SPRING | 2014

the Arizona Business Lawyer

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Business Law Section of the State Bar of Arizona
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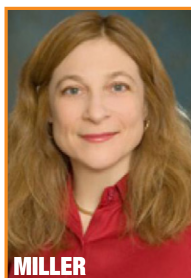
a note from the chair

RAJ N. GANGADEAN | Chair

The Business Law Section is pleased to publish a new issue of the *Arizona Business Lawyer*. On behalf of the Section, I would like to thank the members of the Publications Committee for their diligence in preparing this issue for circulation and "stocking the pipeline" with content for future issues: **Lori Miller**, Editor-in-Chief; **Ryan Opel**, Articles Editor; **Russ Krone**, Managing Editor; and **Shelley Detwiller DiGiacomo**, Editor. If you are interested in submitting an article of interest to practitioners of business law, or serving on the Publications Committee, please contact Ryan Opel at **ryan.opel@gknet.com**.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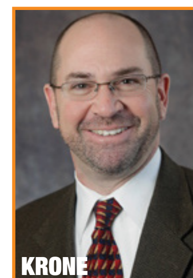
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Legislative Committee Activities

For several years, the Section's Legislative Committee has been working on draft legislation to clarify, modernize and improve various Arizona laws relating to business entities. SB 1353, titled "Arizona Entity Restructuring Act" ("AERA"), addresses several types of deficiencies in Arizona's current statutes relating to "entity-level transactions" (mergers, interest exchanges, conversions, domestications and divisions). It organizes these statutes in

a single location in Title 29, authorizes a broader range of entity-level transactions and standardizes procedural requirements for these transactions.

AERA was approved by the Section members last summer, approved for sponsorship by the Bar's Board of Governors last fall and introduced as a bill this spring in the 2014 legislative session, with Sen. Bob Worsley acting as the lead sponsor. We are pleased to announce that both the Arizona Senate and the Arizona House of Representatives unanimously approved AERA and, on April 23, 2014, Governor Brewer officially signed AERA into law. AERA will be effective from and after December 31, 2014.

Future issues of the *Arizona Business Lawyer* will include a feature article detailing AERA, as well as updates on other Section legislative initiatives that are still in the "pipeline," including amendments to the benefit corporations act and its interplay with other provisions of title 10, other amendments to titles 10 and 29, and revisions to the Arizona LLC Act.

Please join me in thanking our co-Vice Chairs, **Ronda Berckerleg Thraen** and **Thomas Morgan**, for their good work this year in organizing the Section's monthly CLE breakfasts and arranging for speakers to address topics of interest to our members. Please watch your email for invitations and announcements regarding future CLE events. abl

Raj N. Gangadean
Section Chair

We hope you will be able to join us in Tucson this summer for the Section's CLE program at the State Bar Convention. On Thursday, June 12, **Mark Lassiter** will chair a full-day seminar on the rapidly emerging field of Legal Project Management (LPM). Mark and a panel of national experts will present LPM in the context of a hypothetical business acquisition and subsequent litigation. The program will qualify for 6 hours of ethics CLE credit.

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Legal Project Management

Constrained by decreasing revenues and profits in the recent "Great Recession," corpor
departments had to do "more with less." They learned that in "The New Normal" it's now
and they increasingly ***demand*** that their outside counsel abandon the entrenched, hist
pricing model in favor of **"Alternative Fee Arrangements" (AFAs)** and other **value-billing**
and transaction matters. This has shifted the risk of loss arising from poor matter managem

SEE PAGE 22 FOR COMPLETE INFO

Congress Tries To "Jumpstart Our Business Startups"

SEC RULEMAKING GROUNDS SMALL BUSINESS

by Charles R. Berry

Passage of the JOBS Act – A Game Changer for Small Businesses?

In late February 2012, leadership in the United States House of Representatives bundled several stand-alone securities law reform proposals and placed them on the fast track as H.R. 3606, the Jumpstart Our Business Startups ("JOBS") Act. The proposal was enthusiastically supported by business, with some opposition by securities regulators and some consumer protection advocates. Both the House and Senate quickly passed the JOBS Act with bi-partisan support in late March, and President Obama signed the Act into law on April 5, 2012. Upon signing the new law, he remarked that the JOBS Act would be:

> *"for start-ups and small businesses … a potential game changer. … Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors – namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in."*

Key provisions of the JOBS Act include:

- Relaxing federal securities regulation for businesses that qualify as "emerging growth companies";
- Allowing public solicitation in exempt private offerings under the safe harbor of Regulation D utilizing a new Rule 506(c);
- Creating a new "Crowdfunding" exemption to aid private businesses raising capital by allowing them to raise up to $1,000,000 every 12 months in small "public" offerings;
- Raising the limit on exempt small offerings under Regulation A from $5 million to $50 million; and

- Lowering the threshold requiring companies with broadly held equity securities to registering with the Securities and Exchange Commission (the "SEC").

> ***SEC Rule 506(c) permits general solicitation, but the issuer must take reasonable steps to verify accredited investor status of purchasers; no longer may the issuer only rely on an investor's representations***

Rulemaking to Implement the JOBS Act

The JOBS Act, which has seven Titles and a total of 22 pages of text, has proven far more difficult to implement than many people expected. After nearly two years, thousands of pages of releases with proposed rules, and thousands of pages of comments on those releases, the only major provision for which the SEC has adopted final rules is the public solicitation of private offerings under Rule 506(c). The SEC has released for comment proposed rules for Crowdfunding and Regulation A, but none of those rules is final. The most significant aspects of the JOB Act and the SEC's rulemaking initiatives are described on the next page.

TITLE I: EMERGING GROWTH COMPANIES

The JOBS Act created a new class of issuers of securities that are public reporting companies. An "emerging growth company" must have annual gross revenues of under $1 billion. Emerging growth companies receive several breaks from regulatory requirements, including:

- Exemption from certain required votes such as "say on pay" and golden parachutes, and modification of certain disclosure requirements;
- Relaxed disclosure of financial information, exemption from public accountant reports on internal financial controls, and possible exemptions from new accounting standards;
- Relaxed executive compensation disclosures; and
- Provisions designed to facilitate public offerings, including confidential SEC reviews and an initial public offering "onramp".

TITLE II: ACCESS TO CAPITAL FOR JOB CREATORS – RULE 506(C)

A Break with Tradition – General Solicitation of Private Offerings Permitted

Section 4(a)(2) of the 1933 Act provides an ***exemption*** from registration for "transactions by an issuer not involving any public offering". Traditionally, this exemption (formerly Section 4(2)) meant absolutely no advertising; public solicitation prohibited reliance on the private offering exemption.

Congress directed that the SEC remove the ban on general solicitation in private securities offerings conducted under Rule 506 of Regulation D and Rule 144A (a safe harbor for sales to institutional buyers) so long as the securities are ***sold*** only to:

- Accredited Investors as defined in Rule 501 of Regulation D – which lists eight categories of investors; among them individuals with a $1,000,000 net worth or annual income of $200,000 (individual) or $300,000 (joint); and
- Qualified Institutional Buyers ("QIBs") – generally large institutional investors with at least $100,000,000 in investable assets.

The JOBS Act provides that issuers may generally solicit if "using such methods as determined by the [SEC]" they verify that purchasers are accredited. Congress directed that the SEC issue rules on that Title by July 4, 2012. Proposed rules were issued for comment on August 29, 2012; and final rules went into effect September 23, 2013.

As now written, SEC Rule 506(c) permits general solicitation, but the issuer must take ***reasonable steps*** to verify accredited investor status of purchasers; no longer may the

issuer only rely on an investor's representations, as is the standard with traditional offerings under what is now Rule 506(b).

