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STARTUP & ACCELERATE

**Avoiding a Taxing Situation: Considerations
for Your Startup**

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Tax Issues Arise In:

- 1. Formation**
- 2. Operation**
- 3. Compensation**
- 4. Realization**

General Tax Overview

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General Tax Overview--Individuals

- An individual's rate of tax depends upon whether the relevant income is ordinary or capital in nature.
 - Ordinary income (wages, interest, royalties, dividends, etc.) is generally subject to tax at a rate of up to 37%.
 - Capital gains (gains from the disposition of assets held for investment, generally, but also most dividends from domestic corporations) are subject to tax at a rate of up to 20%.
 - Additionally, "Net Investment Income" is subject to an additional 3.8% tax. Raises total tax burden on corporate dividends to 39.8%.
- Losses can generally offset income, but "capital" losses may only be used to offset capital gains plus a tiny amount (\$3,000) of ordinary income.

Formation Tax Issues

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Varieties of Legal/Tax Form

- Corporation. Any entity formed under corporation law of a state is also a corporation for tax purposes.
- S corporation. Any corporation satisfying the requirements may file an election to be treated as an "S" corporation. Requirements include limitations on the number and type of shareholders, only a single class of stock, etc. Election is prospective to next taxable year or retroactive if made within 75 days of the start of the taxable year.
- Partnership. LLCs, LPs or other types of partnership or non-corporate entities are pass-through by default, but can elect to be treated as a corporation for tax purposes.
 - Election can be prospective, or retroactive 75 days. So when forming a new LLC for which corporate treatment is desired, file election within 75 days of formation.
 - Single-member entity is thus either a disregarded entity or a corporation, while a multiple-member entity is a partnership or a corporation.
 - LLC that elects corporate treatment may also elect "S" corporation status if qualified.

Contributions of Property

- Corporations (including “S” corporations)
 - In general, contributions of property in exchange for stock are tax-free provided that the contributors as a whole own 80% or more of the voting power and value of the stock of the corporation following the contribution.
 - Helpful when IP or other “soft” assets are developed outside corporate solution and has value in excess of basis, as long as “all substantial rights” in the IP are transferred
 - Note that contributions must be “in exchange for” stock. i.e., cash, debt and certain debt-like “non-qualified preferred stock” will not qualify as tax-free consideration.
 - “Non-qualified preferred” is stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent and that carries with it certain repurchase/redemption rights exercisable within 20 years or has dividend right keyed to certain indices. Not an issue in S corporation due to “one class of stock” rule.

Contributions of Property (Cont.)

- Corporations (cont.)
 - Note that contributors as a group must own the requisite percentage of stock. Who counts as part of the “control group” may depend on the facts. Those contributing de minimis amount of property solely to qualify other contributors as tax-free won’t count.
 - In the case of “S” corporations, only U.S. individuals and certain types of trusts or estates qualify as good shareholders and they can only number up to 100.
- Partnerships
 - Contributions to partnerships in exchange for an interest generally are tax-free regardless of the percentage of ownership.
 - Contributions of encumbered property may result in a shift of liabilities that is treated as a distribution of cash, reducing basis in the contributed property and then resulting in gain.

Contributions of Property (Cont.)

- Note that services do not qualify for tax-free treatment, i.e., “sweat equity” is generally taxable, whether it is a “C” corporation, an “S” corporation or a partnership.
- In the corporate context, warrants or options may give employees an upside stake with no or little current tax, subject to certain requirements in the case of “S” corporations.
- In the partnership context, “profits interests” may be issued with no gain to recipient.
- Further discussion in compensation section

Operational Tax Issues

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Entity Level and Shareholder Taxes

- Corporations
 - Net taxable income subject to tax at a flat rate of 21%. Other than for certain very large corporations with respect to their “financial statement income”, the “corporate AMT” has been repealed (operated alongside the normal corporate tax regime and imposed lower flat rate on wider base).
 - No deduction available for dividend distributions, which are taxed *again* at the shareholder level to the extent made out of accumulated earnings at a 23.8% maximum rate.
 - Shareholders are not subject to tax on corporate income until distributed. Shareholders do not get the benefit of corporate losses, which may generally only be carried forward, not back. Further, NOL deduction is limited to 80% of corporation’s taxable income.

