STOCK TRANSACTIONS – TAX ISSUES

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1. WHAT'S THE BEST STRUCTURE FOR EXITING THE BUSINESS IN A TAXABLE TRANSACTION?

1.1 Sale of C corporation stock when Section 1202 applies – Zero tax on the sale. Careful, long-term planning needed to protect the Section 1202 exclusion. No AMT preference any more. Tax-free reorg available as a back-up.

1.2 Sale of C corporation stock to an ESOP (sponsored by the corporation) in a Section 1042 transaction – Possible zero tax on sale. no gain on sale of shares if sale proceeds rolled into securities of U.S. companies, carryover basis; margin loans available to tap the cash; step up in basis at death escapes any tax. Capital gain on boot or sale of the U.S. securities. Requires feasibility study and annual appraisal and administration costs. Sale of all shares might require several years. Tax-free reorg available as a back-up.

1.3 Sale of S corporation stock – One level of tax. All gain taxed as capital gain, installment sale treatment available. Undistributed S corporation income will have increased share basis, decreasing gain on sale. Tax-free reorg available as a back-up.

1.4 Sale of C corporation stock. One level of tax. All gain taxed as capital gain, installment sale treatment available. Basis in shares might be tiny. Tax-free reorg available as a back-up.

1.5 Sale of S corporation stock with a Section 338(h)(10) or 336(e) election – One level of tax. Treated as sale of assets, so ordinary income on gain from cash method receivables, on inventory and depreciation recapture; capital gain on sale of goodwill. Big tax benefit to buyer, who might gross up the price to cover the ordinary income. Installment sale method available for income other than depreciation recapture. Tax-free reorg available as a back-up.

1.6 Sale of assets by S corporation – One level of tax. Ordinary income and capital gain as noted above for sale of S corporation stock with a Section 338(h)(10) or 336(e) election. Sales tax likely without pre-sale planning. Installment sale method available for income other than depreciation recapture. Tax-free reorg available as a back-up.

1.7 Sale of interest in multi-member LLC or partnership – One level of tax. Ordinary income and no installment method to the extent the sale price is allocable to income from providing services and inventory. Capital gain and installment method available for rest of price. Often difficult to achieve a tax-free combination as a back-up.

1.8 Sale of assets by multi-member LLC or partnership – One level of tax. Possibly the same as a sale by an S corporation, without the California entity tax. Gain might be allocated to the "partner" who contributed the assets sold. Often difficult to achieve a tax-free combination as a back-up.

1.9 Sale of stock by C corporation and buyer makes a "straight" Section 338 election (aka a "Section 338(g) election") – One level of tax. Treated as stock sale to seller, followed by a dissolution of the corporation by the buyer (triggering "inside" gain, resulting in a higher basis in the assets for the buyer and permitting the buyer to amortize goodwill over 15 years). Rare. Makes sense only for buyers with cash and big NOLs to absorb the gain. Tax-free reorg available as a back-up.

1.10 Sale of assets by C corporation – Two levels of tax. Corporation pays tax on "inside" gain from sale. Shareholders pay tax on distribution of after-tax sale proceeds. "Outside" transaction is capital, with application of basis if the corporation elects to dissolve. "Outside" transaction is dividend with no application of basis if not. Tax-free reorg available as a back-up.

2. Using Section 1202 to Eliminate or Minimize the C Corporation Double Tax

2.1 Gain on the sale or exchange of qualified small business stock is excluded from both regular tax and the alternative minimum tax. Up to $10 million in gain can be excluded for a single corporation.

2.1(a) As a consequence, in a stock sale there would be no gain to the seller.

2.1(b) In a sale of assets, a distribution of appreciated property or a liquidation, there would be one level of tax – on the "inside" gain.

2.2 To qualify for the exclusion:

2.2(a) The selling shareholder can't be a C corporation.

2.2(b) The stock must be held for five years.

2.2(c) The issuing corporation must be a domestic C corporation, but not a DISC, a regulated investment company, a REIT, a REMIC or a co-op.

2.2(d) The shares must be issued by the C corporation to the taxpayer after September 27, 2010. For stock issued before that date but after August 10, 1993, a less wonderful version of the exclusion is available.

2.2(e) The taxpayer cannot exchange the stock of another corporation for the stock of the qualified small business. The taxpayer can transfer cash, other property or services for the stock.

2.2(f) The assets of the issuing corporation must not exceed $50 million after the stock is issued to the taxpayer.

2.2(g) At least 80% of the assets of the issuing corporation must be used for the active conduct of a "qualified business." For active software companies with income from royalties, special rules apply.

2.2(h) The issuing corporation must not redeem its shares from the taxpayer for two years before or after the qualified small business stock is issued.

2.2(i) Redemptions of stock from others within one year before or after the stock issuance will break the exclusion.