Final Rules for General Solicitation – What are Reasonable Steps to Verify?

Generally, reasonable verification must be done by the issuer on a "case-by-case" basis. However, the issuer may rely on the following four "safe harbor" verification methods (which are non-exclusive and non-mandatory) for individuals:

1. ***Income ($200,000/$300,000)***. Internal Revenue Service forms (W-2, 1099, K-1, 1040) that show the last two years of income, plus written offering representations from the purchaser.
2. ***Net Worth ($1,000,000)***. *Assets* – bank, brokerage and other statements, certificates of deposit, tax assessments and appraisal reports. *Liabilities* – a report from a nationwide credit reporting agency.
3. ***Third Party Confirmation***. Written confirmation from a licensed professional securities dealer, SEC registered investment advisor, licensed attorney in good standing in all jurisdictions in which the attorney is licensed, or a certified public accountant in good standing.
4. ***Prior Purchasers***. Certification from purchasers who purchased securities from the issuer prior to September 23, 2013, that they continue to be Accredited Investors.

Confirmation that Section 4(a)(2) Applies

The SEC clarified that Rule 506(c) is derived from the Section 4(a)(2) exemption, confirming that securities issued under 506(c) are *Covered Securities*. That classification exempts those securities from state registration requirements.

Other Rule 506(c) Requirements About Public Solicitation

Form D Filings. Form D filings must indicate whether the issuer is relying on Rule 506(b) or Rule 506(c), but an issuer cannot rely on both. An issuer may switch from a 506(b) to a 506(c) offering to use general solicitation, and earlier 506(b) sales will not be disqualified.

Enhanced "Bad Actor" Standards. The new rules include enhanced standards specifying who is a "bad actor", and providing that offerings involving issuers affiliated with "bad actors" are disqualified from using the Rule 506 private offering exemption. The amendments expand disqualifications from reliance on Rule 506 securities offerings by issuers that have been, or that have officers, directors, affiliates or placement agents that have been, the subject of certain criminal, civil, or administrative proceedings under federal or state laws.

Proposed Rules for General Solicitation

There are many ***proposed*** rules for general solicitation under Rule 506(c). These rules are not in effect yet, but they could include:

1. ***Pre-General Solicitation Offering Filing***.
File Form D *15 days before* using general solicitation.
2. ***Post-General Solicitation Offering Filing***.
File amended Form D *within 30 days after* General Solicitation offering.
3. ***Legends***.
Include required legends in general solicitation materials.
4. ***Disqualification***.
A one-year "penalty box" disqualification from using Rule 506 for failure to comply with Form D requirements.
5. ***Additional Disclosures in Form D***.
Would amend half of the 16 current disclosure fields and create six new fields to require additional information, including:
   - types of general solicitation used;
   - verification methods;
   - issuer's website;
   - number of purchasers (including types of Accredited Investors);
   - use of proceeds;
   - name and address of any person who controls the issuer; and

- whether a Broker-Dealer was used.

6. ***Provide SEC with General Solicitation Materials***. Issuers would need to provide materials by the date of their first use. The obligation would expire two years after effective date.

TITLE III: CROWDFUNDING

Crowdfunding is perhaps the most highly touted, and the most misunderstood, aspect of the JOBS Act. **Crowdfunding rules are only proposed, and Crowdfunding is not yet legal**.

Title III is nine pages. On October 23, 2013 the SEC proposed Crowdfunding rules (585 pages, with a separate Financial Industry Regulatory Authority ("FINRA") proposal for registration of Funding Portals – 60 pages). Comments were submitted through February 3, 2014, and are being considered.

The essential elements of Crowdfunding will include:

- Offering size would permit an issuer to raise up to $1 million every 12 months (including non-Crowdfunding sales).
- Issuers ***must*** offer only through a new concept, a *Funding Portal*.
- Significant disclosures about the issuer and its securities will be required. Proposed rules include:
  - guidelines for disclosure;
  - requirements to provide updates throughout offering period;
  - annual disclosures to investors and the SEC.

The Proposed Rules Explain Who May Offer and How They May Do So:

1. ***No direct selling***. Issuers must sell through an SEC-registered securities dealer or an SEC-registered "Funding Portal."
2. ***Issuers cannot advertise***, but may direct prospective investors to the registered securities dealer or Funding Portal.
3. ***No public companies*** (*i.e.*, publicly reporting issuers).
4. ***Domestic companies*** (U.S. based only).
5. ***Bad actor provisions apply*** (*i.e.*, certain bad actors cannot use the exemption).

Funding Portals; a New Concept:

- Cannot offer investment advice.
- Cannot hold, manage, or handle investor funds.
- Regulated by FINRA; subject to SEC oversight.
- May provide certain "ancillary services."

It remains to be seen whether or not many persons will register as or act as Funding Portals. Many concerns have been voiced as to how Funding Portals will be paid and the

perceived extraordinary costs involved, particularly when the maximum amount that can be sold in a Crowdfunding offering is $1,000,000. One of the most serious issues is whether the only persons willing to bear the offering risks are purveyors of fraud rather than legitimate small businesses.

TITLE IV: SMALL COMPANY CAPITAL FORMATION (OFTEN REFERRED TO AS REGULATION A+)

Title IV (2 pages) instructs the SEC to amend existing Regulation A to create new and improved "mini public offering" rules. Regulation A was originally adopted in 1936, with a $100,000 limit, which was last raised to $5 million in 1992. It is rarely used. In the four years from 2009-2012, there were 19 qualified Regulation A offerings filed with the SEC for a total of $73 million in offerings.

Proposed Rule – Regulation A+

On December 18, 2013, the SEC issued a proposed new rule for Regulation A (384 pages). Comments are due by March 24, 2014. The proposal has commonly been referred to as Regulation A+. **These rules are proposed, Regulation A has not yet been amended, and Regulation A+ cannot yet be relied upon**.

As proposed, the SEC's rules would update and expand the Regulation A exemption by creating two tiers of Regulation A offerings:

- Tier 1 – securities offerings of up to $5 million in a 12-month period, including up to $1.5 million for the account of selling securities holders.
- Tier 2 – securities offerings of up to $50 million in a 12-month period, including up to $15 million for the account of selling securities holders.

Basic Requirements

- The proposed rules also would update Regulation A to, among other things:
  - Permit companies to submit draft offering statements for nonpublic SEC review prior to filing.
  - Permit the use of "testing the waters" solicitation materials both before and after filing of the offering statement.
  - Modernize the qualification, communications, and offering process in Regulation A to reflect analogous provisions of the Securities Act registration process, including requiring electronic filing of offering materials.

Additional Tier 2 Requirements

- In addition to the basic requirements, companies conducting Tier 2 offerings would be subject to the following:
  - Investors would be limited to purchasing no more than 10 percent of the greater of the investor's (a) annual income, or (b) net worth.
  - The financial statements included in the offering circular would be required to be audited.
  - The company would be required to file annual and semiannual ongoing reports and current event updates that are similar to the requirements for public company reporting.

Eligibility

- Regulation A would be available to companies organized in and with their principal place of business in the United States or Canada, as is currently the case under Regulation A.
- The exemption would ***not*** be available to companies that:
  - Are already SEC reporting companies and certain investment companies.
  - Have no specific business plan or purpose or have indicated their business plan is to engage in a merger or acquisition with an unidentified company.
  - Are seeking to offer and sell asset-backed securities or fractional undivided interests in oil, gas, or other mineral rights.

- Have not filed the ongoing reports required by the proposed rules during the preceding two years.
- Are or have been subject to a Commission order revoking the company's registration under the Exchange Act during the preceding five years.
- Are disqualified under the proposed "bad actor" disqualification rules.

