FAMILY OFFICE TAX ROUNDTABLE

McDermott Will & Emery

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MERGER & ACQUISITION TAX PLANNING IN LIGHT OF CURRENT & (POTENTIAL) FUTURE TAX REFORM

SPEAKERS

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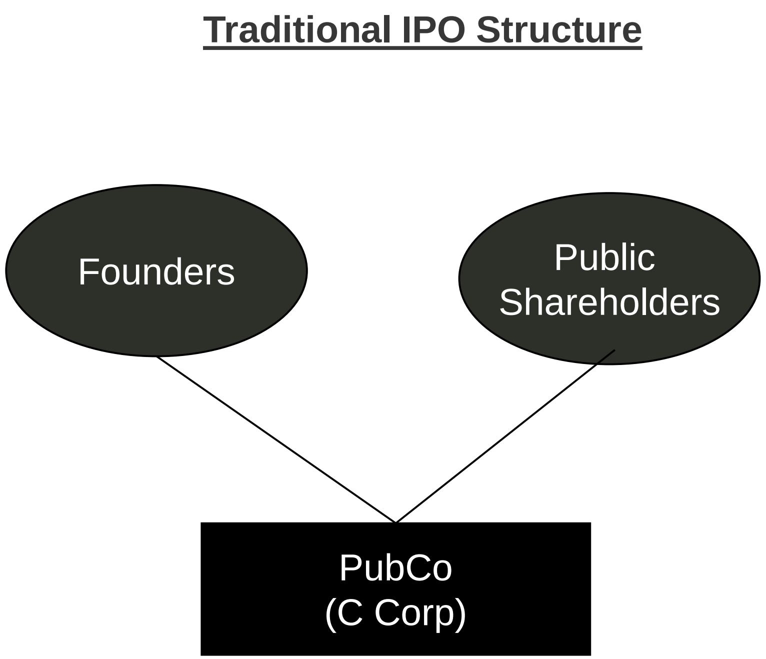
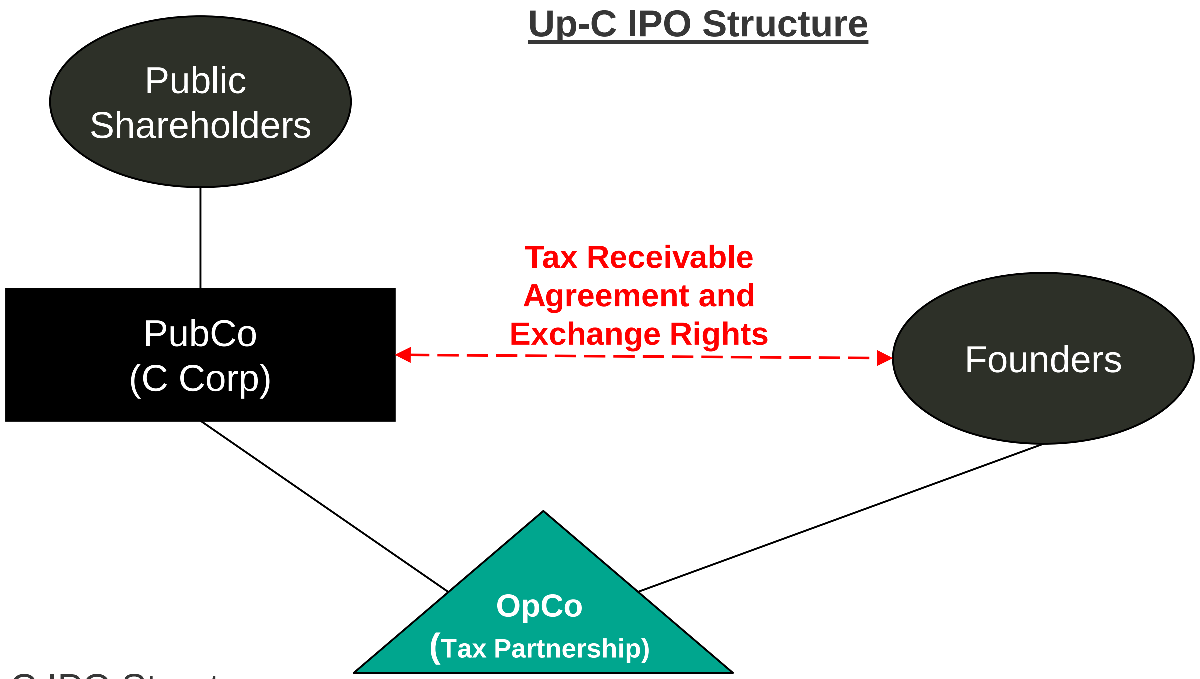
OVERVIEW

