

Emerging Issues for the Tax Advisor to a Startup or Closely Held Silicon Valley Company

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Emerging Issues

Incorporation/Formation

Workouts

Equity Compensation

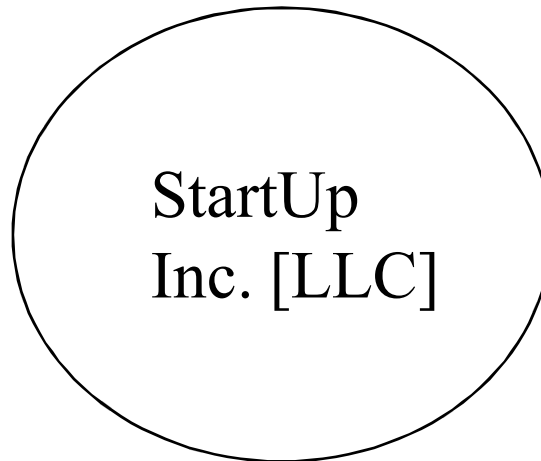
International

Incorporation/Formation Issues

Services



Technology



Cash

Emerging Issues - LLCs

- Equity Compensation Issues
- Venture Capital Style Agreements
- Debt or Equity Workouts
- Taxation of Carried Interest

LLC - Equity Compensation Issues

- Under Rev. Proc. 93-27, the receipt of a profits interest is generally not a taxable event for the partner or the partnership.
- A member has a capital interest if he or she has a share of unrealized appreciation in the partnership's assets.
- In Rev. Proc. 2001-43, the IRS stated that it would not tax the employee or the partnership on grant of a non-vested profits interest.
- Proposed Regulation 2005-43, eliminates the different tax treatments between profits and capital interests. Tax on value of partnership interest received; i.e. the liquidation value.

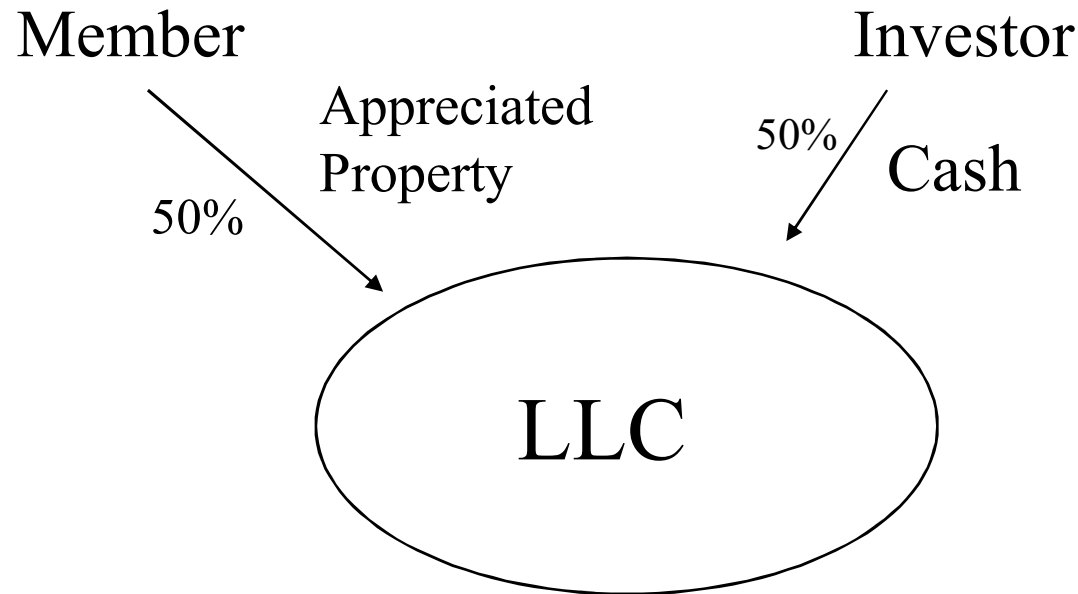
Partnership Equity for Services Regulations

- Proposed Regulations published May 24, 2005
- Rev. Proc. 2001-43 and Rev. Proc. 93-27 Will Be Obsoleted
- Section 83 Applies to Profits Interest
- Section 83(b) Election Required for Unvested Profits Interest
- Partnership Deduction in Year of Employee's Income Inclusion
- Partnership Recognizes No Income on Capital Shift
- Safe Harbor Election
- Forfeiture Allocations Required
- Effective When Finalized

LLC – Venture Capital Type Distributions

- Preferred Returns
- 704(c) and Reverse 704(c) Adjustments
- Warrants
- Proposed Regulations on Non-Compensatory Options

704(c) Trap



- Preferred Return to Investor
- No Tax Distribution/Advance Clause
- No Interpretation/Amendment Clause
- Similar Issue with Partner Recourse Debt

LLC – Debt and Equity Workouts

- COD Income under Section 108(e)(8):
 - When a LLC issues a membership interest in satisfaction of a debt obligation, the LLC generally recognizes cancellation of indebtedness (“COD”) income to the extent the debt contributed exceeds the fair market value of the membership interest and any other property received by the contributing party in the exchange.
- Exclusion under Section 108(a):
 - COD income determination is made at the partnership level, the bankruptcy/insolvency question is resolved at the partner level.
- Allocation of COD Income.
- Reduction in Partners’ Liabilities.