Proposed Preemption of Blue Sky Laws

- Under current Regulation A, offerings are subject to registration and qualification requirements in the states where the offering is conducted unless a state-level exemption is available. This has been identified by the General Accounting Office and market participants as a central factor for the limited use of current Regulation A.
- In view of the range of investor protections provided under the proposal, the SEC has proposed that state securities law requirements would be preempted for Tier 2 offerings. The proposal also explores alternative approaches to addressing this matter, including the coordinated review program proposed by the North American Securities Administrators Association ("NASAA"). Needless to say, some NASAA members object to being preempted.

Some Observations on the Current Status of the JOBS Act

- The JOBS Act was touted as creating ***new opportunities for small business to raise capital.***
- New Rule 506(c) permits public solicitation of private offerings and allows startups, venture capital funds and private investment vehicles to tell more people that they are raising money. However, the primary use to date has been large issuers advertising Rule 144A sales to QIBs, not start-ups and small businesses.
- In the roughly two years since passage of the JOBS Act, the only final SEC rules are those relating to Rule 506(c), which were adopted nearly 15 months after the date mandated by the law. Legislators, practitioners, and potential users have voiced their frustrations with continuing delays in adopting final rules. Proposed rules have been voluminous, and proposals have often posed more questions than they have answered. In particular, the complexity of proposed Crowdfunding regulations seems almost insurmountable for the small business issuers that wish to raise $1 million or less.
- Regulation has not relaxed; this is, and will remain, a complicated and highly regulated area of law with *serious pitfalls for the unwary.* abl

about the author

CHARLES R. BERRY is a shareholder in the Phoenix office of Polsinelli, where he represents corporations, limited liability companies, partnerships, other business entities and individuals in a wide spectrum of transactions, focusing primarily on capital formation, business management and real estate. He has extensive experience in securities regulation, public offerings, business mergers, acquisitions and sales, private placements and compliance with the periodic reporting requirements of the Securities Exchange Act of 1934. Mr. Berry is past Chairman of the Business Law Section and the Securities Regulation Section of the State Bar of Arizona.

Post-Acquisition Disputes: Common Pitfalls and How to Avoid Them

by Bradley J. Preber

Business owners and executives go to extraordinary lengths to make sure that the sale or purchase of a business is successful. Nevertheless, many of these transactions result in litigation or arbitration to resolve a post-acquisition dispute. Sometimes this occurs because the transaction was poorly designed. Sometimes there were untrue or misleading representations. Sometimes there was "a clash of corporate cultures." But a surprising number are the result of misunderstandings about common accounting terms.

Many purchase and sale agreements call for the seller to prepare financial statements for the business to be sold. These financial statements normally include a balance sheet reflecting the assets and liabilities on, or near, the closing date, and statements of operations and cash flows for the period immediately prior to the closing date. These statements may be audited by an independent accountant.

It is common for the buyer to prepare its own financial information for the purchased business sometime after closing has occurred. In some cases, this information is limited to a balance sheet; buyers commonly compare their balance sheet to the seller's as a way to determine if the purchase price was fair.

In certain circumstances, the buyer may prepare a more complete set of financial statements, including a balance sheet together with income and cash flow statements for a defined period of time after closing. This would be typical for transactions including earn-out provisions.

Earn-out provisions provide for supplemental payments to sellers, or to the executives of seller entities, as incentives to remain involved in the business after the sale, or to secure anti-competition agreements or other promises. Earn-outs are often based on financial performance after the sale and purchase agreement is signed. For example, earn-out bonuses may be based on hitting specified targets for sales, gross margins, net profits or cash flows.

Most of the time, the financial statements to be used for a purchase and sale are to be prepared and presented by the seller in accordance with the generally accepted accounting principles ("GAAP") in effect on, or near, the closing date, and applied on a consistent basis to prior periods. As plain and simple as that sounds, misunderstandings frequently occur between buyers and sellers over differences in the recording and reporting of amounts in the financial statements. These are the trouble spots that often give rise to post-acquisition disputes.

COMMON PITFALLS

GAAP allows management some choice regarding what accounting principles to use and how to apply them. The Accounting Principles Board in its Opinion No. 22 states that "accounting policies … are the specific accounting principles and the methods of applying those principles that are judged by management … to be the most appropriate … " In short, GAAP requires the exercise of considerable judgment and the use of estimates.

Post-acquisition disputes often occur because the seller is responsible for preparing the financial information of the business before a sale, and the buyer is responsible for preparing this information after the sale. Each uses its own independent judgment, relies on its own interpretations of GAAP and calculates its own accounting estimates. In doing so—surprise—they rarely use the same thought processes or methods. In other words, they do not prepare the financial information using identical and consistently-applied accounting policies.

To prevent these disagreements, it is critically important for all parties to understand how the presale financial statements were prepared with regard to subjective areas and estimates. In some cases, it may even be prudent to have the parties agree beforehand about the accounting policies and estimation practices to be used, right down to the detailed methodologies and calculation formulas. The good news is that the focus of discussions on these matters can generally be limited to a handful of areas—the "Pitfalls"—that frequently drive disputes. These include:

- *Materiality;*
- *Differing Accounting Policies;*
- *Accruals, allowances, loss contingencies and reserves;*
- *Cut-off issues;*
- *Expense allocations;*
- *Taxes; and*
- *Disclosures*

Let's consider these one by one.

MATERIALITY

Materiality is an accounting and auditing concept that involves a quantitative and qualitative judgment regarding what might be important to financial statement users. It may apply to a monetary amount (*i.e.*, quantitative judgment) or to the completeness of a disclosure (*i.e.*, qualitative judgment), among other items. Materiality is a subjective term, usually defined by way of a "reasonable person" rule-of-thumb.

As it relates to financial statements, materiality is typically evaluated by considering the financial statements taken as a whole. Accordingly, certain individual line items reported in financial statements (and the items making up these balances) may be considered immaterial by management or by auditors. GAAP does not apply to immaterial items, meaning that certain items reported in the financial statements may, technically, not be in compliance with GAAP.

For example, say that total assets reported on the balance sheet are $10 million. Accepting that it's impractical, if not impossible, to get complete accuracy for every dollar recorded, the concept of materiality provides for an assessment of the amount of misstatement that could potentially effect the decision-making of a reasonable person. Clearly an error of $1,000, or .0001 percent of assets, would be considered immaterial. An error of $1 million, however, would be material.

Materiality as used in connection with the sale of a business is not the same as materiality used in the preparation of financial statements. Therefore, use of financial statement materiality by the seller and buyer is typically inappropriate. Materiality for the sale and purchase of a business is defined by what is important to the seller and buyer. As a safe harbor, each party should treat items as material if there is a strong likelihood that one of the parties might consider

Materiality as used in connection with the sale of a business is not the same as materiality used in the preparation of financial statements. Therefore, use of financial statement materiality by the seller and buyer is typically inappropriate.

Trouble frequently starts when the seller has not adequately apprised the buyer about the accounting policies selected...

it important. Therefore, the parties may need to have a number of candid discussions to get a sufficient understanding of potentially important matters. The determination of materiality by each party always includes an evaluation of monetary significance (*i.e.*, the dollar amount each party believes would influence their decision-making) and/or percentage magnitude (*i.e.*, the percent or ratio change each party considers critical). These are considered quantitative factors. Materiality also requires the parties to assess certain qualitative factors, such as the honesty, integrity and reliability of the other party.

Disputes are created because the parties fail to discuss and agree on materiality for purposes of closing the books. Consequently, the buyer finds fault with a number of items immaterial to the seller's financial statements taken as a whole. A buyer may dispute individual transactions, line items, accounts, groups of accounts, or the classification of balances that when taken together may rise to the level of an alleged material misstatement. In any case, sellers and buyers could reduce or eliminate such arguments by agreeing to definitive thresholds for materiality in connection with any rights to initiate post-acquisition disputes.

