

# Tax Talk

*A quarterly publication of Bridges & Dunn-Rankin, LLP*

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Dear Clients and Friends,

Summer time. Backyard barbecues, Braves games, swimming, Friday afternoon golf, summer vacation, and, supposedly, a slower time for CPA firms. While admittedly, we don't have the deadline pressure right now of April 15, September 15 or October 15, we are quite busy with extended tax returns, financial statements, structuring transactions, handling IRS and DOR matters, and doing ongoing planning for our clients.

Shortly after the last issue of our newsletter, healthcare legislation was enacted which included significant tax provisions taking effect at various dates over the next few years. We covered those provisions in an e-mail which went out to you in late March, so we won't repeat them here. There has been no major Federal tax legislation enacted since then, but there is significant tax legislation working its way through Congress as this newsletter goes to print; including provisions which would significantly increase the tax on "carried interests" and provisions which would

subject S-corp K-1 income to self-employment tax.

In this issue we will review potential tax legislation on the horizon and recently enacted Georgia tax legislation exempting retirement income, discuss structuring M&A transactions, and consider the growing Federal deficit and why tax increases may not be sufficient to cure the deficit.

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

*Kent Bridges*



Kent Bridges,  
Managing Partner

**Tax Legislation on the Horizon**

Legislation currently working its way through Congress would extend expired favorable tax provisions like the R&D tax credit, the new markets tax credit, 15-year depreciation for qualified leasehold improvements, 50% bonus depreciation, the itemized deduction for sales tax, and the deduction for qualified tuition. It would also increase the exclusion from taxable income for gain on the sale of qualified small business stock held at least 5 years, increase the immediate write-off of start-up costs from \$5,000 to \$20,000, and extend to September 30 the date for closing on homes under contract by April 30 to qualify for the homebuyers tax credit. However, such legislation also includes provisions which could be very costly for service-provider partners in investment partnerships and LLCs and for shareholders in certain S corporations. Below is a synopsis of these two potential revenue-raising provisions.

*"Carried interests"* – Venture capital funds, hedge funds, private equity funds, oil & gas deals, and real estate ventures are typically structured as partnerships or limited liability companies (which are taxed like partnerships), and increasingly operating companies are structured as LLCs as well. The managers of these partnerships often receive a share of the profits (or future appreciation of the entity) disproportionate to their share of the contributed capital. This so-called "carried interest" is designed to closely align their interests with that of the investors and motivate

them to increase the value of the investments.

Under partnership tax law, a service provider receiving an interest in a partnership is generally only subject to tax on the receipt of the ownership interest to the extent it is a "capital interest", meaning the amount that the partner would receive in excess of his investment if the partnership immediately sold all of its assets for their fair market value and liquidated. "Future profits interests," on the other hand, are generally not subject to tax until such profits or gains are actually realized, and then often at the more favorable long-term capital gains rate.

Following regular news reports of private equity fund and hedge fund managers reaping hundreds of millions of dollars in compensation taxed mostly as long-term capital gains, legislation was proposed in Congress in 2007 to tax such "carried interests" as ordinary income. Such proposed legislation met with stiff opposition, and was never enacted. Now, however, the House of Representatives has passed legislation which would treat a significant portion of a service-provider partner's income from an "investment services partnership interest" (ISPI) as ordinary income (subject to ordinary income tax rates and self-employment tax), notwithstanding that its character might otherwise be capital gain or dividend income (eligible for more favorable tax treatment).

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Michael A. Sudduth, CPA

### Member in the Spotlight – Michael Sudduth

Michael Sudduth joined Bridges & Dunn-Rankin at the beginning of 2003 after a five year career with Arthur Andersen. While at Andersen, he served as a tax preparer and advisor to some of Atlanta's wealthiest families. Michael holds a Bachelor of Science degree (Magna Cum Laude) in Accounting and Finance from Berry College and a Master of Taxation degree from Georgia State University.

Michael did not have to travel far to find Bridges & Dunn-Rankin. He grew up in and still lives in nearby Smyrna. Outside of the office, Michael enjoys reading and spending time with family and friends. He is an active member of Peachtree Presbyterian Church.