2.3 Qualified small business stock acquired by gift or inheritance can qualify for the exclusion.

2.4 A shareholder of an S corporation or a "partner" in an entity classified as a partnership for income tax purposes can use the exclusion (i) if he held his interest in the pass-through entity when that entity acquired the small business stock and (ii) if he held his interest in the entity until it disposed of the small business stock.

2.4(a) The distributee of qualified small business stock from a partnership can use the exclusion if the distributee held his interest in the partnership when the partnership acquired the small business stock and if the distributee held his interest in partnership until the partnership distributed the small business stock to the distributee.

2.4(b) Note that if an S corp distributed the qualified small business stock, the S corporation would recognize gain on the distribution, so the exclusion would apply then.

2.5 If the taxpayer contributes to the issuing corporation more than $1 million in cash or assets with a tax basis of more then $1 million, or a combination of the two totaling more than $1 million, the $10 million limit on gain is increased to ten times the basis of the contributed assets.

2.6 Note the many ways to blow the exclusion. It is best used as a planning tool when something else prevents the business from using an LLC or an S corp.

3. SECTION 1244 STOCK

3.1 Tax benefit

3.1(a) Section 1244 allows an individual shareholder to treat loss on the sale of certain stock as ordinary loss, not capital loss.[1]

3.1(b) The maximum amount of capital loss that can be changed to capital gain each year is $50,000 per taxpayer - $100,000 for a joint return. The limit applies to the year in which the loss is realized, not the year in which the shares were issued. The limit applies to taxpayers, so an individual with losses of $60,000 from each of three corporations in the same year would be limited to one $50,000 benefit, not three.

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[1] Individual partners of partnerships that hold Section 1244 stock may also use the benefit. Treas. Reg. § 1.1244(a)-1(b)(2). "Individual" does not include a an estate or a trust. *Id*. Will shares in a grantor trust (such as a typical "living trust" qualify? It's unresolved after all these years. Maybe due to lack of audit activity. Shareholders of an S corporation that owns stock in another corporation cannot use Section 1244 for the stock in the other corporation. Rath v. Comm'r, 101 T.C. 196 (1993). Note that the requirements for Sections 1202 and 1244 are similar, but not the same. Nor is a "small business corporation" the same for these purposes as for Section 1361 (eligibility to be an S corporation). This could be a poster child for unnecessary complexity in the Internal Revenue Code.

3.1(c) Section 1244 rarely useful for those S corporation shareholders who are active in the business – who can use the pass-through losses to offset ordinary income from other sources.

- ◊ Those losses will drive down the basis in the shares.

- ◊ When the active shareholder finally abandons the business or sells the shares, there will be little, if any, basis left in the shares.

- ◊ A low basis in the shares means not much capital loss, if any, will be realized.

- ◊ Section 1244 is helpful only when – and to the extent – that capital loss is realized.

3.2 The rules

3.2(a) Like Section 1202, there are several limitations on Section 1244.[2]

3.2(b) The stock must be issued for money or property – not for services, stock or other securities.[3] The increase in stock basis from capital contributions or expenses to protect an existing investment does not benefit from the Section 1244 recharacterization.[4]

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2 *See generally* A. Polito, SMALL BUSINESS CORPORATION STOCK: SPECIAL TAX INCENTIVES, Tax Mgmt. Port. (BNA) No. 760-3rd (2016).

3 I.R.C. § 1244(c)(1)(B). Stock issued after 1984 may be common or preferred stock. The stock must not be acquired by purchase, gift, inheritance or distribution from another entity. Treas. Reg. § 1.1244(a)-1(b)(2).

4 Treas. Reg. § 1.1244(c)-1(b); Smyers v Comm'r, 57 T.C. 189 (1971).

3.2(c) The corporation must be a domestic corporation.[5]

3.2(d) Most of the corporation's gross receipts must be from an active business, not from "royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities."[6]

3.2(e) The capitalization of the corporation must not exceed $1MM, using the basis of contributed property and reducing that basis by debt to which the property is subject.[7]

3.2(f) If the taxpayer cannot use the ordinary loss in the year in which the loss is realized, the taxpayer can carry it forward as an NOL.[8]

3.2(g) The issuing corporation should maintain records to support the qualification of the shares as Section 1244 stock, but it is not required to do so as a condition of the benefit.[9]

3.2(h) The taxpayer must retain records that support taking the tax benefit.[10] However, since 1995 it has not been necessary to file with the tax return a statement supporting the position.[11]

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5 I.R.C. § 1244(c)(1).

6 I.R.C. § 1244(c)(1)(C). There does to appear to be an exception for "active" royalties earned by a software company, as there is for Section 1202 and for the personal holding company rules.

7 I.R.C. § 1244(c)(3)(A). A redemption of shares does not reduce the amount contributed for this purpose. Treas. Reg. § 1.1244(c)-2(b)(1).

