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UPDATE FOR ACCOUNTANTS & FINANCIAL PLANNERS

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Top 40 Federal Tax Developments of 2022 (through Dec. 2, 2022)

By David S. De Jong, LLM, CPA

Public Law 117-169, the Inflation Reduction Act of 2022:

- Extended the limitation on ordinary business losses by individuals through 2028.
- Extended the health insurance premium credit through 2025 with modifications.

- Effective 2023, created an annual rather than a lifetime limitation on the residential energy credit with a yearly cap of \$1,200.
- Effective 2023, increased the tax credit for purchasing new all-electric vehicles to \$7,500 and created a credit for the first purchaser of a used all-electric vehicle up to \$4,000 (can be claimed only by low and middle income taxpayers on dealer purchases of up to \$25,000 on vehicles at least two model years old claimable only once every three years).

- Effective 2023, created a 15 percent minimum tax on the adjusted financial statement income of C corporations with financials showing over \$1 billion in average profit over a three-year period (estimated to be 150 companies).
- Created a one percent tax on the fair market value of stock in a public company that is redeemed if the total redemption value is at least \$1 million.

- Increased the research and development tax credit that can be claimed by small businesses against payroll taxes by \$250,000 to \$500,000.
- Increased the IRS budget by \$80 billion over ten years to hire more personnel and to upgrade technology.

Proposed Regulations under Code Section 408
take 275 pages to explain the changes to the Minimum Distribution Rules as a result of the 2019 SECURE Act; annual distributions will be required prior to the 10-year deadline for removing the account balance if the decedent had reached the required beginning date before death but will not be required if he had not.

Proposed Regulations under Code Section 2010
reiterate that 2018-2025 gifts will generally remain nontaxable even if larger than the post-2025 exemption at death; however, that rule will generally not apply to pre-2026 transfers that are ultimately includable in gross estates.

In Blum v. Commissioner, 129 AFTR2d 2022-1170, the Ninth Circuit Court of Appeals agreed with the Tax Court that payments for legal malpractice in mishandling a physical injury suit are taxable to the recipient as the settlement was entered to compensate the plaintiff for the harm caused by the malpractice rather than for the physical injuries sustained in the underlying negligence action; In Dern v. Commissioner, TC Memo 2022-90, the Tax Court concluded that damages paid to a sales representative who was terminated because he could not make in-person calls following a heart attack were taxable as the payment was not for physical injury but was for emotional distress and otherwise as set forth in the Complaint as no physical injury arose or was worsened by the Company's conduct.

In Gericke v. Truist, 129 AFTR2d 2022-2099, the Third Circuit Court of Appeals agreed with a New Jersey Federal District Court that Truist properly issued a 1099-C to the plaintiff inasmuch as Regulations require issuance of the form on an identifiable event including a creditor's decision to discontinue collection activity; the Court stated that the 1099-C is not a means of accomplishing an actual discharge of debt so that collection activity could resume (forcing the individual to deal with whether the reporting of income is required).

In Domdom v. Commissioner, TC Summary Opinion 2022-17, the Tax Court denied an income earned abroad exclusion to an individual working in Iraq in a “walled compound” where he leased out his California home and his former spouse and children lived in his Nevada home, the Court noting that his abode remained in the United States where he kept his car and bank accounts; In Morgan v. Commissioner, TC Summary Opinion 2022-10, the Tax Court determined that an individual who met the 330 in 365 days abroad test had his tax home in Saudi Arabia where he worked under a US Government contract, concluding that he had significant community involvement and stronger ties to Saudi Arabia than he did to the United States.

In Musselwhite v. Commissioner, TC Memo 2022-57, the Tax Court, looking at eight factors found six of them in favor of IRS, determined that a loss on sale of four lots by a personal injury lawyer was capital in nature rather than ordinary; the taxpayer did not help himself by using the term “investments” in the entity name and in the purpose of the entity.

In Milkovich v. United States, 129AFTR2d 2022-869, a divided Ninth Circuit Court of Appeals reversed a Washington Federal District Court and allowed a bankrupt couple, whose recourse home mortgage was converted to nonrecourse on filing a bankruptcy, to deduct over \$100,000 in interest being paid at the time of a short sale despite not having to report relief from indebtedness income due to insolvency.

In Oakbrook Landholdings, LLC v. Commissioner, 129 AFTR2d 2022-1031, the Sixth Circuit Court of Appeals agreed with the Tax Court, in opposition to the 2021 Eleventh Circuit decision in Hewitt v. Commissioner, and sustained IRS Regulations denying a conservation easement when no portion of permitted improvements to the easement could benefit the donee.

Champions Retreat Golf Founders, LLC v. Commissioner, TC Memo 2022-106, the Tax Court determined that the value of an easement on property with a golf course and capable of sustaining residential housing was in excess of \$7.8 million, rejecting the IRS value at \$20,000, based on the prohibition of further subdivision of the property and the restriction on future construction of additional buildings and structures; the taxpayer had utilized an original valuation at over \$10 million.

In Harwood v. Commissioner, TC Memo 2022-8, the Tax Court allowed most pre-2018 travel expenses of a union steamfitter who traveled through Oregon and Washington doing temporary jobs, finding that his “tax home” was in Yakima, Washington, with his family despite no actual jobs in that city for a number of years as Yakima was centered in his region and that he kept good records of his expenses; in Nelson v. Commissioner, in a Bench Opinion the Tax Court determined that the “tax home” of an individual whose employer had offices in Washington, DC and Dallas and whose additional self employment income took him for periods to Atlanta, the Dominican Republic and Africa had his tax home in the DC area as he derived most of his income from employment and DC was the primary location of his employer.

In In Re: Gilbert, 130 AFTR2d 2022-5719, a New Jersey Bankruptcy Court found that qualified retirement plans enjoy protection from creditors under the law even if there is no anti-alienation provision in the retirement plan.

In In Re: Hoffman, 129 AFTR2d 2022-_____, the Eleventh Circuit Court of Appeals reversed a Georgia Federal District Court and held that Roth IRAs enjoy the same protection from creditors under federal law as do traditional IRAs.

In Estate of DeMuth v. Commissioner, TC Memo 2022-72, the Tax Court found that only one of eleven checks using the annual exclusion for gifts cleared by the time of death, thus the others were not completed transfers and were to be includable in the decedent's estate.

