Optimizing Business Structures

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Objectives

- Present an overview of the tax laws and legal issues affecting what type of entity our business clients should use to conduct their operations or holding of rental properties
- Ascertain planning points and pitfalls based on the type of entity selected
  - Getting into and out of an entity classification status
  - Utilization of losses
  - How personal income tax treatment is modified through use of entity
  - Sec. 199A deduction and Pass-through entity tax
  - State and local implications
  - Cross Border Tax and Compliance
- Thoroughly review the "life cycle" of a business from formation to operational issues to Termination/Sale/Gift/Bequest

New Client with New Business

- Three individuals want to combine together: money person, idea person and service person
- Which entity should they operate through?

Federal Tax Considerations

- Allocation of Income
- Utilization of losses
- Entity Level Tax
- Withdrawing Cash/Property from Entity
- Fringe Benefits
- Self-employment tax
- Cross Border Consequences
- Utilization of Debt
- Succession Planning

State and Local Tax Considerations

- Nexus
- Allocation of Income and Apportionment
- Entity Level Taxes
- Pass-through Entity Tax
- Combined Reporting

Nexus

- State and Local Tax Authorities Need Nexus to Tax an Entity
  - Nexus is generally considered to be a sufficient connection between a person and a state, or a sufficient connection between an activity, transaction, or property and a state that allows the state to subject the person, and the activity, property, or transaction to its taxing jurisdiction
- Consequences of Nexus Determination:
  - When nexus is satisfied, the State can potentially tax all of the taxpayer's income or require the taxpayer to collect and remit sales tax on all of its sales
  - If there is no nexus between the State and the taxpayer then the State cannot require anything of the taxpayer

Nexus Creating Activities Vary Based on Entity

- Partnership/Sole Prop Nexus
- NY Reg § 132.4(a)(2) provides how flow-through businesses obtain nexus in New York:
  - Test 1: A business, trade, profession or occupation…is carried on within New York State by a nonresident when such nonresident occupies, has, maintains or operates desk space, an office, a shop, a store, a warehouse, a factory, an agency or other place where such nonresident's affairs are **systemically and regularly carried on**, notwithstanding the occasional consummation of isolated transactions without New York State. This definition is not exclusive.
  - Test 2: Business is carried on within New York State if activities within New York State in connection with the business are conducted in New York State with a **fair measure of permanency and continuity**."

Partnership/Sole Prop Nexus

- New York Business
  - Vogt v. Tully (53 NY2d 580)
    - Single general partner located in New York
    - Performed substantial personal services
    - Utilized personnel and services of another company which was provided to the partnership on a contractual basis under a compensatory arrangement
- Systemically and regularly carried on
  - Physical location in-state required
  - Must have performed services in New York State
  - Must not have exclusively performed services in other states
- Fair measure of permanency and continuity
  - Appears to not require physical presence but never interpreted that way under NY Law
  - Consider application of Wayfair

Franchise Tax Nexus

- Several ways for corporation to have franchise tax/GCT nexus
  - State of Incorporation
  - Commercial Domicile (headquarters): State where a business is headquartered and directs its operation (this may be different from the place of incorporation)
  - NY Tax Law §209(1)
    - all **domestic corporations** which are incorporated in the state, and
    - **foreign corporations** for
      - (1) "Doing business" in New York
      - (2) Employing capital in NY,
      - (3) Owning or leasing property in NY or
      - (4) Maintaining an office in NY
      - (5) "deriving receipts from activity in this state"--**Economic Nexus**
        - 1,138,000 in New York receipts

Constraints on Nexus:

- There are three (3) major constraints on nexus:
  - United States Constitution
  - Public Law 86-272 (PL 86-272); and
  - State Law

Public Law 86-272

- Even if a foreign corporation has nexus under the above referenced rules, states are prohibited from taxing foreign corporations that satisfy the elements of federal statute Public Law 86-272
- Public Law 86-272 restricts a state from taxing corporations whose only activities within the state consist of the "solicitation of orders" for sales of "tangible personal property" provided that:
  - the orders are sent outside the state for approval and
  - the goods are shipped from outside the state
- Allows corporations to have significant physical connections with a State and not be subject to their income tax laws
- For example:
  - A corporation can have an employee regularly enter into a state to solicit business so long as they satisfy the requirements of PL 86-272
  - A corporation can utilize independent contractors in the State, even IC's with brick-and-mortar stores

Application of Public Law 86-272

- From a choice of entity perspective, under federal law, PL 86-272 only applies to corporations
- PL 86-272 applies to pass-through entities in New York
  - At the federal level, PL 86-272 only applies to C-corporations, however, in Advisory Opinion TSB-A-08(4)I, New York stated that it also applies to S-corporations and LLC's taxed as partnerships
  - Need to consider the specific interpretation of your state and local tax authority

New York State – “Final” Franchise Tax Regulations

- Attempted Minimization of PL 86-272 to Economic Nexus
  - Under previous draft regs if the requirements of P.L. 86-272 are otherwise met, the out-of-state corporation is protected from this economic nexus rule
  - “Final” Regs adopt guidance from the Multistate Tax Commission which look to limit the application of PL 86-272 for corporations engaged in solicitation of orders through the internet
    - PL 86-272 does not include activities that out-of-state corporations may engage in “via the Internet, including interacting with customers or potential customers through the corporation’s website or computer application”
    - Regulation Examples
      - A foreign corporation regularly provides assistance to its customers after its products have been delivered, either by email or electronic chat that customers initiate by clicking on an icon on the corporation’s website. For example, the corporation regularly advises customers on how to use products after the products have been delivered. Since this activity does not constitute, and is not entirely ancillary to, the solicitation of orders for sales of tangible personal property, the corporation is not exempt from tax under this section.
      - A foreign corporation places internet cookies onto the computers or other electronic devices of is customers. These cookies gather customer search information that will be used to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale. Since this activity does not constitute, and is not entirely ancillary to, the solicitation of orders for sales of tangible personal property, the corporation is not exempt from tax under article 9-A under this section.

Allocation of Income and Apportionment

- If there is a NY business, there are different ways to determine how the taxpayer’s allocation will be determined.
  - **Incorporated business**
    - C-corp and S corp at the NY State level allocate using a single sales factor based on location that customer receives a benefit
    - C-corps at the NYC level also use a single sales factor
    - S-corporation at the NYC level use a three-factor formula:
      - Property percentage,
      - Payroll percentage and
      - Gross income percentage.
  - **Unincorporated business (partnership or sole proprietorship)**
    - In the case of an ***unincorporated business*** such as a partnership or a sole proprietorship conducting business both within and without New York, the books and records of the business must be used for allocation if they truly reflect the business activities to the satisfaction of the Commissioner.
    - **Alternatively, they must use the “Three Factor Method”** Reg. §132.15 (key difference is sourcing of gross income factor, and location of customers)

Entity and Pass-through Entity Level Taxes

- NYS- Franchise Tax, Filing fees for other pass-through entitles
- NYC – GCT and UBT
- NYS PTET update
  - PTET election extended to September 15, 2022 for all pass-through entities
  - Estimates are based on when you file PTET election
    - Before March 15, 2022, the March 15, 2022 and June 15, 2022 estimates must both equal 25% of the required annual payment
    - After March 15, 2022, and before June 15, 2022, an estimated payment with the PTET election must be made equal to 25% of the required annual payment
    - After June 15, 2022, and before September 15, 2022, an estimated payment with the PTET election must be made equal to 50% of the required annual payment.
    - On September 15, 2022, an estimated payment with the PTET election must be made equal to 75% of the required annual payment

NYS PTET Update (con't)

- S-corporations
  - Under the prior PTET law, an S corporation calculated its PTET based on NYS source income irrespective of the shareholders' state of residence
  - Under new legislation all of the income allocated to the shareholders would now be subject to the PTET, rather than only the New York source income.
  - Effective January 1, 2022, the Bill created two types of S corporations for PTET purposes: an "electing standard S corporation" and an "electing resident S corporation."
  - An "electing standard S corporation" is one that does not certify that all its shareholders are NYS residents. For these entities, the PTET remains calculated based solely on its NYS source income.
  - An "electing resident S corporation" is one that certifies at the time of its annual PTET election that all its shareholders are NYS residents. Once made, the certification is irrevocable. For these entities, effective January 1, 2022, the PTET is based on all income, gain, loss, or deduction to the extent included in the resident shareholder's NYS personal income tax.
- S Corporations having all resident shareholders should reexamine the PTET election if the entity had little or no New York source income
- Election:
  - Resident S Corporations must file a state mandated certification attesting to the resident status of all of their shareholders at the time the PTET election is made. If the certification is not filed, Resident S Corporation status will be denied and the regular S Corporation allocation rules will apply. For S Corporations that have already elected into the PTET and qualify for Resident S Corporation status, the new required certification must be filed no later than September 15 of this year.

NYC PTET

- New York City PTET enacted as part of the 2022 budget bill (first local tax PTET)
- Follows similar formula of other PTETs (important to note that PTET workaround minimizes a significant difference between Corporate utilization and other entity forms)
  - Elective tax that applies to partnerships, LLC (not SMLLCs) and S-corps, must be made by March 15, 2023
    - Partnerships can elect into the NYC PTET with both resident and nonresident partners but the tax is only computed on amounts flowing through to the resident partners
    - S-corps with only NYC residents can make the election
    - S-corps without a NYS election can likely not make the election
  - Effective for tax years January 1, 2023
  - Must have elected into the State PTE to utilize the City PTE

NYC PTET

- Calculating the PTE Taxable Income
  - Partnerships –
    - Includes all items of income, gain, loss and deductions to the extent included in the resident partner's taxable income.
    - Taxable income does not include any amounts attributed to nonresident partners not subject to NYC personal income taxation (such as corporations, upper-tier partnerships, and nonresident individuals).
      - Not included since there is SALT impact
  - S-corps
    - An S corporation includes all items of income, gain, loss, and deduction to the extent included in the taxable income of NYC resident shareholders.
- Part-year residents
  - Not clear whether this will follow the State rule (more of less than half year)

Combined Reporting

- New York will REQUIRE combined reporting if:
  - Corporations are engaged in a unitary business with other corporations, and
  - The corporations meet the capital stock ownership requirement. This test is met if one corporation/shareholder owns more than 50% of stock in the other corporation
- New York will PERMIT combined reporting if the capital stock ownership requirement is met
  - No other factors or requirements need to be satisfied in order for corporations to combine report.