Bridges & Dunn-Rankin is proud to have Michael Sudduth as a member of our firm.

### Tax Legislation on the Horizon – continued

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An “ISPI” is a partnership interest held by someone who provides management or advisory services with respect to securities, real estate, commodities, etc. For 2011, 50% of the income from an ISPI would be converted to ordinary income status. For 2012 and beyond, 75% of the income would be so converted. Any portion of the partnership interest which was received for money or property contributed (rather than for services provided) would not be subject to these rules.

This legislation is currently under consideration by the Senate, but has not yet been passed.

*S-corp income subject to self-employment tax* – Wages paid to a

### Georgia Increases Retirement Income Exclusion

Current Georgia law provides an exclusion from income taxation for retirement income up to a limit of \$35,000 per year for each individual age 62 or over. Income eligible for the exclusion includes interest, dividends, rents, royalties, capital gains, pensions and annuities, and up to \$4,000 of earned income.

Recent legislation expands this very favorable exclusion for those

### Structuring M&A Transactions

Thinking about selling your company? How you structure the transaction could have a significant impact on the after-tax amount you realize.

*Asset sale or stock sale* – As a general rule, buyers prefer asset deals and sellers prefer stock deals. From the buyer’s perspective, with an asset deal the buyer avoids taking on potentially unknown liability claims against the business and gets a “basis step-up” in the assets purchased (generally meaning that the buyer can begin writing off its purchase price for tax purposes over a period of 15 years or less, depending on the nature of the assets purchased). From the seller’s perspective, a stock sale is generally cleaner, usually results in more favorable tax treatment, and means that liabilities go with the business to the buyer. There are exceptions to this general rule of buyers preferring asset deals and sellers preferring stock deals (e.g. there may be valuable contracts which are unassignable), but even then the buyer will generally want a structure that results in the transaction being treated as an asset

shareholder of an S corporation are subject to FICA, but amounts reasonably classified as dividend distributions and profits retained in the company are not subject to FICA or self-employment tax. Accordingly, owners of S-corps have historically been able to manage their FICA tax burden, so long as they are paid a reasonable rate of compensation for their services.

Legislation just passed by the House, however, would subject to self-employment tax all K-1 income of shareholders of S-corps which are partners in professional service firms or where the principal asset of the business is the reputation and skill of three or fewer employees. This legislation, which is currently under consideration by the Senate, could result in a significant tax increase for S-corp shareholders.

who are at least 65 years of age as follows:

2012	\$ 65,000
2013	\$100,000
2014	\$150,000
2015	\$200,000
2016	Unlimited

deal for tax purposes (e.g. a “Section 338(h)(10) election”, as discussed below). Ultimately, the deal structure will most likely be dictated by the seller’s entity type; although this can have a direct impact on the deal price.

*C-corps* – If the selling entity is a C-corp, then the transaction will most likely have to be a stock sale. With a sale of assets by a C-corp, two levels of taxation result: one at the corporate level, and then a second level of tax at the shareholder level. And C-corps do not enjoy a lower rate on long-term capital gains like individuals do. Accordingly, assuming substantially appreciated assets, the total Federal and state tax bite on a sale of assets by a C-corp can be greater than 50% (versus Federal and state tax on a stock sale that would more likely be around 20%). For this reason, a C-corp seller will generally insist on a stock sale, but, as a result, may have to accept a lower price or a smaller pool of

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## Structuring M&A Transactions – continued

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potential suitors.

*S-corps* – When it comes time to sell the business, the S-corp has a great advantage over the C-corp. Similar to a C-corp, an S-corp can be sold in a stock transaction (including a tax-free stock-for-stock transaction as discussed further below). However, unlike with a C-corp, an S-corp can also sell appreciated assets and generally get a tax result similar to that of a stock transaction (i.e. one level of taxation at the favorable long-term capital gains rates that apply for individuals). Assuming the buyer prefers a transaction that is a stock sale for legal purposes but treated as an asset deal for tax purposes, the S-corp can also accommodate this by agreeing to a “Section 338(h)(10) election”, whereby tax law permits a stock transaction to be treated for tax purposes as an asset deal. While an asset deal and a stock deal generally have similar tax results for an S-corp, there can be differences between the two. For example, the S-corp may have ordinary income assets which it is selling (e.g. cash basis receivables, appreciated inventory, or fixed assets subject to depreciation recapture) or its shareholders might be resident in a state with a lower tax rate than that of the state(s) in which the S-corp operates. Also, if the S-corp has been an S-corp for less than 10 years and was at one time a C-corp, then consideration will have to be given to potential exposure to the “built-in gains tax” (corporate level tax which potentially applies to any gain which existed at date the S election was made).