In Kellett v. Commissioner, TC Memo 2022-62, the Tax Court found that a business information website activity became a business with deductible rather than amortizable expenses when the website's functionality was completed which was four years prior to profitability.

In Vorreyer v. Commissioner, TC Memo 2022-97, the Tax Court, proffering that a taxpayer cannot deduct expenses paid on behalf of another party, denied a deduction to stockholders for corporate expenses which they paid individually; under the facts, the Court would have treated the individual payments as capital contributions to the corporation which constructively paid the expenses.

In Aspro, Inc. v. Commissioner, 129 AFTR2d 2022-1581, the Eighth Circuit Court of Appeals agreed with the Tax Court that payments made by a C corporation to two corporations and an individual who collectively owned 100 percent of the stock were not consulting payments but were distributions in the lack of any documentation to the contrary.

In Hood v. Commissioner, TC Memo 2022-15, using a multi-factor approach the Tax Court allowed a deduction by a C corporation for about one half of a \$5 million bonus paid in two consecutive years to the owner of a highly successful construction company above and beyond about \$200,000 in straight compensation; the owner worked 60-70 hour weeks and grew the company from scratch to about \$70 million in revenue.

In Slone v. Commissioner, TC Memo 2022-6, the Tax Court once again found that transferee liability applied when stock in a C corporation with significant built-in gain was sold after depleting the corporation of funds to pay the taxes.

In Donoghue v. Commissioner, No. 21-6737, the US Supreme Court declined to hear an appeal from a 2021 decision of the First Circuit Court of Appeals which had sustained a Tax Court decision finding that the “virtual” breeding, racing and selling of horses was not an activity engaged in for profit where there was not a single year with positive earnings in 30 years; in Olsen v. Commissioner, 130 AFTR2d 2022-6350, the Tenth Circuit Court of Appeals agreed with the Tax Court that an individual lacked a profit motive in a sale and lease back arrangement where repayment would be from the sale of solar lenses (the Court found that the taxpayer did not research profitability and accepted Government testimony that the system could not generate electricity and would never be commercially viable as established).

In Pediatric Impressions Home Health v. Commissioner, TC Memo 2022-35, the Tax Court agreed with IRS that nurses working for a staffing agency and paid on an hourly basis were employees rather than independent contractors despite the fact that they could do other work in their off hours, citing the use of terms such as “employed” and “full-time” in their communications as well as the requirement of giving two weeks notice on termination; the Court denied Section 530 relief inasmuch as the workers had been previously treated as employees.

In Scott v. United States, 130 AFTR2d 2022-6312, the Eleventh Circuit Court of Appeals sustained a Florida jury's finding that a daughter who was "accounting manager" for her father's HVAC company with discretionary authority and signature ability was liable for the trust portion of unpaid payroll taxes.

In Hancock County Land Acquisitions, LLC v. United States, 130 AFTR2d 2022-5529, the Eleventh Circuit Court of Appeals agreed with a Georgia Federal District Court that IRS cannot be enjoined per the Anti-Injunction Act from enforcing the tax assessed on a partnership related to a \$180 million deduction for donation of a conservation easement; in Harper v. Commissioner, 130 AFTR2d 2022-5550, the First Circuit Court of Appeals reversed a New Hampshire Federal District Court and held that a suit to enjoin IRS from using information obtained from a third party summons regarding cryptocurrency was not barred by the Anti-Injunction Act which the US Supreme Court previously stated does not apply to information gathering but only acts of assessment and collection.

In Green Valley Investors v. Commissioner, 159 TC No. 5, a divided Tax Court concluded that IRS violated the Administrative Procedure Act in issuing a 2017 Notice which identified certain syndicated conservation easement transactions as “tax avoidance” and, accordingly, “listed property”; the Court agreed with an earlier decision of the Sixth Circuit Court of Appeals.

In Remisofsky v. Commissioner, TC Memo 2022-89, the Tax Court agreed with IRS that a doctor's alcoholism and depression was insufficient for penalty abatement for late filing and payment as he was able to continue his profession and, in any event, his wife could have gathered the needed information; in Bennett v. Commissioner, in a Bench Opinion the Tax Court found that a physician who failed to timely file and pay was subject to both penalties as she showed an ability to practice medicine despite an alleged reduction in hours

In Oosterwijk v. United States, 129 AFTR2d 2022--512, a Maryland Federal District Court refused to abate substantial penalties when a taxpayer's CPA firm failed to file an extension and subsequently incorrectly advised the taxpayer that penalties would stop on a late filed extension; the first time penalty abatement policy did not apply due to a \$6 abatement several years prior.

In United States v. Katholos, 130 AFTR2d 2022-5484, a New York Federal District Court reiterated that a taxpayer must file an FBAR when the taxpayer has a beneficial interest in a foreign account irrespective of legal title, leaving the issue of willfulness to a subsequent merits trial.

In Bittner v. United States, No. 21-1195, the US Supreme Court agreed to review a decision of the Fifth Circuit Court of Appeals at 128 AFTR2d 2021-6760, in which the Court held that the penalty for a nonwillful FBAR violation is on an account by account basis each year rather than on a per person basis, causing a penalty over five years of \$2.72 million rather than \$50,000 (the case was argued on November 2, 2022); in United States v. Hadley, 129 AFTR2d 2022-1279, a Florida Federal District Court reached the same results.

In Hallmark Research Collective v. Commissioner, 130 AFTR2d 2022-_____, a unanimous Tax Court found that the 90-day rule for filing a petition in the case of an alleged deficiency is absolute and not subject to equitable tolling; the US Supreme Court previously and unanimously found in Boechler v. Commissioner that the 30-day appeal period on Collection Due Process appeals was nonjurisdictional and subject to tolling.

In Pond v. United States, 129 AFTR2d 2022-1483, a North Carolina Federal District Court agreed with IRS that its regulations supplanted the common law mailbox rule and that the taxpayer, who sent a claim for refund by regular mail, could not prove timely mailing when IRS had no record of receiving the return; the courts differed on the issue prior to IRS updating its regulations.

In United States v. Taylor, 130 AFTR2d 2022-5564, a North Carolina Federal District Court determined that a limited liability company and a trust were both alter egos of a couple when they controlled the accounts and used funds to pay their living expenses as opposed to a debt of over \$7 million to the IRS.