What is a Unitary Business?

- A unitary business relationship exists when there is functional integration of business activities or centralization of management between parent and subsidiaries, and the companies are interdependent (*F. W. Woolworth Co. v. N. Mex. Tax & Rev. Dept. U.S. Sup.Ct. 80-1745, 06/29/1982,* ***458 US 354, 102 SCt 3128** , **73 LEd 2d 819;*** *rev'g N.M. SupCt* ***95 N.M. 519, 624 P2d 28*** .).
- In *Mobil Oil Corp. v. Vermont Tax Commissioner, (1980)* ***445 US 425*** , the U.S. Supreme Court set out the following factors, which have become the basis of determining whether a business is unitary:
  - (1) Functional integration;
  - (2) Centralization of management; and
  - (3) Economies of scale.(cost advantages that a company obtains due to size, output or sale of the operation)
- In *Exxon Corp. v. Wisconsin Department of Revenue* (1980) 447 US 207, another landmark U.S. Supreme Court decision, vertically integrated companies were found to be unitary.
  - Vertical Integration: an arrangement where a company produces the component parts of its business, as well as, controls the end product.
    - Example: the IPhone and iPad have hardware and software designed by Apple, which also designs its own processors for the device
  - Dell would be an example of horizontal integration where they sell the labtop at the end of the day but the hardware and software are from other companies.

Combined Reporting- Can Be Helpful

- Combined returns provides a benefit in the following manner:
  - Permits a profitable corporation to offset its income with the losses of another corporation
  - Permits a corporation with a high New York allocation percentage to use the non-New York tax attributes of a related corporation to dilute its New York allocation percentage.
- **Affiliated Group Election:**
  - Corporation that meet 50% ownership test can elect to be treated as a combined group even if they do not meet the unitary business test.
  - Making the election:
    - Must be made on an original timely return
    - Any corporation entering the commonly owned group while the election is in place will be forced to be included into the combined group
    - The election is irrevocable and binding for the taxable year and the next 7 tax years
    - Automatic renewal unless revoked
    - If revoked, cannot elect again for another 3 years

Cross Border Considerations

- Outbound Transfers
  - IRC 367(a) – changes nonrecognition treatment for corporate non-recognition exchanges under 332, 351, 354, 356 and 361 of the IRC
  - IRC 7874 – Anti-inversion rules
- Inbound Transfers
  - Generally non-taxable but opportunity for check-the-box pre-inbound planning
  - Without corporate entity, subject to branch profits
- Treaty Considerations
  - Permanent Establishment determinations
  - Reduced withholding on interest, dividends, royalties, branch profits

Cross Border Considerations

- Withholding Obligations
  - Significant withholding obligations for foreign partners of US Partnerships (37% WH for individuals and 21% for corps)
  - Dividend withholding under FDAP regime may require 30% WH subject to treaty exception
- Difference in Tax Information Reporting, Schedule K-2 and K3, Corporate Transparency Act
- Sourcing of income
  - Partnership
    - Partnership is considered a person for federal income tax purposes. Therefore, income sourced by reference to the residence of the taxpayer will be sourced based on the residence of the partnership
    - The source of the income retains its source from partnership to partner
  - S-corporation
  - C-corporation
- CFC, PFIC, GILTI

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Legal Entity vs. Taxable Entities

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Legal Entity vs. Taxable Entities

- Legal Entities:
  - Refers to the legal consequences of operating through a particular entity as defined in the relevant state statute
- Taxable Entities
  - The federal tax treatment of a business in the U.S. is partly dependent on how it is organized. Organized refers to how the entity is formally created for state law purposes. (Although check-the-box significantly alters this treatment)
  - However, if you choose to create a legal corporation, you must be taxed as a corporation and can choose to either be a C or S corporation.
  - Options:
    - Corporation (C or S)
    - Partnership
    - Disregarded Entity
    - Trust or Estate

Legal Entity

- Refers to the legal consequences of operating through a particular entity as defined in the relevant state statute
- What are some types of legal entities?
  - Sole Proprietorship
  - General Partnership
  - Limited Partnership
  - Limited Liability Partnership
  - Limited liability Company
  - Professional Limited Liability Company
  - Corporation
- Legal entities are created under State law. Every State in the United States has its own entity laws. For example, every State has laws for the creation and operation of corporations, LLCs, partnerships.

Respecting Entity Formalities

- RISK:
  - *If an owner of an entity treats themselves and that entity as one and the same, that owner has diminished its ability to rely on the level of liability insulation that is otherwise available to that owner under the laws of the state of organization or qualification. Once this insulation is pierced, other owners are also at risk*

Respecting Entity Formalities

- If we want a court to treat an entity as being separate from an individual, WE have to treat it that way too.
  - Separate bank accounts
  - Actions taken with proper consent
  - Agreements entered into on behalf of the entity, not the individual
  - *Importance of operating agreement*

Decision Making

- Risk
  - Absent a hierarchy of decision-making power, employee/manager actions are unpredictable. By setting clear power structures, an entity can maximize order, ensure obligations to and from that entity are enforceable and reliable, and prevent or otherwise seek recourse for actions taken outside the scope of permissibility
- Management Decisions Vary Based on Entity
  - Corporation – Officers and Directors, subject to exceptions in shareholders agreements (voting, major decisions, etc.).
  - LLCs:
    - LLCs can be “member managed” or “manager-managed”.
    - This is typically laid out in the Operating Agreement
  - Partnerships
    - General Partnership – subject to any exceptions in a partnership agreement, all partners manage the entity
    - Limited Partnership – the general partner manages the partnership subject to “major decisions” and other exceptions provided in the partnership agreement.
      - Corporate General Partner Permitted:
        - In order to use a corporation as a general partner, the corporation must have “substantial” value/worth. If not, the IRS can change the tax characteristic of the entity from a partnership to a corporation since a limited partnership must have at least one general partner.
  - Limited Liability Partnerships and PLLCs

Decision Making

- Value of implementing a decision-making system may not appear immediately
  - Do we really need a voting system for, for example, indebtedness on day 1?
  - Consider difficulty amending…
  - Consider accountability for decisions made…

Breaking a Dead-Lock

- Buy/Sell (context of Morganton)
  - Highest offer, one-way offer, etc.
- Board
  - Odd numbers vs. even numbers
- Third party advisors/tie-breakers
  - Question of bias?
- Mediation?

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Comparison of Legal Forms

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Sole Proprietorship that are not LLCs

Formation:

- No registration or formal filing required to create a sole proprietorship.
- All assets of the Sole prop are held in the individual owner's individual name
- Should obtain taxpayer ID (EIN) for payroll purposes
- Sales tax registration required if a vendor
- Filing is required for an assumed name (DBA) – "doing business as"
  - Instead of your business adopting your individual name—you can create a DBA
    - Open a bank account under the name for business and financial purposes
    - Market and advertise to increase visibility of your business
    - Create a professional business identity for your customers and vendors
  - File a Certificate of Assumed Name in the County Clerk's office in each county in which proprietor does business (this is the same rule for general partnerships, and limited liability partnerships"
  - Obtain licenses, permits, and zoning clearance

Sole Proprietorship that are not LLCs

Owner	• Always a single individual owner • If more than one owner, then partnership absent formal filing
Management	• By owner
Liability	• Unlimited

Limited Liability Company (LLC)

Why do we have LLCs?

- Prior to the Repeal of General Utilities
- Only corporations offered owners liability protection but the IRC imposed a double taxation on the corporation's income
- Then came the limited partnership. -- PROBLEM WITH MANAGEMENT
- Then came S-corporations, which provided corporate limited liability with pass-through treatment but S-corporations have many restrictions on them.

Limited Liability Company (LLC)

- **LLCs are Hybrid Entities**
  - Theoretically provides limited liability to its owners and only a single level of tax
    - Misconceptions:
      - Not really limited liability:
        - Sales tax automatically
      - Single level of Tax
        - This is incorrect since you can check-the-box and treat an LLC as many different types of taxable entities depending on its owners
- Formation:
  - "Articles Of Organization" with Secretary of State
  - Publication Requirement in New York- only state in U.S.
- Other
  - Publication Requirement in New York
  - Professional Limited Liability Company ("PLLC")

LLC vs. Corporation

- Same limited liability as corporations (at least this is the intent of the various states' enabling statutes)
- Not many court decisions on this issue though
- Some say "better" liability protection since creditors and other third parties can only step into being K-1 recipients (i.e., no say in business decisions unlike corporate counterparts)
- Watch out for Trust Funds

Duration of Entity

- Corporation:
  - perpetual experience (unless stated otherwise in its Charter)
- Partnership:
  - Depends on the operating agreement/partnership agreement
    - Can be tied to accomplishment of a particular goal;
    - Can be tied to a particular period of time;
    - Can be perpetual; or
    - If the operating agreement is silent, in many instance its dissolvable upon the consent of any member.

Partnership

- General Partnership
  - Formation:
    - General partnerships are formed by either a written agreement among the partners (partnership agreement) or informally when two or more owners join together in an activity to generate profits
  - Owners:
    - 2 or more general partners
    - There are no limited partners
  - Liability:
    - There is no limited liability- therefore, creditors of a general partnership can collect from both the partnership's assets and the personal assets of the owner-partners
    - All partners are jointly and severally liable - explain what that means
      - Legal obligation whereby two or more people each have individual liability for the whole.
    - Liability for other partners:
      - A general partner can be subject to a malpractice judgment brought against the partnership, even though the partner was not personally involved in the malpractice.

Limited Partnership (LP)

- Formation in NY requires:
  - General Partner executing a partnership agreement, and
  - Filing of certificate of limited partnership with the Department of State
  - Name of the partnership must include reference to Limited Partnership form and be proper under state law and not conflict with others
- Ownership
  - Partnership that must have at least one general partner and one or more limited partners
- Liability Protection:
  - General partners are treated the same as they are under a general partnership—i.e., responsible for all debts
  - Limited partner's risk of loss is restricted to that partner's value or worth in the entity.
- When Use LP?
  - Typically use a limited partnership where you need to raise capital but the investors do not want to take on liability.