LLC – Taxation of Carried Interest

- On June 25, 2008, the House of Representatives passed legislation that would tax income from carried interest as ordinary income, instead of capital gain, to the extent the carried interest payments do not reflect a reasonable return on invested capital. The Senate is expected to oppose the legislation.

Emerging Issues – C Corp.

- Code Section 83
- Code Section 351
- Taxation and Holding Period of Warrants and Convertible Debt
- Revenue Ruling 2007-49 on New Vesting Restrictions

C Corp. – Code Section 83

- Section 83(b) Election Could Not Be Amended Where it Was Improper As Not Being Timely Filed. PLR 200832019
- Section 83(b) Election to Include Nonvested Stock in AMT Income was valid and could not be rescinded. Kadillak v. Comr.(9th Cir.)

C Corp. – Vesting Restrictions Revenue Ruling 2007-49

- Three holdings for changes in vesting restrictions pursuant to a transfer:
 - 1) When the service provider transfers substantially vested stock and the transfer places restrictions on that stock causing it to become substantially nonvested, there is no effect under Section 83.
 - 2) When the service provider transfers substantially vested stock for substantially nonvested stock in a reorganization described in 368(a), Section 83 applies to the nonvested stock received.
 - 3) When the service provider transfers substantially vested stock for substantially nonvested stock in a taxable stock acquisition, Section 83 applies to the nonvested stock received.

Sale for Partially Recourse Note / Non-Recourse Note

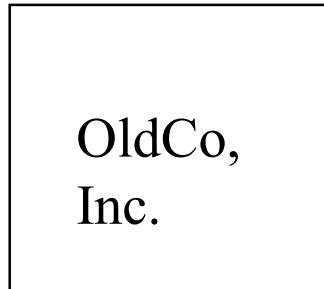
- Treatment as Option
- Partial Recourse to Holder
- Security
- Interest Rate