In Maehr v. State Department, No. 21-912, the US Supreme Court declined to hear an appeal from the Tenth Circuit Court of Appeals which had sustained a Colorado Federal District Court decision rejecting a constitutional challenge to the ability of IRS to obtain passport revocation through the State Department for “seriously delinquent tax debt”; in Franklin v. United States, 130 AFTR2d 2022-6000, the Fifth Circuit Court of Appeals, affirming a Texas Federal District Court, concurred.

In In Re: Golden, 129 AFTR2d 2022-1630, a California Bankruptcy Court went against the weight of recent authority and allowed an individual to discharge income tax liability for a year in which a substitute for return was prepared by IRS prior to the actual filing of the return, the Court noting that financial and family difficulties prevented timely filing, the return was filed within a reasonable amount of time from the extended due date (17 months) and the late filed return reduced the assessed tax.

In IRS v. Ransdell, 129 AFTR2d 2022-579, a Florida Federal District Court agreed with a Bankruptcy Court that living a lavish lifestyle with excessive personal spending and even large discretionary expenditures is not sufficient standing alone to deny discharge of a bankrupt from an obligation to IRS otherwise eligible for discharge; in In Re: Fernandez, 130 AFTR2d 2022-5688, a Florida Bankruptcy Court held that a physician could discharge hundreds of thousands of dollars in tax debt where he was treated as an independent contractor and failed to make estimated taxes, finding that his spending was high but not necessarily excessive or lavish despite numerous overseas trips and expensive jewelry purchased for successive wives.

In Revenue Procedure 2022-32, IRS extended the time for electing portability by estates not otherwise required to file an estate tax return up to the fifth anniversary of the first spouse's date of death with the submitted return stating at the top that it is "filed pursuant to Rev. Proc. 2022-32 to elect portability under Section 2010(c)(5)(A)."

In Notice 2022-36 and News Release 2022-155, IRS announced that it would not impose the penalty for late filing on 2019 and 2020 Forms 1040, 1041, 1065, 1120 and 1120-S among other returns with certain narrow exceptions provided the applicable return is filed by September 30, 2022 (with a refund being generated to those who have already paid such penalties); IRS will give similar relief in the case of 2019 and 2020 information returns filed by the August 1 following the due date.

In News Release 2022-183, IRS warned employers about claiming the Employee Retention Credit when they may not qualify, with eligibility limited to those who sustained a full or partial suspension of operations due to orders from an appropriate governmental authority limiting commerce, travel or group meetings during 2020 or the first three quarters of 2021, those who experienced a significant decline in gross receipts during 2020 or during the first three quarters of 2021 or those qualified as a “recovery startup business” for the third and fourth quarters of 2021.

In IRS Fact Sheet 2022-20, IRS stated that issuance of a Form 1099-K from money raised on a “crowdfunding” website does not automatically cause taxation to the person receiving the form and that facts and circumstances must be examined to determine whether these amounts are gifts.

In Chief Counsel Memorandum 202237010, IRS indicated that businesses that have their Paycheck Protection Program (PPP) loan forgiven even though they did not meet the requirements are taxable on the relief from indebtedness.

In Chief Counsel Advice 202204007, IRS ruled that a C corporation which provides a search website for rental properties is a broker company and ineligible for the exclusion under Code Section 1202 for qualified small business stock.

THE END



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Nonqualified Deferred Compensation

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NON-QUALIFIED DEFERRED COMPENSATION – DIFFERENT TYPES

- a) Annual Bonus/Profit Sharing Plans
- b) Phantom Equity/Change in Control Plans
- c) Partnership Equity/Profits Interests
- d) Restricted Stock Plans
- e) Stock Option Plans
 - i. Incentive Stock Option Plans
 - ii. Non-qualified Stock Option Plans
- f) Section 409A
- g) Section 457(f)

a) ANNUAL BONUS/PROFIT SHARING PLANS

- Way to incentivize key individuals prior to the sale of the Company. Can be tied to company performance, employee productivity or both.

a) ANNUAL BONUS/PROFIT SHARING PLANS (CONT'D.)

- Unless truly discretionary, must be in writing and must comply with Section 409A of the Code (discussed later).

a) ANNUAL BONUS/PROFIT SHARING PLANS (CONT'D.)

- Company receives a compensation deduction, generally in the year paid.

a) ANNUAL BONUS/PROFIT SHARING PLANS (CONT'D.)

- Subject to income tax withholding and payroll taxes
- Special Timing Rule
 - Generally FICA taxes are required to be paid/withheld at the later of (i) when the services are performed or (ii) when there is no substantial risk of forfeiture (i.e., upon vesting)

a) ANNUAL BONUS/PROFIT SHARING PLANS (CONT'D.)

- **Special Timing Rule (continued)**
 - In most instances, this rule is favorable for the employee as future payments avoid additional FICA taxes (including any earnings on such amounts)
 - No remedy (i.e. refund) if the amounts are not ultimately paid

a) ANNUAL BONUS/PROFIT SHARING PLANS (CONT'D.)

- Amounts can be deferred subject to certain limitations. However, deferred bonus payments accrue on the company's books for financial reporting purposes. This can create liquidity problems in the future and may also have an adverse impact on borrowing.
 - Consider the use of formula limitations to protect the company.

a) ANNUAL BONUS/PROFIT SHARING PLANS (CONT'D.)

- How are amounts calculated?
 - Net Income?
 - Owner Draws?
 - Both of the above require a degree of transparency with respect to employees
 - Tied to individual employee performance?
 - Effective for individual enhancement, does not necessarily tie to broader company objectives
 - Combination of all

b) PHANTOM EQUITY/ CHANGE IN CONTROL PLANS

- “Phantom” equity plans attempt to transfer the economic benefit of ownership (or a portion thereof) without transferring any of the other rights and obligations (voting, inspection, etc.)

b) PHANTOM EQUITY / CHANGE IN CONTROL PLANS (CONT'D.)

- Essentially a contractual promise to pay. Amounts are treated as a bonus and deductible by the company when paid
- Downside for employee is that they do not receive capital gains treatment; upside is that they do not have to come out of pocket to buy-in

b) PHANTOM EQUITY / CHANGE IN CONTROL PLANS (CONT'D.)

- Wide flexibility in design
- Change in control plan—pays plan participants “if, as and when” the company is sold and payment is received by the company and its equity holders

b) PHANTOM EQUITY/ CHANGE IN CONTROL PLANS (CONT'D.)

