

Morgan Lewis

# TECHNOLOGY MARATHON

## Tax Implications for Fintechs

Sarah-Jane Morin, Barton Bassett, Daniel F. Carmody, Cosimo  
A. Zavaglia, and Kendall J. Keshtar

**Monday, May 22, 2023** | 12:30-1:30 pm ET

# Presenters



**Sarah-Jane Morin**



**Barton W.S. Bassett**



**Daniel F. Carmody**



**Cosimo A. Zayaglia**



**Kendall J. Keshtkar**

**Morgan Lewis**

# Agenda

- Formation considerations
- Code section 1202 (qualified small business stock) considerations
- Offshore tax considerations
- State and local tax considerations

# FORMATION CONSIDERATIONS

**Presenters:** Sarah-Jane Morin and Kendall Keshtkar

# What Type Should I Choose?

- Liability Protection
- Administrative Burdens
- Sophistication
- Investment Exit
- Common Interests
- Management
- Taxation

# What Types Are Available?

- Individual proprietorships
- Business entities (non-natural person individuals) under state law:
  - general partnerships (GPs)
  - limited partnerships (LPs)
  - limited liability companies (LLCs)
  - limited liability limited partnerships (LLLPs)
- Business entities under federal law:
  - corporations
  - partnerships
  - S corporations
- State and local tax laws, depending on the particular jurisdiction, do not always follow the federal tax rules.

# What Types Are Available? (cont.)

	Individual/Sole Proprietorship	C Corporation	S Corporation	LLC/Partnership
Number of Owners for Tax Purposes	1	1 or more stockholders	1 to 100 stockholders	1 or more members
Types of Owners for Tax Purposes	Individual	No restriction	Limited to certain types	No restriction
Tax Treatment	Disregarded	Opaque	Flow-through, if meets requirements, though allocations must be pro-rata	By default, flow-through, either disregarded if wholly owned or partnership if multi-member.  May elect to be treated as opaque

# Sole Proprietorships: Individual Taxation

- An individual's rate of tax depends upon whether the relevant income is ordinary or capital in nature.
  - Ordinary income
  - Capital gains
- Losses can generally offset income
- Excess business loss (EBL) limitation



# LLCs

- An LLC is a state-law entity concept that has no direct entity analogue under the federal tax rules.
- “Check-the-box” rules

	Default Classification	With "Check-the-Box" Election
Single Member LLC	Disregarded Entity	Corporation
Multiple Member LLC	Partnership	Corporation

# C Corporations: Double Tax

- C corporation earnings are subject to two levels of taxation:
  - The corporation
  - The shareholder individuals
- Certain corporate losses can be carried forward indefinitely, but may be used only against 80% of taxable income.
- In the aggregate, due to the double tax, the corporate rate may be slightly over the maximum individual rate, though this is fact dependent.
- Corporate Alternative Minimum Tax (CAMT)

# Partnerships: Single Level of Tax

- Partnerships are not subject to tax.
- Treated as flow through entities.
- Partners pay tax on the partnership earnings regardless of whether (or not) earnings are distributed to the partners.
  - Potential issues
- Certain determinations are made at the partnership level.

# Disregarded Entity: Non-Corporation Entities with a Single Owner

- Issues regarding how developed a single member entity should be treated.
- Single-owner, non-corporate state law entities are ignored.
- A common example of a disregarded entity is a single-member LLC that does not elect to be classified as a corporation.

# S Corporations: Half Partnership/Half Corporation

- S corporations generally are not taxed on their earnings: income and losses pass through to the shareholders.
- S corporations are still tax “people” so non-cash distributions are taxed.
- A corporation must satisfy a host of requirements to be an S corporation on an **ongoing basis**:
  - It must not be an “ineligible corporation.”
  - It must not have more than 100 shareholders.
  - All shareholders must be eligible to hold S corporation stock.
  - It must have a single class of stock.
- Tax consequences are **severe** if eligibility is lost.

# **CODE SECTION 1202 QUALIFIED SMALL BUSINESS STOCK**

**Presenter:** Dan Carmody

# QSBS Overview

- Section 1202 of the Internal Revenue Code provides for the exclusion of some or all of the gain if QSBS is sold after a five-year holding period.
- There are four primary requirements to satisfy in order to receive the exclusion under Section 1202
  - Five-Year Holding Period
  - Stock of a C-Corp Acquired at “Original Issuance”
  - Qualified Small Business Requirement
  - Active Business Requirement

# Amount of Gain Subject to Exclusion

- Section 1202(a)(1):** Generally provides an exclusion for **50% of eligible gain** from the sale or exchange of QSBS held for more than 5 years.
- Section 1202(a)(3):** Increases the exclusion to **75%** for QSBS issued after February 17, 2009 and before September 28, 2010.
- Section 1202(a)(3):** Increases the exclusion to **100%** for QSBS issued after September 27, 2010 (together with a 100% exclusion from the alternative minimum tax under Section 57(a)(7)).
- Excluded gains are also not subject to the 3.8% “Medicare” tax on net investment income under Section 1411.