C Corp. – Code Section 351

- Stock/Capital for “Property”
- License In
- Valuation

Busted 351

Shareholders



Inventor

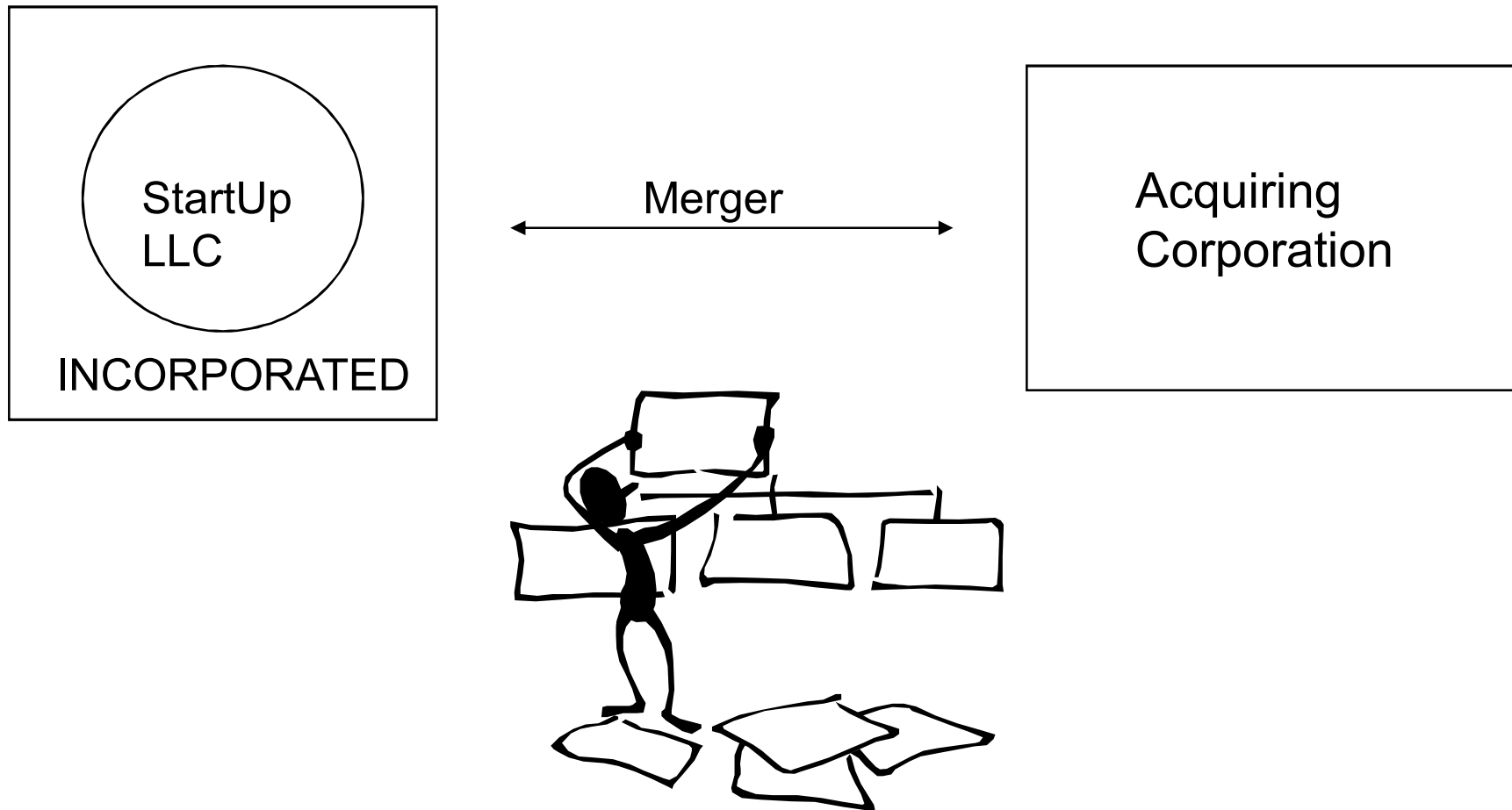


Patent

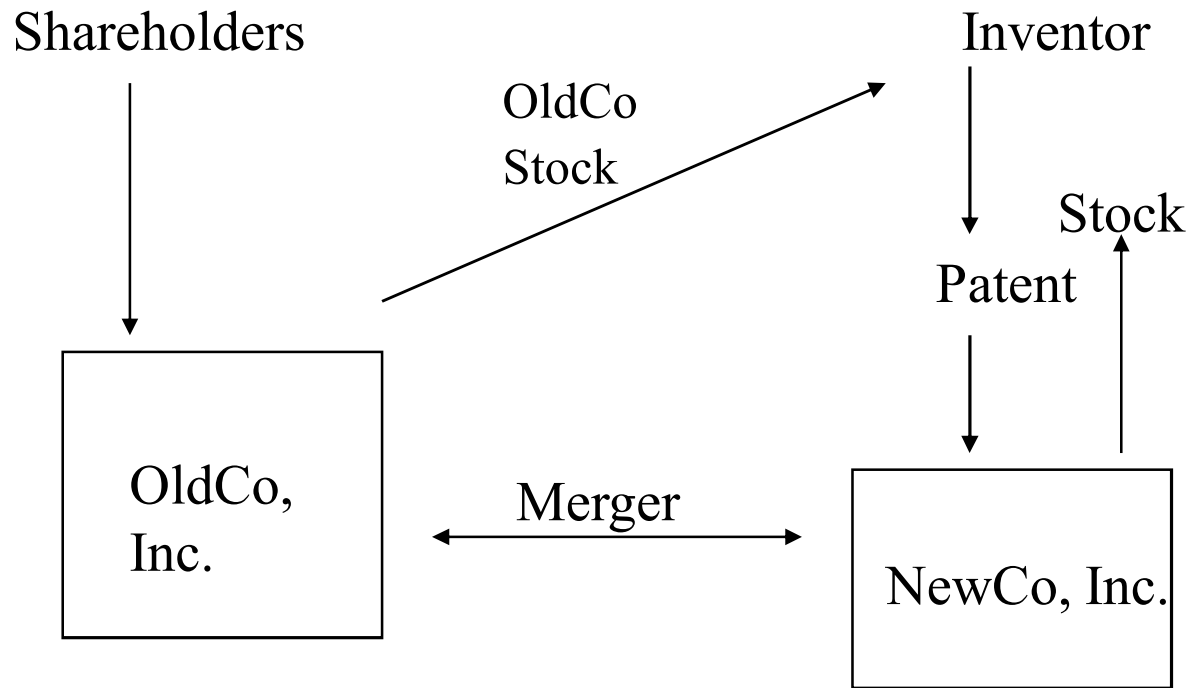


OldCo wants Inventor's patent for restricted stock
Inventor wants OldCo Stock
Can't do a 351 because of 80% requirement