- Section 1411 Planning
  - Up-C IPO
  - Pre-Transaction S Corporation Election
  - Personal Goodwill Sale
- Payroll Tax Planning
  - LP Conversion
  - S Corporation Election
- Domestic Income Tax Planning
  - Electing Out of Installment Sale Reporting
  - Retroactive Check-the-Box/S Corporation Election Planning
  - Section 1202 – Qualified Small Business Stock
  - Purchase Price Allocations
  - Carried Interests (Section 1061)
- International Tax Planning
  - Withholding on Transfers of Partnership Interests
  - GILTI and US Partnerships
  - GILTI and Proposed Surcharge

SECTION 1411 PLANNING – UP-C IPO



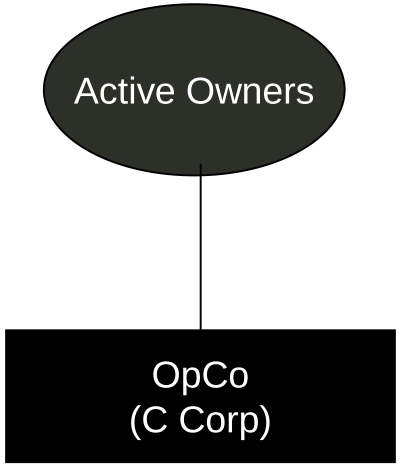


- Traditional IPO Structure
  - Pre-IPO conversion of flow-through entity to Delaware C corporation
  - Sale of stock to public in IPO
  - 3.8% net investment income tax (NIIT) under Code Section 1411 applies to IPO gains, dividends from PubCo and future sales of PubCo stock

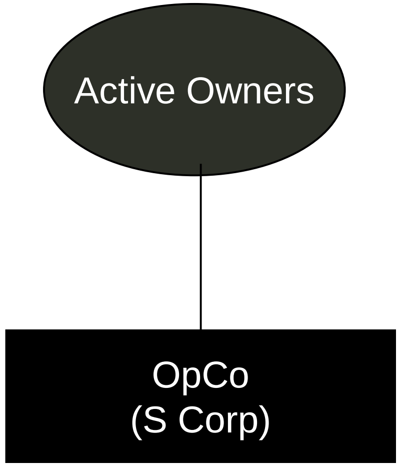
- Up-C IPO Structure
  - Business remains in flow-through form post-IPO
  - Founders sell OpCo Units to PubCo in IPO – no 3.8% NIIT if founders are active under Code Section 469
  - Tax Receivable Agreement (TRA) provides for payment of 85% of realized tax benefits associated with Section 743(b) adjustment resulting from founders' sale of OpCo Units to PubCo – TRA payments result in additional step-up and additional TRA payments (iterative calculation)
  - Founders have rights to exchange OpCo Units into PubCo shares – no 3.8% NIIT if founders are active under Code Section 469. Exchanges result in additional TRA payments (again, an iterative calculation)

SECTION 1411 PLANNING – PRE-TRANSACTION S CORPORATION ELECTION

Prior to S Election:

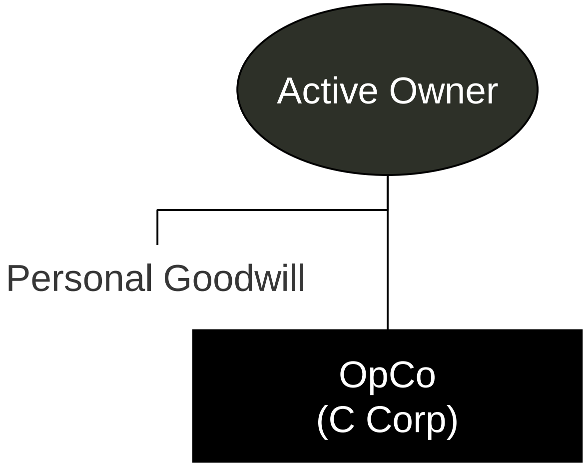


After S Election:



- Assume OpCo enters into an LOI to sell 100% of OpCo stock to Buyer for $100 million
- Assume all of OpCo's owners are "active" in OpCo's business for Code Section 469 purposes
- **Income Tax Planning Strategy**: OpCo's owners file a Form 2553 (S Corporation Election) for OpCo to be effective prior to the sale and sells OpCo stock with no Code Section 338(h)(10) election. If OpCo's owners had sold C corporation stock, the gain would have been subject to the 3.8% NIIT. When OpCo's owners sell S corporation stock, the gain is not subject to the 3.8% NIIT. The S corporation election is otherwise tax neutral to Buyer and Seller because no Code Section 338(h)(10) election is made. In a transaction in which $100 million of gain is recognized, the tax savings to the Active Owners is $3.8 million