Entity Level and Shareholder Taxes

- S Corporations
 - Generally not subject to entity-level tax other than to the extent of certain realized “built in gains” from a time prior to having made election to be treated as an “S” corporation.
 - Shareholders of S corporations currently include a pro-rata share of the entity’s net taxable income or loss in their own taxable income. Allocation is made on per-share, per-day basis, i.e., there can only be one class of stock.
 - Distributions from an S corporation typically are not subject to tax in hands of shareholder to the extent made out of S corporation taxable income. May be taxable to the extent made out of accumulated earnings of a prior “C” corporation.
 - If “S” qualification is lost, corporation is subject to tax as a regular “C” corporation.

Entity Level and Shareholder Taxes

- Partnerships
 - Generally not subject to entity-level tax.
 - Partners/members currently include the entity's net taxable income or loss in their own taxable income. Allocation depends on the governing agreement, but within certain very broad rules, are quite flexible.
 - Distributions from a partnership typically are not subject to tax, but rather reduce a partner's tax basis in its interest. Tax basis includes (a) contributions, (b) undistributed income and (c) share of partnership liabilities.
 - Complexity of economic arrangement among owners is possible, with corresponding complexity of filings and compliance.

Entity Level and Shareholder Taxes

- Special Flow-Through Issues
 - Many owners of partnerships and S corporations may be eligible for a qualified business income (QBI) deduction – also called the Section 199A deduction – for tax years through 2025. The deduction allows eligible taxpayers to deduct up to 20 percent of their QBI, resulting in a maximum tax rate on that income of 29.6%. QBI component is subject to multiple limitations including the type of trade or business, the amount of W-2 wages paid by the qualified trade or business and the unadjusted basis immediately after acquisition of qualified property held by the trade or business.
 - Use of losses in an S corporation or partnership is limited by numerous rules, including the equity owner's basis in its interest, and in the case of a partnership, by the amount viewed "at risk" therein, or whether the activity of the partnership is "passive" as to the owner.

Compensation Tax Issues

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General Compensation Issues

- Corporations
 - Typically, salary paid to employees is subject to normal wage and payroll withholding, and subject to employer-level payroll tax and is ordinary income to recipient.
 - Equity compensation can come in several flavors:
 - Options
 - “Incentive stock options” or “nonqualified stock options” (ISOs or NQSOs).
 - ISOs get certain favorable treatment, including no income event on exercise and tax at capital gains rates on sale provided certain thresholds and holding periods are complied with.
 - NQSOs are not taxed at grant, but are taxed at ordinary income rates and subject to wage and payroll withholding and employer-side taxes when exercised based on difference between exercise price and value of stock received.
 - Note that this can present cash-flow issues since exercise is typically a cashless event.

General Compensation Issues

- Corporations (cont.)
 - Restricted stock (stock subject to forfeiture for employment-related reasons) is generally not taxed until the restrictions lapse, at which point full value of stock is taxed at ordinary income rates and is subject to wage and payroll withholding and employer-side taxes.
 - However, an employee may make an “83(b)” election to include the value of the stock at the time of grant in income at the grant date. Note that if the stock is later forfeited, the employee’s loss is limited to the amount paid for the stock.
 - Other types of compensation include “stock appreciation rights”, which function economically like an option, and “restricted stock units” or “phantom shares,” which function economically like restricted stock. However, these plans pay out cash based on equity value rather than actual equity.