Limited Liability Partnership (LLP)

- Ownership:
  - Same as LP but only available to professionals in New York State
  - Used where active involvement of partners in the business preclude limited partnership status
- Liability:
  - LLP partners are personally liable for their own negligence and those that they supervise but not other partners

Corporations

- Formation:
  - Articles of Incorporation filed with the State- in NYS its filed with the NYS Department of State
- Owners:
  - Shareholders- can be anyone
- Management
  - Board of Directors or Officers
- Liability:
  - Generally provides limited liability to its owners subject to corporate veil being pierced
  - Liability protection is the same whether S or C corp
  - Limited liability is not available to all corporations.
    - Professional individuals (e.g., accountants, attorneys, architects, and physicians) may incorporate or create LLC or PLLCs, these entities do not provide limited liability for the performance of professional services.

Comparison of Taxable Entities

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Taxable Entities - Disregarded Entity

- In General:
  - A disregarded entity is not a taxable entity separate and distinct from the individual that owns the company
  - Rather, the entity is a flow through entity, whereby the entity earns the income, gains, losses and deductions, but those amounts then flow through to the owner of the company.
- Income and Losses:
  - The individual owner reports all business income and expenses on Schedule C of Form 1040
  - Schedule C income is also subject to self-employment tax
    - A self-employed person's net income is subject to SE tax of 15.3% (the 12.4% of Social Security tax plus the 2.9% of Medicare tax).
    - 147,000 is FICA Wage Base
- The owner of the Sole Prop or LLC reports all net profit or loss from the business during the year whether or not ANY MONEY IS distributed. Therefore, if and when a distribution is made, it is not tax again.

Disregarded Entity:

- <u>Character of Income and Deductions:</u>
  - Income and expenses of the proprietorship retain their character when reported by the proprietor.
    - Character refers to capital or ordinary
  - For example, ordinary income of the proprietorship is treated as ordinary income when reported by the proprietor, and capital gain earned by the proprietorship is treated as capital gain

Partnership

- Flow through entity- no separate entity level income tax on the partnership itself
- <u>Tax Reporting:</u>
  - While there is no separate entity tax on a partnership, the partnership is required to report the partnership's business activities on Form 1065
  - A partnership reports the income of the entity by aggregating the ordinary business income/loss of the entity.
  - Any other items of income/deductions that are not from the business itself are reported separately to each partner.
- <u>Self-Employment Income</u>
  - The net income that flows through to a partner from the partnership is subject to SE Tax since partners are not treated as employees. In addition, all guaranteed payments are subject to SE
    - <u>Exception: Limited Partner:</u>
      - If a limited partner is merely receiving income as an investor, the income received by the limited partner is not subject to SE Tax. A partner will be treated as a general partner if:
        - The partner has personal liability for partnership debts by virtue of his status as a partner
        - The partner can enter into contractual relationships on behalf of the partnership, or
        - The partner works more than 500 hours in the partnership's trade or business during the tax year
      - **New IRS Compliance Campaign related to limited partner's exposure to SECA**

Partnership

- Distributions:
  - A distribution from a partnership should not be confused with a partner's "distributive share". A distribution is actual money taken out of the partnership by the partner. The distributive share refers to the income, gains, losses, deductions that flow-through to the partner at the end of the partnership's tax year.
  - Distributions to partners are generally not subject to tax but there are ways that distributions can become taxable and you should be aware of when this will occur.
    - No basis or distribution in cash exceeds basis. Pro-rata distributions of property, including hot assets, will never trigger a taxable gain/loss
    - Negative capital account
    - Distribution recharacterized as a disguised sale

Corporation

- The IRC has two types of Corporations:
  - C-corporation which is governed by Subchapter C of the IRC
  - S-corporations which is governed by Subchapter S of the IRC
- S-Corporation:
  - The S-corporation rules are a combination of the C-corporation rules and the Partnership rules (Subchapter K).
    - When subchapter K is silent as to the treatment of a particular transaction, Subchapter C rules apply
  - Report business activities on Form 1120S
  - Shareholders receive a Form K-1 just like in a partnership
  - Similar to a partnership in that:
    - No entity level tax, flow-through income, gain, losses, deductions and credits, and separately and non-separately stated items of income.
    - Distributions are generally not subject to tax again

C-Corporations

- Double taxation: Entity level tax as the corporation earns the money
  - Reported on Form 1120
  - Flat 21% tax rate
- Character of Business Income and Losses
  - Unlike all other entities, the character of the items of a C-corporation do not flow through to the C-corporation shareholders. Rather all of the income and losses stay with the C-corporation
- Shareholder level tax upon Dividend Distribution
  - Dividends to shareholders, other than certain corporate shareholders are not deductible

Minimizing Double Taxation

- Compensation, loan, lease or sale.
  - Each type of distribution is closely analyzed by the IRS to determine if they are reasonable—be careful
  - Thinly Capitalized: If the company is thinly capitalized, the debt can be recharacterized as equity. If the debt is recharacterized as equity, the interest payments can be reclassified as distributions.
- Not making Distributions:
  - IRC §532: 20% tax imposed by the federal government upon companies with retained earnings deemed to be unreasonable and in excess of what is considered ordinary.
- Return of Capital Distributions
- Electing S-corporation Status

General Considerations

C corporations

- Best for taking advantage of 100% exclusion under Code Sec. 1202(b)
- Best for owner/employee fringe benefits

S corporations

- Best for employment tax savings
- Cash Distributions tax free subject to sufficient basis and disguised sale rules
- Only one layer of tax normally upon liquidation

Partnerships/LLCs

- Greatest flexibility for "getting owners and/or property into or out of" partnership entity; excellent for holding rental properties
- Cash and property distributions tax-free subject to disguised sale rules
- Can be dissolved without any immediate tax effect

Proprietorships

- Especially with use of SMLLC, offers same limited liability
- Simplest to form w/ no need for extra federal/state tax returns

199A

- Code Sec. 199A: "20% QBI Deduction"
  - Provides individuals taxpayers with a deduction up to 20% of Qualified Business Income (QBI) of a pass-through entity (Sole prop, partnerships and S-corps)
  - **<u>Importance of 199A depends on the following:</u>**
    - Whether income exceeds threshold exclusion amount
      - The threshold amount is $340,100 for married couples filing jointly, $170,050 for married individuals filing separately, and $170,050 for all others. The phase-in range amount is $440,100 for married couples filing jointly, $220,050 for married individuals filing separately, and $220,050 for all others.
      - If taxable income exceeds applicable amount, need to consider SSTB, wage and property limitations

199A

- **Whether business is a Specified Service Trade or Business (SSTB)**
  - Includes
    - Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.
    - Also includes any trade or business which involves the performance of services that consist of: investing and investment management; trading in securities, partnership interests, or commodities; or dealing in securities, partnership interests, or commodities.
- **Aggregation Rule**
  - Allows taxpayers to aggregate multiple trades or business for purposes of calculating the QBI deduction
  - For qualifying taxpayers, the aggregation rules allow the wage and qualified property limitations of 199A to be calculated for the combined trade or businesses rather than for each trade or business separately. Depending on the facts, aggregation may allow a taxpayer to claim a greater QBI deduction than if the wages and capital limitation was applied separately.

Example

- A taxpayer who is over the applicable taxable income threshold has QBI of $100 each from two trades or businesses *A* and *B*. *A* has $50 of W-2 wages, and *B* has $20 of W-2 wages. Neither *A* nor *B* owns any qualified property. If the QBI deduction is computed separately for *A* and *B*, *A* would generate a QBI deduction of $20, since 50% of W-2 wages, $25, exceeds 20% of QBI, $20. *B* would receive a QBI deduction of $10, since 50% of W-2 wages, $10, is less than 20% of QBI, $20. In this separate scenario the total QBI deduction for both *A* and *B* is $30 ($20 for *A* + $10 for *B*). If *A* and *B* were aggregated, the total QBI of the combined trade or business would be $200, and the total W-2 wages would be $70. The QBI deduction for the aggregated group would be $35, since 50% of the W-2 wages, $35, is lower than 20% of the QBI of the combined group, $40. Note that the aggregation of *A* and B results in a net increase to the QBI deduction of $5 over not aggregating the businesses. As illustrated in a later example, aggregation is not always beneficial.

Aggregation allowed if:

- (a) the same person or group of persons, owns, directly or by attribution under §267(b) or §707(b), 50% or more of each trade or business to be aggregated;
- (b) the common control relationship exists for the majority of the tax year, including the last day of the tax year, in which the items are included in income;
- (c) all of the items attributable to each trade or business are reported on returns in the same tax year (excepting short years);
- (d) none of the trades or businesses to be aggregated is an SSTB; and
- (e) two of three conditions are met
  - (1) the trades or businesses provide products, property, or services that are either the same or customarily offered together,
  - (2) the trades or businesses share facilities or share significant centralized business elements, or
  - (3) the trades or businesses are operated in coordination with, or reliance upon, one or more businesses in the aggregated group.