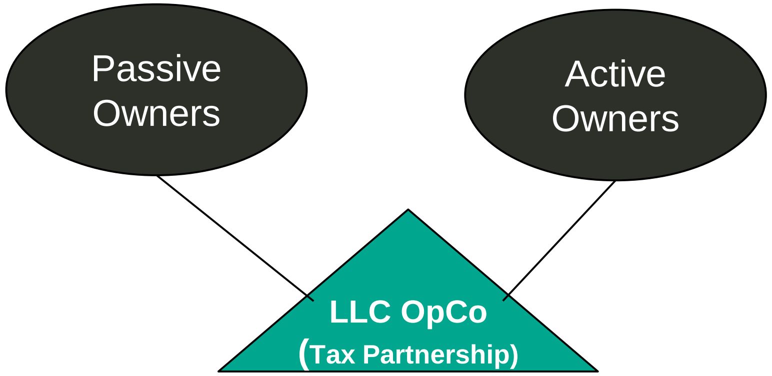
SECTION 1411 PLANNING – PERSONAL GOODWILL SALE



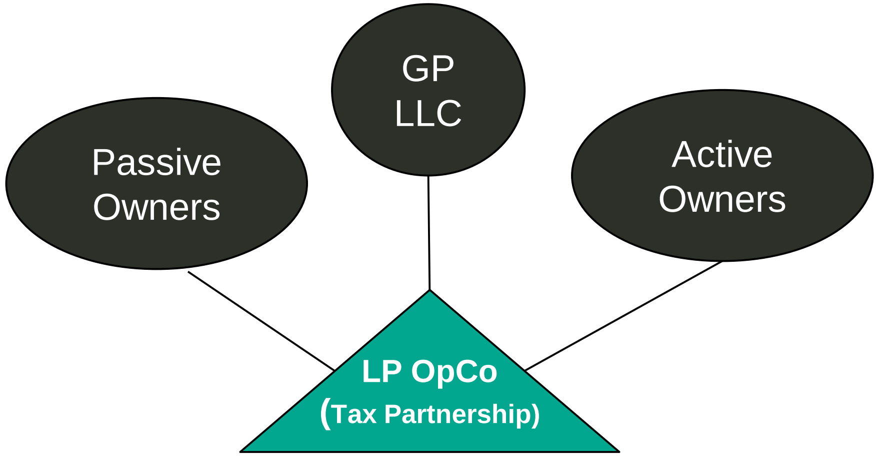
- Assume OpCo is a C corporation and an asset acquisition is a non-starter for Active Owner due to two layers of tax (corporate and shareholder). A stock deal delivers no tax basis step-up to Buyer
- Assume Active Owner could take substantially all of OpCo's clients/customers without recourse by OpCo (i.e., no non-compete agreement in place)
- **Income Tax Planning Strategy**: Active Owner sells his/her personal goodwill and 100% of the stock of OpCo. Active Owner enters into a non-compete in connection with the transaction. Buyer gets a tax basis step-up in the acquired personal goodwill and Active Owner is only subject to one level of tax on both aspects of the transaction. *See Martin Ice Cream Company v. Commissioner*, 110 TC 189 (1998). 3.8% NIIT does not apply because the transaction is the sale of goodwill of an active business owner

PAYROLL TAX PLANNING – LP CONVERSION

LLC Structure



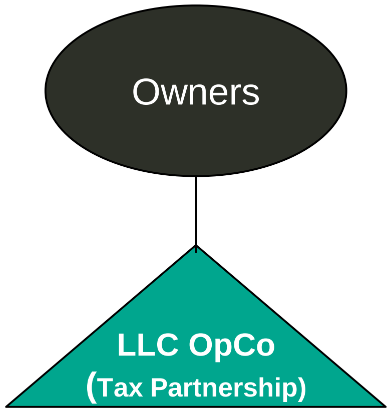
LP Structure



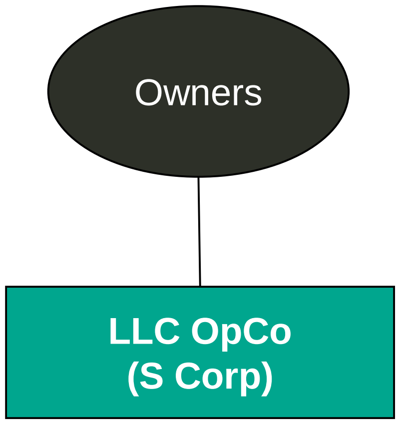
- LLC Structure
  - Passive Owners' share of LLC OpCo's income is subject to 3.8% NIIT
  - Active Owners' share of LLC OpCo's income is subject to self-employment taxes (which would be subject to an additional 12.4% tax rate on amounts above $400,000 under Joe Biden's plan)
- Limited Partnership Structure
  - Passive Owners' share of LP OpCo's income remains subject to 3.8% NIIT
  - Active Owners' share of LP OpCo's income is arguably not subject to self-employment taxes under Code Section 1402(a)(13) (limited partner exception) and not subject to 3.8% NIIT because they are active in the business under Code Section 469