DIFFERING ACCOUNTING POLICIES

Financial statements generated in connection with the sale of a business are typically prepared and presented in accordance with GAAP, and, as discussed, GAAP allows management latitude with respect to which accounting principles to use and how to apply them. Additionally, the language "GAAP, consistently applied" is often cited in the purchase agreement and calls for the use of pre-closing accounting policies in the preparation of the financial statements, contingent on those policies being in conformity with GAAP.

Trouble frequently starts when the seller has not adequately apprised the buyer about accounting policies selected and the reasons therefore. In these cases, the buyer and seller are likely to select differing accounting policies, apply independent judgment, and arrive at divergent estimates while preparing their respective financial statements. Simply put, the seller and buyer may prepare and report financial statements using inconsistent accounting policies and differing judgments.

This pitfall can be mitigated by the seller providing a clear understanding of their historic accounting policies prior to the closing of the transaction and perhaps even including the specific language and example calculations for these policies.

ACCRUALS, ALLOWANCES, LOSS CONTINGENCIES AND RESERVES

In lay terms, accruals are estimates of revenues and assets, or expenses and liabilities, properly recorded using GAAP. Allowances and reserves generally are meant to record assets and transactions at estimated net realizable amounts as required by GAAP. Allowances for doubtful accounts receivable, inventory-obsolescence reserves, sales returns and allowances, fixed asset depreciation and goodwill impairment adjustments are common examples.

According to the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC"), loss contingencies are to be charged to income if they are "probable" and the "amount of loss can be reasonably estimated." Accruals, allowances, reserves and loss contingencies are pointin-time estimates that require significant judgment about the outcome of uncertain future events involving unpredictable courses of action. This is the equivalent of educated fortune telling for accounting matters.

For example, at the time the seller prepares the financial statements, they may believe that products in inventory are likely to be profitably sold in the future. This judgment includes assumptions about future customer buying habits, marketing programs to be used, technological changes anticipated, competitor responses known or anticipated and sales force performance. Based on this positive view for the future sales prospects of its inventory, the seller may elect not to reserve for any future losses. The buyer, using its own judgment, different assumptions and perhaps a little hindsight, may subsequently conclude that the same inventory is, and was on the date of sale, worthless and should have been fully reserved. These differing positions can result in a dispute.

To avoid post-acquisition disputes related to these types of estimates, it is important for the buyer to perform due diligence sufficient to understand and gain comfort over the seller's judgments and assumptions. Conversely, the seller

must be willing to fully disclose these judgments and assumptions to the buyer. That may be challenging if this information is deemed confidential and proprietary. Ultimately, if the buyer is uncomfortable with the seller's judgments and assumptions—or disclosure thereof—it may ask for changes before the deal is executed. Alternatively, both parties might consider reaching an agreement to use pre-defined methods, formulas and assumptions to calculate accruals, allowances, loss contingencies and reserves.

CUT-OFF ISSUES

Cut-off policies stop, or "cut-off," the collection of information used to prepare financial statements. With respect to acquisitions, cut-off pertains to the time allowed to collect information, two weeks for example, in order to prepare financial statements in connection with the sale. Cut-off policies are designed to identify, capture, record and report economic activity in the proper period, taking into consideration practical limitations related to document collection and the need for timely information.

Cut-off is often a post-acquisition problem because the seller and buyer use different cut-off periods. The seller is often required to prepare the preliminary financial statements within a few days after the date of sale. As such, the cut-off period is artificially shortened versus the seller's customary cut-off period. As a result, estimates are more heavily relied upon in an attempt to capture the necessary information. Later, when the buyer prepares their version of the financial statements, the cut-off period is extended using the seller's customary cut-off policy, or another applied by the buyer. A longer cut-off period may provide more accurate information, but it can differ from the estimates made by the seller's staff due to the shortened period. As a result, financial statement balances may differ between the seller and buyer, causing a dispute.

One way to preempt this issue is for both parties to agree on specific cut-off dates for specified account activity. It should be noted that irrespective of cut-off policy utilized, the financial statements must properly match expenses against revenues in the appropriate period (even if that means estimating expenses) in order to comply with GAAP.

EXPENSE ALLOCATIONS

Management may allocate expenses in an attempt to match them to corresponding revenue generating activities (*e.g.*, allocation of overhead costs to operating units). Among other benefits, allocating expenses assists management in its efforts to measure organizational performance. Post-acquisition disputes may occur from inconsistencies in the types and methods of expense allocations used by the seller and buyer. This is particularly true for sales and acquisitions that provide for deferred purchase price payments from the buyer to the seller based on future earnings, often referred to as earn-out provisions.

Earn-out provisions generally call for the buyer to pay the seller additional purchase price amounts based on future operational performance, such as net earnings or cash flows. Earn-out provisions are usually based upon a written agreement or a general understanding between the parties that the accounting methods and policies used to prepare the earn-out calculations will be consistent with those used by the seller prior to the acquisition. However, subsequent to the closing of the sale and acquisition transaction the facts and circumstances may change. These changes may cause the buyer to make business decisions that affect the type of expenses incurred and allocated to the earn-out calculations. The objective of the seller is to minimize expenses to maximize the earn-out. Conversely, the buyer's goal is to minimize the earn-out by strictly accounting for actual expenses incurred and reasonably applicable to the earn-out calculation. As a result, the parties may find themselves in a dispute over expenses.

This may be particularly true in circumstances where a business division, segment or unit of a consolidated group is sold piecemeal or acquired and accounted for by the buyer as a part of a larger consolidated enterprise. Oftentimes, divisions, segments or units of a business do not report all of the applicable expenses benefitting a division, segment or unit in

individual, stand-alone sets of financial statements. For example, expenses related to overhead and management may only be captured and reported at the parent company level. When the divisions, segments or units are consolidated into a single set of financial statements, the consolidated expenses are correct. However, for purposes of the future earn-out calculation these expenses may not have been identified by the parties on an individualized basis for the division, segment or unit sold and purchased; thereby, creating a potential future disagreement.

The source of the potential disagreement can be the seller or the buyer. If the seller fails to disclose to the buyer the expense allocations and methods used historically for the division, segment or unit sold, the seller may get an unfair windfall in the earn-out payment because the buyer fails to include such allocated costs in the earn-out calculation. On the other hand, if the buyer fails to recognize that certain expenses have not been historically and appropriately allocated to the purchased division, segment or unit during due diligence, the earn-out payment may be unfairly reduced by inconsistently applied expense allocations.

The avoidance of problems in this area requires the seller and buyer to agree on how to calculate expense allocations at closing and in the future. However, that is predicated on the seller being willing to fully disclose expense allocations and methods to the buyer. As mentioned above, that disclosure may be difficult to obtain from the seller if this information is deemed confidential, proprietary or otherwise competitively important. Using this information, the buyer must reconcile its own expense allocation methods with those of the seller to facilitate agreement at closing.

TAXES

Tax matters can be complex and require counsel from international, state and local, employment, regulatory, federal taxation and legal professionals. Similar to the GAAP matters mentioned earlier, management judgment is required to elect tax positions and prepare tax returns. In many cases, the failure to properly assess the tax implications of a transaction can be disastrous for both the seller and the buyer.

Due to the complexities, the judgment involved and the high potential for adverse consequences, parties will often initiate disputes over small tax-related matters. This is because of the potential involvement of third party regulators (e.g., the IRS) in the resolution of most tax related matters and the associated risk of business and personal fines and penalties. In severe cases, civil or criminal charges may even be brought. Many business executives recognize this risk and address it by engaging tax advisors to counsel them, or otherwise take extra steps to secure tax opinions for important or controversial matters.