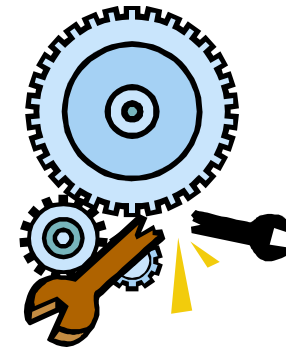
Tax Free Reorganization



Busted Merger



Step Transaction - sale
Continuity of Business



Copyright

- Costs
 - Most copyright costs must be capitalized (no current deduction)
 - Subject to depreciation
 - 195 Startup expenses
 - Inventory costs
 - Software may be depreciated over 36 months
- Revenues
 - Capital Asset does not include copyright held by person whose personal efforts created it or to whom it was assigned in a carryover basis transaction
 - Personal efforts of corporation?
 - Inventory
 - Software as franchise

Trademarks

- Acquisition Costs
 - Expenses to develop trademark must be capitalized
 - No depreciable life
 - Section 195 (startup costs) does not apply
 - Section 197 15 year amortization
 - Contingent or periodic payments deductible
- Income from Disposition
 - Receipt of amounts contingent on productivity, use or disposition are non-capital
 - Retention of any significant power, right or continuing interest (quality control) results in ordinary income

Patents

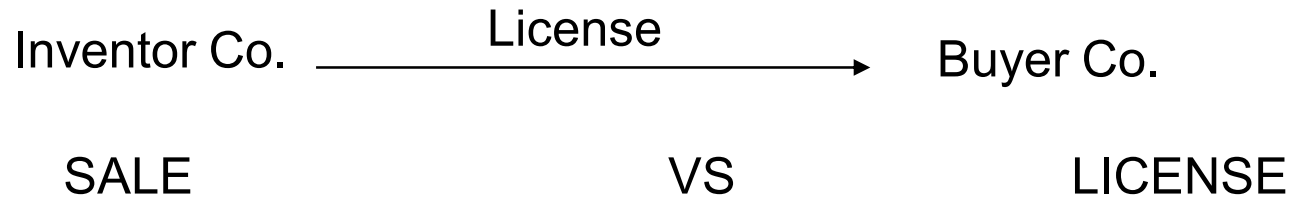
- Deduction of R&D Expenses under 174
- Section 41 Credits
- Capitalize and Amortize
- 1235 Capital Gains
 - Available to Holders
 - Inventor
 - Obtained an interest in the invention before reduction to practice
 - N/A Related Party Transactions
 - N/A Employer of Creator

Trade Secrets & Know How

- Section 1235 applies to potentially patentable trade secrets
- Treatment as Property
- Transfer of all substantial rights
 - No retained rights to use



All Substantial Rights



- Use of the patent limited geographically within the country of issuance;
- Time period of less than the remaining life of the patent;
- Limited to specific trades or industries;
- Rights that are less than all the rights covered by the patent;
- Limit on further sublicensing;
- Grant of less than all the claims or inventions covered by the patent; and
- Retention of a right to terminate the transfer at will or on condition subsequent.

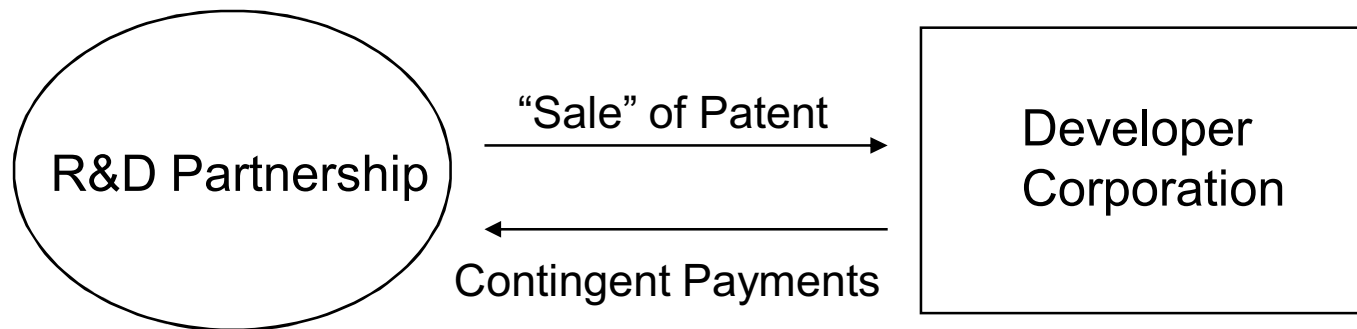
Retained Rights that do not result in License:
Right to use invention
Security interest