8 I.R.C. § 1244(d)(3).

9 Treas. Reg. § 1.1244(e)-1(a)(2).

10 Treas. Reg. § 1.1244(e)-1(b).

3.3 Section 1244 plan

3.3(a) A Section 1244 plan has not been required – or helpful – since 1978. Even though some corporate sets still arrive with these plans.

3.3(b) However, if stock was issued on or before November 6, 1978, and not pursuant to a Section 1244 plan, it cannot qualify as Section 1244 stock.[12]

3.4 The bottom line:

3.4(a) Because of the relatively small amount of the tax benefit afforded by Section 1244, it will rarely make sense to structure investments with it in mind.

3.4(b) The business considerations should dictate the transaction, not the possible use of Section 1244 if the new venture fails.

3.4(c) It is good to be aware of Section 1244 when filing returns that include capital loss on closely-held stock, and to see if it applies.

(footnote continued from previous page)

11 Notice 94-89, 1994-2 C.B. 560; T.D. 8594, 1995-1 CB 146.

12 Treas. Reg. § 1.1244(c)-1(f)(1)(i).

4. THE SECTION 83(B) ELECTION

4.1 Background: Exercise Schedules and Vesting Arrangements

4.1(a) The principal alternatives:

◊ The employee can receive the shares immediately.

◊ In the alternative, after the employee acquires the stock, his right to realize the full fair market value of the stock when he disposes of it can "**vest**" either at a future date or in increments over time. In that case, his rights in the stock are subject to a "**substantial risk of forfeiture.**"

Example 1: Sarah received a stock bonus of 100 shares of ABC Co. stock in December, 2015, when they were worth $1,000 each. She paid nothing for the shares.

Her right to receive the full value of the shares when she disposes of them vests in 20 shares each year on January 1 in 2016, 2017, 2018, 2019 and 2020.

If she terminates employment with ABC Co. before 2021, she "**forfeits**" the non-vested shares -- that is, she must return them to ABC Co. without receiving any compensation for them.

At the termination of her employment, ABC Co. must buy from her any vested shares at their market value at that time.

On January 1, 2016, when the shares were worth $1,200 each, 20 shares vested. She had wage income of $24,000 on that date, and ABC Co. was entitled to a deduction for wages paid in the same amount. Sarah's basis in each of these shares was $1,200. On January 1 in each of 2017 and 2018, 20 more shares vested.

In March, 2018 Sarah terminates her employment with ABC Co. when the value of each share is $2,000. She has 40 non-vested shares which she returns to ABC Co. for no compensation. For her 60 vested shares, she receives $120,000 from ABC Co. She has a basis in her three 20-share blocks of vested shares equal to the value of each block on the date that it vested. In each case, the value on the vesting date was less than $2,000 per share. Accordingly, she has long-term capital gain on the shares that vested in 2016 and 2017, and short-term capital on the shares that vested on January 1, 2018.

◊ As a third alternative, the employee can receive the shares over a period of time or when specified goals are achieved.

4.1(b) Generally, stock is "vested" if, on any disposition of it by the employee, he will realize its full value.

4.1(c) Stock is "**non-vested**" if, when the employee disposes of it, the employee receives less than its full value because a predetermined milestone has not been achieved before the disposition.

◊ Typically, the employee receives the lesser of what he or she paid for non-vested shares (perhaps, but rarely, with an interest factor to compensate for the company's use of the employee's funds, or the value on the date he sells them).

◊ The disposition of non-vested stock is commonly called a "forfeiture" (although this term technically means a return of the stock for no consideration). The possibility that the milestone will not be achieved and that the stock will be surrendered for less than its full value is called a "substantial risk of forfeiture" in tax lingo.[13]

◊ The period during which the stock is non-vested is known as the "vesting period."

◊ For example, a vesting arrangement might provide a stock bonus to the chief financial officer, but if he terminates employment for any reason within five years, he must return the stock to the company without receiving any payment for it. However, this restriction will "**lapse**" (that is, it will terminate) if the company's initial public offering occurs before the expiration of the five-year period. If the CFO sells the stock after the restriction lapses, he will receive its full value at that time.

4.1(d) Vesting arrangements include "**cliff**" vesting, where 100% of the shares become vested as of a particular date or when a specified event occurs (for example, all of the shares become vested when the company's annual sales reach $1 million, at the initial public offering or when a "liquidity event" occurs), or staggered vesting, in which a percentage of the shares vest as specified milestones are achieved (for example, 20% of the stock becomes vested at the end of each year for five years).

4.1(e) Stock subject to a vesting arrangement is known as "**restricted stock.**"

4.2 Background: Golden handcuffs

4.2(a) Arrangements that prevent an employee from immediately acquiring all of the shares allocated to him or that impose a vest-

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13 I.R.C. § 83(c)(1).

ing arrangement are sometimes called "**golden handcuffs**" because they provide him with a special incentive to continue the employment relationship.

4.2(b) Although the incentive effect is similar, *deferring the transfer* of the shares to the employee has substantially different tax and legal consequences than a *vesting* arrangement.