If there is a theme with respect to mitigating the potential for post-acquisition disputes, it is the need for disclosure between the buyer and seller. Tax matters are no exception. The seller must be willing to disclose potentially controversial tax positions taken. Similarly, the buyer must make it a priority to reconcile their tax positions with that of the seller in order to identify and dispose of differences that may drive post-acquisition disputes.

DISCLOSURES

Buyers often get concerned about inadequate or omitted seller disclosures due to the belief that information was hidden intentionally. Suspicions arise and trust erodes. Many times, buyers feel the only way to regain transaction integrity is to elevate the situation to a post-acquisition dispute.

To foster transparency and trust, the seller should disclose any material information needed to read and fully understand the financial statements prepared in accordance with the acquisition. In particular, due to the frequency with which disputes arise stemming from common pitfalls, the seller should be exceptionally diligent about transparency surrounding related party transactions, off-balance sheet obligations and potential adverse subsequent events. For its part, the buyer should consider redoubling due diligence efforts in these and other areas to satisfy itself that it is entering into the transaction with sufficient knowledge and comfort over the representations made by the seller.

AVOIDING COMMON PITFALLS

By attending carefully to the foregoing trouble spots, both seller and buyer will increase the likelihood that they will avoid postacquisition disputes. The following is a “short list” of items for parties to consider when preparing and presenting financial statements in connection with the sale of a business to avoid the common pitfalls:

1. Reach agreement on how the financial statements in connection with the sale are to be prepared by the parties. It may be prudent to agree on items such as accounting policies and accounting estimates to be used, including detailed methodologies and formulas.

2. Clearly identify significant liability accruals, loss contingencies and asset reserves and consider using agreed-upon methods, formulas and assumptions to evaluate and compute these estimates.
3. Understand the seller's cut-off policies and agree to use a standard cut-off policy after the sale.
4. Identify any allocations affecting the financial statements in connection with the sale and reach agreement surrounding the allocation methodologies employed.
5. Identify and agree on the inclusion of any tax assets and liabilities in the financial statements prepared for the sale. Engage professional advisors and secure tax opinions for important or controversial matters.
6. Identify and require the full and complete disclosure of important matters related to reading and understanding the financial statements prepared in connection with the sale. These are equivalent to the footnotes required under GAAP for financial reporting purposes. Buyers should consider performing due diligence procedures to determine the completeness and appropriateness of disclosures, especially with respect to related party transactions, off-balance sheet obligations and potential adverse subsequent events.
7. Consider joint access agreements to allow the parties access to any critical records (*e.g.*, financial books and records), resources (*e.g.*, key accounting personnel) and tools (*e.g.*, software applications) necessary to prepare financial statements in connection with the sale.
8. Agree to specific quantitative materiality thresholds for individual and aggregated items to qualify for dispute resolution. (Note that it is generally impractical to identify all of the qualitative factors.) abl

about the author

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HAPPY UCC TRAILS

BY GARY R. ZWILLINGER

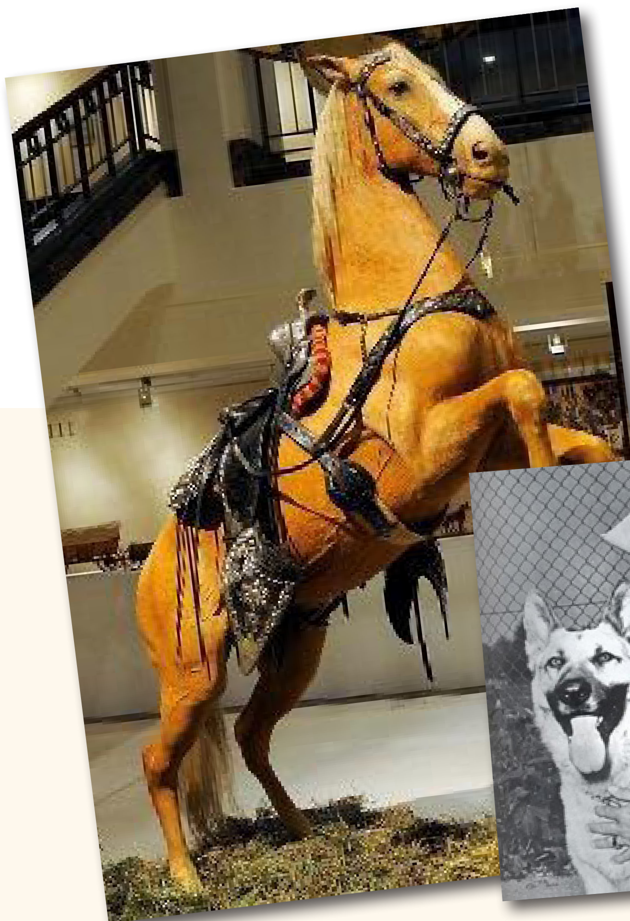
Sometimes a piece of offhand legal advice and a rather dry legal statute can have a cultural affect far more reaching than one might expect. I grew up with Roy Rogers and Dale Evans as a Saturday morning television staple in my house (boxed somewhere in between *The Lone Ranger*, *Crusader Rabbit*, *Sky King*, *Rocky and Bullwinkle* and *My Friend Flicka*). In fact, my mother was such a fan that my middle name is Roy. I have a kinship.

A client of the firm has, for a long time, consulted with the Rogers-Evans family, first in California as they tried to unsuccessfully establish a "Dollywood" kind of town known as RogersDale, and more recently, with respect to a Roy Rogers – Dale Evans Museum in Branson, Missouri.

The dramatic economic downturn had seriously hurt the Museum to the point where rent was delinquent. About four years ago, the landlord was taking action, including foreclosing on a personal property security interest it had on Trigger, Roy Roger's stunning and trusty horse. I had heard, and it was confirmed, that upon Trigger's death, he had been stuffed by one of the Western Hemisphere's premier taxidermists (see the accompanying photo).

Well, when I heard this, it got me riled up. The issues of non-payment of rent to a landlord who, I assume, was owed its rent, had nothing to do with my reaction. This wasn't about landlord/tenant relations – this just wasn't right. Trigger is an American icon, more appropriately residing in the Smithsonian next to Dorothy's ruby red slippers or Archie Bunker's chair (I've been to the Smithsonian a few times and Trigger would fit right in between these two culturally-iconic pieces).

As I was talking to my client, who was on his way to Branson, it occurred to me that then-recent changes to the Uniform Commercial Code weren't known by everyone. To perfect a security interest in Trigger, the landlord would have needed to file its UCC-1 Financing Statement in the state of domicile of the entity that owned Trigger (see A.R.S. §§ 47-9305 and 47-9307 and the exact corresponding Missouri Uniform Commercial Code sections). I knew the domicile state for this entity was California, and my hope was that the landlord had filed its Financing Statement in Missouri only. If so, although the landlord would still have a security interest in Trigger, it would not be "perfected" under the Uniform Commercial Code and other creditors might prime that unperfected security interest in bankruptcy (and the threat of that bankruptcy would create the leverage to free Trigger from the landlord).