Software: Patent or Copyright

- Copyright
 - Not Capital Asset in hands of Creator
 - One year capital gains holding period
- Patent
 - Sale by Holder qualifies for capital gain transaction
 - 1235 instant capital gains



Associated Patentees Character Converter

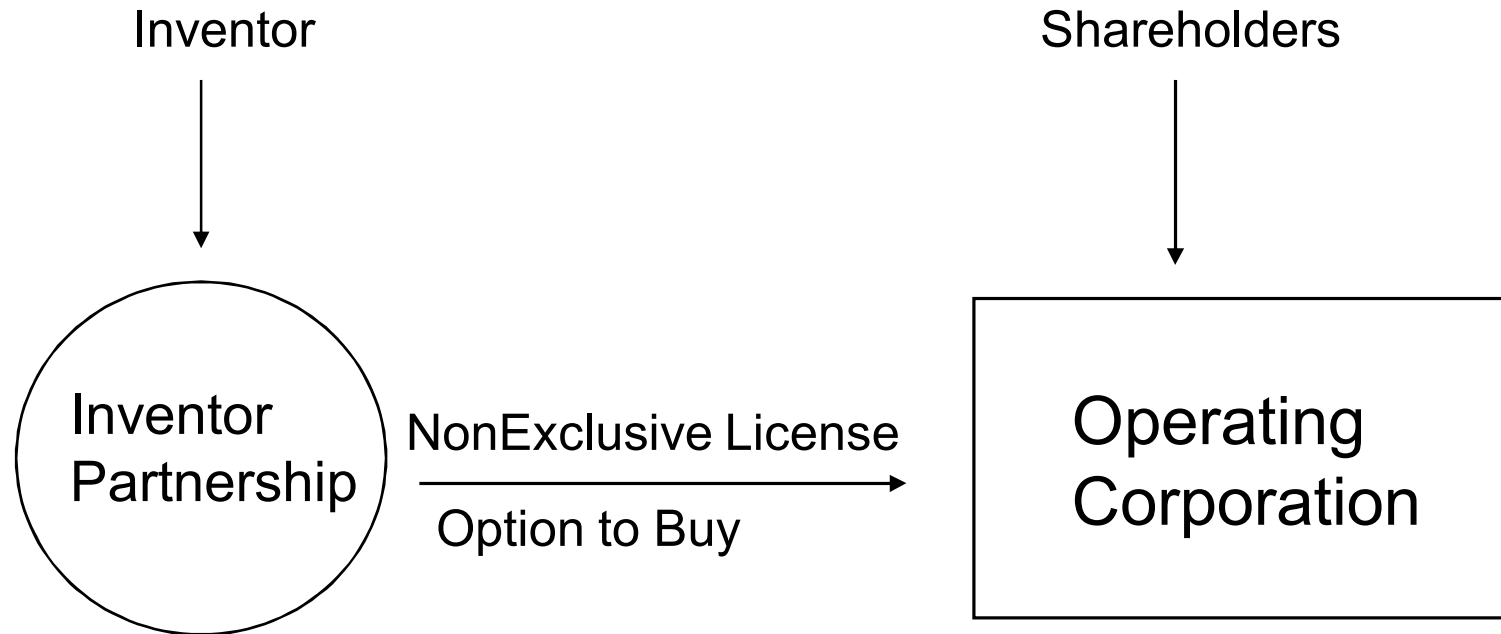


Associated Patentees, Inc.: current deduction for payments based on patent's use or production

R&D Partnerships

- LDL Research & Development II, Ltd.
 - Partnership had no real prospect of exploiting technology
 - Developer relied on to conduct technology business
 - Only possibility that partnership would ever act
- Kantor v. CIR
 - Partnership must have realistic possibility of entering its own business
 - Prospect of entering business must be shown at time of expenditure
 - Option to acquire exclusive rights for nominal sum
 - Lack of Capability to enter business
- Scoggins v. CIR
 - Developer had significant cost option to acquire IP
 - Partnership was capable of developing business if developer did not

Scoggins Partnership



R&D Deductions
1235 Capital Gain Treatment

Bankruptcy Remote Patent Holding Partnership
174/1235 Arbitrage
Section 351 Tax Free Treatment
Is it financeable?

C Corp. – Equity Warrants and Convertible Debt

- Revenue Ruling 72-265:
 - Except where the Code explicitly requires recognition, the exchange of a convertible debt for stock of the obligor corporation is not a realization event.
- Warrant holders are treated similarly. Rev. Rul. 78-182.
- What if convertible debt / warrant holder is also a service provider?

Emerging Issues – S Corps.