PAYROLL TAX PLANNING – S CORPORATION ELECTION

Tax Partnership Structure

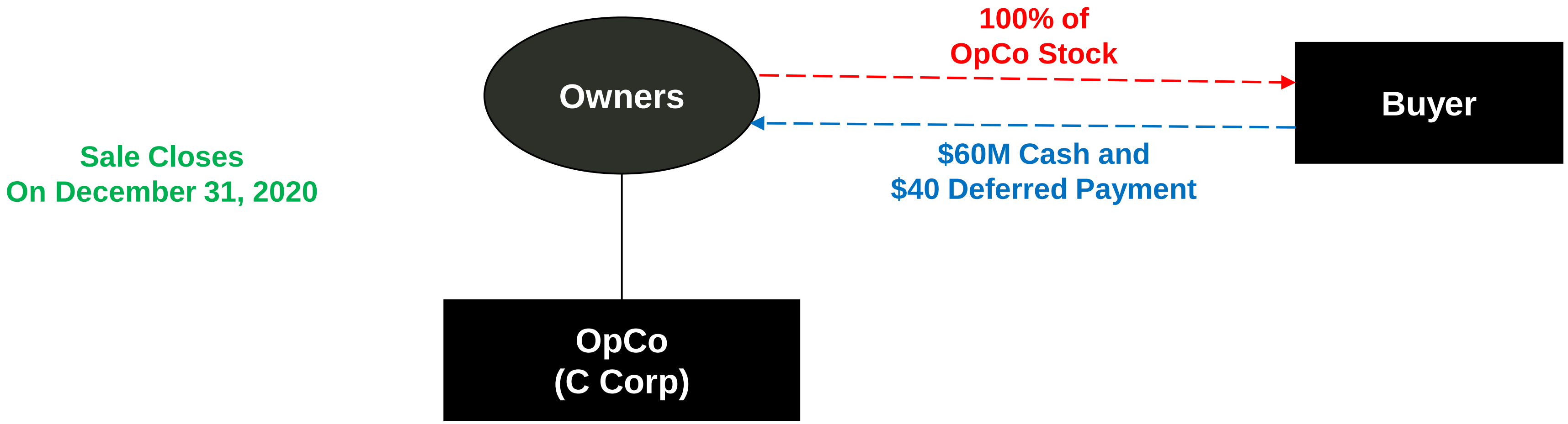


S Corporation Structure



- LLC Structure
  - Passive Owners' share of LLC OpCo's income is subject to 3.8% NIIT
  - Active Owners' share of LLC OpCo's income is subject to self-employment taxes
- S Corporation Structure
  - Passive Owners' share of LLC OpCo's income remains subject to 3.8% NIIT but Active Owners' share of S Corporation income is not subject to self-employment taxes other than reasonable compensation (which is subject to FICA)
  - But consider other impacts of S corporation election (e.g., no tax basis for nonrecourse debt, appreciated property locked in S corporation solution, etc.)