- Change in Control Plans—Things to Consider
- Calculation of Amount Payable
 - Usually “Net Proceeds” received by entity or its equity owners
 - Common subtractions—deal expenses (brokers, advisors, sales taxes, etc.) loan payoffs and amounts paid under owner employment/consulting/noncompete agreements
 - Less common—return of preferred equity payments
 - Usually, the idea is to put the phantom equity participants in the same position as the “common” equity holders

b) PHANTOM EQUITY / CHANGE IN CONTROL PLANS (CONT'D.)

- Change in Control Plans—Things to Consider
 - Calculation of Amount Payable
 - Thresholds?
 - Many plans incorporate a threshold amount which must be received by the company/equity owners to trigger participation
 - Work similar to a strike price for options
 - “Capped Amount” allows participants who leave the company on good terms (i.e., not for “cause”) to receive a portion of the payment up to the capped amount—usually an estimate of the company’s value as of the date of termination of employment

b) PHANTOM EQUITY / CHANGE IN CONTROL PLANS (CONT'D.)

- Change in Control Plans—Things to Consider
 - Payment Terms
 - Generally paid only if, as and when there is a liquidity event—earnouts and other deferred payments can create complications
 - Paid on the same time/schedule as amounts paid to equity holders
 - Watch for 409A considerations on payment terms
 - Important to script the deduction in connection a liquidity event

b) PHANTOM EQUITY/ CHANGE IN CONTROL PLANS (CONT'D.)

- Change in Control Plans—Things to Consider
 - Most effective when the workforce believes that the owners are committed to liquidity event in the near term
 - May need to combine with another incentive program to get full buy-in
 - Consider imposing restrictive covenants if not already in place

c) PARTNERSHIP EQUITY

- For entities taxed as partnerships (most LLCs), company can issue “profits interests” which provide the service provider with a share of the future appreciation and income of the Company (no right to the current value)

c) PARTNERSHIP EQUITY (CONT'D.)

- What type of interest?
 - Capital Interest
 - Gives the recipient a current right to existing partnership capital
 - Generally taxable and governed by Section 83 (see 1.721-1(b)(1))
 - Profits Interest—anything other than a capital interest (See Rev. Proc. 93-27)

c) PARTNERSHIP EQUITY (CONT'D.)

■ Profits Interests

■ Rev. Proc. 93-27—deals with vested profits interests

- No income to recipient on grant (and no corresponding deduction to entity)
- Requirements:
 - Received in connection with the provision of services to the partnership in a partner capacity (or in anticipation of becoming a partner)
 - Interest cannot relate to a substantially certain and predictable stream of income
 - Recipient cannot dispose of interest within two years of receipt
 - Cannot be a publicly traded partnership

c) PARTNERSHIP EQUITY (CONT'D.)

■ Profits Interests

■ Rev. Proc. 2001-43 addresses substantially non-vested profits interests

■ In order to achieve non-recognition treatment:

- All of the requirements of Rev. Pro. 93-27 apply; plus

- Both partnership and recipient must treat the recipient as a true partner for tax purposes from the date of grant

- Recipient must receive allocations of income and loss; must get K-1, etc.

- Neither partnership nor recipient take any compensation deduction

c) PARTNERSHIP EQUITY (CONT'D.)

■ Profits Interests

■ Is an 83(b) election required?

- No, not if the Rev. Proc. is followed
- Consider making a protective 83(b) election

■ Notice 2005-43

- Published with proposed regulation that have not been finalized
- Authorizes the use of liquidation method in determining value

c) PARTNERSHIP EQUITY (CONT'D.)

■ Profits Interests

- Use of hurdles becoming increasingly more common
- Must book-up capital accounts
 - Failure to do so may change character of interest granted
 - In addition, will alter the economic deal between the parties
 - Consider use of “catch-up” special allocations

c) PARTNERSHIP EQUITY (CONT'D.)

■ Profits Interests

- Despite the name, profits interest holders become partners
- Ensure that the recipient is required to become party to partnership or operating/LLC Agreement
- Consider creating a non-voting class of interest

d) RESTRICTED STOCK PLANS

- Provides a mechanism to transfer equity to key executives. Employees can be granted equity at the company as part of overall compensation or can buy-in. If an outright grant, employee will be taxed on the fair market value of the equity received
- Makes a grant difficult for companies with substantial value
 - Consider creating a second class of stock if a C corporation

d) RESTRICTED STOCK PLANS (CONT'D.)

- Restricted stock is subject to “vesting” over a period of time in order to maximize employee retention
- Vesting can be tied to continued employment, company objectives, individual objectives or combination
- If employee leaves or is terminated, stock is repurchased at a discounted value (typically amount paid by employee for the stock)

d) RESTRICTED STOCK PLANS (CONT'D.)

- Biggest upside for executive is that he or she will become eligible for capital gains rates on the sale of the company or upon termination of employment if company required to repurchase

d) RESTRICTED STOCK PLANS (CONT'D.)

- Executive becomes an owner of the company and will therefore have access to corporate information and will also enjoy other typical shareholder rights (voting, inspection, etc.)
- Consider using a class of non-voting stock

d) RESTRICTED STOCK PLANS (CONT'D.)

- Employee may wish to make a Section 83(b) election to start the capital gains clock
- Absent a Section 83(b) election, employee pays tax on the fair market value of the stock at the time of vesting, not the time of grant
- An 83(b) election accelerates that tax to the date of grant, but has adverse tax consequences if stock is forfeited or decreases in value

d) RESTRICTED STOCK PLANS (CONT'D.)

- 83(b) election, if made, must be filed within 30 days following the transfer of property to the recipient
- Generally, no relief for late elections
- Company must receive a copy of the 83(b) election

d) RESTRICTED STOCK PLANS (CONT'D.)

- To be considered restricted stock, the stock must be subject to a substantial risk of forfeiture:
 - The performance of future substantial services (or refraining from the performance of same) or
 - The occurrence of a condition related to the purpose of the transfer coupled with a risk of forfeiture if such condition does not occur (e.g., sale of the company by X date)

d) RESTRICTED STOCK PLANS (CONT'D.)

- Taxation of Restricted Stock
 - Recipient pays tax on the fair market value of the shares less any amounts paid
 - Upon vesting in absence of an 83(b) election
 - Upon grant if an 83(b) election is made
 - Corporation receives a compensation deduction
 - Subject to payroll taxes and income tax withholding
 - Have explicit authorization to allow the corporation to withhold from other compensation to cover payroll taxes and income tax withholding or to require employee to make payment at the time of grant/vesting

d) RESTRICTED STOCK PLANS (CONT'D.)