Determining eligibility

- Does the activity rise to the level of trade or business?
- IRC §162 trade or business definition is relevant for 199A purposes but there are important deviations
  - o Trade or business conducted by former employees
  - o Rental or licensing of tangible or intangible property if rented or licensed to a trade or business conducted by an individual or relevant passthrough entity (RPE) that is commonly controlled (Put another way, if there is a self-rental activity between an individual or RPE and a commonly controlled trade or business, the self-rental activity will be considered a trade or business for Sec. 199A purposes even if it does not meet the Sec. 162 definition of trade or business.)
  - o Notice 2019-07 provides a safe harbor for certain rental real estate businesses that qualify as trades or business for 199A purposes only

199A – Guaranteed Payments vs S-corp Wages

- IRC sec 199A(c)(4)(B) – QBI does not include guaranteed payments to a partner
  - Guaranteed payment reduces the amount of income eligible for the QBI deduction
  - Guaranteed payment is not treated as W-2 Wages for wage-based limitation
- QBI does not include reasonable compensation paid to S-corp shareholders
- Any benefit to be gained?
  - Payments out of net profits for a partnership, unlike guaranteed payments, allow the recipient partner to use the QBI deduction
  - Example
    - ABC Partnership has $2M in QBI split evenly between 4 partners which includes an $800,000 guaranteed payment to Partner A
    - Partner A would have taxable income of $1.3M but the QBI would only be $500,000 and not $1.3M
    - If partner instead receives a priority profit allocation, the QBI becomes $1.3M

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Structural Tax Issues for Different Entity Classifications

Scott Ahroni, Shareholder

David Cykiert, Shareholder

Allocation of Income

- Partnerships offer a lot of allocation flexibility
- S-corporations no flexibility
- C-corporations have no allocation because income does not pass through
- DE – no allocation available because only single owner

Entity Level Tax

- C-corporation is the only taxable entity type that has an entity level tax at the federal level
- Different NYS/NYC rules for the taxation of entities

Withdrawing Money/Property from Entity

- C-corporation: Dividend
- Partnerships:
  - Distributions are generally not taxable to the extent they do not exceed the basis in the partner's partnership interest
  - Guaranteed payments are taxable
- S-corporations:
  - Similar to partnerships in that distributions are generally not taxable to the extent they do not exceed the basis in the shareholder's basis in the stock

Fringe Benefits

- C-corporations: all fringe benefits are deductible to the corporation and excluded as income from the individual shareholder receiving the fringe benefit
- S-corporation: only fringe benefits paid to shareholders owning 2% or less of stock are excluded from income
- Partnerships: no special fringe benefit rule

Self-employment tax

- Self-employed individuals generally must pay self-employment tax (SE tax) as well as income tax. SE tax is a Social Security and Medicare tax primarily for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners.
  - C-corporations: N/A
  - S-corporation: distributions are not subject to SE tax but may be recharacterized
  - Partnership and DE: S/E imposed on all income except for limited partner

Formation of the Taxable Entity

Scott Ahroni, Shareholder
David Cykiert, Shareholder

Entity Classification

- Federal Implications:
- Federal entity classification is important because:
  - It allows you to identify and properly account for what type of business entity your client is operating
- Federal Entity Classification is defined in the "check the box" regulations under 301.7701-1 to 301.7701-8.
  - The reason they call these the check the box regulations is you can use Form 8832 to check the box on what type of entity you want to operate.

Check-the-Box Regulations

- Under check the box, any "eligible entity", may check-the-box and elect to treat itself as any taxable entity it so desires.
- In order for an entity to be "eligible" for a check-the-box election, the entity must be:
  - A business entity; and
  - An eligible entity
- Business Entity:
  - Mere co-ownership of property is not a business
  - Identifying a partnership is most challenging
- Eligible Entity:
  - Any entity which is not a domestic corporation or a "per se" foreign corporation

Check-the-Box Regulations

- When Election Should Be Filed?
  - When the entity is relevant and either
    - Entity desires initially to be classified differently than it would be classified under the default rules, or
    - Entity desires to change its classification
- For domestic entities, the default classification is based on the number of owners
- For Foreign Entities, default classification is based on number of owners and limited liability offered to owners

Foreign Entities

- For Foreign Eligible entities: based on (1) number of members and (2) limited liability –is member personally liable for the debts of the entity?
  - Corporation if - all members have limited liability
  - Partnership if - 2 or more members and at least one member does not have limited liability
  - Disregarded entity if - single owner and does not have limited liability

Properly making the election:

- Default classification: The default classification of an entity is effective until the entity affirmatively elects to change its classification
- Preparing the Form:
  - **Must be signed by**
    - Each owner on the date of the entity classification change, or
    - Any officer, manager or owner who is authorized to make the election and who represents to having such authorization under penalties of perjury.
    - *Retroactive elections*.—
      - Each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign the election. **This is the case even if filing was made by an authorized person.**

Properly making the election:

- **Effective Date:**
  - The effective date of the election is typically the date the Form 8832 is filed.
  - Flexible:
    - You can make the effective date up to 75 days prior to the filing of the Form 8832 or up to 12 months after the filing of Form 8832
- Form 8832 must be attached to the annual return of the entity or of the individual owners return if an entity return is not required.
  - If the entity or the individual taxpayer(s) fail to attach Form 8832 to their individual returns, the IRS will impose penalties but this will not cause a valid election to terminate

What happens if you do not make the timely election?

- **Late Entity Classification Election Relief Broadened, Extended**
  - An entity that failed to timely file their election can file such election up to three years and 75 days from the effective date if:
    - (1) the entity has either:
      - Not filed federal tax or information returns for the first year in which the election was intended because the due date for such filing has not yet passed, or
      - The entity has timely filed all required federal tax and information returns consistent with its required classification for all of the years the entity intended the requested election to be effective;
    - (2) the failure was due to reasonable cause; and
    - (3) all previous owners must sign the election.

60-month limitation on making election:

- Entities are limited to making the check-the-box election to once every 60 months.
- **First election doesn't count**
- **5 years is not 60 months**
- The IRS may waive the 60-month limitation when there has been a more than 50% change in the ownership of the entity

Tax Consequences Upon Making Election

- If going from flow-through entity/disregarded, to corporation generally not taxable
  - Carryover of tax attributes
  - Consider taxability of AR
- If going from corporation to pass-through, taxable liquidation

Getting Into the Entity

- Generally non-recognition under 351 or 721 so long as its property for entity interest
- 351 has extra requirement of control
  - 80% control by transferors
  - Accommodation transfers
  - 351 is mandatory – when would you want to structure out of 351?
- Transfer of assets to an entity subject to liabilities
  - C-corporation:
    - Liabilities in excess of adjusted bases of property transferred = gain (Sec. 357 (c))
    - Does not matter that shareholder remains guarantor on underlying debt
    - Debt taken out shortly before Sec. 351 transfer "tainted" = "boot"
  - Partnerships – increase and decreases need to be considered under IRC 752

S-corporations

- S corporation
  - Same as C corps but Form 2553 election “must’ be filed by 15th day of 3rd month of desired tax year
  - New York State has its own separate election; New York City doesn’t not recognize the S-corporation
  - “Late elections” allowed in certain circumstances
  - Generally, all shareholders must sign Form 2553, although if timely, can designate a corporate representative who signs for everyone
  - Includes husbands and wives, even if shares are to be held in only one spouse’s name
  - Continuous monitoring of S corp requirements needed to maintain valid election

Capitalizing the Business - Venture Capital

- Term Sheets - negotiate before drafting
  - Preferred Stock vs. Common stock
  - Protective provisions
  - Future Issuances
  - dilution/anti-dilution
  - Board construction

Capitalizing the Business - Basics

- Founder investments (founder vesting)
- Indebtedness
- Equity
- Convertible instruments (SAFEs, Notes, Options, Warrants)
  - Concept of Caps vs. Discounts

Tax Basis

- Generally, transferor and entity take carryover basis
- Impact of boot
  - C-corporations – taxable
  - Partnerships- may not be
- Liabilities
  - Only partnership basis is increased by liabilities
  - Liabilities may also be treated as boot and can cause taxable events for your client

Effect of Liabilities

- C corporations
  - Share of corporate liabilities do not increase S/H's basis unless debt is recharacterized as equity and related interest deduction is not allowed (Code Sec. 385)
  - If debt contributed exceeds the adjusted basis of the property transferred boot is created (Code Sec. 357)
- S corporations
  - Corporate liabilities do not increase S/H's basis.
  - Only direct loans from S/H to S corp create "debt basis" which allow loss utilization
  - Debt Basis has no effect on stock basis and ability to take tax-free distributions
- Compare this "stock" v. "debt" basis to partnerships?
  - General partner's share of both recourse and nonrecourse debt increases basis
  - Guaranteed debt specifically allocated to partner(s) who agreed to do this if they have no right of subrogation
  - Limited partner's basis only increased by share of nonrecourse debt
  - Generally no income on debt transferred in connection with the contribution of property
  - Gain is recognized only if the debt allocated away from the owner exceeds their adjusted basis (i.e., treated as cash received under Code Sec. 731)

Reporting Results of business operations

- Partners/Partnership
  - Partners are taxed on flow-through income and can deduct flow-through losses subject to loss limitation rules
    - Basis Loss Limitation
    - Passive Loss Limitation
    - Capital Loss Limitation
    - Excess Loss Limitation

Excess Business Loss Limitation

- A single taxpayer has $300,000 of interest and dividends, $500,000 ordinary loss (e.g., K-1, Box 1 T/B loss) from a partnership and $100,000 of ordinary income (e.g., K-1, Box 1 T/B income) from an S corp with material participation in both business activities. Under pre-TCJA rules, this would result in a $100,000 taxable loss for the taxpayer ($300,000 - $500,000 + $100,000). Now, the two "business interests" are first combined to get an overall loss of $400,000, which is then limited to $250,000 under the Code §461(l) EBL limitations which can be used to offset the $300,000 of nonbusiness (i.e., dividend and interest) income for a net positive income of $50,000. This calculation of the EBL would be included on the individual tax return Form 461, Limitation on Business Losses, which would be attached to the taxpayer's Form 1040. The disallowed $150,000 loss which is the excess of the $400,000 of business and other income over the new limitation $250,000 for a single taxpayer in this example is not permanently lost but is instead carried forward as a net operating loss (NOL).

