLC's current cash profits.

This enhances the value of units held by Minority Members. Many if not most closely held LLCs have the opposite provision, namely, zero required distributions other than (maybe) tax burden distributions.
Reorganizing the LLC

Amend/restate the LLC’s governing documents:

Give the minority members a much better deal than all other members

• By specific definition, if a Member has less than 15% of the outstanding units, he is a “Minority Member” (e.g., a donor advised fund); Minority Members have special privileges and economic benefits.
Reorganizing the LLC

Amend/restate the LLC’s governing documents:

Give the minority members a much better deal than all other members

• Specifically, the Minority Members face zero restrictions as to the transfers of their units. Other Members in this LLC are subject to multiple rules and procedures including the “deep chill factor” of rights of first refusal.
Amend/restate the LLC’s governing documents:

Give the minority members a much better deal than all other members

• Specifically, each Minority Member has an open ticket to take cash and leave. They have the right to be redeemed via a standing put option. And, there is a very short fuse – just 15 days. *This short gap between notice and receipt of funds is a significant enhancement over the usual arrangement of long-term wait and see (often at the mercy and pleasure of third parties).*
Considerations for the Charity

- Evaluating, receiving and redeeming the gift
  - Transferability
  - Liquidity
  - Valuation
  - Risk
Valuation – When?

- For charitable contributions, we typically get involved after the contribution was made, after the deal has closed, and before the tax return is due.

- There may be circumstances to involve valuation professionals before the deal closes. This is particularly the case if you don’t have an advisor who is experienced with valuation issues.
Valuation – Why?

• The deal is done – don’t we already know the value?

• Why do we need a valuation if the deal closed?
  o IRS requires an appraisal
  o Charitable contribution form (Form 8283) requires appraiser’s signature
  o Does the value received in the transaction reflect the value of the contributed interest on the date of the contribution?
Valuation Considerations

• Ripeness Doctrine Issues
  o As of the valuation date (date of contribution) how certain are we that the deal will close?
  o Value is based on what is “known or knowable” as of the valuation date

• What differences exist between minority owners and controlling owners?
  o No difference in a liquidity event
  o Transaction price typically reflects controlling interest
Ripeness Doctrine Impact on Valuation

• Consider various alternatives:
  o Deal closes based on what is expected as of valuation date
    ➢ Look at existing suitors and any offers/LOIs that have been received
  o Deal does not close
    ➢ Stay private for a period of months or years
    ➢ Look to the next best suitor(s) and close relatively soon

• Probability-weight the alternatives
Minority Discount Considerations

• Discount for Lack of Control (DLOC or Minority Interest Discount)
  o General concept: minority interests are worth less on a pro-rata basis than controlling interests because of the minority’s inability to exert control
  o Examples:
    ➢ Controlling owner overpays himself in the form of compensation, reducing the amount available for distribution
    ➢ Controlling owner pays above-market rent to a related party, reducing the amount available for distribution
    ➢ Controlling owner can decide on the timing and amount of distributions
Minority Discount Considerations continued

- All shareholders (controlling or minority) receive the same price per share when selling 100% of the business.

- DLOC only applies when controlling and minority shareholders would receive different values in a hypothetical transaction (e.g., stay private scenario).

- Can be calculated as a percentage of total value or reflected in the cash flows.
Marketability Discount Considerations

- aka Discount for Lack of Marketability or DLOM

- Private company liquidity differs from public company liquidity

- 100% interests in private companies can be sold, but typically require large transactions costs

- Minority interests typically have no market
Case Study – Ripeness Doctrine Issues

• Contribution was made approximately 2 months before closing

• Part of the deal would be paid in stock of the buyer and buyer had not yet provided financials to the seller

• RESULT: reasonable probability that the transaction would not close. We prepared two weighted scenarios:
  o 70% probability that the deal closes
  o 30% probability that the company does not reach a deal and continues as is
Case Study – DLOC/DLOM Issues

• What would a typical operating agreement contain that would influence discounts?
  o Amount and timing of distributions at the sole discretion of the manager
  o Minority interest holder unable to control cash flows (e.g., set compensation)
  o Restrictions on transferability of units

• With such restrictions, what would be the FMV of the 5% transferred interest?
# Case Study – Traditional Operating Agreement

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Equity Value Before Adjustments</th>
<th>Discount For Lack of Control</th>
<th>Discount For Lack of Marketability</th>
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<th>Probability</th>
<th>Weighted Value</th>
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<tbody>
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<td>Sale of Business Scenario</td>
<td>$25,000,000</td>
<td>3.0%</td>
<td>$24,250,000</td>
<td>70.0%</td>
<td>$16,975,000</td>
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<tr>
<td>Stay Private Scenario</td>
<td>$25,000,000</td>
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<td>30.0%</td>
<td>$5,400,000</td>
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**Concluded Value (rounded)**

100.0% $22,375,000

**Ownership Interest**

5.0%

**Value of Ownership Interest (rounded)**

$1,119,000
Case Study – Amended Operating Agreement

• Operating Agreement was amended prior to the contribution. Amendments included:
  o Sets timing and amounts of regular distributions
  o Eliminates certain discretionary expenditures (e.g., owners’ salaries)
  o Minority owners (who hold less than 15%) receive a put right
### Case Study – Amended Operating Agreement

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**Concluded Value (rounded)**

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**Ownership Interest**

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**Value of Ownership Interest (rounded)**

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Case Study – Valuation Conclusion

• Fair Market Value of contributed ownership interest is slightly less than cash received by donor advised fund due to uncertainty of transaction (Ripeness Doctrine)

• Amended Operating Agreement resulted in a $75,000 increase to the charitable contribution amount claimed on the tax return due to the reduction in the DLOC and DLOM
Thank you.

Questions?