- Upon grant, recipient will become a stockholder of the corporation and should become a counterparty to the corporation's stockholders' agreement
- In some instances, the grant document may provide the corporation with more favorable repurchase terms than generally applicable to other stockholders

d) RESTRICTED STOCK PLANS (CONT'D.)

- S corporation considerations
 - While restricted, the restricted shares issued are not considered to be outstanding for the purposes of the S corporation second class of stock rule
 - If the employee makes an 83(b) election, however, the shares are considered to be outstanding and must receive identical rights to distributions and allocations
 - Restricted shares can be non-voting; subject to any limitation in the certificate of incorporation

d) RESTRICTED STOCK PLANS (CONT'D.)

- Additional Considerations
 - For stock with substantial value, consider using promissory note to allow recipient to purchase restricted stock
 - Must be at least 51% recourse or will be deemed an option
 - Consider making 83(b) (assuming purchase is equal to fair market value, should not be any immediate income tax consequence)
 - Note repaid upon earliest of (i) termination of employment, (ii) sale of the company or (iii) as required under the note
 - Employee should pledge shares as security

e) STOCK OPTION PLANS

- Gives the executive the right to purchase equity in the Company at its current value at some time in the future
- Like restricted stock, options can “vest” over time to maximize retention
- In practice, most grantees at private companies do not exercise until immediately before a liquidity event (no capital gains on sale)

e) STOCK OPTION PLANS (CONT'D.)

- Incentive Stock Option Plans (ISOs)
 - Governed by Sections 421 and 422 of the Code
 - Ignoring alternative minimum tax considerations, generally:
 - No deduction to corporation at time of grant or upon exercise
 - No income inclusion to recipient upon grant or exercise
 - Exercise of an ISO is a preference item for alternative minimum tax purposes

e) STOCK OPTION PLANS (CONT'D.)

- Incentive Stock Option Plans (ISOs)
 - To retain ISO tax treatment
 - Must be granted to an employee (non-employee directors/advisors cannot receive an incentive stock option)
 - Short exercise period following termination of employment (no more than 90 days)
 - Option holder must hold the shares following exercise for a minimum of later of (i) two years from the date of grant and (ii) one year from the date of exercise
 - Must be granted at fair market value; must be at least 110% of fair market value for options granted to individuals who hold more than 10% of the voting power of the corporation

e) STOCK OPTION PLANS (CONT'D.)

- Incentive Stock Option Plans (ISOs)
 - To retain ISO tax treatment
 - Option cannot be transferrable, except by will or descent
 - Must be granted pursuant to written plan approved by the corporation's board of directors and stockholders within 12 months
 - Neither the plan nor any option granted under the plan can have a duration in excess of 10 years

e) STOCK OPTION PLANS (CONT'D.)

- Incentive Stock Option Plans (ISOs)
 - To retain ISO tax treatment
 - \$100k limitation
 - No more than \$100k worth of shares that become exercisable for the first time in any one year can qualify as an ISO
 - All ISO's held by a recipient are considered on a first in, first out basis

e) STOCK OPTION PLANS (CONT'D.)

■ Incentive Stock Option Plans (ISOs)

- If requirements are satisfied, any gain on the disposition of the shares will qualify as long-term capital gain
- If holding period requirement is not satisfied:
 - Disqualified Disposition
 - Treated as a non-statutory option with recipient being taxed on the delta between the fair market value at the time of exercise and the option strike price
 - Corporation receives a corresponding deduction
 - NOTE: Employers are not required to withhold payroll taxes on a disqualified disposition
 - Compare result on a cash out of an option, which would be subject to payroll tax withholding

e) STOCK OPTION PLANS (CONT'D.)

- Incentive Stock Option Plans (ISOs)
 - Changes to Option terms
 - Any “modification” extension or renewal of an option treated as a grant of a new option and the option must be tested again for compliance

e) STOCK OPTION PLANS (CONT'D.)

- Non-qualified Stock Option Plans
 - Generally, an option that does not satisfy the requirements to be treated as an ISO
 - Much more flexible

e) STOCK OPTION PLANS (CONT'D.)

- Non-qualified Stock Option Plans
 - Tax treatment
 - No income to recipient upon grant (and no corresponding deduction to corporation)
 - Unless NSO has readily ascertainable fair market value—most will not
 - Upon exercise, recipient is taxed on the difference between the strike price and the fair market value
 - If recipient is an employee, will be treated as wages and subject to payroll tax withholding
 - Have explicit authorization to allow the corporation to withhold from other compensation to cover payroll taxes and income tax withholding or to require employee to make payment at time of exercise

e) STOCK OPTION PLANS (CONT'D.)

- Non-qualified Stock Option Plans
 - Basis in shares is equal to strike price plus gain recognized
 - Corporation receives a compensation deduction at the time of exercise

e) STOCK OPTION PLANS (CONT'D.)

- Non-qualified Stock Option Plans
 - Very flexible
 - No statutory requirement that option be issued at fair market value, but 409A substantially reduces the utility of this exception
 - Can be granted to employees and non-employees alike
 - No fixed term
 - No written plan requirement, but should be documented
 - Allows for the grant of one-off options

e) STOCK OPTION PLANS (CONT'D.)

- For both NSOs and ISOs
- Grant Agreement should impose certain requirements:
 - Require optionee to become a party to the corporation's stockholders agreement
 - Consider adding non-compete/non-solicit of employees and customers
 - Consider alternative repurchase terms in the event of a termination/departure following exercise
 - Watch for second class of stock concerns with respect to S corporations

e) STOCK OPTION PLANS (CONT'D.)

- For both NSOs and ISOs
 - Issues in connection with sale of entity
 - Will need to track down former employees who still have options—can be expensive and time consuming
 - Often results in an option cancellation payment
 - Will be treated as wages and subject to payroll taxes and income tax withholding
 - Different result with ISOs if there is an exercise followed by a disqualified disposition
 - Substitution
 - Can be done without being deemed a new grant if no new features are added

f) SECTION 409A

- Applies to non-qualified deferred compensation
- Generally, any arrangement which provides an employee or service provider a legally binding right to compensation in one year that is not paid until a subsequent tax year. Applies to a wide variety of compensation arrangements (all of the above)

f) SECTION 409A (CONT'D.)