General Compensation Issues

- S corporations
 - Types of compensation are generally the same, and taxed the same, as is true for corporations generally. However, equity compensation is subject to slightly different rules.
 - In the case of ordinary compensation, care must be taken to ensure that both (a) the right to that compensation is not itself viewed as a second class of stock, and (b) if paid to an equity owner, the compensation is not viewed as in respect of that equity owner's stock, also creating a "second class of stock" issue.
 - Note that restricted stock and other equity must be given only to a shareholder that is permitted under the S corporation rules – individuals, trusts, estates, etc.
 - Regulations provide safe harbor for employee options, provided that the exercise price is equal to FMV of the underlying stock at grant.
 - Transfer of options would require a "re testing" that may cause the options to fall out of the safe harbor.

General Compensation Issues

- Partnerships
 - Salary paid to non-equity owners taxed under normal rules.
 - Amounts denominated as salary paid to equity owners are generally treated as “guaranteed payments” and reported on a Form K-1, rather than as wages reported on a W-2. There is no withholding or employer-side payroll taxes on guaranteed payments. Rather, employee is generally subject to self-employment tax on these amounts.
 - Some taxpayers avoid these issues by forming a “Management Holdco” that owns the management interest in the operating entity. The employees then are W-2 employees of the operating company in respect of their salary and receive a K-1 from the Management Holdco for their share of residual income.

General Compensation Issues

- Partnerships (cont.)
 - In general, a partner is subject to self-employment tax (SECA) at a rate of 15.3% on their share of residual allocated income from a partnership.
 - The “limited partnership” exception, however, provides that persons who are “limited partners” in a partnership are not subject to SECA tax on their share of residual income. There has been much debate over what constitutes a “limited partner” in the context of LLCs. The IRS is actively litigating this issue, particularly focusing on money managers.
 - Entities formed as partnerships often compensate employees with “profits interests,” which give the employee a share of income and appreciation in asset value from the grant date forward. If structured correctly, they are nontaxable at grant and provide the opportunity for capital gains on an exit.
 - SECTION 409A

Tax Issues on Exit

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Asset Transaction Basics

- Asset transactions are often favored by buyers, for several reasons:
 - They get a step up in asset basis, which means that the purchase price they pay for the acquired assets can be deducted from income over time (generally 15 years), saving them tax in future years.
 - They generally do not assume the seller's tax methods, procedures or liabilities, and so get a "fresh start." There is, however, some risk of successor liability.
- Asset transactions are often disfavored by sellers, for several reasons:
 - Potential for ordinary income (non-corporate sellers) to extent that purchase price is allocated to depreciable assets, cash-basis receivables.
 - Potential for two layers of tax if seller is a "C" corporation (or "S" corporation in certain circumstances).
 - State level taxes may differ from sale of equity depending on where the entity does business.
 - Hassle of getting leases, permits, etc., transferred.

Stock/Equity Transaction Basics

- Stock transactions are often favored by sellers, for several reasons:
 - They generally can recognize solely capital gain, which for individuals is taxed at a lower rate.
 - There generally is only one layer of tax.
 - State taxes generally limited to the state of residence.
 - No need to handle transferring individual assets.
- Stock transactions are often disfavored by buyers, for several reasons:
 - They generally succeed to the target's historic (usually low) asset basis, and so cannot amortize their purchase price to offset future income or gain except on an exit.
 - They generally step into the shoes of the sellers in terms of the target's tax methods, procedures and liabilities, and so have potential exposure for pre-closing taxes or mistakes.

Stock Transactions that Act Like Asset Transactions

- Corporate Target
 - If the corporate target is an S corporation, or is a subsidiary in a group of corporations, the sellers and buyers can jointly make an election to treat the transaction as an asset sale for tax purposes.
 - The target is treated as selling its assets at the close of business for the purchase price to a “new” target that takes a stepped-up basis in the assets, with the “old” target then liquidating and distributing the proceeds to the equity owners.
 - So the actual sale of stock is ignored, and gain is recognized at the entity level.
 - Note that for foreign targets, corporations with large NOLs, you could make similar election even if target not an S corporation or member of a consolidated group. Otherwise, DON'T.