4.2(c) Generally, if the employee is very optimistic that (1) the value of the shares will increase during the vesting period and (2) the conditions will be satisfied (that is, that he or she will remain employed until all of the shares vest, or that the company will reach the specified targets while he or she remains employed), *and* the employee has the cash to pay any current tax or can get the employer to cover that tax, then the employee will prefer restricted stock to a stock option. This is because the employee can minimize the tax cost of acquiring the shares by making a Section 83(b) election when restricted stock is received.

4.3 Section 83 Tax Issues

4.3(a) Vesting

- ◊ Generally, for tax purposes the employee is treated as receiving additional compensation income when the employee's rights in the stock become vested.[14]

- ◊ The amount of compensation equals the excess of the fair market value of the stock on the date that it becomes vest-

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[14] I.R.C. § 83(a); Cal. Rev. & Tax. Code § 17081 (incorporating I.R.C. § 83).

ed over the amount the employee pays for it.[15] That excess is sometimes called the "spread."

◊ If the employer properly treats the spread as compensation for income tax reporting purposes, the employer will be entitled to a deduction for that amount.[16]

◊ The employee may elect at the time that he receives non-vested stock to treat the stock for tax purposes *as if* it were vested.[17]

- If this "**Section 83(b) election**" is made, the employee takes into income in the year that he receives the non-vested stock the excess of the fair market value of the shares on the date of the transfer over the amount, if any, that he pays for the stock.

- The employer is entitled to its deduction at that time, subject to the withholding rule.

- If the election is made, there are no tax consequences when the stock eventually becomes vested.

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15 *Id.* This amount is also "wages" subject to FICA taxes. Rev. Rul. 79-305, 1979-2 C.B. 350 (property subject to vesting); Rev. Rul. 78-185, 1978-1 C.B. 304 (property not subject to vesting). The plan or agreement can specify the source of cash to cover these taxes.

16 I.R.C. § 83(h); Treas. Reg. § 1.83-6. The Federal Circuit Court held that the employer's deduction could not be tied to the amount that the employee actually reported as income. Robinson v. U.S., 335 F3d 1365 (Fed. Cir. 2003), *cert. denied*, 540 US 1105 (2004).

17 I.R.C. § 83(b); Treas. Reg. § 1.83-2.

Note: The Section 83(b) election must be filed within 30 days after the stock is issued. *This is a very short fuse and requires careful planning and diligent follow-up.*

◊ Until a "**transfer**" occurs, the employee cannot make the Section 83(b) election for non-vested property and is not treated as receiving vested property.[18]

- A transfer occurs when the employee will have both the upside benefits and the downside risks when the stock vests.

- If the employee is protected from a drop in value or if the employee's right to participate in the appreciation in the property's value is capped (for example, if his/her employment is terminated for cause), then no transfer occurs until the limitations are dropped or the property is disposed of; the entire amount of the spread at that time is ordinary income to the employee and, subject to the withholding rule, deductible by the employer.

- For shares subject to an option, the transfer occurs only when and to the extent that the option is exercised (unless the option is actively traded on an established market).

- If the stock is paid for with a nonrecourse promissory note (employer looks only to the pledged stock for payment), the transaction is treated as an option to buy stock that is partially exercised as each payment is made on the note. *Avoid using nonrecourse notes*

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[18] I.R.C. § 83(b); Treas. Reg. § 1.83-3(a).

and always examine the note and pledge documents to be sure that they are clearly full recourse (employer looks to all of employee's assets for payment, no limitations).

4.3(b) The Employee's Tax Basis in the Shares

To determine whether to make the Section 83(b) election, it is necessary to understand the effect of the election on the tax basis in the stock.

◊ The employee's tax basis in vested stock equals the fair market value of the shares on the date that the stock becomes vested.[19]

◊ The employee's tax basis in non-vested stock for which he/she makes a Section 83(b) election is the value of the shares on the date he/she acquired them.[20]

◊ The employee's tax basis in other non-vested stock is the amount, if any, that he/she pays for it.[21]

4.3(c) Disposing of the Stock

◊ **Vested Stock** (or Non-vested Stock *with* an 83(b) Election)

- If the employee disposes of vested stock at a gain, the gain will be capital gain.[22]

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19 Treas. Reg. § 1.61-2(d)(2)(i), (6)(i).

20 Treas. Reg. § 1.83-2(a).

21 Treas. Reg. § 1.83-1(b)(2).

- If the employee disposes of vested stock at a loss, the loss will be short-term or long-term capital loss, depending on whether he held the stock for more or less than one year after the later of the Section 83(b) election or the vesting date.[23]

- These rules also apply to non-vested stock for which the employee made the Section 83(b) election.