- Significant penalties in the event of a violation under Section 409A. Current income inclusion beginning on the date the deferred comp is no longer subject to a substantial risk of forfeiture, plus a 20% penalty.

f) **SECTION 409A (CONT'D.)**

- **Strict rules regarding deferral elections (generally an election to defer must be made by the end of the year before the year in which the services are performed)**

f) **SECTION 409A (CONT'D.)**

- Unless an exception applies, payments subject to 409A can only be made upon occurrence of (i) “separation from service” (6 month delay for “Specified Employees”), (ii) fixed time or pursuant to fixed schedule detailed in writing, (iii) death, (iv) disability, (v) change in control (as defined in the regulations and (vi) unforeseeable emergency

f) **SECTION 409A (CONT'D.)**

- **Generally, no accelerations or further deferrals**

f) **SECTION 409A (CONT'D.)**

- Exceptions available for certain short-term deferrals and separation pay plans—if these exceptions apply, issues presented by Section 409A can be avoided

f) SECTION 409A (CONT'D.)

- In connection with equity awards:
 - Watch for discounted stock options and restricted stock
 - If granted at a price below fair market value, will be treated as deferred compensation and subject to 409A
 - In practice, makes the use of discounted options very difficult

f) SECTION 409A (CONT'D.)

- In connection with phantom equity and change in control plans
 - Generally only becomes payable upon a change in control; typically avoids 409A if amounts can be paid at closing or within the short-term deferral window
 - If payment later than 2 ½ months following the close of the year in which the change in control occurs, may still be 409A compliant if payments will qualify as transaction based compensation
 - Generally speaking, must be paid within 5 years of a change of control

g) SECTION 457(F)

- Section 457 governs deferred compensation plans for certain tax-exempt organizations (TEOs) and state and local governments
- 457(b) governs “eligible compensation plans”
- 457(b) plans are subject to annual contribution limits and timing rules on distributions
- Similar to 401(k)

g) SECTION 457(F) (CONT'D.)

- Section 457(f) plans are “ineligible” plans that do not meet the requirements of 457(b)
 - Usually geared to higher level executives as a supplemental retirement plan benefit
 - Amounts deferred should be examined for excess benefit considerations and included in any compensation analysis
 - 457(f) amounts deferred remain subject to the organizations creditors

g) SECTION 457(F) (CONT'D.)

- Generally very flexible
 - Can be funded with employer contributions or employee salary reductions (subject to 409A timing rules)
 - Generally employee contributions must be elected in year that precedes the date the services are performed
 - Earning grow tax deferred as long as amounts are subject to a substantial risk of forfeiture

g) SECTION 457(F) (CONT'D.)

■ Tax considerations

- Generally, 457(f) amounts must be included in income when no longer subject to a substantial risk of forfeiture
 - This is different from 409A deferrals, which can be deferred beyond the lapse of a substantial risk of forfeiture, subject to timing rules
- Additional deferrals are permitted, but must be made in compliance with Section 409A and payment schedule established at time of deferral

g) SECTION 457(F) (CONT'D.)

■ Tax considerations

- In practice, most 457(f) plans are structured either to (i) provide for a lump sum payment of the vested amounts upon lapse of the substantial risk of forfeiture or (ii) provide for a distribution to cover taxes on the amounts deferred as of that date, with the balance to be paid at a later date in compliance with 409A
- Many 457(f) plans having rolling vesting dates to spread out the distribution requirements and income inclusion

COMPENSATION CONSIDERATIONS

457(F) AND 409A

- Tax considerations
- In practice, most 457(f) plans are structured either to (i) provide for a lump sum payment of the vested amounts upon lapse of the substantial risk of forfeiture or (ii) provide for a distribution to cover taxes on the amounts deferred as of that date, with the balance to be paid at a later date in compliance with 409A
- Many 457(f) plans having rolling vesting dates to spread out the distribution requirements and income inclusion

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Pros & Cons of a Revocable Trust

By David B. Torchinsky, JD, CPA

OUTLINE

1. **Knowing the Basic Estate Planning Documents**
2. **Why Use a Revocable Trust?**
3. **Fiduciary Succession**
4. **Issue Spotting with your Clients**

KNOWING THE BASIC ESTATE PLANNING DOCUMENTS



Lifetime-Only Documents = Financial Powers of Attorney, Advance Medical Directives & Living Wills, HIPAA Authorization Forms



Testamentary Documents = Last Will and Testament and Revocable Trust (which can also be a lifetime document)



Other Estate Planning Documents = Marital Agreements (Pre & Post Nups); Irrevocable Trusts

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Financial Power of Attorney

- Purpose

- The designated Power of Attorney can step into the shoes of the incapacitated individual and conduct his or her financial affairs on behalf of such individual.

- Understanding the term incapacity

- Understand when the Power of Attorney is effective

- Immediately.
 - Upon incapacity (Springing).

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

■ Financial Power of Attorney

Type of Power of Attorney?

- Durable
- Limited
- General

What powers does the Power of Attorney provide?

- Real Property
- Contracts
- Gifting
- Payments for Education, Health, etc. for descendants

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

■ Financial Power of Attorney

Who is the Agent?

- Family
- Friend
- Corporate
- Professional individual
- Sole agent
- Co-agents

How much access does Agent have?

Other considerations

- Location
- Knowledge
- Family dynamics
- Age

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Advance Medical Directive and Living Will
 - Purpose
 - The designated Health Care Agent will be consulted by doctors at such time that an individual cannot communicate his or her health care desires
 - Understanding the term incapacity
 - Understanding when Advance Medical Directive is effective
 - Effective immediately
 - Upon incapacity (Springing)
 - Know when the doctor is going to look to individual, agent or the Advance Medical Directive itself

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

▪ Advance Medical Directive and Living Will

Who is the Health Care Agent

- Family
- Friends
- Corporate/Professional individuals
- Sole agent
- Co-agents

Other considerations

- Location
- Knowledge
- Family dynamics
- Age

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Advance Medical Directive and Living Will
 - Directives
 - Does it reflect client's wishes?
 - Understand the medical terminology
 - Terminal Condition
 - Vegetative State
 - End-Stage Condition

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Advance Medical Directive and Living Will
 - Directives
 - No medical intervention, no food and water
 - No medical intervention, food and water
 - Medical intervention, food and water