Reporting Results of business operations

- S-corporations
  - Similar to partnerships
- C-corporations
  - Entity is respected and therefore, look for recharacterization issues or treatment under IRC 301
- State and Local Considerations
  - Nexus and allocation methods for entities vary
- Basis Adjustments

Form 7203

- Requires S-corporation shareholders to report their stock and debt basis when they:
  - Are claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations),
  - Received a non-dividend distribution from an S corporation,
  - Disposed of stock in an S corporation (whether or not gain is recognized), or
  - Received a loan repayment from an S corporation.
- In basis audits, the auditors will require the taxpayer to supply basis schedules and support for claiming losses and eligibility of loss

If new client is an existing business

- Prepare a map
  - Evaluate existing agreements:
    - Key provisions to examine: Term, transferability; ownership of deliverables.
  - Review intellectual property:
    - Are rights recorded? Have rights been protected? Examine existing third party uses. Consider siloing IP
  - Scaffold HR protections
    - Class-action waivers; arbitration agreements; PIAA/NDA
  - Structure equity incentive pools
    - Compensation for highly-sought after talent

If new client is an existing business

- Prepare a map (continued)
  - Review Organizational documents
    - Sufficiency of shares; compliance with bylaws, etc.
  - Review past major decisions
    - Does the proper record of consents exist? Can we track equity ownership?
  - Threatened or Pending Litigation.
    - Discuss any potential exposures (notices, demands, known defaults); Discuss proper protections (insurance, indemnities, etc.); Consider proactive resolutions

Review Entity Classification

- Considerations when converting from
  - Partnership to corporation
    - Ensure proper elections are made depending on type of corporation you wish to use
      - An LLC that is eligible to elect S status and timely files Form 2553, is not required to file Form 8832
      - Ensure one class of stock rule can be met if converting to S-corp
  - C-corporation to S-corporation
    - Make election ASAP since only pre-conversion asset appreciation is subject to BIIG Tax and quicker you begin running the 5-year clock
    - Defer disposition of loss assets

Passing on the Business

- Succession
- Sale of Business
- Dissolution/Liquidation

Ending/Exiting the Business

- Revisit prior considerations:
  - Extra incentive to make sure client is considering prior slides: in the event of a sale, company will be required to represent it has all necessary consents, no litigation, ownership of IP, etc.

Succession/Transferability

- Concept of "closely-held" businesses.
  - The more restrictions on transferability, the greater the familiarity with owners
  - Becomes important where owners have rights with respect to corporate records and actions
- Consider limitations on transfer
  - Manager/board consent;
  - Member/stockholder approval;
  - Permitted transferees;
  - ROFR, Drag rights and Tag rights;
  - Repurchase right death or disability;
  - Forfeiture on breach of obligation to entity.

Transferability in an LLC

- With a Corporation, the economics of a share are generally inexorable from the share.
- In certain instances with an LLC, the "economic interest" can be separated from the actual ownership interest.
  - This means that a person can receive income without the voting or other rights that would otherwise have come with that right.
    - Operating agreements can restrict some or all of the transfer of the voting interest, the economic interest, or the membership interest in the aggregate
    - The transferee of an LLC interest is not a "Member" by right. Has to be admitted. Typically by joinder, other vote of the partnership, etc.

Transferability in a Corporation

- With a corporation, if the securities are "unregistered" (not for sale on a public exchange) then they cannot be resold unless there is an applicable exemption:
  - 144 – sales by unaffiliated parties, satisfying certain holding periods
  - 4(a)(1) – sales by any person other than an issuer, underwriter or dealer

M&A ROUNDTABLE

MERGERS AND ACQUISTIONS

M&A Was Red Hot In 2021!!

$2.9 trillion in transactions in 2021 in US

Accounted for 60% of transactions globally

Deal values continued to rise to new highs in 2021

Drivers of 2021 activity:

- Demands for technology
- Pent-up demand from 2020
- Cheap financing and strong markets
- Threat of tax changes

Who Are The Key Players?

Strategic buyers = competitor

- Larger local/regional competitor
- Consolidator (private equity backed)
- National/multinational company

Buy with cash and possibly earnout

Who Are The Key Players? *(continued)*

Financial buyer = private equity group or family office

Buy with cash, equity rollover, possibly earnout; need to utilize debt

Generally a control deal; some will do minority recaps

Who Are The Key Players? *(continued)*

They have cash!!

- PEGs raised $733 billion in 2021 and sitting on $1.3 trillion of “dry powder”
- Strategics are flush with access to cash

PEGs and strategics are motivated buyers – 80% of execs say in the market for a deal

Why motivated to grow through acquisition??

- Strategic – accretive to growth; share price
- Financial – limited partners want to see return; competition to attract new investors

Who Are The Key Players? *(continued)*

Intermediaries in Middle Market Transactions

- Buy-side investment bankers – outsourced Business Development Team
- Sell-side investment bank – deep industry knowledge engaged to find and pursue best buyer/manage auction

Pre-transaction Business Protection

Before sharing confidential information, need a strong NDA

Key protection for sellers (including if you are selling a division) = NDA with nonsolicit of employees, no contact beyond finite group of management team

Key protection for buyers = narrow reach to affiliates

"Typical" M&A Process – 4-6 Months

- Both sides will want a comprehensive team of advisors – legal, accounting, tax, etc.
- Financial and tax due diligence – QOE; sales and use tax
- Operational due diligence focused on integration

“Typical” M&A Process – 4-6 Months

Legal due diligence on key areas:

- Regulatory
- Labor & Employment
- Benefits
- Contracts
- Legal proceedings and compliance with law
- Other industry-specific diligence as needed

“Typical” M&A Process – 4-6 Months

- Both sides will want a comprehensive team of advisors – legal, accounting, tax, etc.
- Financial and tax due diligence – QOE; sales and use tax
- Operational due diligence focused on integration

What's Going On In This Red Hot Market?? – "Seller's Market"

- Highly competitive pricing
- Aggressive buyers preempting auctions
- Use of earnouts declining
  - ~ 20% of deals
  - ~ 44% are revenue-based

Representation and Warranty Insurance

Use of Rep and Warranty Insurance ("RWI")

How it works:

- Premium of 2-4% of desired limit
- Retention (deductible) of 0.5-1% of deal value
- Escrow 50%-100% of retention

Representation and Warranty Insurance *(continued)*

- Benefit of RWI
  - More cash at closing for Seller
  - More risk protection for Buyer
  - Example: $100,000,000 transaction*:

	Escrow	Buyer Risk Coverage	Seller Closing Cash Delta
RWI	$400,000	$20M Limit (2x)	$9.6M
No RWI	$10M	$10M Escrow (1/2x)	($9.6M)

*Parties may split $800K premium.

Representation and Warranty Insurance *(continued)*

- Can only insure for unknown risks
  - diligence risks = exclusions
  - market exclusions
    - transfer pricing
    - underfunded benefit plans
    - availability of NOLs or other tax attributes
    - asbestos or Polychlorinated Biphenyls

Representation and Warranty Insurance *(continued)*

- At least 65% of deals use RWI
- 95% of policies acquired by buyer
- 46% of the time, buyer pays; 25% of the time cost is split
- Minimizes negotiation of indemnity
- Strategic buyers tend to be late adopters of RWI – good way to differentiate bid

Trend Of "Walk Away" Structure

- Seeing a number of deals in the middle market trend toward a "walk away" structure

	2018-2019	2020-2021
RWI sole remedy for all reps	14%	38%
RWI sole remedy for non-fundamentals	23%	25%
RWI not exclusive remedy	54%	23%

Heightened Diligence Focus

Regulatory

Sales and use tax

Wage and hour matters

Material customers/customer concentration

What Does 2022 Hold – “Crystal Ball” Predictions

- Deal volumes will continue
- Competitive process
- Record amounts of cash
- Pressure from investors to deploy capital
- Talent acquisition
- Possible headwinds
  - financial markets and macroeconomic factors, interest rates, inflation
  - Increased anti-trust scrutiny

ATTRACTING AND RETAINING KEY TALENT

The Great Resignation…What is it?

- In 2021, 47.8 million individuals voluntarily quit their jobs, with November of 2021 reaching a 20-year high of 4.5 million.*
- According to the results of a Pew Research Center survey, the top reasons given by employees for quitting were:
  - low pay
  - lack of opportunities for advancement
  - feeling disrespected
- Other studies have found that a toxic corporate culture to be the top reason for the unprecedented increase in voluntary terminations.**

- Bureau of Labor Statistics, U.S. Department of Labor, The Economics Daily, Number of quits at all-time high in November 2021 at https://www.bls.gov/opub/ted/2022/number-of-quits-at-all-time-high-in-november-2021.htm (visited May 03, 2022.

** MIT Sloan Management Review, "Toxic Culture is Driving the Great Resignation:, January 11, 2022

The Great Resignation…What Are Employers Doing to Address It?

Attracting and Retaining Key Talent During the Great Resignation

Option Based Awards

- Incentive Stock Options
- Nonqualified Stock Options

Deferred Equity Awards

- Restricted Stock Units
- Performance Shares (Units)

Option Based Awards – General Overview

- Stock options are the right to purchase a specified number of shares of stock at a specified price for a specified period of time.
- Stock options provide for actual share ownership. Stock options can be designated as either “incentive stock options” (“ISOs”) or as “nonqualified stock options” (“NQSOs”).

Option Based Awards – Incentive Stock Options - Generally

- ISOs must be designated as such at the time of grant.
- ISOs must comply with Code Section 422.
- Exercise price must not be less than the FMV of the underlying shares on the grant date (or 110% of the FMV of the underlying shares on the grant date if the grantee is at least a 10% shareholder of the company).
- ISOs generally vest according to service and/or a performance schedule.

Option Based Awards –
Incentive Stock Options - Taxation

- Not taxed at grant or at vesting.
- No tax at exercise, but the spread is a tax adjustment item for purposes of calculating a recipient’s alternative minimum tax.
- Subject to a two year rule (“Qualifying Disposition” vs. “Disqualifying Disposition”).
- An employer is not entitled to a compensation deduction in connection with an ISO unless a Disqualifying Disposition occurs.

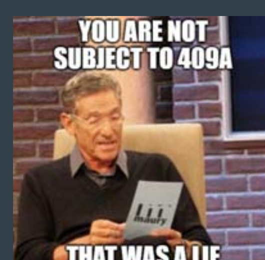
Option Based Awards –
Incentive Stock Options - Advantages and Disadvantages

Advantages

- Risk free investment during the option term
- Actual share ownership
- Capital gain treatment for recipient
- No FICA taxation

Disadvantages

- No employer deduction (unless Disqualifying Disposition)
- Potential AMT impact
- Valuation required for Code Section 409A and accounting purposes
- Only has value when stock appreciates



Option Based Awards – Nonqualified Stock Options - Generally

- NQSOs are any options that are not ISOs.
- NQSOs may be granted to all service providers (e.g., consultants, directors and other non-employees).
- NQSOs generally vest according to service and/or a performance schedule.