◊ **Non-vested Stock** (*No* 83(b) Election)

- In contrast, if the employee forfeits or otherwise disposes of non-vested stock (and the employee did not make a Section 83(b) election):

- If the amount that the employee receives for the stock is less than the employee's tax basis, the employee will have an ordinary loss;[24] and

- If the amount that the employee receives for the non-vested stock exceeds his tax basis, the excess will be ordinary income and the employer will be entitled to its deduction, subject to the withholding rule.[25]

(footnote continued from previous page)

[22] I.R.C. §§ 1221, 1222.

[23] *Id.*; Treas. Reg. § 1.83-4(a).

[24] Treas. Reg. § 1.83-1(b)(2).

[25] Treas. Reg. §§ 1.83-1(b)(2), 1.83-6(a).

4.3(d) When to Make the Section 83(b) Election

◊ The Section 83(b) election provides tax advantages if the value of the stock increases during the vesting period, but results in tax disadvantages if the stock either is forfeited or does not increase substantially in value during the vesting period.

◊ Generally, an employee would make the Section 83(b) election if he believed (1) that he would not forfeit his stock during the vesting period and (2) that the value of his stock would increase substantially during that period.

- Making the election accelerates his tax payment (the taxable event becomes the acquisition of the stock, rather than the expiration of the vesting period), but he/she pays tax on what he/she believes to be the lower "spread" on the earlier date.

- If the employee holds the stock for more than one year, the appreciation in value will be taxed at preferential long-term capital gain rates. Without the election, the appreciation would be ordinary income. The tax is imposed when the employee sells the shares.

- The employer's deduction is also accelerated.

◊ However, if the employee makes the Section 83(b) election and then either forfeits the shares or otherwise disposes of them at a loss, he/she will have a capital loss.

- If the employee had not made the election, he/she would have either no loss or an ordinary loss that could offset compensation income.

- Capital loss first offsets capital gain; a net capital loss can offset no more than $3,000 of an individual's ordinary income in any year.[26] An individual's unused capital loss can be carried forward indefinitely until it is exhausted.[27] It cannot be carried back.

4.4 Payment by the Employee

4.4(a) There are several ways that the employee can pay for the shares. (As noted above, the employee can also receive the shares for no payment as a "stock bonus.")

4.4(b) The employee can pay for the shares with cash, a promissory note or a combination of the two.

- ◊ Generally, the note should bear interest at a rate at least equal to the minimum rate necessary to avoid imputed interest for tax purposes.[28]

Although a California corporation is generally prohibited from issuing shares at less than their fair market value and from accepting a promissory note in payment for the issuance of its stock, statutory exceptions apply when the stock is issued to employees pursuant to an employee stock purchase plan.[29]

- ◊ It is also possible for the employee to pay for the shares (or to satisfy the income tax withholding obligation) with previously acquired stock or a portion of the stock acquired when an option is exercised (called a "cashless exercise"); however, these methods of payment (which are common and convenient) raise unresolved tax issues.

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26 I.R.C. §§ 1211(b), 1222.

27 I.R.C. § 1212(b).

28 I.R.C. § 7872.

29 Cal. Corp. Code §§ 408, 409.

4.5 Paying the Employee's Section 83 Tax

4.5(a) If the price to be paid by an employee for stock is less than the market value of that stock, another consideration is whether the employer will pay the employee's income tax on the stock issuance.

4.5(b) There is no requirement that the employer do so.

4.5(c) As noted above, the employer receives a deduction in the amount of the excess of the fair market value of the stock over the amount the employee pays for the shares on the date that either the stock becomes vested or the employee elects to have the stock treated as vested for tax purposes. The employee takes this amount into income.

Note: By paying all the employee's tax, an employer with substantial taxable income can "trade" its "extra" deduction resulting from the stock issuance for the employee's "extra" income resulting from the stock issuance.

◊ In effect, such an employer pays to the Internal Revenue Service and the California Employment Development Department as employee income tax withholding the same tax dollars that it would otherwise pay as corporate tax.

◊ The employer's deduction is available only if the employer properly reports the employee's income from the transaction for income tax withholding purposes.

Example: In 2016 Sarah received stock valued at $100,000 as a stock bonus. Both Sarah and her employer (a C corporation) were in a 40% combined federal and California tax bracket. Sarah owed tax of $40,000 and her employer was entitled to a $100,000 deduction (subject to the reporting and withholding rule) worth $40,000.

The employer decided to "give up" its deduction to cover Sarah's taxes. The employer declared a cash bonus of $67,000 to Sarah, but paid $18,000 to the California Employment Development Department and $49,000 to the Internal Revenue Service as income tax withholding for Sarah. Sarah's tax on the total compensation of $167,000 ($100,000 + $67,000) was $67,000, so all of her income tax was covered. Her employer's deduction was $167,000, which reduced the employer's taxes by $40,000. In effect, the employer used cash it would have paid to tax authorities as the employer's tax and instead paid the same amount to cover Sarah's taxes.