- Phantom Stock Plans
- Unvested Shares, 2nd Class of Stock Issue
- Recent Regulations

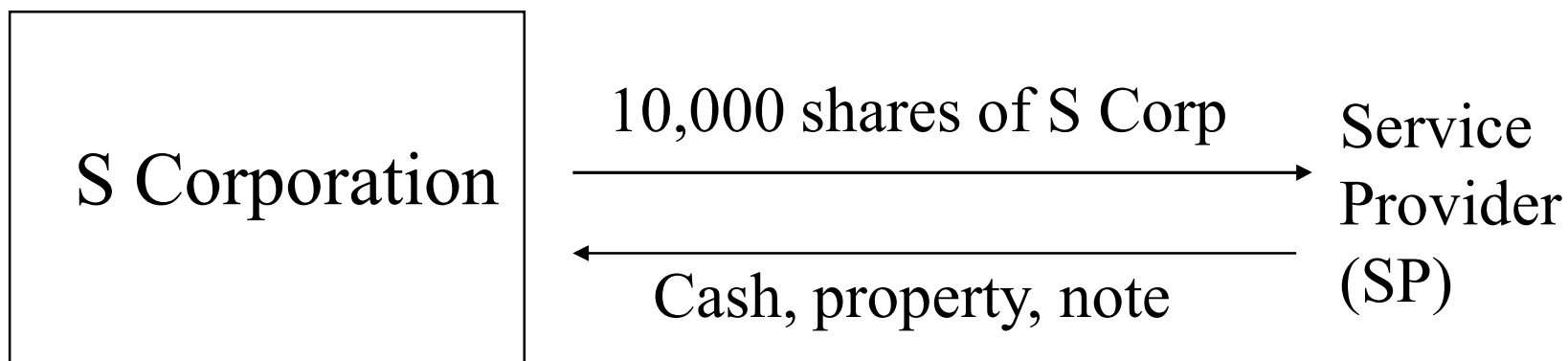
S Corps. – Phantom Stock Plans

- Award employees with phantom stock or some other form of compensation bonus tied to the performance of the S Corp. Like other forms of employee compensation, these payments will be tax deductible to the corporation.
- An option plan must be subject to restrictions on exercise and repurchase.
- 338(h)(10) Problem.
- 409A Issues.

S Corps. – Unvested Shares

- Without a Section 83(b) election, until stock is substantially vested, the employee is not recognized as the owner of the stock. Reg. 1.1361-1(b)(3).
- With a Section 83(b) election, the S Corp. must be careful to give stockholders the same rights as other stockholders.

S Corporation - Restricted Stock



Terms:

Price and Value = \$1 per share

S Corp has right of repurchase on termination of employment

Repurchase Right lapses over time based on continued employment

S Corporation – No 83(b) Election

SP not treated as owner of non-vested (subject to right of repurchase) stock until vesting

SP's income on each vesting date is value of vested stock less SP's cost

Distributions on nonvested stock may result in second class of stock

S Corporation – 83(b) Election

SP treated as owner of non-vested stock upon purchase

S Corporation Option Plan

Compensatory option plan is not second class of stock

100 shareholder limit

Exercise and transfer of option stock must be restricted to qualified S corporation shareholders

S Corp must have repurchase right if optionee exercises and later becomes non resident alien

Phantom or Virtual Stock

Right to a payment on occurrence of a liquidity event

Not a second class of stock

Unfunded deferred comp plan, subject to section 409A
– exception for:

Short term deferrals if benefit paid
within 2 ½ months after end of year of vesting

Benefit may be reduced in discretion of employer
by grant of additional phantom stock units under plan

Emerging Issues – 409A

- Deadlines
- Option Re-pricing
- Founders Waive Compensation
- Severance Agreements
- Valuation

Code Section 409A

All amounts deferred under a nonqualified deferred compensation plan are included in income at time of deferral or when no longer subject to substantial risk of forfeiture unless plan complies with section 409A

Amount included in income is increased by interest and penalty of 20% of amount included in income

Section 409A Requirements

Distributions allowed only at separation from service, death, disability, fixed schedule, emergency or change in control.
No Acceleration.

Deferral elections must be made in year before compensation is earned. Performance based compensation elections can be made up to 6 months before end of year earned.

Funding. Offshore trust results in current income. Protection of trust assets from company's financial failure results in income.

409A - Exceptions

Fair market value options

Short term deferrals

Restricted stock

Certain SARs on publicly traded stock

Severance arrangements covering no key employees

409A - Deadlines

- January 1, 2009 is the deadline for all nonqualified deferred compensation documents to comply with the final regulations.
- Exception for grandfathered amounts; those earned and vested as of December 31, 2004.

409A – Option Re-pricing

- Re-pricing is permitted without any significant accounting or tax disadvantage; they no longer trigger variable accounting.
- Re-pricing is like a “new” option, so holding period resets.
- Multiple re-pricings may be a problem because the option price will be “floating.”