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Advance Medical Directive and Living Will
 - Organ donation
 - Body donation
 - Special instructions
 - Burial or cremation instructions
 - HIPAA considerations

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Last Will and Testament
 - Who are the nominated fiduciaries (i.e. Personal Representative/Trustee/Guardian)
 - Family
 - Friends
 - Corporate
 - Professional individuals
 - Sole agent
 - Co-agents
- Successor Fiduciaries
- Multiple Fiduciaries
 - Unanimous.
 - Majority.
- Resignation and Removal
- Other Considerations regarding fiduciaries
 - Knowledge
 - Family dynamics
 - Age

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Last Will and Testament
 - Definition of Family and Descendants
 - Spouse
 - Children
 - Step-relations
 - Outlining the Powers of the Fiduciary (i.e. Personal Representative & Trustee)
 - Survivorship requirements

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Last Will and Testament
 - Payment of Debts, Taxes and Expenses
 - Payment of debts
 - Mortgage
 - Credit Card
 - Payment of taxes
 - Estate
 - Individual
 - Payment of expenses
 - Funeral
 - Shipping costs for distributions
 - Storage
 - Estate/Gift Taxes
 - Apportionment?
 - Inheritance Taxes

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Last Will and Testament
 - Specific distributions
 - Identification of property
 - Identification of beneficiaries
 - Allocation of expenses
 - Clarity is the key
 - Distribution of tangible personal property
 - Household furniture and furnishings, jewelry, books, clothing, personal effects, automobiles...etc.
 - Definitions

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Last Will and Testament

- Distribution of the “Residuary Estate”

- All remaining property not previously disposed of (does not include assets with beneficiary designations).

- Know the assets

- Marital Distributions.

- Trust.

- Outright.

- Estate Tax Planning

- Providing for children, family or other beneficiaries.

- Trust.

- Outright.

- Providing for minors.

- Trust.

- Uniform Transfers to Minors Act.

- Providing for disabled individuals.

- Special Needs Trust.

- Protection of Public Benefits.

- “Per Stirpes” (by representation) vs. “Per Capita” (by number of individuals).

- Charity.

- Survivorship requirements.

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

■ Revocable Trust

- Functions during lifetime.
- Assets in Trust will avoid probate.
 - Understand probate v. nonprobate.
 - Probate is a public process.
 - Probate can be costly.
 - Probate is time consuming.
- If incapacity occurs, the successor Trustee can immediately step in and continue to administer trust without delay.
- The use of a Trust provides privacy.
 - Trust administration is typically private.

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Revocable Trust
 - Who is the nominated Trustee?
 - Family
 - Friends
 - Corporate
 - Professional individuals
 - Sole agent
 - Co-agents
 - Successor Trustee
 - Multiple Fiduciaries
 - Unanimous.
 - Majority.
 - Resignation, Removal and Appointment of Successor Trustees

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Revocable Trust
 - Definition of Family and Descendants
 - Spouse
 - Children
 - Step-relations
 - Powers of the Fiduciary
 - Payment of debts
 - Payment of taxes
 - Payment of expenses
 - Broad
 - Narrow
 - Discretion?
 - Estate/Gift Taxes
 - Apportionment?
 - Inheritance Taxes

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Assets of the Revocable Trust
 - Assets titled in the Trust
 - Assets naming Trust as beneficiary
 - Identifying assets that client may want to consider transferring to trust during lifetime

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Revocable Trust
 - Specific distributions
 - Identification of property
 - Identification of beneficiaries
 - Allocation of expenses
 - Clarity is the key
 - Distribution of tangible personal property
 - Household furniture and furnishings, jewelry, books, clothing, personal effects, automobiles...etc.
 - Definitions

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

■ Revocable Trust

■ Distribution of the “Residuary Estate”

- All remaining property not previously disposed of (does not include assets with beneficiary designations)
- Know the assets
- Marital Distributions
 - Trust
 - Outright
 - Estate Tax Planning
- Providing for children, family or other beneficiaries

- Trust
 - Outright.
- Providing for minors
 - Trust
 - Uniform Transfers to Minors Act
- Providing for disabled individuals
 - Special Needs Trust
 - Protection of Public Benefits
- “Per Stirpes” (by representation) vs. “Per Capita” (by number of individuals)
- Charity
- Survivorship requirements

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Revocable Trust
 - Spousal Planning
 - Outright
 - Disclaimer planning
 - Bypass/Credit Shelter Trust
 - Income/Principal to Spouse/Beneficiary
 - Ascertainable Standard
 - QTIP Trust
 - All income to Spouse in order to qualify
 - Principal distributions (Discretion v. Ascertainable Standard)
 - Marital Trust

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Revocable Trust
 - Planning for descendants as part of Residuary Distributions
 - Outright
 - Beneficiary Trusts
 - Age Based Distributions
 - Achievement Based Distributions
 - Lifetime Trusts
 - Includes Generation Skipping Transfer Tax Planning
 - General Considerations
 - Family Dynamics
 - Could impact selection of fiduciary for beneficiary trusts
 - Family Circumstances
 - Special Needs/Supplemental Needs
 - Divorce

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Revocable Trust
 - Special Needs/Supplemental Needs Planning
 - Can be created under Revocable Trust
 - Can be created as a separate and independent Trust
 - Designed to supplement individual receiving public benefits
 - Designed to protect and preserve public benefits from being terminated
 - Administration can be complex
 - High burden of reporting
 - Generally, Trust provides Trustee with broad discretion regarding distributions