*Limited liability companies (LLCs)* – LLCs enjoy the single level of tax benefit enjoyed by S-corps, while providing greater flexibility in terms of number and type of owners, equity structure, and allocations. Similar to the purchase of an S-corp, a buyer can generally get asset sale treatment for tax purposes, even if the transaction is structured legally as a purchase of LLC units.

Unlike an S-corp or a C-corp, however, an LLC generally cannot be merged tax-free with a corporate purchaser, and (because of look-through rules that apply to partnerships) the owners of an LLC generally cannot avoid having ordinary income with respect to cash basis receivables, appreciated inventory and depreciation recapture. An LLC can often be merged tax-free with another LLC.

*Nature of the consideration* – The nature of the consideration received in the sale can also have bearing on the resulting tax. If a significant portion of the consideration is in the form of buyer’s stock, then (assuming a C-corp or S-corp target) the stock may be received tax-free (assuming a properly structured tax-free reorganization transaction). Similarly, assuming an LLC seller and an LLC buyer, units of the LLC buyer may be received tax free. If a portion of the consideration is buyer’s note or earn-out, then the gain associated with that consideration can generally be deferred.

*Covenants not to compete and consulting arrangements* – The buyer will often insist on a covenant not to compete and a consulting agreement with key shareholders of the seller. Under current law, covenants not to compete generally receive the same tax treatment for the buyer as goodwill and going concern value (i.e. 15 year amortization for asset transaction), regardless of the length of the agreement. Amounts properly classified as payments for consulting services, however, can generally be deducted by the buyer over the period to which the services relate. For the seller, amounts allocated to covenant not to compete or consulting agreement result in ordinary income (and also self-employment tax for consulting services). Accordingly, the seller will generally prefer to maximize the allocation to stock proceeds (generally taxed as long-term capital gain) and minimize the allocation to covenant not to compete and consulting agreement.

## Client in the Spotlight – Paragon Legal Technology Support

Complex litigation cases can involve hundreds of thousands of documents (physical and electronic) that must be reviewed, copied or scanned, organized, preserved and presented in a manner that is admissible in court. So where do attorneys turn for assistance in managing this process? The smart ones often turn to Paragon Legal Technology Support.

Under the leadership of principals Paul Cowley and Marc Muzi, Atlanta-based Paragon assists law firms and corporate legal departments with digital evidence collection and preservation, discovery plan development, forensic imaging, keyword searching and presentation of results, file listings, and password recovery,

using secure chain-of-custody methodologies to ensure admissibility in court. In its mission to assist the legal industry in a transition from hard document productions to electronic, the company also provides Continuing Legal Education (CLE) courses on electronic discovery. Paragon can assist customers nationwide, and works with premiere law firms such as Alston & Bird and Bondurant Mixson & Elmore.

Bridges & Dunn-Rankin is proud to be associated with Paragon Legal Technology Support.