Option Based Awards – Nonqualified Stock Options - Taxation

- Not taxed at grant or vesting.
- Spread is taxed at exercise as ordinary income (Form W-2 or 1099-MISC).
- Employer recognizes a compensation deduction equal to the income.
- At disposition, the spread between the exercise price and sale price is taxed at capital gains rates (short-term or long-term, as applicable).
- There is FICA liability associated with an ISO.
- Generally exempt from Section 409A.

Option Based Awards –
Nonqualified Stock Options – Adv's and Disadvantages

Advantages

- Risk free investment during the option term
- Actual share ownership
- Tax deduction at exercise

Disadvantages

- Ordinary income for recipients
- Potential cash flow concerns at exercise for recipient's tax liability
- Valuation required for Code Section 409A and accounting purposes
- Only has value when stock appreciates

Non Equity Awards -
Stock (Unit) Appreciation Rights - Generally

- "SARs" represent the right to receive the appreciated value of a specified number of shares of stock.
- Similar to options in terms of taxation of upside spread.
- SARs may have a specified maturity date or may be structured as a grant that vests and can be exercised.
- The duration and/or vesting period differs depending on the issuer's objectives. SARs may be settled either in cash or in stock, and the method of settlement will change the tax treatment for the award.
- Shareholder approval may be required.

Non Equity Awards -
Stock (Unit) Appreciation Rights - Taxation

- There is no taxable income to a recipient at grant or vesting.
- Upon settlement, the cash or stock payment is taxable to the recipient at ordinary income rates.
- For cash-settled SARs, there is FICA/FUTA tax liability at the time the SARs are settled (paid); for stock-settled SARs, there is FICA/FUTA tax liability at the time of exercise.
- If settled in stock, capital gain on the subsequent appreciation.
- Employer is entitled to a tax deduction in the amount, and at the time, the recipient realizes ordinary income.

Non Equity Awards -
Stock (Unit) Appreciation Rights – Adv's and Disadvantages

Advantages

- No exercise price
- Recipient protected against downside as he/she does not pay if value decreases
- Company may avoid issuing equity rights by settling in cash
- One of most flexible awards

Disadvantages

- Less share ownership options for participants
- When settled in cash, cash outlay by company required
- May not provide adequate incentive if value decreases

Non Equity Awards - Phantom Equity

- A phantom equity award is a promise to pay cash based on the value of the company's stock at a later date.
- These are not real equity (i.e., hypothetical or phantom equity).
- Does not result in stock dilution.
- Taxed as compensation (ordinary income) to service provider when paid. Corresponding deduction to employer.
- Must be designed so as to be exempt from, or comply with, Code Section 409A.

Non Equity Awards - Phantom Equity – Advantages and Disadvantages

Advantages

- Retention incentive
- Easy to administer
- Provide value even if share price declines
- Effective internationally

Disadvantages

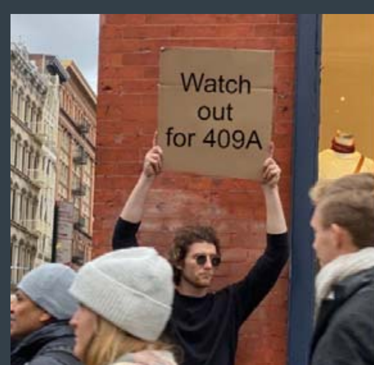
- Requires cash outlay
- Tax deduction delayed until award is paid
- Can be accounting implications if paid in cash in same manner as bonus

Deferred Equity Awards - Restricted Stock Units - Generally

- Represent the right to receive a share of stock or an amount equivalent in value at a future date.
- Such future issued stock may be subject to vesting conditions.
- RSUs can be settled in cash, shares or a combination of the two.
- Recipients generally do not receive dividend and voting rights until actual shares are issued, though dividend equivalents can be provided.

Deferred Equity Awards - Restricted Stock Units - Taxation

- No taxable income at grant or vesting if the award complies with the provisions of Code Section 409A.
- The FMV of the award is taxed at ordinary income tax rates when the cash or stock underlying the award is delivered.
- If RSUs are settled in stock, any gain or loss realized upon the recipient's subsequent transfer of issued shares is taxed as either a long-term or short-term capital gain.
- Code Section 409A must be complied with to avoid negative tax consequences.
- In limited circumstances recipients may be able to elect to defer income recognition up to 5 years after exercise under Code Section 83(i) if the RSU was granted pursuant to a broad-based equity plan.



Deferred Equity Awards - Restricted Stock Units - Advantages and Disadvantages

Advantages

- Value even if share price declines
- Actual share ownership if paid in stock
- Eliminates Code Section 83(b) requirement
- Effective internationally

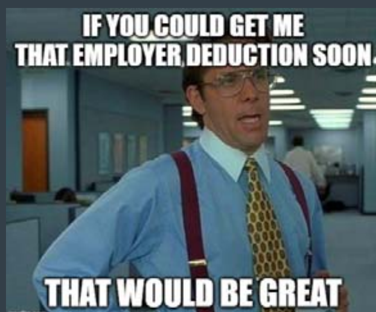
Disadvantages

- Less upside when compared to options
- Code Section 83(b) not available
- No voting rights or share ownership until delivery of stock, if any

Deferred Equity Awards - Performance Shares (Units) - Generally

- An award of stock that is expressed as a target number of shares the company will issue to the participant based on achievement of specified performance metrics.
- Note that in some cases restricted stock can be called “performance shares” if it vests upon the achievement of a performance condition.
- Typically, no shares are issued before the award vests.
- May be denominated in a fixed number of shares or be structured to track performance.
- Similar to an RSU whose payment is conditioned on and determined by the achievement of performance-based criteria.
- Performance units can be designed to be settled in cash, shares, or a combination of each.

Deferred Equity Awards - Performance Shares (Units) - Taxation



- No taxable income to a recipient at grant or vesting if the shares are not actually settled.
- Once shares or cash related to shares are paid to a recipient, the recipient recognizes ordinary income.
- An employer is entitled to a tax deduction equal to the amount recognized as compensation by the recipient when the award is paid.

Deferred Equity Awards - Performance Shares (Units) – Adv's and Disadvantages

Advantages

- Awards can be based on metrics not tied to share price
- Can pay in cash or stock
- Effective internationally
- Ability to defer post-vesting

Disadvantages

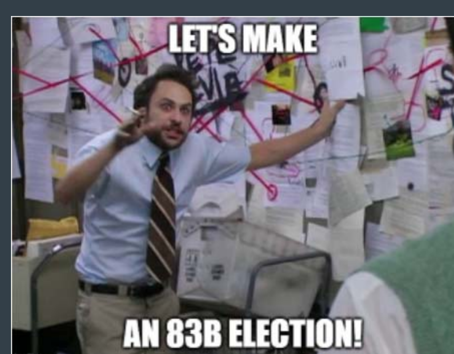
- Payouts can occur even when value declines
- Goals not tied to share price
- One of more complex awards

Current Equity Awards - Restricted Equity - Generally

- Restricted stock is shares of stock granted to a recipient at reduced or no cost.
- Subject to restrictions on transferability and substantial risk of forfeiture.
- The restrictions lapse over a specified vesting period or upon the achievement of specified vesting conditions.
- Vesting is typically delayed for a fixed period or until performance criteria is satisfied; the duration of restriction will differ depending on the issuing entity's objectives.
- A corollary (restricted units) can be used in the partnership context.

Current Equity Awards - Restricted Equity - Taxation

- Depends on whether a Code Section 83(b) election is made.
- If the participant makes a Code Section 83(b) election:
  - then the FMV at the time of grant is subject to ordinary income tax and there is no taxation at vesting, and
  - A subsequent sale of restricted stock results in capital gain.
- If the participant does not make a Code Section 83(b) election, taxation is deferred but subject to more value being taxed as ordinary income.
- An employer is entitled to a tax deduction in the amount and at the time in which the recipient realizes ordinary income.



Current Equity Awards - Restricted Equity - Advantages and Disadvantages

Advantages

- Value even if share price declines
- Actual share ownership
- Less shares needed to compensate in same manner than options
- Dividends and voting rights may attach

Disadvantages

- Less upside when compared to options
- Code Section 83(b) election can be complex
- International Limitations
- Potential cash flow concerns at exercise for recipient's tax liability

Current Equity Awards - Profits Interests - Generally

- Bona fide equity ownership interest in a partnership (i.e., a general partnership, a limited partnership, or an LLC taxed as a partnership) that does not represent a claim to any value as of the date of grant and is not subject to taxation upon grant or vesting.
- Safe harbors
  - Rev. Proc. 93-27 – Defines a profits interests.
  - Rev. Proc. 2001-43 – Special rules for profits interests that are not fully vested (which is the norm).

Current Equity Awards - Profits Interests - Taxation (fully vested)

- The grant of profits interests is not a taxable event.
- The company does not get a deduction.
- On exit, whether a sale of partnership interests or a sale of assets by the partnership, the gains are taxed at the long-term capital gains rate subject to “hot assets” and holding period exceptions.

Current Equity Awards - Profits Interests - Taxation (not fully vested)

- Typically, a grantee will not be taxed upon the grant of the nonvested profits interest or as the applicable vesting thresholds are met.
- Typically, a grantee will not need to make an election under Section 83(b) (although there is nothing to prevent a grantee from making such an election and such election would necessarily show $0 of “spread” and, thus, $0 of income triggered by the election).
- On exit, whether a sale of partnership interests or a sale of assets by the partnership, the gains are taxed at the long-term capital gains rate subject to “hot assets” and holding period exceptions.

Current Equity Awards -
Profits Interests - Advantages and Disadvantages

Advantages

- Participates in the post-grant upside, much like NQSO.
- Accretion largely taxed as long-term capital gains (as opposed to what is normally ordinary income in the NQSO setting).
- No cash outlay at grant, vesting or exercise by the worker/partner.

Disadvantages

- The worker/partner's "paycheck" typically has to be reported as a guaranteed payment (i.e., functionally like a Form 1099) and not with a Form W-2.
- Can be adverse implications for cafeteria plan and related plan participation.