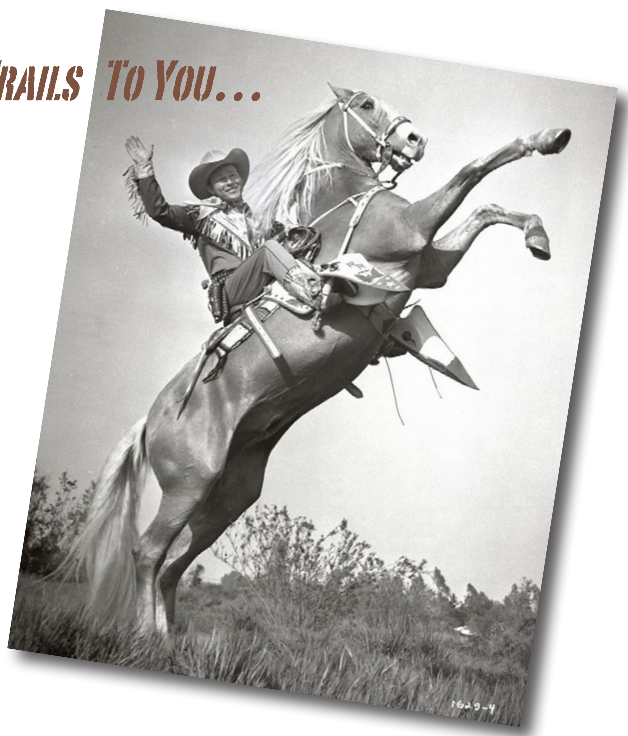
HAPPY UCC TRAILS

A few weeks later I heard that, in fact, the filing by the landlord had been done improperly and the Rogers-Evans family had the leverage they needed. I heard that Trigger was not foreclosed upon by the landlord/creditor. I walked away very pleased and forgot about the story (except when the occasion arose and it was appropriate to tell it).

A few weeks ago, I was walking my dog on a golf course near my house with a friend from Kansas City, Missouri. We passed the house of another homeowner who I thought lived in Kansas City, so I introduced them. It turned out that this homeowner actually lived in Wichita but did most of his real estate development business in Branson, Missouri. Well, hearing this, I immediately turned the conversation to the Rogers-Evans Museum (I can't help myself) and asked if he knew anything about it. He looked at me as if I was from Mars and told me that he was the landlord of the Museum. I asked him to confirm the UCC-1 story and he told me that he had made a big mistake and filed his financing statement in the wrong state. I thought to myself, "what a great circle of life story." He wasn't that pleased to meet me, but I had a grin a mile long. It's times like this that I love being a lawyer.

The story doesn't end wonderfully because the Rogers-Evans' family ultimately sold Trigger (and Bullet – Roy's dog) in a Sotheby's auction to some rich television and radio station owner. At least the family got some money and hopefully Trigger and Bullet have a happy home. Ah, the Uniform Commercial Code. abl

HAPPY TRAILS TO YOU...



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S Corporations Revisited?

Choice of Entity in Light of the 2013 Medicare Surtaxes

by Kelly C. Mooney, J.D., L.L.M. & Timothy D. Brown, J.D.

The 2012 year witnessed a host of activity and changes with respect to the federal tax laws, including the U.S. Supreme Court's decision upholding the Patient Protection and Affordable Care Act1 and the re-election of President Obama. The combination of these events ensured the introduction of two new Medicare surtaxes in 2013, namely the 3.8% net investment income tax ("*NII*") under Internal Revenue ("*IRC*") § 141[1] and the 0.9% additional Medicare tax ("*AMCT*") under IRC §§ 3101(b) and 1402. Both of the new surtaxes went into effect on January 1, 2013 and serve to increase taxes on the earned and investment income of higher-income taxpayers.

Perhaps unexpectedly, the introduction of the AMCT and NII surtaxes favors the use of S corporations[2] over other types of pass-through entities in certain cases. The use of an S corporation, unlike a limited liability company[3] ("LLC") or partnership, can prevent the imposition of self-employment taxes (provided that "reasonable compensation" is paid to shareholder-employees) and the imposition of the AMCT surtax on S corporation allocations. These benefits are largely unavailable to the owners of partnerships and LLCs. Consequently, 2013 and beyond may see a renewed proliferation of S corporations in the context of service oriented businesses.

This article briefly explains the operation of the new AMCT and NII surtaxes and then considers the choice of entity ramifications of the new taxes for 2013 and beyond.

The 0.9% AMCT

The AMCT increases the Medicare taxes payable on the wages and self-employment income of certain high-income taxpayers by 0.9%. Currently, employees pay Social Security tax at a rate of 6.2% on the first $113,700 of wages in 2013 and Medicare tax at a rate of 1.45%.[4] Self-employed individuals pay Social Security tax at a rate of 12.4% on the first $113,700 of self-employment income in 2013 and Medicare tax at a rate of 2.9%.[5] For purposes of this article, wages and self-employment income subject to Social Security and Medicare tax are referred to as "earned income."

The 0.9% AMCT is imposed on earned income in excess of $250,000 for married couples filing joint, $125,000 for married couples filing separate, and $200,000 in all other cases.[6] In the case of employees, the AMCT increases the employee side Medicare tax from 1.45% to 2.35% on wages in excess of the thresholds. There is no employer portion of the AMCT. Employers, however, are required to withhold AMCT from wages paid to an individual in excess of $200,000 in a calendar year without regard to the individual-employee's filing status or amount of other wages or compensation.[7] The employer's obligation to withhold AMCT commences when wages paid to an individual-employee exceed $200,000.[8] Employees cannot request that employers withhold AMCT on wages under $200,000. As a result, married couples who expect that their combined wages will create AMCT liability should consider requesting additional income tax withholding or making estimated tax payments.

For example, assume individual A, who is married and files a joint return, receives $190,000 in wages from his employer for the calendar year. Individual B, A's wife, re-

ceives $150,000 in wages from her employer for the same year. Neither A's or B's employer is required to withhold AMCT because neither A's or B's wages exceed $200,000. However, A and B are liable for AMCT in the amount of $8,100 ($340,000 combined wages minus the $250,000 married filing joint threshold equals $90,000 times the 0.9% AMCT).[9]

In the case of self-employment income, the AMCT increases the Medicare tax from 2.9% to 3.8% on self-employment income in excess of the thresholds, with one caveat – the threshold is reduced to the extent of wages reported by the taxpayer (or the taxpayer's spouse if a joint return is filed).[10] As an example, assume individual C, who is married but files separate, receives $150,000 of self-employment income and $200,000 in wages in the same calendar year. Since C's wages do not exceed $200,000, C's employer does not withhold AMCT. Nonetheless, C's wages reduce his $125,000 AMCT threshold as married filing separate to $0. C is liable for $675 of AMCT on his wages (0.9% times $75,000($200,000 - $125,000)) and $1,350 of AMCT on his self-employment income (0.9% times $150,000($150,000 - $0)) for a total AMCT liability of $2,025.11

The 3.8% NII

The NII picks up where the AMCT on earned income leaves off. The NII imposes a 3.8% surtax on net investment income in cases in which a taxpayer's "modified adjusted gross income" exceeds the same thresholds applicable to the AMCT.[12] Modified adjusted gross income for these purposes is adjusted gross income plus certain otherwise excluded foreign income.[13] Thus, although the AMCT and NII income thresholds are the same, the tax base is different – earned income for AMCT and modified adjusted gross income for NII. The NII represents the first ever expansion of Medicare taxes into the realm of investment income.

Investment income subject to the 3.8% NII includes the following items: (i) gross income from interest, dividends, annuities, royalties, and rents, other than income generated in the ordinary course of a trade or business; (ii) gross income derived from a trade or business that is either a passive activity under IRC § 469 or that consists of the trading of financial instruments or commodities; and (iii) net gain attributable to the disposition of property, other than property held in a trade or business that is neither a passive activity nor consists of the trading of financial instruments or commodities.[14] In cases involving a pass-through entity, the determination of whether income is generated by a trade or business or constitutes investment income is made at the entity level rather than the owner level.[15] However, even if income under categories (i) and (iii) is not investment income at the entity level, it can be investment income at the owner level if the owner is inactive (i.e., does not materially participate in the activity or the activity is a rental activity).[16]

For example, if a small loan company classified as an S corporation earns interest on its loans in the ordinary course of its business, the company's interest income is not investment income at the entity level. However, the company's interest income is investment income to an inactive shareholder at the owner level and potentially subject to the 3.8% NII.[17] Similarly, if a partnership sells a capital asset not held in its trade or business, the gain is investment income at the entity level and investment income for each of the partners.[18] On the other hand, if a partnership sells equipment used in its trade or business, any gain is not investment income at the entity level but will be investment income to any inactive partners. Moreover, distributions from pass-through entities that are in excess of the owner's basis generally are taxed as capital gain and, thus, are investment income potentially subject to the 3.8% NII.