## Our Federal Deficit and Why Tax Increases May Not Cure It

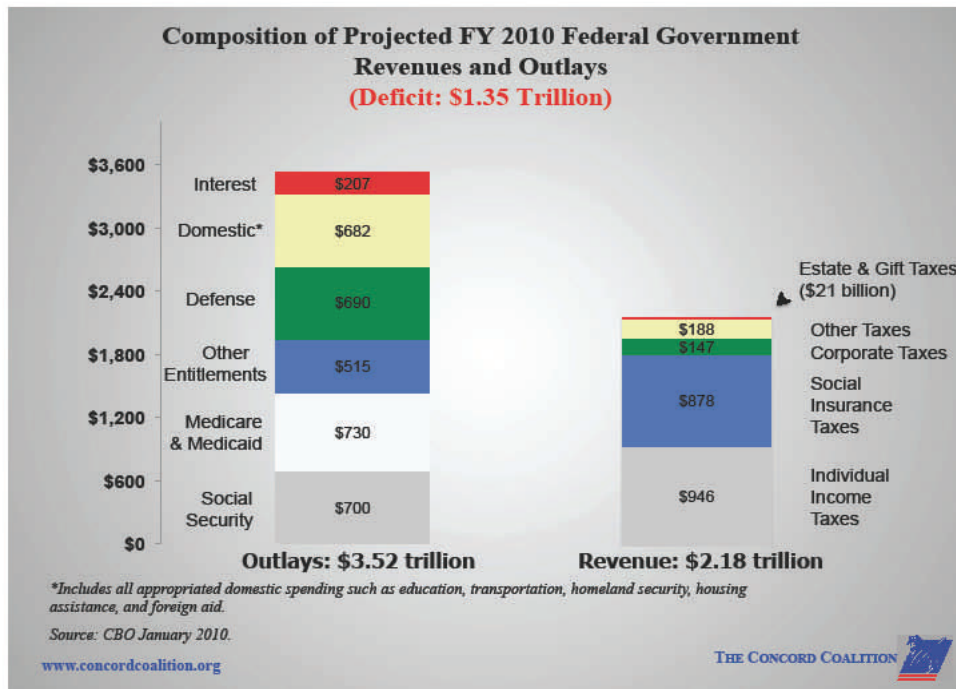
The general consensus amongst our clients seems to be that tax rates are going to rise in the U.S. and will likely be high for quite some

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## Our Federal Deficit and Why Tax Increases May Not Cure It – continued

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time to come. Given the current deficit, that outlook is not surprising. Our client, Doug Cox, recently sent us the chart below.



Doug, a former CFO of ITC Holding Company and former audit partner with Arthur Andersen, is now retired and volunteers his time on behalf of The Concord Coalition, speaking to groups about the causes and consequences of federal budget deficits, the long-term challenges facing America's unsustainable entitlement programs, and how to build a sound foundation for economic growth. As Doug points out, and as you can see from the graph above, we could double individual income taxes and still run a \$400 billion deficit. Further, it is questionable as to whether increasing tax rates actually increases tax revenues.

A recent Wall Street Journal article points out that when the maximum Federal individual tax rate fell to 28% in 1988 – 1990 from 50% in 1986 that individual income tax receipts rose to 8.3%

of GDP in 1989 versus 7.9% in 1986. The top tax rate rose to 31% in 1991 and revenue from individual income taxes fell to 7.6% of GDP in 1992. The top tax rate was increased to 39.6% in 1993, yet individual income tax was only 7.8% of GDP in 1993, 8.1% in 1994, and did not get back to the 1989 level until 1995. When tax rates increase, taxpayers tend to reduce their taxable income (e.g. they shift their investments to tax-favored investments or vehicles, defer recognition of gains, work less, etc.). This is particularly true of the higher-income taxpayers at whom most of the new taxes and higher rates are aimed. Some economists estimate that the “elasticity of taxable income” ratio for high-income taxpayers may be greater than 1; meaning that an increase in marginal rates may actually result in a decline in taxes collected.

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#### Your Referrals Are Appreciated

We are sometimes asked whether we are accepting new clients. The answer is yes. We have been very blessed over the years, and always seem to have plenty to do. However, due to natural attrition (e.g. clients selling their business) and the need to provide growth opportunities for our employees, we must always be on the lookout for new clients. Our new business comes almost exclusively from referrals, and so we greatly appreciate your referrals.

Bridges & Dunn-Rankin, LLP is an Atlanta-based full-service accounting firm serving clients in the technology, real estate, services, manufacturing, distribution, construction and healthcare industries, as well as high net worth families.

*The information provided in this newsletter is presented for educational and informational purposes only, and is not intended to constitute legal, tax or accounting advice. The articles provide only a very general summary of complex rules. For advice on how these rules may apply to your specific situation, contact a professional tax advisor.*