Stock Transactions that Act Like Asset Transactions (Cont.)

- Partnership/DRE Target
 - *Partnership Target*
 - If the target is a partnership, and the buyer is acquiring 100% of the interests, the transaction is treated as an asset purchase by the buyer. Note, it is still treated as a sale of interests to the sellers.
 - If the target is a partnership, and a buyer is acquiring less than 100% of the interests, the default treatment is a sale of interests, i.e., producing no basis step up to the buyer and capital gain to the seller.
 - However, buyer may get basis step up if special election made by partnership for year of the sale (irrevocable thereafter). *And*, seller may recognize ordinary income to the extent of “hot assets” – inventory, depreciable property, unrealized receivables.
 - *DRE Target*
 - If the target is a single-member LLC, always treated as an asset sale for tax purposes.

Special Tax Provisions Governing Exits – Section 1202

- Section 1202 can be a very helpful provision for persons owning and disposing of “Qualified Small Business Stock” (“QSBS”)
- If the requirements of Section 1202 are satisfied, a person selling QSBS can permanently exclude up to 100% of any gain on the stock from gross income. Depending on how much gain may be excluded, Section 1202 has the effect of sharply reducing the tax rate (potentially, to zero) on the sale of any QSBS.
- This provision was designed to encourage individuals to invest in and develop small businesses. Whether it actually does so is open to question.

Special Tax Provisions Governing Exits – Section 1202 (Cont.)

- Stock that is sold must be “Qualified Small Business Stock”
- Stock *must have been held for more than five years* at the time of sale.
- For any one taxpayer, the maximum amount of gain with respect to the stock of a single issuer that is eligible for the benefit is the greater of \$10,000,000 or 10 times the taxpayer's basis in the stock of the issuing corporation *at issuance*.
- “Qualified Small Business Stock”
 - The interest sold must be “stock”.
 - The stock must have been issued after August 10, 1993.
 - The issuing entity must be a domestic “C” corporation
 - The taxpayer acquired the stock at original issuance for money, property (other than corporate stock), or services provided to the issuing corporation (other than as underwriter).
 - The corporation issuing the stock satisfies the “qualified small business” requirement.
 - The corporation issuing the stock satisfies the “active business” requirement.

Special Tax Provisions Governing Exits – Section 1202 (Cont.)

- “Qualified Small Business”
 - This test is satisfied if two asset-based requirements are met:
 - The aggregate gross assets of the corporation (or any of its predecessors) must have been no more than \$50,000,000 from the date of enactment of Section 1202 to immediately before the stock was issued;
 - Immediately after the issuance, the aggregate gross assets of the corporation, including amounts received by the corporation in the issuance, must continue to be no more than \$50,000,000.
 - Gross assets measured as amount of cash plus the aggregate adjusted bases of other property held by the corporation

Special Tax Provisions Governing Exits – Section 1202 (Cont.)

- “Active Business”
 - The corporation must use at least 80% of its assets, measured by value, in the active conduct of one or more qualified trades or businesses, other than;
 - Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial 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;
 - Any banking, insurance, financing, leasing, investing, or similar business;
 - Any farming business (including the business of raising or harvesting trees);
 - Any business involving the production or extraction of products of a character with respect to which a depletion deduction is allowable under §613 or §613A; and
 - Any business of operating a hotel, motel, restaurant, or similar business.

Special Tax Provisions Governing Exits – Section 1202 (Cont.)

- Important Things to Consider
 - To maximize benefits, those with QSBS should
 - (1) not contribute the stock to a partnership,
 - (2) consider QSBS implications before redeeming any shares, and
 - (3) understand the impact of QSBS representations to potential investors.
 - Note that there is a five-year hold requirement.