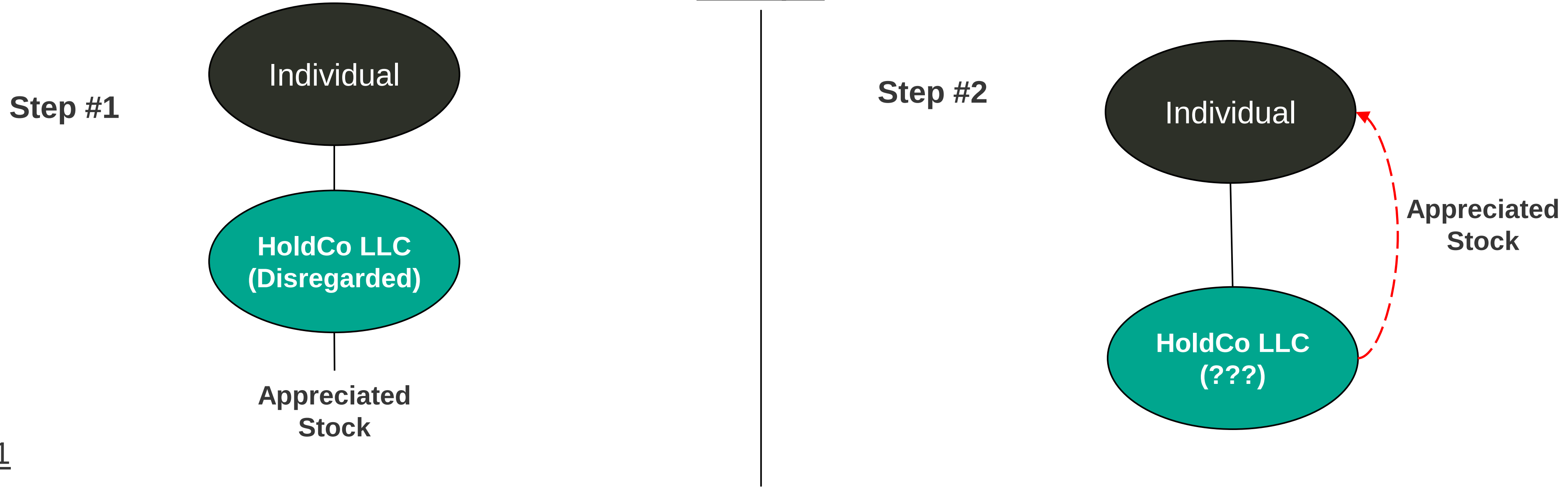
DOMESTIC INCOME TAX PLANNING – ELECTING OUT OF INSTALLMENT SALE REPORTING



- <u>Default Income Tax Treatment</u>
  - $60M taxed in 2020 at 2020 income tax rates
  - $40M taxed in future tax years at then applicable income tax rates
- <u>Electing Out of Installment Sale Reporting</u>
  - Assume owners elect out of installment sale reporting
  - All $100M taxed in 2020 at 2020 income tax rates
  - Owners can wait until due date of 2020 tax return (with extensions) to decide whether to elect out of installment sale reporting (with maximum visibility into possible increases in applicable income tax rates)

DOMESTIC INCOME TAX PLANNING – RETROACTIVE CHECK-THE-BOX ELECTION/S CORPORATION PLANNING

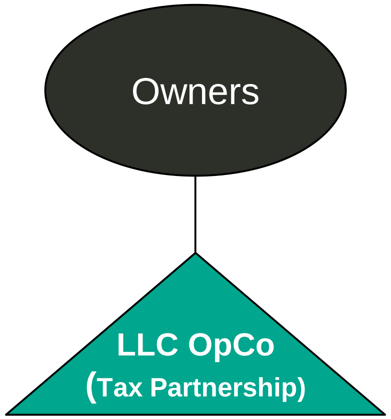
Example



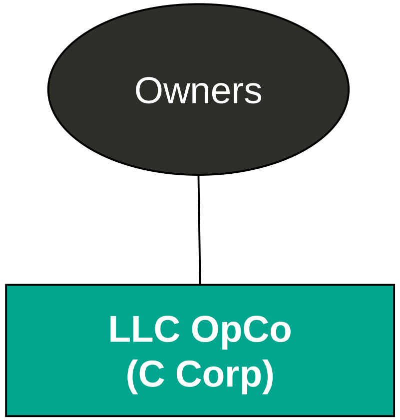
- Step #1
  - On December 21, 2020, Individual contributes appreciated stock to a new LLC (HoldCo LLC). HoldCo LLC defaults to disregarded entity status
- Step #2
  - On December 31, 2020, HoldCo LLC distributes appreciated stock to Individual
  - On or before March 13, 2021, if long-term capital gains rates have significantly increased (under a Democratic administration and Congress), Individual makes an S corporation election (which acts as a check-the-box election) to be effective as of December 30, 2020 and the distribution of the appreciated stock is taxable at 2020 long-term capital gains rates
  - If long-term capital gains rates remain the same, no S corporation or check-the-box election is made for HoldCo LLC and the contribution and distribution of the appreciated stock are both disregarded for federal income tax purposes