# Limitation on “Eligible Gain”

**Section 1202(b)(1)** provides a per-issuer yearly limit on the amount of “eligible gain” to which the 1202(a) exclusion can apply equal to the greater of:

- (A) \$10 million, reduced by the aggregate amount of eligible gain previously taken into account by the taxpayer for prior taxable years as a result of the disposition of QSBS issued by the corporation in question; or
- (B) 10 times the aggregate adjusted “basis” of QSBS issued by the corporation in question and disposed of by the taxpayer during the taxable year.

**Basis:** If a taxpayer transfers property (other than money or stock) to a corporation in exchange for the stock of the corporation, for purposes of Section 1202, the basis of such stock in the hands of the taxpayer shall in no event be less than the FMV of the property exchanged therefor (Section 1202(i)(1)(B)).

# Qualified Small Business Requirement (§1202(d))

- Any domestic C corporation that satisfies two gross asset tests.
- Gross asset tests:
  - (1) “Aggregate gross assets” must not have exceeded \$50M at any time after 8/10/93 and before the issuance of the stock in question; and
  - (2) Immediately after the issuance of the stock in question, “aggregate gross assets” must continue to be no more than \$50M
- “Aggregate gross assets”
  - Means the amount of cash + aggregate adjusted bases of other property held by the corporation
    - Contributed property (and other property with basis determined, in whole or in part, by reference to basis of contributed property) is treated as having basis equal to FMV immediately after contribution.
  - In applying “immediately after the issuance” test, includes the amount received by the corporation in exchange for the stock in question

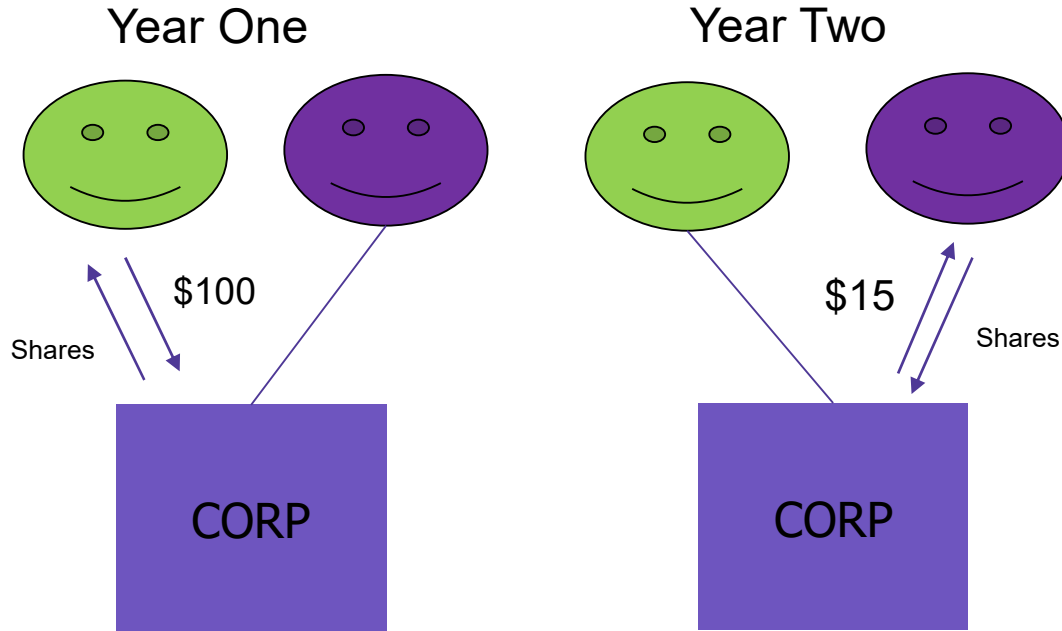
# Active Business Requirement (§1202(e))

- A corporation meets the active business requirement for any period if during that period:
  - The corporation is an “eligible corporation”, and
  - The corporation uses at least 80% of its assets, measured by value, in the active conduct of one or more “qualified trades or businesses”.
- “Qualified trades or businesses” is any trade or business *other than*:
  - any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
  - any banking, insurance, financing, leasing, investing, or similar business;
  - any farming business (including the business of raising or harvesting trees);
  - any business involving the production or extraction of products of a character with respect to which a deduction is allowable under §613 or §613A, and
  - any business of operating a hotel, motel, restaurant, or similar business
- Limited authorities as to what constitutes a qualified trade or business for purposes of Section 1202(e).