409A – Founders Waive Compensation

- Under the general rule of Notice 2005-1, a plan provides for “deferral of compensation” if, a service provider has a “legally binding right” to compensation in one taxable year but the compensation is actually or constructively received in a later taxable year.
- No PLRs are issued because a controlling shareholder / founder / executive may choose to defer compensation but have the power to later modify the terms of that deferral contract.

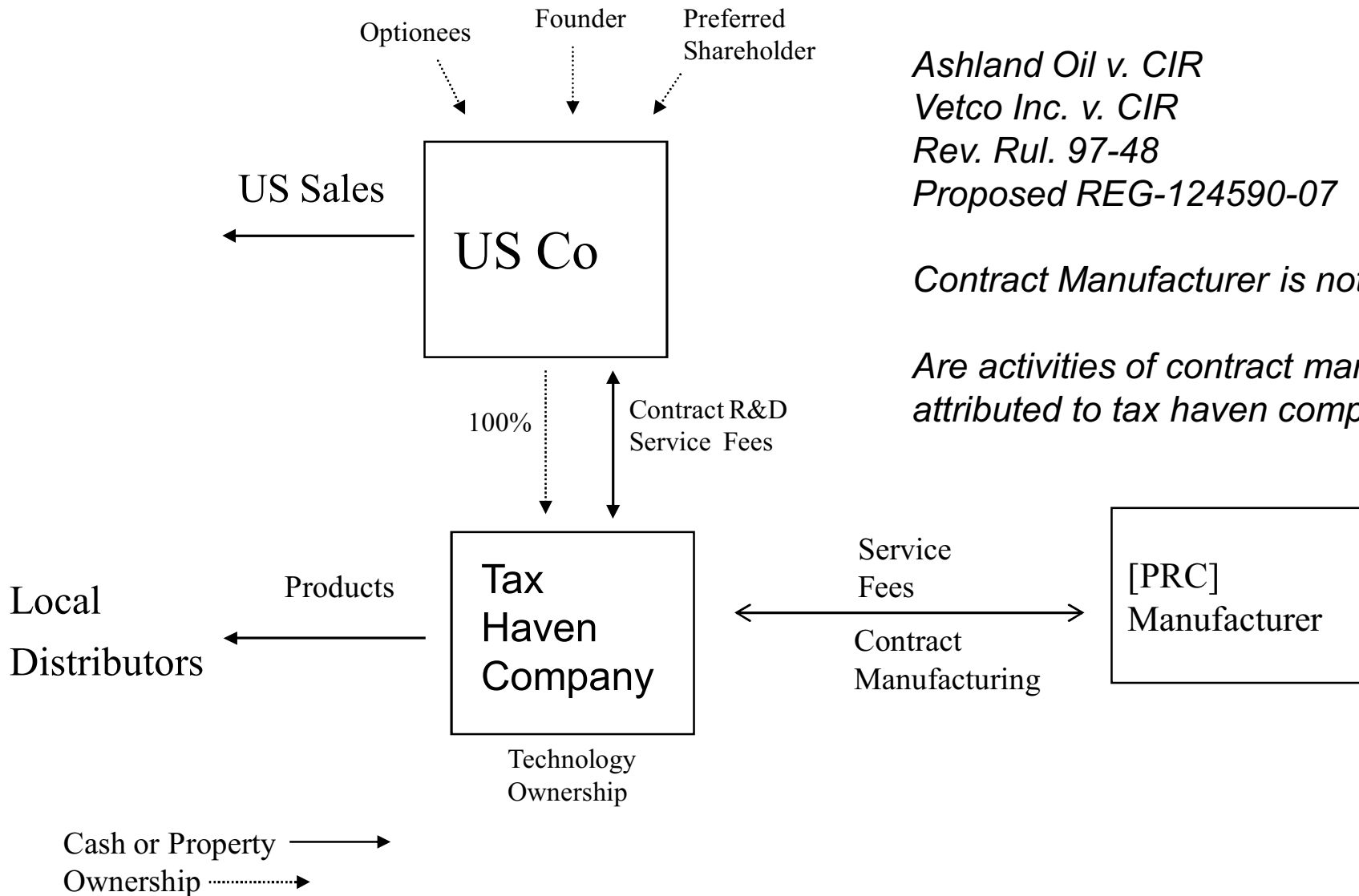
409A – Severance Agreements

- Exception Available Upon Involuntary Separation:
 - Payment may not exceed 2X the *lesser* of:
 - The Employees annual compensation for the preceding tax year; or
 - The IRC Section 401(a)(17) limit for the year of separation (\$230,000 for 2008) .
 - Payments are made no later than end of second calendar year following separation.
- Exception Also Available Upon Certain “Good Reason” Terminations.