DOMESTIC INCOME TAX PLANNING – SECTION 1202

Tax Partnership



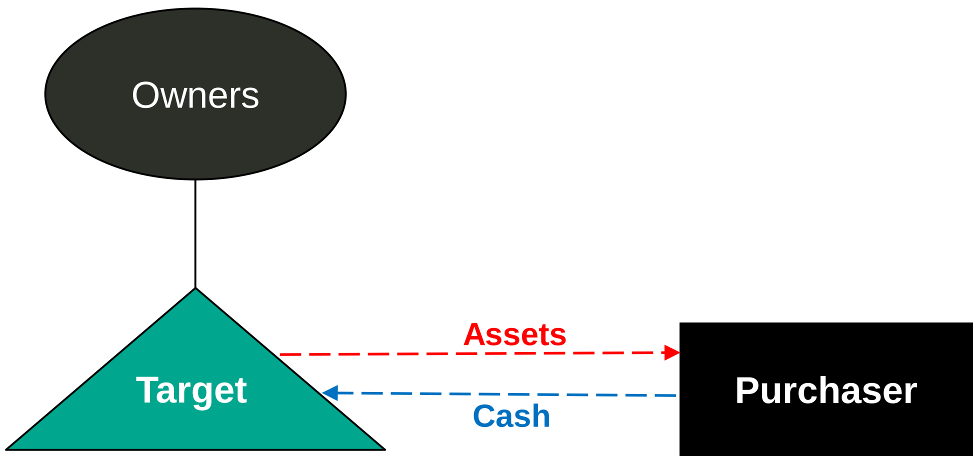
C Corporation



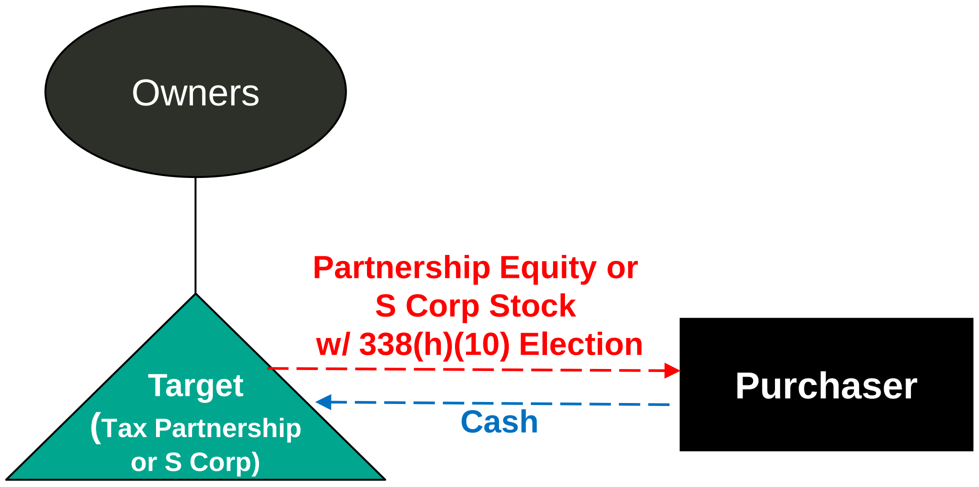
- LLC Structure
  - Gain on sale subject to long-term capital gains rates (assume 39.6% under Democratic administration)
- C Corporation Structure with Code Section 1202 Benefits
  - Check-the-box election begins five-year holding period for Code Section 1202 using fair market value (FMV) as 10X basis
  - Greater of $10M or 10X Code Section 1202 basis excluded from capital gains on exit
  - But consider other impacts of C corporation election (e.g., two-layers of tax, no outside basis build-up, no individual use of losses, etc.)

DOMESTIC INCOME TAX PLANNING – PURCHASE PRICE ALLOCATIONS

Asset Sale (in Form)

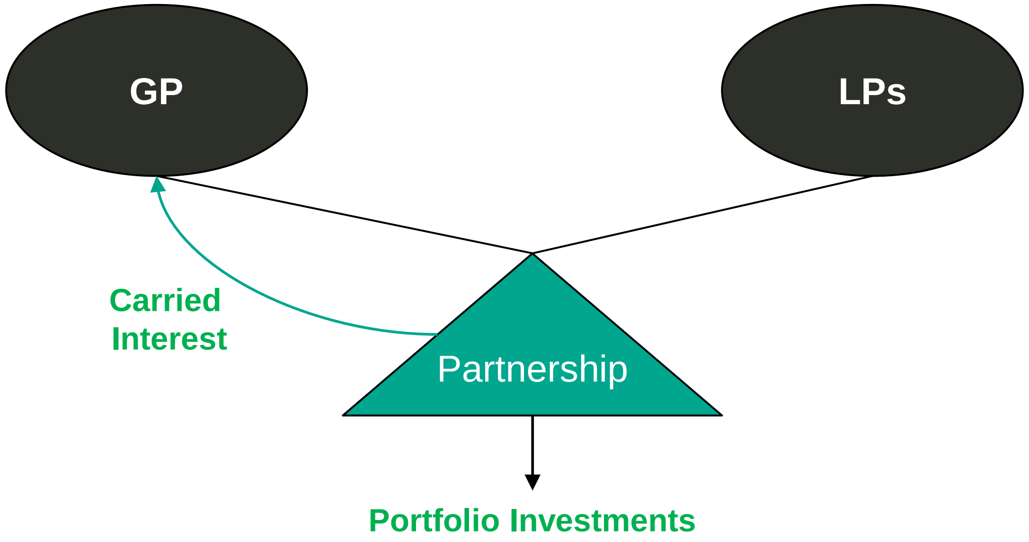


Equity Sale (Asset Sale for Tax)