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

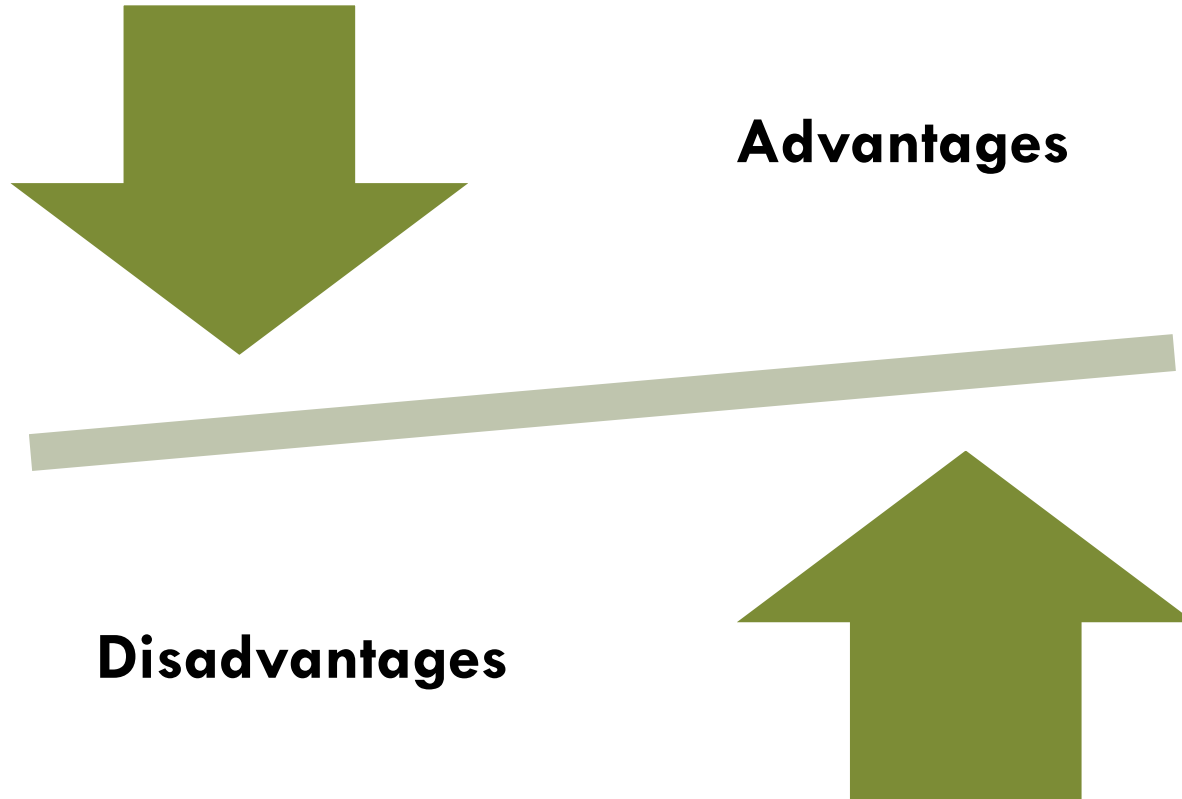
- Irrevocable Trust
 - Revocable Trust becomes irrevocable at death
 - Irrevocable Trust can be created during individual's lifetime
 - Generally must seek Court intervention to amend Irrevocable Trust for material matters
- Uses for Irrevocable Trust
 - Gifting
 - Life Insurance
 - Estate Tax Planning
 - Planning for Descendants

KNOW YOUR CLIENT'S ESTATE PLANNING DOCUMENTS

- Marital Agreements (Pre- and Post-Nups)
 - Ongoing financial obligations
 - Disposition of certain property upon death
 - Waiver of certain rights
- Inheritances
 - Anticipated inheritances – potential tax issues
 - Does the client have a power to direct assets remaining in a trust of which he/she is a beneficiary?

WHY USE A REVOCABLE TRUST?

WHY USE A REVOCABLE TRUST?




FIDUCIARY SUCCESSION

FIDUCIARY SUCCESSION

- Trustees/Powers of Attorney/Personal Representative

ISSUE SPOTTING

ISSUE SPOTTING WITH YOUR CLIENTS

- Titling of Assets
 - Beneficiary Designations
 - Proper Format/Execution of Documents
 - Competency
 - Family Dynamics
 - Influence/Influencers
 - Access
 - Spending Patterns
- 

ISSUE SPOTTING

- Proper Execution of Document(s)
 - Confirm formalities
 - Witnesses
 - Notary (if necessary)
 - Signatures
 - Review Document(s)
 - Make note of inconsistencies
 - Signature
 - Initials
 - Formatting
 - Physical appearance
 - Timeline of Events
- Competency

ISSUE SPOTTING

Oral Commitments

- Was there an oral contract?
- Follow-up?
- Reliance?

Isolation stemming from Pandemic




- Changes to planning
- Deviation or significant fluctuation in asset allocation/gifting

ISSUE SPOTTING

- Titling of Assets
 - Individual Name
 - Trust
 - Joint
 - Tenant in Common
 - Tenants by Entirety
 - Tenants with Right of Survivorship
 - Presumptions under Law
 - Business Interests
- Titling can significantly impact distribution

ISSUE SPOTTING

- Beneficiary Designations


- Individual
- Trust
- Payable on Death
- Transfer on Death
- Circumstances?
 - Divorce
 - Separation
 - Beneficiary predeceased
 - Beneficiary with Special Needs
- Minor Beneficiary: Make sure Beneficiary Designations reflect current circumstances
- Red flags
 -  Recent changes reflecting new beneficiary
 -  Recent changes favoring new individuals (including those providing care or in control of individual)
 -  Changes inconsistent with Will/Trust plan


ISSUE SPOTTING

- Debts

- Review with clients outstanding obligations

- Red Flags

-  Two individuals are co-owners on the deed to a house. However, only one individual is the obligor on the mortgage/note.

-  Separated or divorced client, both individuals remain obligated on a mortgage to a house.

ISSUE SPOTTING

- Explosive Family Dynamics
 - Relationships
 - Who gets along?
 - Are individuals in fiduciary roles who will conflict with beneficiaries?
 - Location
 - Be aware of existing conflicts
 - Be aware of children/descendants being favored over others.
 - Confirm Intent
 - Is a relative a caregiver?
 - Are they being compensated
 - Is a relative living with client?
 - Be aware of added benefits to relative
 - Gifts

ISSUE SPOTTING

- Influence/Influencers
 - Who are the spheres of influence for the client?
 - Be aware of inconsistent actions
 - Be aware of changing patterns
 - Keep a timeline of events
 - Monitor changes in agents/fiduciaries
 - Monitor beneficiary changes
 - Monitor disposition changes under Will/Trust

ISSUE SPOTTING

- Capacity
- Access
 - Be aware of who has access to client
 - Who is transporting client?
 - Who has access to checkbook?
 - Who is an authorized party on financial accounts?
 - Who may know client's online passwords, if any?
 - Who does the client depend on?
- Spending Patterns
 - Monitor expenses/debts
 - Be aware of changes inconsistent with general activity
 - Be aware of outliers such as large one-time distributions

ISSUE SPOTTING

- Vulnerable Adult
- Controlling Third Party
- Budget deviations
- Gifting deviations
- Drastic asset transfers inconsistent with estate plan