Current Equity Awards -
Pseudo Profits Interests

- Bona fide equity ownership interest in a C corporation that largely mimics the "share in the upside" aspect afforded to profits interests.
- Does not represent a claim to any value as of the date of grant and as such should not be subject to taxation upon grant if fully vested. If not fully vested, a Section 83(b) election should be made.
- Care should be taken, in terms of both state law corporate law compliance and tax law compliance to ensure the intended result.
- Cannot be used in an S corporation setting due to "second class of stock" prohibitions.
- Gain from the sale of pseudo profits are taxed at the long-term capital gains rate subject holding period exceptions.

Comparing and Contrasting

Option Based Awards

- Incentive Stock Options
- Nonqualified Stock Options

Deferred Equity Awards

- Restricted Stock Units
- Performance Shares (Units)

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Business Succession Planning

Scott Ahroni, Shareholder

Business Succession Planning

- Use of income and estate planning strategies to implement a survival plan for a business in cases of retirement, death, or illness
- Risks of not having a Business Succession Plan
  - Business is lost to estate taxes
  - Not enough liquidity to support itself during owner transition
  - No formal transfer arrangement
  - Family disagreements
  - Potential heirs aren't equipped or knowledgeable enough to own or manage business

Business Succession Planning

- Planning Vehicles
  - Buy-sell Agreement
  - Shareholders agreement, partnership agreement, Operating agreement
    - Manger-managed vs. Owner-managed
    - Redemptions
  - Through a will/trust, giving executor or trustee the power to transfer business (business interests are included in a decedent's probate estate)
- Succession Planning Concerns
  - Who will succeed me?
  - Income Tax Issues
  - Estate and Gift Tax

Legal Considerations

- Similar considerations when starting a company:
  - How should the entity be structured
  - Liability protection
  - Compensation for continued presence (want to avoid 2036 issues and possible redemption issues)
  - Management considerations
  - Employment Contracts

Tax Issues To Consider

- Income Tax Implications
  - Dependent on how succession plan is implemented sale/gift/inheritance
  - Income tax on trusts depends on whether trust is grantor or non-grantor
- Estate Tax
  - Unified Credit
  - Marital Deduction
  - Assets in trust generally not be subject to estate tax if trust was irrevocable
- Gift Tax
  - Annual Exclusion - $16,000
  - Marital deduction
- GST on transfers to skip generation
- State and Local Issues

Transfer of Business Assets - Sale

- Sale of Partnership
  - Character of gain/loss is based on underlying assets of partnership
    - Hot Assets - Purchase price allocated to hot assets will generate ordinary income tax consequences
    - Collectible Gains
    - Unrecaptured 1250 Gain
  - Installment Sale Treatment
    - Sale proceeds related to inventory and Recapture income from IRC 1245 and 1250 property must be reported in the year of the sale
    - Losses from the sale of a partnership interest to a related party are not deductible.
  - Purchase of partnership interest creates outside basis
  - IRC § 754 election

Sale of S-Corp Stock

- Generally, results in capital gain treatment other than gain on collectibles
- § 338(h)(10) election
  - For federal income tax purposes treats stock purchase as asset purchase followed by a liquidation
  - It remains a stock purchase for all other legal purposes, such as contracts and licensing; avoid transfer and sales tax
  - Buyers receive step-up in basis and ability to amortize goodwill and sellers generally receive higher purchase price
  - Requirements to get § 338(h)(10) treatment
    - Target must be a corporate sub or S-corp
    - Corporate buyer
    - Acquire at least 80% of total voting power and value of the corporation
    - All shareholders must consent

Sale of C-Corp Stock

- Stock sale
  - If stock sale - Capital gain treatment
  - If asset sale – double tax on sale of assets and then liquidation unless foreign owners
  - IRC 1202 - Qualified Small Business Stock
    - IRC 1202 is a gain exclusion provision
    - Section 1202 applies to the sale or exchange of certain “qualified small business stock” issued after August 10, 1993 and held by a non-corporate taxpayer for more than five years.
    - As originally drafted, it allowed for 50% of the gain from certain sales of stock to be excluded from taxation, which could be increased to 60% if the stock related to a corporation that was a qualified empowerment zone business under Section 1397C(b).
    - The exclusion was subsequently increased to 75% for stock acquired after Feb. 17, 2009 and before Sept. 28, 2010.
    - PATH Act permanently extended the 100% exclusion to stock acquired after Sept. 27, 2010.

Summary of Exclusion Amount

50%*	QSB Stock Acquired after August 10, 1993	QSB Stock Acquired before February 18, 2009
75%	QSB Stock Acquired after February 17, 2009	QSB Stock Acquired before September 28, 2010
100%	QSB Stock Acquired after September 27, 2010	

*60% for stock of qualified empowerment zones business

Terms and Conditions Apply

- The type of shareholder
- How the stock was purchased
- The type of entity
- The nature of the entity
- The assets of the entity
- How long the stock is held
- The shareholder's track record

Type of Shareholder

- The exclusion applies to taxpayers other than a corporation (with special rules for pass-through shareholders).
- Eligible shareholders include individuals and trusts.
- Eligible pass-through entities include partnerships, S corporations, and regulated investment companies.

How the Stock was Purchased

- The stock must be acquired by the taxpayer at its original issue in exchange for money, other property (not including stock), or as compensation for services provided to the entity.

Type of Entity

- C corporation which is neither:
  - a DISC or former DISC,
  - a corporation with respect to which an election under section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect, a regulated investment company,
  - a real estate investment trust,
  - a REMIC, nor
  - a cooperative.

Nature of the Entity

- For stock to be qualified small business stock (QSBS), its issuer must meet these requirements:
  - it must be a qualified small business until immediately after the stock is issued;
  - it must remain a C corporation during substantially all of the taxpayer's holding period; and
  - it must meet active business requirements during substantially all of the taxpayer's holding period.

Nature of the Entity

- At least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of one or more qualified trades or businesses.
- "Qualified trade or business" means any trade or business other than:
  - A trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
  - Any banking, insurance, financing, leasing, investing, or similar business;
  - Any farming business (including the business of raising or harvesting trees); and
  - Any business of operating a hotel, motel, restaurant, or similar business.
- If in connection with any future qualified trade or business, a corporation is engaged in certain "start-up activities" and/or certain R&D activities, then the assets used in such activities are treated as used in the active conduct of a qualified trade or business.

Assets of the Entity

- Aggregate gross assets of the corporation at all times after 1993 and before the stock issuance does not exceed $50,000,000 (computed pursuant to aggregation rules).
- The aggregate gross assets of the corporation immediately after the stock issuance does not exceed $50,000,000 (computed pursuant to aggregation rules).
  - "Aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation except that the adjusted basis of any property contributed to the corporation shall be determined as if the basis of the property contributed to the corporation were equal to its fair market value as of the time of such contribution.

How Long the Stock is Held

- A shareholder must hold the stock for at least five years before claiming gain exclusion under Section 1202.
  - NOTE: The holding period for stock options and warrants does not begin until the option or warrant has been exercised.

The Shareholder’s Track Record

- If a taxpayer has eligible gain for the taxable year from one or more dispositions of Section 1202 stock, the aggregate amount of such gain which may be excluded cannot exceed the greater of:
  - $10,000,000 (reduced by the aggregate amount of eligible gain excluded in prior taxable years and attributable to dispositions of stock issued by such corporation) or
  - 10 times the aggregate adjusted bases of qualified small business stock issued by the corporation and disposed of by the taxpayer during the taxable year.

Gift/Inheritance of Business Interests

- Business Purpose for the Succession Planning Vehicle
  - Maintain control of and manage entity assets;
  - Increase the value of entity assets;
  - Protect entity assets from claims of creditors and from divorce;
  - Consolidate fractional interests in assets transferred to the entity;
  - Facilitate and simplify intra-family gifting and ownership;
  - Provide flexibility in business planning not available through trusts or corporations.

Tax Considerations upon Gift/Death

- Partnership
  - Death of a partner can lead to:
    - IRC §754 elections and IRC §743 Adjustments
    - Close of a partnership's tax year with respect to the deceased partner
    - Post-death allocation of income
    - Possible change in the partnership's year end

Partnerships/LLCs

- IRC §754 Election and IRC 743 Step-up
  - Step-up in basis to fair market value at death is available for beneficiaries
  - Partnership permitted, by election, to adjust the "inside bases" of its assets to reflect the stepped-up basis for the new partner for their inherited interest (Code Secs. 754 & §743)
  - Pre-death built-in gain and ordinary income recapture is eliminated as well

Partnerships/LLCs

- **Close of partnership's tax year with respect to the deceased partner**
  - Partnership's tax year must close for the deceased partner (IRC §706)

  Sec. 706(d)(1) states if there is a change in a partner's interest in the partnership during a tax year, then each partner's distributive share of partnership items must be determined in such a way to consider their varying interests.)

Varying Interest Rule and Post Death Allocation

- **Regulations provide some flexibility for determining how partnership items are allocated:**
  - Interim-closing method (default rule)
  - Proration method
    - Requires adjustments for "extraordinary" items (such as sales of assets) that must be specifically allocated based on actual ownership on the date of those events.
    - Conversely, a cash-basis taxpayer using the interim-closing method will need to adjust for cash-basis items collected after the date of the interim close
- **Post-death allocation of income**
  - If partnership interest goes to the estate and then to beneficiary all in same year, then Schedule K-1 should go to beneficiary - Regs. Sec. 1.706-1(c)(2).
  - If different tax years, estate will receive a K-1

Possible Change in partnership's year end

- The tax year end of a partnership is generally a function of the tax year end of its partners. Transfers of interests of any kind can affect the partnership's required year end. In general, a partnership's year end is determined by the following rules:
  - The partnership must adopt the tax year of the partner (or group of partners with the same tax year) that owns an interest in profits and capital of greater than 50%;
  - If no partner (or group of partners with the same tax year) owns greater than 50% of profits and capital, then the partnership must adopt the tax year of all partners owning 5% or more of the partnership; and
  - If no partner owns greater than 5%, or if those that own greater than 5% do not have the same tax year, a calculation must be performed to compute the year that generates the "least aggregate deferral" of taxable income.