4.5(d) Under this "**tax bonus**" or "**gross-up**" arrangement, the employee takes a basis in the stock equal to its market value on the date it is issued ($100,000 for Sarah in the above example) and has capital gain (or loss) when he later sells the shares.

4.5(e) This works best with a stock bonus or a bargain sale to the employee, because the employer can be reasonably certain of its tax status before going forward. If the employer has no taxable income or a tax loss, the "tax bonus" provides no immediate tax reduction to the employer, so it creates negative cash flow. Accordingly, this technique (i) is mostly used at the end of the employer's tax year, when the results come into better focus, and (ii) is rarely used with stock option plans.

Note: The additional compensation will reduce pre-tax earnings for financial statement purposes. Because the employer's taxes are also reduced, there should be little effect on after-tax income. These financial accounting issues should be explored with the employer's accountant.

4.6 Securities Laws

4.6(a) Issuing stock and granting options to employees raise important securities law issues that are beyond the scope of this outline, but should be considered in the design of the program.

4.6(b) Note: The securities laws apply to the *grant* of the option -- not the issuance of the shares. Registration or permit requirements must be satisfied or, if an exemption from these requirements is available for the transaction, federal and state filings or disclosure may be required.

4.7 Buy-Back Arrangements

4.7(a) In addition to issues involving the acquisition of shares by the employee, the employer should also consider how the shares will be retrieved when the employee terminates employment, when the employee's marriage ends, or when the employee or the employee's spouse dies.

4.7(b) The corporation may also wish to retrieve the shares in the event that a shareholder decides to sell shares to a third party.

4.7(c) The buy-back agreement should be signed at the time the employee receives the options to acquire the shares. If there is no option involved, the employee should sign the buy-back agreement when the employee gets the shares.

4.8 Non-Intuitive Tax Consequences

Before implementing an incentive compensation arrangement, the tax consequences – including Section 409A – must be explored in detail.

4.9 ERISA

The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), may also apply.

4.10 Financial Accounting and Loan Covenants

An incentive compensation arrangement may affect the employer's income statement. For a closely-held business, this can affect loan covenants. *Because the financial accounting treatment of these arrange-*

ments differs in many respects from the treatment for income tax purposes, any specific proposals should be reviewed by the corporation's accountants before announcing to employees the adoption of the proposal.

4.11 Compensation Consultants

When an employer considers adopting an incentive compensation plan, compensation consultants can provide substantial value.

4.11(a) Consultants can design a plan that advances the company's strategic plan.

4.11(b) Consultants can speak with employees to assure that the proposed plan will actually create an incentive. Sometimes the employee's time horizon is shorter than the employer's, and stock is less attractive to the employee than cash, even deferred cash taxed at ordinary income rates.

4.12 Offhand Promises

4.12(a) Officers should proceed with extreme caution in any discussions with an employee concerning the employee's possible right to acquire an interest in the business.

4.12(b) No commitment should be made to any employee before the proposal has been thoroughly evaluated from a legal, tax and financial accounting standpoint with respect to its effects on the employer.

4.12(c) Casual statements such as "when this business does well, you'll do well," "I consider you my partner," "don't worry, you will share in any sale of this business" or even "I am going to talk to my lawyer this afternoon about getting you some stock in this company" can easily lead to inflated expectations and should be avoided.

◊ Employees will not forget such statements and will regard them as promises (which, in some circumstances, courts may enforce).

5. S CORP STOCK TRANSFER ISSUES

5.1 The corporate and tax law rules collide when S corporations directors want to pay dividends to people who no longer hold shares.

5.2 **A Parable.** Let's say Dave owns 25% of the outstanding shares of Widget Corporation, which was an S corporation for all of 2016. Dave transferred all of his shares to Jennifer on January 1, 2017. On March 1, 2017 Widget Corporation pays a dividend to the shareholders of record on March 1, 2017. The dividend is intended to allow the 2016 shareholders to pay their tax on Widget Corporation's 2016 income. Jennifer is the shareholder of record on March 1, so Jennifer receives the dividend on her shares.

5.2(a) Dave says to Jennifer "Excuse me, but that's my dividend you're holding. It is supposed to pay my tax liability for holding those shares in 2016. You, Jennifer, don't need it because you did not hold any Widget Corporation shares in 2016. In fact, the IRS regulations allow me to receive this dividend without creating a one-class-of-stock problem."[30]

5.2(b) Jennifer says "Sorry, Dave. I keep the dividend. Although tax law allows it, corporate law does not allow a California corporation to declare a dividend to shareholders of record as of a date earlier than the date of the directors action. We did

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[30] Treas. Reg. § 1.1361-1(*l*)(2)(iv).

not cover this in our Stock Purchase Agreement, so I have no obligation to give my dividend to you."[31]

5.2(c) Dave rends his garment -- and goes looking for the accountant and attorney who advised him in the stock sale.[32]

5.2(d) Moral: To assure that the people who pay taxes on the S corporation's income get the benefit of that income, they need either (i) to include in the price of the shares the value of the inherent right to receive tax-free distributions, or (ii) to cause the S corporation to distribute immediately before any stock transaction all of the cash that the corporation can distribute tax-free.[33]

6. AN EXISTING BUSINESS ENTITY STARTS A NEW BUSINESS

6.1 For business entities, the best arrangement is usually to have the individual owners of the existing business own directly interests in the new entity. (In other words, create a new ***brother-sister*** entity rather than a subsidiary.) This provides the individual owners with the maximum flexibility and avoids the taxes that would be generated by taking apart an affiliated group of corporations.