# Original Issuance of Stock – Restrictions on Redemptions

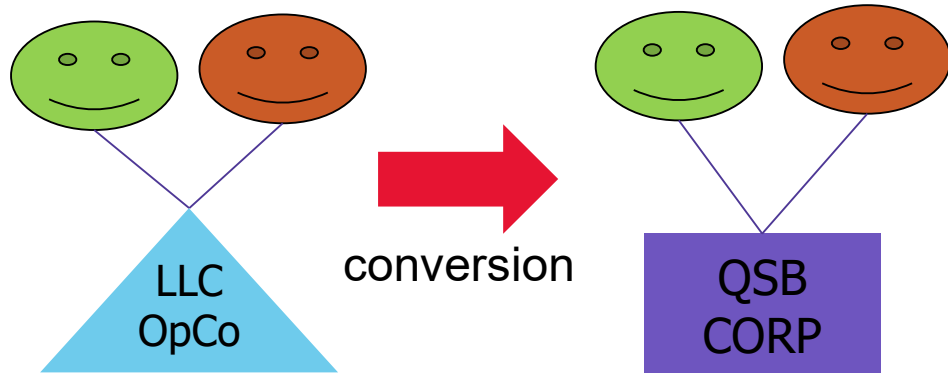
- Stock acquired by a taxpayer is not treated as QSBS if at any time during the 4-year period beginning on the date two years before the issuance of the stock, the corporation redeems (directly or indirectly) its stock from the taxpayer or a person related to the taxpayer
- Significant redemptions of the issuing corporation's stock may also disqualify stock as QSBS within a 2-year period beginning on the date one year before the issuance
- Exceptions:
  - *De minimis* redemptions
  - Redemptions triggered by a termination of the services of an employee or director
  - Redemptions triggered by death, disability or mental incompetence, or divorce

# Why the Concern with Redemptions?



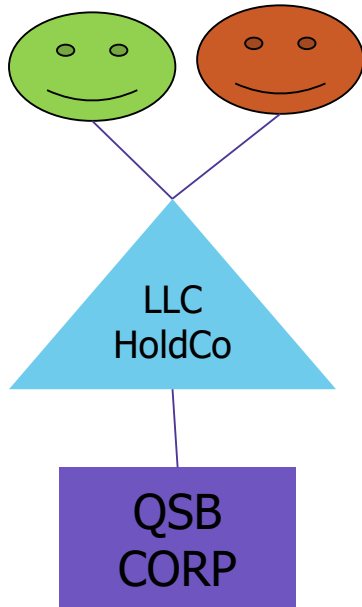
- Contributions/Redemptions may in substance represent a cross-purchase of shares
- Rule is overly broad and can taint issuances that do not have the substance of a cross-purchase
- Need for restrictive covenants?

# Partnership Incorporations



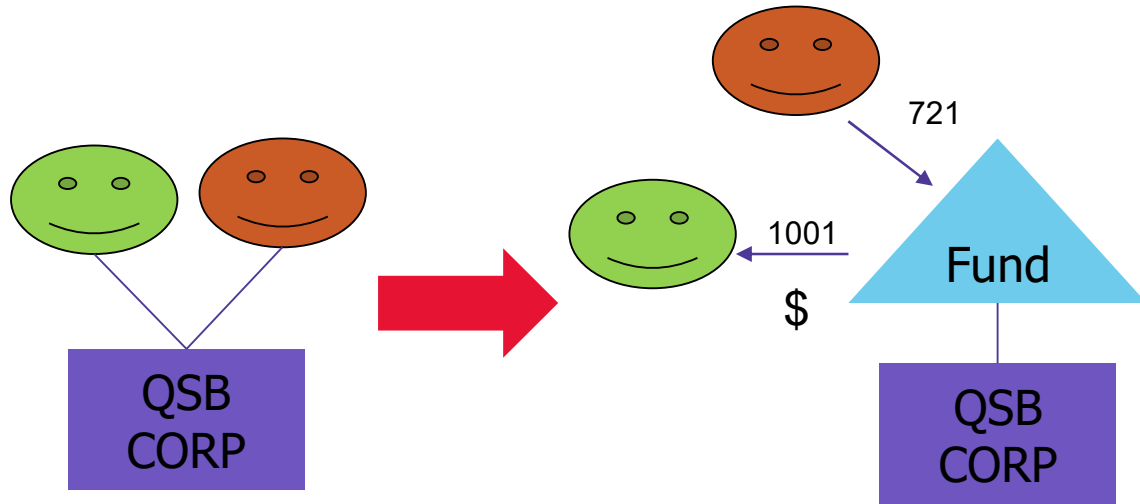
- If LLC OpCo converts to a state law corporation, LLC OpCo is deemed to: (1) contribute assets and liabilities to the new corporation, and then (2) LLC OpCo is deemed to distribute shares to historic members.
- Partnership distributions do not break the original issuance requirement.
- Orange and Green can now potentially apply 1202 on a future disposition, but current built-in gain will not be eligible for 1202 benefits

# QSBS Treatment on Stock Held by a Passthrough



- If LLC HoldCo sells QSBS, Members may be able to benefit from section 1202 exclusion
- LLC Holdco must meet five-year holding period
- Benefit is limited to Member’s “proportionate share” which is determined through reference to interest member held in the passthrough entity when stock was acquired.
- What is Green’s “proportionate share” if Orange holds a preferred equity interest in the LLC HoldCo?