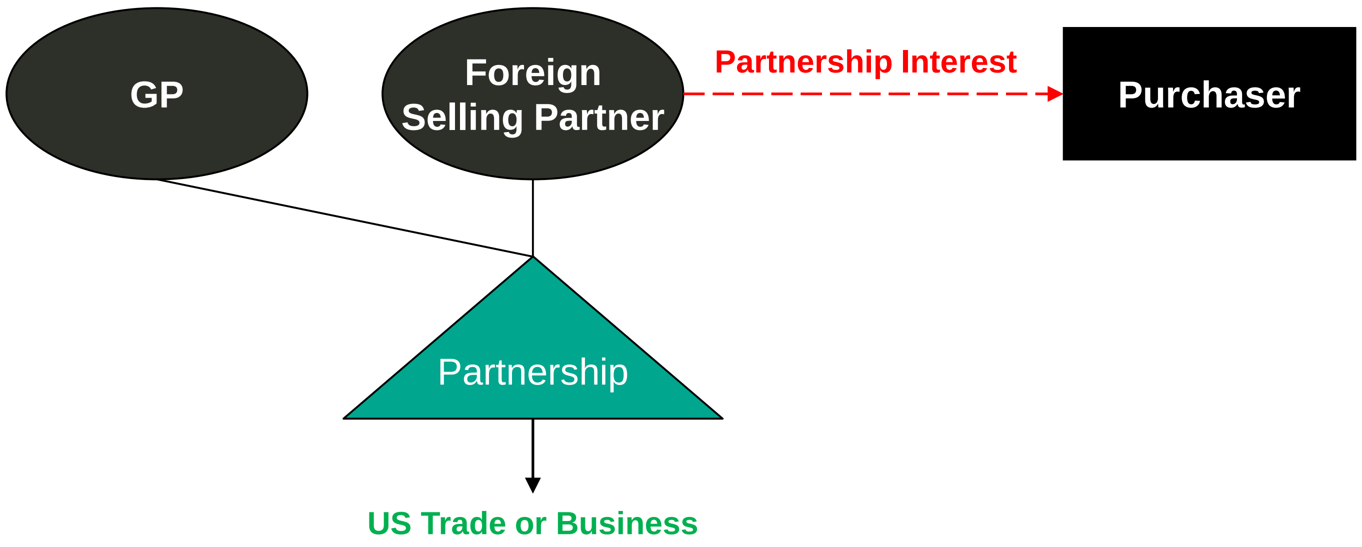
- Pre-Capital Gain Rate Increase
  - Buyers and Sellers heavily negotiate purchase price allocations due to “win-lose” aspects (e.g., depreciation recapture for sellers and shorter depreciable lives for buyers)
- If Long-Term Capital Gains are Taxed at Same Rate as Ordinary Income
  - Sellers might be neutral as to the purchase price allocation, which creates opportunities for buyers to allocate purchase price to A/R and assets subject to bonus depreciation and/or other shorter depreciable/amortizable lives

DOMESTIC INCOME TAX PLANNING – CARRIED INTERESTS (SECTION 1061)



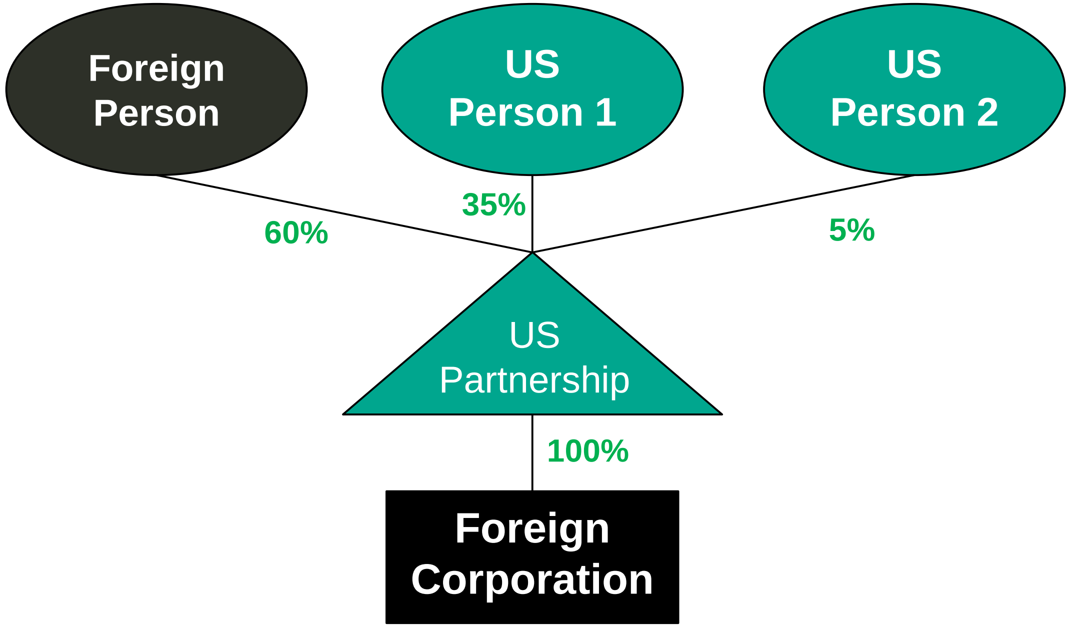
- Taxation of Carried Interests
  - Section 1061 enacted as part of TCJA of 2017; proposed regulations published on July 31, 2020
  - Subject to exceptions, recharacterizes certain net long-term capital gain to short-term capital gain for "applicable partnership interests" (API)
  - 3-year holding period
- Considerations
  - Once an API, always an API (subject to certain exceptions)
  - Rules apply to tiered structures (e.g., partnership carry vehicle held by partnership partners)
  - Transfers to related persons can trigger immediate taxation (e.g., gifts to spouse, children, etc.)