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[31] The identity of the person entitled to a dividend from a California corp can be changed "by agreement" (Cal. Corp. Code § 701(d)), but the shareholders and the S corporation should be very wary of doing so, because the agreement might be the create a second class of stock, terminating the S corporation status.

[32] Dave's accountant tells him that he reduced his gain on the sale of his shares by the tax basis in the shares that he would have lost if he received the distribution. Dave says "Great, I saved 24 cents on the dollar, but lost 76 cents on the dollar to Jennifer."

[33] If the corporation needs the cash, the shareholders can loan it back to the corporation.

6.2 When creating a brother-sister arrangement is not possible, generally liability-prone businesses should be operated in separate **subsidiary** corporations or single-member LLCs.

The entity with the capital should own the shares or interest in the operating entity that conducts the business.

6.3 When a **holding company** structure is in place or is being implemented, the holding company should not operate directly any liability-prone business. See *Exhibit A*, Holding Company Example.

6.4 S corporations can have wholly-owned corporate subsidiaries that are disregarded. These "**QSubs**" are less flexible and have more tax traps than single-member LLCs.

[End of outline.]

Exhibit A
Holding Company Example

Choice of Entity

Situation: Existing corp (C or S) has operating business and other appreciated assets (maybe real estate, art, a second or third business) in the corporation.

Concern: A claim against the operating business can be satisfied with the other valuable assets.

Tip: Create a holding company structure to isolate the operating business from the valuable assets.

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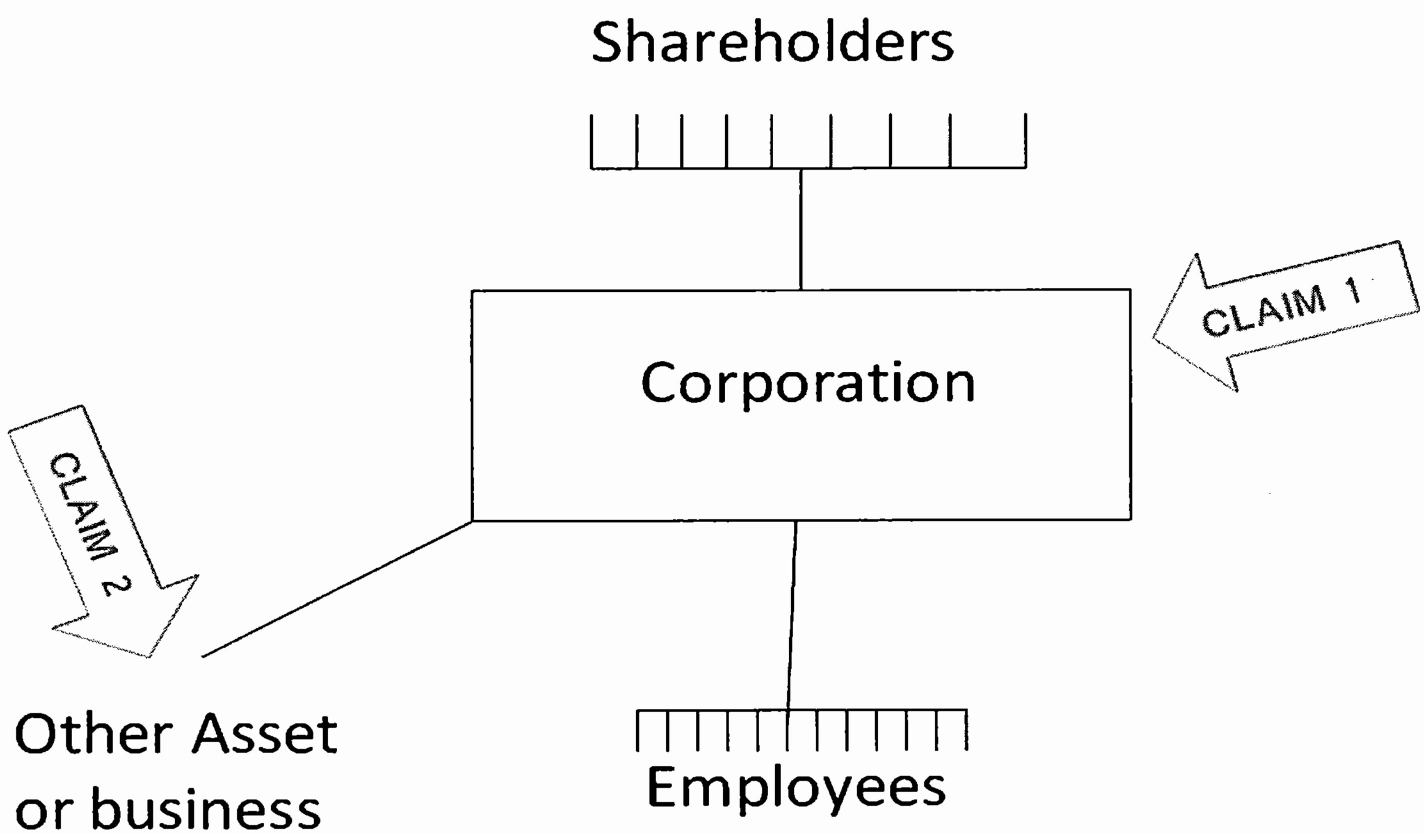
Old Structure