Emerging Issues - International

- Proposed Contract Manufacturing Regulations
- 7874 Migration
- Foreign Funds / PFIC Rules

International – Contract Manufacturing Regulations



Ashland Oil v. CIR
Vetco Inc. v. CIR
Rev. Rul. 97-48
Proposed REG-124590-07

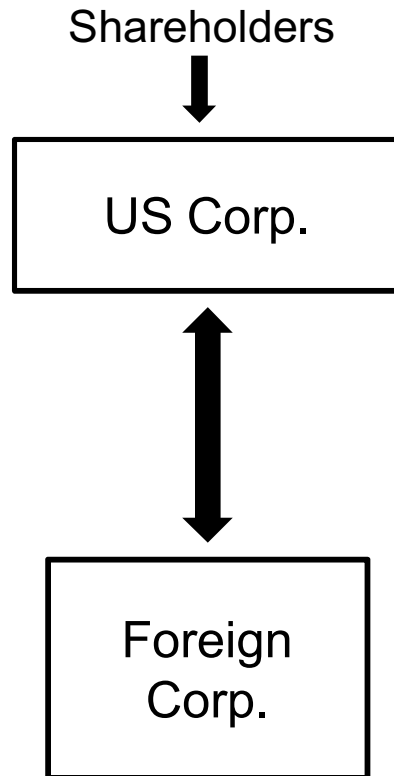
Contract Manufacturer is not a branch

Are activities of contract manufacturer attributed to tax haven company?

Contract Manufacturing – Proposed REG-124590-07

- Generally, Foreign Based Company Sales Income (FBCSI) does not include income derived by a CFC from the sale of products that it manufactured.
- However, the manufacturing branch rule applies where the CFC conducts its manufacturing activities outside of its country of organization (through a “branch or similar establishment”) AND a tax-rate disparity test is satisfied.
- Under the new definition of manufacturing, a CFC in a contract manufacturing arrangement will be considered as the actual manufacturer of the property it sells if, acting through its own employees, it makes a “substantial contribution” to the manufacture of the property sold.
- Therefore, if a CFC satisfies the new “non-physical” definition of manufacturing in regards to its contract manufacturing arrangement, the CFC qualifies for the manufacturing exception to FBCSI.
- Two Perceived Problems: (1) the “substantial contribution” test factors carry a lot of uncertainty in treatment; and (2) the new broader definition of manufacturing results in broader application of the manufacturing branch rule (no longer limited to physical manufacturing activities).

International – 7874 Migration



Option 1: exchange of shares so Shareholders own Foreign Corp.

Option 2: unrelated Foreign Corp. engages in 351 with US Corp.

- Taxation of migration under Options 1 and 2.
- Economic motivation:
 - US taxation of foreign source income;
 - Interest expense; and
 - Earnings stripping.
- Discouraged by US:
 - Section 163(j) and Section 7874.

International – 7874 Migration

- **80% Identity Transaction** – when the foreign corporation owns all of the properties held directly or indirectly by the US corporation; and as a result of the acquisition, 80% of the shares of the foreign corporation are held by former shareholders of the US corporation (and the foreign corporation does not have substantial business activities in the foreign country of organization); THEN the foreign corporation is treated as a US domestic corporation.
- **60% Identity Transaction** – when the above is true, but between 60 and 80% of the shares of the foreign corporation are held by former shareholders of the US corporation; THEN the taxable gain recognized in the US by the US shareholder on the inversion transaction cannot be offset by tax attributes and there is potential for an excise tax.
 - Excise Tax - companion §4985 imposes a 15% excise tax on the value of stock-based compensation held by certain insiders of an “expatriated corporation” and their family members if (and only if) gain, if any, is recognized in whole or part by any shareholder by reason of the expatriation transaction.

International – Foreign Funds / PFIC Rules

- Foreign Funds – US investors can defer income as long as PFIC provisions are not implicated and distributions are not made.
- PFIC rules:
 - Income Test: 75% of gross income is passive
 - Asset Test: 50% of assets produce passive income
 - Interest charge on "excess distributions" from PFICs
 - QEF Election

Emerging Issues – Preparer Penalties

- General rules
- New standard of care
- Disclosure – Five options:
 - (1) Using Form 8275 or the tax return.
 - (2) If no “substantial authority” then provide disclosure to the taxpayer with the tax return.
 - (3) If meets “substantial authority” then advise taxpayer of Section 6662 penalties.
 - (4) If tax shelter or reportable transaction then advise taxpayer of multiple requirements.
 - (5) If possible substantial understatement then advise taxpayer of 6662 penalties and document advice.