INTERNATIONAL INCOME TAX – WITHHOLDING ON TRANSFERS OF PARTNERSHIP INTERESTS



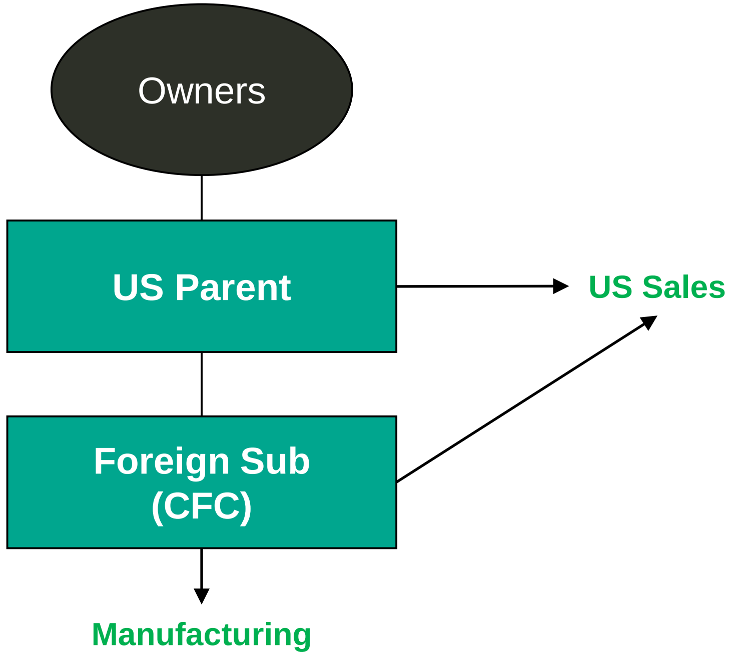
- Withholding Required on Transfer of Partnership Interest (Sections 864(c)(8) and 1446(f))
  - Final regulations under Section 1446(f) published on October 7, 2020
  - 10% withholding required on foreign person's transfer of partnership interest of partnership engaged in a US trade or business
  - Exceptions available upon appropriate certifications by either transferor or partnership
  - No exception for "disguised sales" or earnouts
- Considerations
  - Consider transfer provisions in existing partnership agreements and future partnership agreements
  - A partnership's requirement to withhold amounts not withheld by transferee apply to transfers on or after January 1, 2022

INTERNATIONAL INCOME TAX – GILTI & US PARTNERSHIPS



- <u>Global Intangible Low Tax Income (GILTI)</u>
  - Generally requires “US Shareholders” to include in its income on a current basis a CFC’s GILTI income
  - A US corporation may deduct 50% of the CFC’s GILTI, resulting in an effective rate of 10.5% (13.125% for tax years after 2025)
  - High tax exception applies if CFC’s foreign income tax rate is at least 18.9% (i.e., 90% of the maximum corporate rate of 21%)
  - US partnership’s ownership of foreign corporation generally determines CFC status, but US partners must determine GILTI inclusion, if any
- <u>Considerations</u>
  - Because US partnerships do not calculate GILTI inclusions, “US Shareholder” partners will inquire about US partnership’s ownership in foreign corporations, and may request books and records from such foreign corporations for purposes of calculating their GILTI inclusion
  - Open questions still remain, including partnership reporting of certain income items that are excluded from income at the partner level, certain basis adjustments, etc.

INTERNATIONAL INCOME TAX – GILTI & PROPOSED SURCHARGE



- <u>Considerations</u>
  - Democrats have proposed increasing the minimum GILTI rate to 21%, and imposing a 10% surcharge if US company uses foreign manufacturing facilities to sell products into the US
  - Companies might consider accelerating any existing plans to move manufacturing facilities into the US

THANK YOU