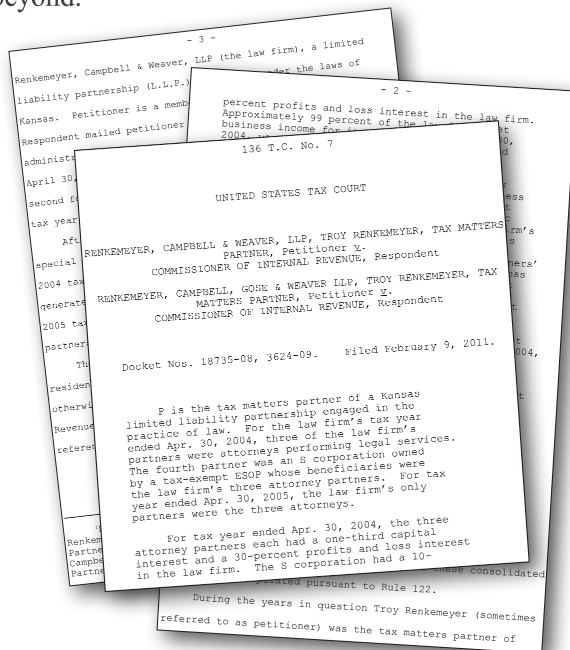
In determining NII, the three categories of investment income discussed above are reduced by deductions that are properly allocable to the income, provided that only amounts paid or incurred to "produce" the investment income are deductible.[19] However, since NII for any year cannot be less than zero, if a deduction is not fully used in the current year, the balance can be carried forward to another year if the Code section permitting the deduction allows for carryovers.[20] Properly allocable deductions include depletion under IRC § 62(a)(4), trade or business deductions covered by IRC § 62(a)(1), investment expenses, taxes, and miscellaneous itemized deductions after the application of the 2% floor, among others.[21]

Neither the AMCT or NII are indexed for inflation. As a result, more and more individuals will likely be subject to these taxes as time passes.

Choice of Entity Ramifications

Although the taxes imposed by the AMCT and NII are relatively small, these new surtaxes intensify a disparity that has long existed with respect to the self-employment tax ramifications of doing business through an S corporation or partnership vehicle. In addition, these taxes are being introduced

at a time when the self-employment tax treatment of limited partners has been called into question by the U.S. Tax Court's landmark decision in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011). Both favor the use of S corporations for active, service-provider owners in 2013 and beyond.


136 T.C. No. 7

UNITED STATES TAX COURT

RENKEMEYER, CAMPBELL & WEAVER, LLP, TROY RENKEMEYER, TAX MATTERS PARTNER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

RENKEMEYER, CAMPBELL, GOSE & WEAVER LLP, TROY RENKEMEYER, TAX MATTERS PARTNER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 18735-08, 3624-09. Filed February 9, 2011.

P is the tax matters partner of a Kansas limited liability partnership engaged in the practice of law. For the law firm's tax year ended Apr. 30, 2004, three of the law firm's partners were attorneys performing legal services. The fourth partner was an S corporation owned by a tax-exempt ESOP whose beneficiaries were the law firm's three attorney partners. For tax year ended Apr. 30, 2005, the law firm's only partners were the three attorneys.

For tax year ended Apr. 30, 2004, the three attorney partners each had a one-third capital interest and a 30-percent profits and loss interest in the law firm. The S corporation had a 10-

THE SELF-EMPLOYMENT TAX DISPARITY

Provided that an S corporation pays reasonable compensation to its shareholder-employees, a shareholder-employee's pro-rata share of the S corporation's income is not subject to self-employment tax.[22] Thus, although the shareholder-employee is subject to employment taxes on compensation, other distributions and the shareholder's pro-rata share of the corporation's income are not subject to self-employment tax. In contrast, a general partner's allocable share of the partnership's income is subject to self-employment tax along with any guaranteed payments (i.e., payments made for services rendered by the partner to the partnership).[23]

Traditionally, under IRC § 1402(a)(13), a limited partner's allocable share of the partnership's income was not subject to self-employment tax though any guaranteed payments received by the partner were.[24] As discussed below, the U.S. Tax Court's decision in *Renkemeyer* overturns this distinction in certain cases. The self-employment tax consequences of membership in an LLC taxed as a partnership are less clear, although many commentators suggest that non-manager members, like limited partners, are not subject to self-employment taxes on their allocable share of the LLC's income, while manager-members may be treated more like general partners.[25] *Renkemeyer* likely impacts this distinction as well in the case of active members.

For obvious reasons, the self-employment tax disparity has long favored S corporations as the entity of choice for self-employment tax purposes. The 2013 imposition of the 0.9% AMCT on earned income only serves to broaden the gap.

THE RENKEMEYER DECISION

In *Renkemeyer*, the U.S. Tax Court held that IRC § 1402(a)(13), which generally provides that a limited partner's allocable share of the partnership's income is exempt from self-employment tax, does not apply to limited partners who actively provide services to the partnership.[26] According to the U.S. Tax Court, the legislative history of IRC § 1402(a)(13) indicates that *only* income of an investment nature was intended to be excluded from a limited partner's self-employment income.[27] As a result, the court concluded that self-employment income includes a limited partner's allocable share of partnership income in cases in which the partner performs services for the partnership (i.e., acts in the manner of a self-employed person).[28]

Renkemeyer involved a law firm organized as a limited liability partnership in Kansas.[29] Each of the firm's lawyers owned a limited partnership interest in the firm and provided legal services to the partnership that generated the firm's business income.[30] Although the law firm reported the business revenues from its practice on its partnership income tax return, no portion of those revenues were treated as self-employment income by the firm's partners.[31] As a result of the U.S. Tax Court's decision, all of the firm's revenues were subject to self-employment tax.

Assuming that *Renkemeyer* is upheld on appeal, the self-employment tax landscape for limited partners who provide services to the partnership will change significantly. Although *Renkemeyer* dealt only with a Kansas limited liability partnership, most commentators concur that, if upheld, *Renkemeyer* also will be extended by the IRS to service provider members of LLCs.[32] When coupled with the new AMCT, the result is a marked increase in the taxes owed by active limited partners and, likely, active LLC members and a new reason to favor using S corporations in these cases.

As an illustration, the following table (*see top of pp. 20*) summarizes the various taxes imposed on the income received by an active, service-provider owner of a partnership,

The Active Owner Post *Renkemeyer*

INCOME ITEM	TYPE OF PASS-THROUGH ENTITY OWNER			
	S SHAREHOLDER	LLC MEMBER	LIMITED PARTNER	GENERAL PARTNER
Compensation or Guaranteed Payment	E + 0.9% AMCT	SE + 0.9% AMCT	SE + 0.9% AMCT	SE + 0.9% AMCT
Entity Distributions (In Excess of Basis)	3.8% NII	3.8% NII	3.8% NII	3.8% NII
Allocable Share of Entity Non-Investment Income[33]	N/A	SE + 0.9% AMCT (Perhaps)	SE + 0.9% AMCT	SE + 0.9% AMCT

LLC, and S corporation in 2013. For purposes of the chart, "E" denotes the 7.65% combined employee-side federal employment tax rate and "SE" denotes the combined 15.3% self-employment tax rate.