Tax Considerations upon Gift/Death

- **S-corporations:**
  - Gain on sale of assets and step-up in basis in shares
    - Since no inside basis step-up need to be mindful of timing
  - Reporting income and loss in year of death
  - Inadvertent terminations
- **C-corporations**
  - Same basis treatment as S-corp

S-corporations

- **Gain on sale of assets and step-up in basis in shares**
  - Unlike a partnership which has a 754 election to equalize the inside and outside basis of the partnership, an S-corporation has no similar option. Therefore, when a shareholder dies the shares are stepped up but the inside basis of the S-corp assets remains the same.
  - Therefore, the benefit of the step-up is deferred until the shareholder disposes of the stock
  - Liquidations should occur in year that gain is realized on assets to ensure that the loss from the liqudaiton can be used to offset the gain from the sale of the assets

S-corporations

- **Reporting income and loss in year of death**
  - Opposite to partnership
    - Pro-rata allocation (default rule)
    - Interim closing of the books (election by all affected shareholders and corporation)
    - Election may be beneficial particularly where extraordinary items occur either pre-death or post-death
      - If the decedent has a taxable estate, perhaps the beneficiaries would want to treat the gain as occuring pre-death so that the estate could take a deduction for the tax and reduce the estate tax obligation

Inadvertent terminations

- Strict rules of who can be the shareholder in an S-corporation. In many cases the successor shareholder whether that be an estate, testamentary trust or beneficiary must take certain steps to remain a qualifying shareholder
- Inadvertent termination relief available

Decedent's Losses

- **Suspended Passive Losses**
  - Unused losses are allowed as a deduction on the decedent's final personal income tax return to the extent that the losses are in excess of the step-up in basis.

  Example: A single taxpayer, died on Sept. 1, 2021. His suspended loss carryover from ABC LLC Partnership was $10,000. At the time of death, the taxpayer's estate received a $2,500 step-up in the tax basis of ABC. (Partnership interest was appraised at $20,000 and had an adjusted tax basis of $17,500.) Therefore, on taxpayer's final Form 1040, U.S. Individual Income Tax Return, the remaining $7,500 of the suspended loss is deductible ($10,000 — $2,500 Sec. 1014 step-up)
- **Suspended losses due to lack of regular tax basis:**
  - Suspended losses due to lack of regular tax basis will disappear upon the transfer from an individual at death to her estate, trust, and beneficiaries.
- **Suspended losses due to lack of at-risk basis:**
  - Unused at-risk losses will also not carry forward to the decedent's estate, trust, and beneficiaries. Instead, these amounts are added to the basis of the interest in the hands of the recipient. However, because this is done prior to the basis adjustment under Sec. 1014, there is no net change in basis.

Transfer Taxes

- Federal, estate and gift tax
  - Unified credit of $12.06 Million in 2022
- New York Estate Tax
  - Estate tax exclusion is $6,110,000.
  - The cliff goes into effect at estate's more than $6,226,500
  - No gift tax but three-year look-back
- Residents and non-residents are treated differently
  - Non-residents have no unified credit for federal transfer tax purposes
  - NY Non-residents have same exclusion as residents

Relevant "choice of entity" issues

- The estate tax planning issues that are relevant in the "choice of entity" to conduct a business include the following:
  - Ascertaining the value of the business enterprise for purposes of either dividing the ownership of that business among family members or negotiating a sales arrangement with other unrelated owners;
  - Determining the value of the business enterprise for transfer tax purposes;
    - Implications of IRC §2701 through 2704
  - Assuring sufficient liquidity to enable payment of any estate tax liability and satisfaction of other cash requirements;
  - Assuring orderly family succession through continuous, coordinated management if the enterprise is to be maintained within the family unit after the death of an older generation member.
    - 2036(b) Issues

Valuation

- Valuation is generally most contested issue with the IRS
- Valuation discounts are theoretically available for any entity but most commonly used with Family Limited Partnerships (FLPs)
- Proposed Legislation to remove discounts
- Consideration should be given to the use of contracts and other obligations that impact valuation as part of the estate plan
  - Buy-sell agreement between estate and existing partners/shareholders
    - Issue with fixing sale price
      - For the buy-sell agreement to fix the value of the business interest for federal estate tax purposes are as follows:

        (1) the decedent's estate must be obligated to sell the business interest;

        (2) the agreement must contain a right of first refusal that prohibits the shareholder or other owner during life from disposing of the stock or other ownership interest without first offering it to the prospective purchaser named in the buy-sell agreement at the contract price offered by another party; and

        (3) the purchase price at death must have been established through an arm's-length business bargain

Pre-death Ownership Restructurings

- Objective is to accomplish a restructuring of the ownership of the enterprise without triggering either income tax consequences or gift and estate tax exposure for the business owner.
- Gift Tax Valuation Issues as part of ownership restructuring
  - Challenging discounts as part of restructuring - IRC §2701 is utilized by the IRS to value retained interests at zero and thus not reducing the full value of the transferred equity interest by the interest retained – apply to both partnerships and corporations

Corporate Restructurings

- Ownership interests may be shifted within an existing corporate structure to accomplish the estate planning objective of shifting value from older family members to younger generation members. This objective ordinarily is accomplished through the use of a corporate recapitalization
- A number of potential tax pitfalls must be avoided in a recapitalization include the following:
  - classification of the exchange of shares as a taxable exchange rather than as a tax-free reorganization;
  - ordinary dividend treatment upon completion of the share exchange;
  - preferred stock “bailout” treatment;
  - estate tax inclusion of the transferred property in the estate of the older generation member as a result of an applicable retained interest; and
  - federal gift tax valuation controversies.

Family Partnerships or Family LLCs

- The most often utilized business entity for estate and gift tax planning amongst families is the Family partnership or Family LLC taxed as a partnership
- The reason for the use of the Family partnership or Family LLC rather than a corporation is the application of certain rules to corporations that do not apply to partnerships
  - IRC §2036(b) – Retention of right to vote controlled corporate stock
  - Flexible Allocation of income and losses
  - Possible dividend treatment of corporate recapitalization
  - Partnership recapitalizations don’t require business purpose and control
  - With partnerships no taxable stock dividend under IRC 305 or possible ordinary income taint on preferred stock shares under IRC 306
  - Valuation Discounts (lack of marketability, limitations on management and key person discounts)

Family Partnerships or Family LLCs

- Assuming valuation discounts are respective, the FLP or LLC as a vehicle for transferring a person's asserts may accomplish the following:

  (1) it may reduce the transferor's federal transfer taxes (discounts due to minority interests and lack marketability);

  (2) it may permit senior members to maintain control of a business for a period of time; and

  (3) it may ensure that interests transferred to younger family members will not be includible in the estate of the older transferor.

FLP as a Device

- Based on the IRS challenges, it is clear that the IRS believes that the FLP is a device to minimize or avoid estate taxes by artificially achieving discounts on transfers of FLP interests
- Based on this perspective, the IRS has challenged the formation of the FLP and the discounting of the value of assets placed into such entities
- In general, these challenges involve a decedent's estate, although occasionally the IRS will question the issue on the gift tax return
- The IRS challenges generally include the following:
  - Lack of economic substance
  - Lack of a "bona fide" arrangement (Section 2703)
  - Assignee interest only at death (2704(a))
  - Transferor's retain control (2704(b))
  - Retained Life Interest (2036)
  - Gifts on formation
  - Discounting the FLP interest
  - Step Transaction Doctrine

Avoiding or Winning Device Arguments

- Document the business succession objective of the new entity

1. Use formal LLC/LLP documents including partnership agreements and operating agreements
2. Use manager-managed LLCs with older generation not in control
   - Consider naming a special manager of the LLC who is not the grantor or subject of the succession plan for purposes of distribution rights
3. Engagement in active participation of the younger generation
   - Contribution of time, money and assets by younger generation
4. Document important business actions
   - Make sure to transfer title to the assets and get insurance on the assets
   - Follow the operating agreement for all distributions, which must be proportional to ownership interests
   - Perform record keeping as any other business
   - Prepare management reports with an emphasis on the business aspect of the FLP
   - Holding annual meetings with minutes (do we get along?)
5. Personal
   - Do not transfer substantially all of taxpayer's assets to the FLP without leaving them sufficient assets for personal expenses
   - Do not comingle personal assets and the FLP assets

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Areas of Focus

Tax

Tax Controversy and Litigation

FinTech and Blockchain Technology

International Tax

State and Local Tax

Scott Ahroni focuses his practice on Federal, State and Local tax controversies. His particular areas of emphasis are audits, administrative appeals and tax litigation in various courts and tribunals, including the United States Tax Court, United States District Court, New York State Division of Tax Appeals, New York State Tax Appeals Tribunal, New York City Tax Tribunal, New York Department of Labor, Unemployment Insurance Appeal Board, and the New York State Appellate Divisions, First and Third Departments. Examples of his practice include:

- Work directly with clients and auditors involving federal, New York State, New York City and New Jersey civil and criminal individual and corporate income tax, sales tax, payroll tax, workers' compensation and unemployment insurance audits;
- Appear and defend clients at the IRS Office of Appeals
- Work with the IRS And NYS Taxpayer Advocate to resolve systemic issues for clients
- Prepare and Domestic and Foreign Voluntary Disclosure Program submissions
- Appearing before the United States Tax Court; U.S. District Court New York State Department of Taxation and Finance Bureau of Mediation and Conciliation and Mediation Services, as well as the Division of Tax Appeals; and the New York City Tax Tribunal and Bureau of Conciliation
- Assisted clients with tax debts, liens and levies including preparing Installment Agreement and Offer in Compromise submissions; Requests for Collection Due Process hearings before IRS Office of Appeals

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Areas of Focus

Corporate & Transactional

David Cykiert leverages his legal and business background to support clients on a broad range of transactions and is committed to providing comprehensive legal advice. Working with Polsinelli attorneys in the Corporate and Transactional practice, David delivers a range of legal services during the life cycle of a client's business. He strives to understand the client's goals, identify hurdles and help ensure that they are on course to meeting their objectives. David's representation spans myriad classes of products and services, including software/hardware, real estate, consumer goods, hospitality and service businesses. David is comfortable starting client relationships at every business life-cycle stage, from pre-concept, to pre-revenue, to pre-capital raise to pre-exit, and is proficient at guiding and leading all nature of corporate transactions at and in between each such stage. Clients appreciate his distinct level of attention to detail, ability to think critically and creatively within tight deal and time parameters, and refusal to abandon a prospective transaction where reasonable solutions exist.

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