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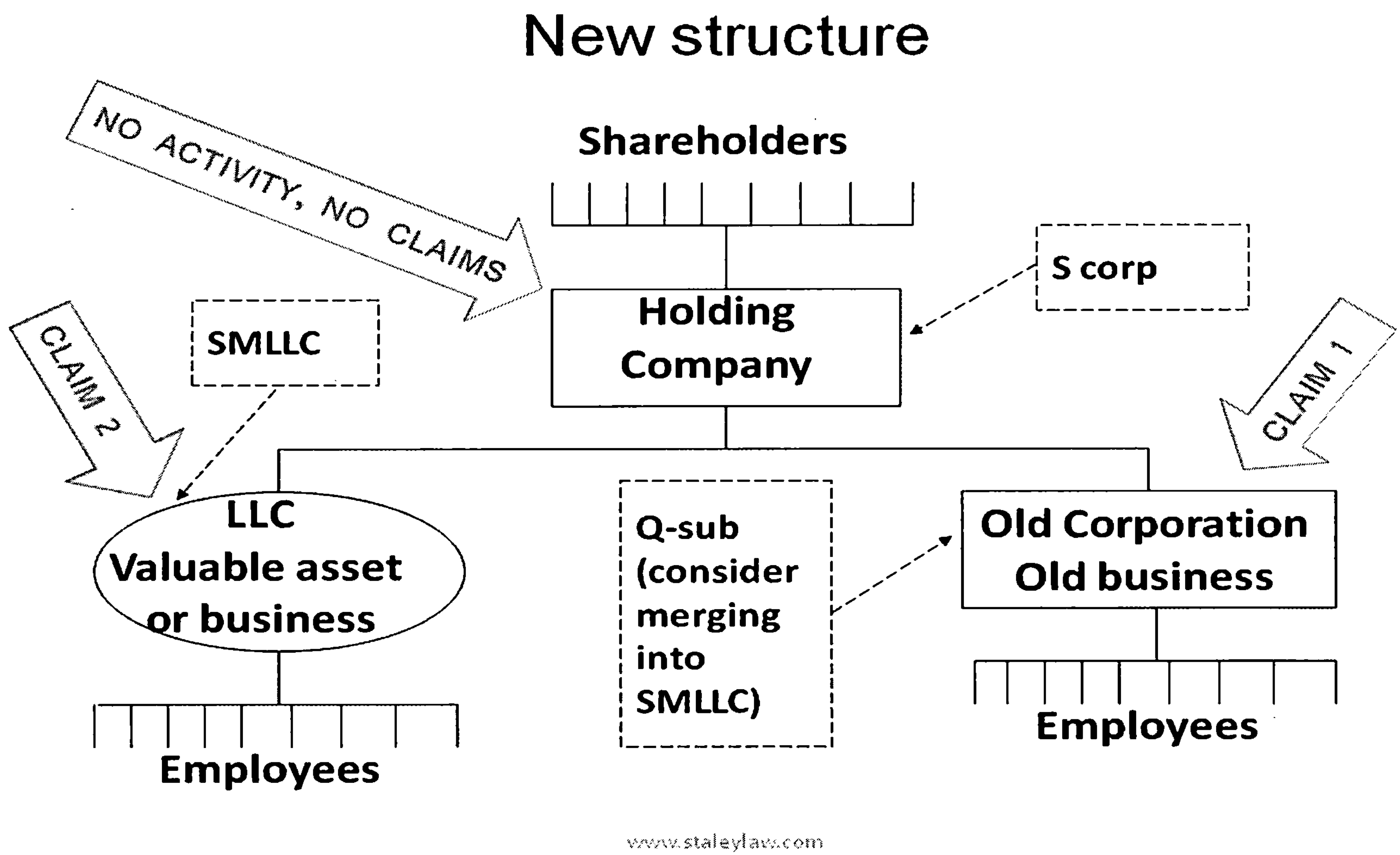

[End of outline.]