As shown above, the use of an S corporation eliminates the imposition of self-employment tax and AMCT on an active shareholder's pro-rata share of the S corporation's income, provided that the compensation subject to employment tax in box 1 is "reasonable." The same benefit does not apply to limited partners, general partners, and likely LLC members if *Renkemeyer* is extended with respect to those owner's allocable share of the entity's income.

In contrast, as illustrated by the table below, in cases involving a passive owner who does not provide services to the entity, the use of an S corporation is tax neutral for self-employment tax and AMCT purposes. The chart below assumes that the investment in the entity is a "passive activity" with respect to each type of owner under IRC § 469.

In sum, the AMCT and NII surtaxes though small must be considered in business and investment decisions in 2013 and future years. These new taxes augment the benefit of using an S corporation in cases involving active, service-oriented owners due to the fact that self-employment taxes, including AMCT, can be avoided. abl

The Passive Owner Post *Renkemeyer*

INCOME ITEM	TYPE OF PASS-THROUGH ENTITY OWNER			
	S SHAREHOLDER	LLC MEMBER	LIMITED PARTNER	GENERAL PARTNER
Compensation or Guaranteed Payment	N/A	N/A	N/A	N/A
Entity Distributions (In Excess of Basis)	3.8% NII	3.8% NII	3.8% NII	3.8% NII
Allocable Share of Entity Non-Investment Income[34]	3.8% NII	3.8% NII	3.8% NII	3.8% NII

ENDNOTES

1. *National Federation of Independent Business (NFIB) v. Sebelius*, 2012-2 U.S.T.C. ¶50,573.
2. The term S corporation should be considered to include any eligible busines entity described in 26 CFR Ch. 1 § 330.7701-2(b) (1), (3), (4), (5), (6), (7) or (8) that elects to be treated as an S-corporation under § 301.7701-3 including, without limitation, limited liability companies
3. The term limited liability company should be considered to include only those LLCs that choose not to be treated as S elected entities under the Code.
4. *See generally* IRC § 3101 (tax on employees). Employers also pay Social Security tax at a rate of 6.2% on the first $113,700 of wages paid to each employee in 2013 and Medicare tax at a rate of 1.45%. However, as noted below, employers are not liable for AMCT.
5. *See generally* IRC § 1401 (self-employment tax).
6. Proposed Treasury Regulation ("*Prop. Treas. Reg.*") § 31.3101-2(b)(2).
7. Prop. Treas. Reg. § 31.3102-4(a).
8. *Id.*
9. Prop. Treas. Reg. § 31.3102-4(b).
10. Prop. Treas. Reg. §§ 1.401-1(b) and 1.1401-1(d).
11. Prop. Treas. Reg. § 1.1401-1(d)(2)(ii).
12. IRC § 1411(a) and (b).
13. IRC § 1411(d).
14. IRC § 1411(c)(1) and (2).
15. Prop. Treas. Reg. §§ 1.1441-1(b) and (d)(3)(ii). Prop. Treas. Reg. § 1.1411-4(b)(2). If items of NII pass-through to a partner or S corporation shareholder, the pass-through entity must separately report those items on Schedule K-1.
16. *Id.* In the case of a rental activity, the activity is generally characterized as passive unless the owner is a real estate professional who materially participates in the rental activity.
17. Prop. Treas. Reg. § 1.1411-4(b)(3), Example 3.
18. Prop. Treas. Reg. § 1.1411-4(b)(2).
19. IRC § 1411(c)(1).
20. Prop. Treas. Reg. § 1.1411-14(f)(1)(ii).
21. Prop. Treas. Reg. §§ 1.1411-4(f), (3)(i) and (3)(ii).
22. Rev. Rul. 59-291, 1959-1 C.B. 255, and *Ding v. Comm'r*, 200 F.3d 587 (9th Cir. 1999).
23. IRC § 1402(a).
24. IRC § 1402(a)(13) provides that self-employment income excludes "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership …."
25. *See, e.g.*, Donald Cunningham and Paul Erickson, *Self-Employment Taxes and the Entity Choice Decision for Owners of Closely Held Firms, Business Entities* (WG&L), Jul/Aug 2004.
26. 136 T.C. at 150.
27. Id.
28. Id.
29. Id. at 138.
30. Id.
31. Id. at 140.
32. *See, e.g.*, W. Eugene Seago, Kenneth N. Orbach, and Edward J. Schnee, *Working With the Unearned Income Medicare Tax*, Journal of Taxation, Mar. 2103.
33. Note that items characterized as investment income at the entity level will retain that character at the owner level and will be subject to the 3.8% NII if the owner's income exceeds the applicable threshold.
34. Since each type of owner is assumed to be "passive" with respect to the entity, the trade or business income of the entity becomes category two investment income at the owner level for NII purposes.

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save the date: thursday, june 12, 2014 (8:45am–5:15pm)

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Thursday, June 12
8:45 a.m. – 5:15 p.m.

Legal Project Management

Constrained by decreasing revenues and profits in the recent "Great Recession," corporate America and its in house legal departments had to do "more with less." They learned that in "The New Normal" it's now a buyer's market for legal services, and they increasingly ***demand*** that their outside counsel abandon the entrenched, historic, "cost-plus," "billable hour" pricing model in favor of **"Alternative Fee Arrangements" (AFAs)** and other **value-billing** approaches in complex litigation and transaction matters. This has shifted the risk of loss arising from poor matter management to law firms, which historically passed those risks on to their clients via the billable hour pricing model. When lawyers and law firms, unaccustomed to the risks of AFAs, started to accept such engagements, they quickly realized that unless they ran their legal matters like professional projects, they would be unprofitable and fail to meet increased client expectations. Thus, the rapidly emerging field of **Legal Project Management (LPM)** was born.

Using a simple hypothetical transaction for the purchase of a business (and related litigation), the panelists, leading experts in LPM, will show you how LPM helps you to successfully plan, price and manage litigation and transaction matters and define, coordinate and organize the various tasks, resources, people and deliverables needed to do so.

Topics include:

- What is LPM?
- Why is LPM just now seemingly emerging in a hundred-year-old profession?
- How does LPM aid and assist the practice of law and the delivery of legal services?
- What do clients think about or expect from LPM?
- What are the challenges and obstacles that law firms face in embracing LPM?
- How does a law firm embrace and integrate LPM into its firm culture and practice areas?
- What resources are available to assist lawyers and law firms in embracing LPM?
- What, exactly, does LPM look like in practice, and how does it differ from normal, current legal "matter management" practices?

Presented by: Business Law Section

Chair: Mark E. Lassiter, The Lassiter Law Firm

Faculty: Byron S. Kalogerou, McDermott Will & Emery LLP
Mark E. Lassiter
Aileen Leventon, QLex Consulting Inc.
Denise Skingle, Nationwide Insurance, VP, Associate General Counsel

6 CLE Ethics Credit Hours

THE STATE BAR OF ARIZONA BUSINESS LAW SECTION

is sponsoring a seminar at this year's State Bar of Arizona Annual Convention. The seminar is entitled, ***Legal Project Management.*** The full day session will provide guidance and insight on managing litigation and transaction matters. Please join our panel of experts for this informational seminar. 6 CLE Ethics Credit hours are available,

click on the cover for more information

CALL FOR PARTICIPATION

The Publications Committee for *The Arizona Business Lawyer* is soliciting articles and essays for future issues. For more information about submissions, or if you would like to serve on the Publications Committee, please contact Articles Editor Ryan B. Opel at ryan.opel@gknet.com.

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