Special Tax Provisions Governing Exits – Section 1045

- Section 1045 allows a shareholder to defer gain realized on the sale of QSBS held for more than 6 months where the shareholder uses the sale proceeds to purchase other QSBS (replacement QSBS) within 60 days following the date of the sale.
- If the section 1045 requirements are satisfied, the shareholder can elect to defer the gain realized on the sale of the old QSBS to the extent the sale proceeds do not exceed the purchase price of the replacement QSBS. The gain deferred instead reduces the basis of the replacement QSBS.
- Section 1045 differs from section 1202 insofar as it provides a tax deferral rather than a tax exclusion. Section 1045 provides a benefit to QSBS shareholders who are unable to benefit from section 1202 (either completely or partially). For example, a shareholder who hasn't held his QSB stock for the section 1202 five-year-holding period might benefit from the section 1045 deferral, and a shareholder whose gain exceeds her section 1202 per-issuer gain limitation might benefit from the section 1045 deferral on the excess portion.

Special Tax Provisions Governing Exits – Section 1045 (Cont.)

- Correspondence with Section 1202
 - Requirements are generally very similar.
 - Unlike under section 1202, however, for purposes of section 1045, the shareholder only must have held the old QSBS for more than six months (unlike the section 1212 holding period of five years). Additionally, for purposes of section 1045, the replacement QSBS must satisfy the active business requirement for only the first six months of the shareholder's holding period.
 - Section 1045 deferral does not apply to any gain treated as ordinary income. It also does not apply where the shareholder seeking to defer tax is a C corporation.
 - Note that holding period of replacement QSBS will include that of the sold QSBS. If otherwise meeting the requirements, this can help you "age into" Section 1202 with respect to the replacement QSBS.

Coronavirus COVID-19 Resources

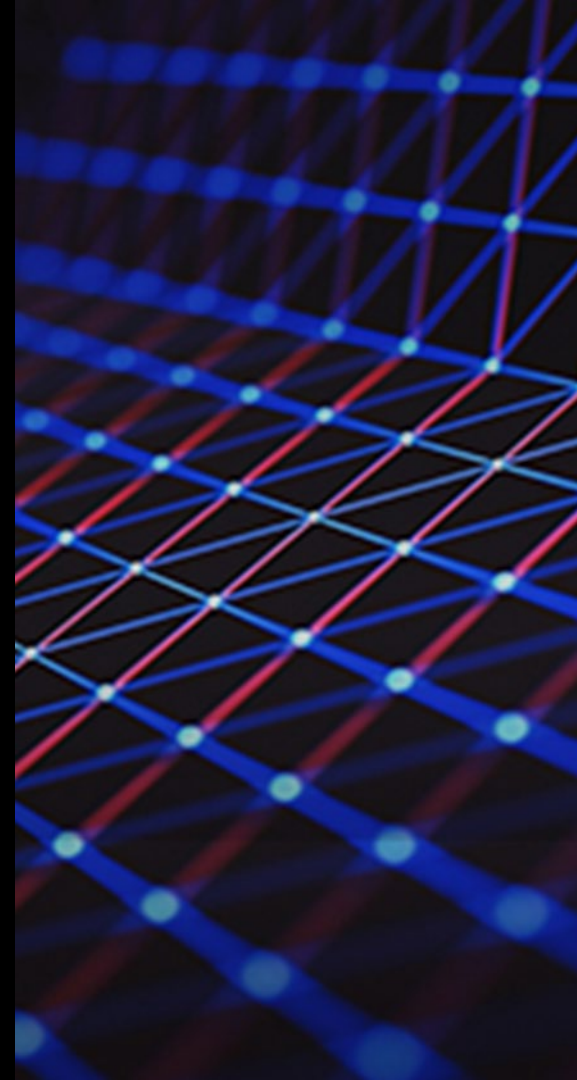
We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

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To help keep you on top of developments as they unfold, we also have launched a resource page on our website at

[www.morganlewis.com/
topics/coronavirus-
covid-19](http://www.morganlewis.com/topics/coronavirus-covid-19)

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to [subscribe](#) using the purple “Stay Up to Date” button.



Biography



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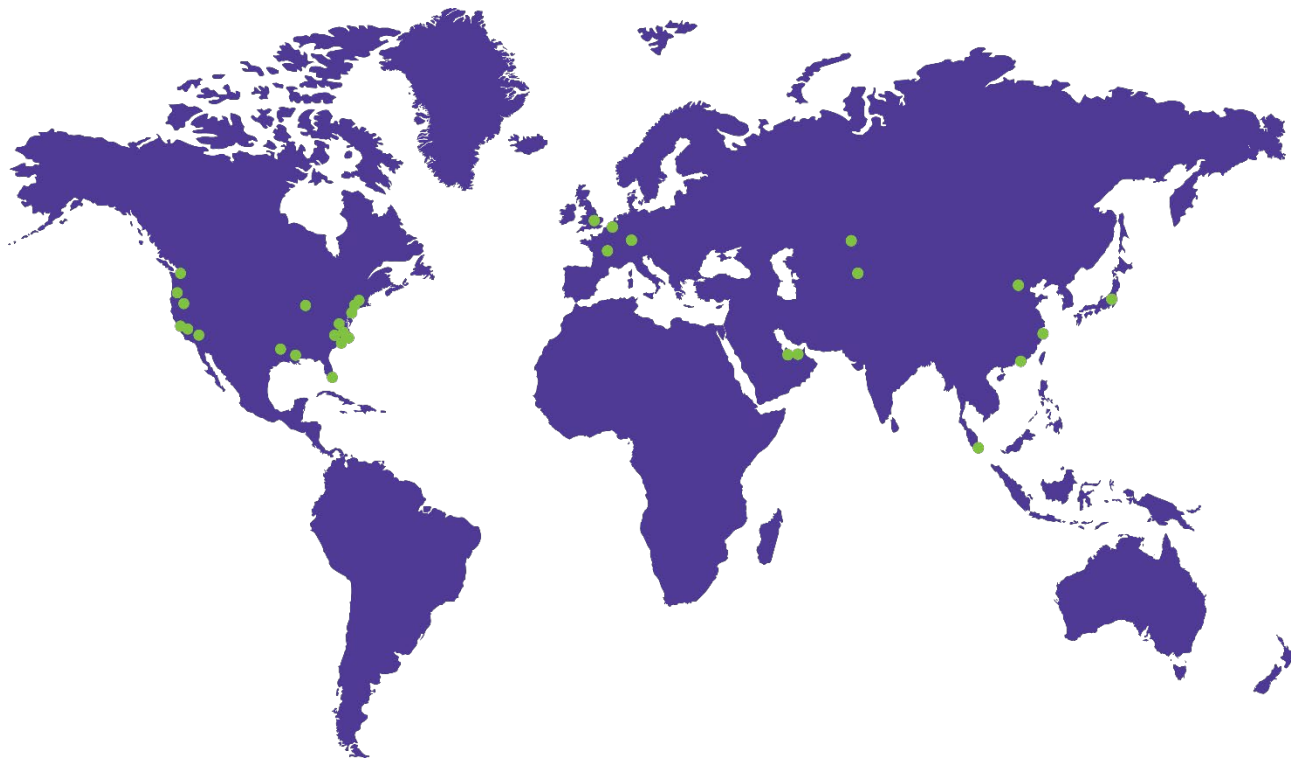
Charles (Chuck) Bogle is a partner in the Firm's tax department. Chuck's practice covers a wide range of federal income tax-related matters, with a principal focus on the tax aspects of structured finance transactions. Chuck represents sponsors, managers, and underwriters in collateralized bond, loan, and debt obligation transactions, as well as issuers and underwriters in various asset-backed and insurance-related transactions, including credit card, auto loan, marketplace loan, payment plan, and mortgage securitizations. In addition, Chuck has a depth of knowledge regarding the tax aspects of both taxable and tax-free mergers, acquisitions and dispositions, particularly in the investment management space.

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