# Danger of Rollover Transactions



- Even though Orange's rollover is a nonrecognition event, Orange has lost ability to use 1202 in the future
- Should Fund consider a corporate acquisition vehicle so that Orange could do a rollover that qualifies under section 351? See discussion below



# QSBS Takeaways

- Never contribute QSBS to a partnership.
- Consider QSBS implications before redeeming any shares.
- Impact of QSBS representations to potential investors.
- Rollovers can present QSBS issues.
- Valuation implications for contributed property.
- No guarantee of continued benefits.
- “Stacking” of benefits.

# OFFSHORE TAX CONSIDERATIONS

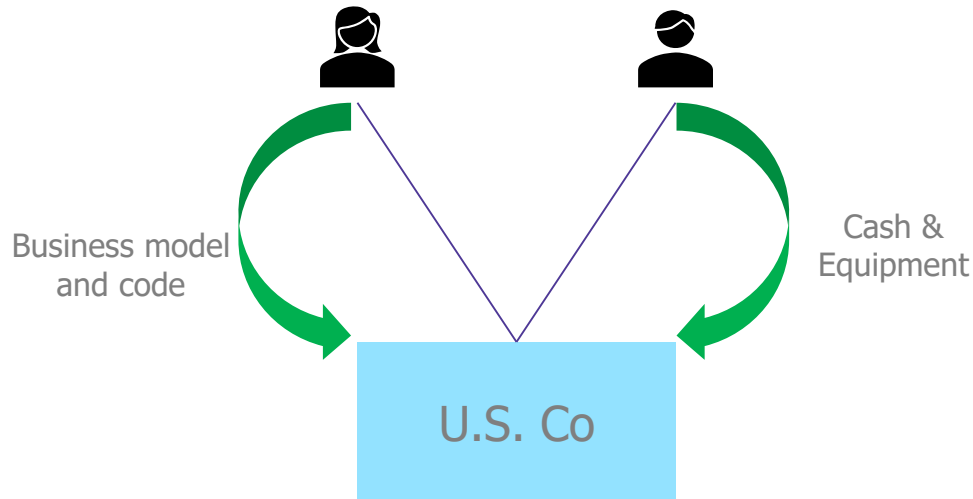
**Presenter:** Bart Bassett

# Common International Structuring Considerations

- Regulatory pressures in the U.S. and access to foreign investors frequently lead Fintechs to pursue “offshore” structures
- Cross-border structures raise a number\* of common tax considerations, including:
  - Cross-border transfers of “intangible property” – Sec. 367(d)
  - “Inversion” issues
  - U.S. anti-deferral considerations
  - Remote employees

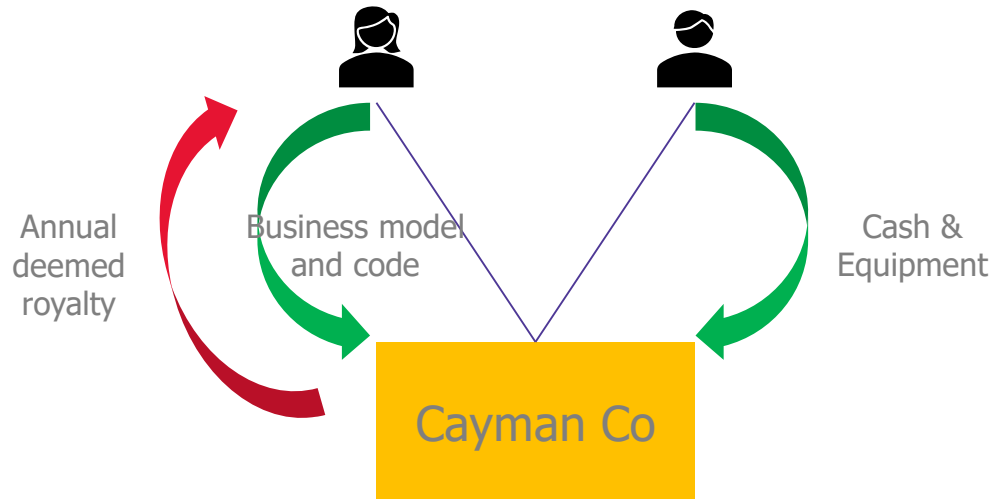
\*Not intended to be a comprehensive list

# Section 367(d) Considerations



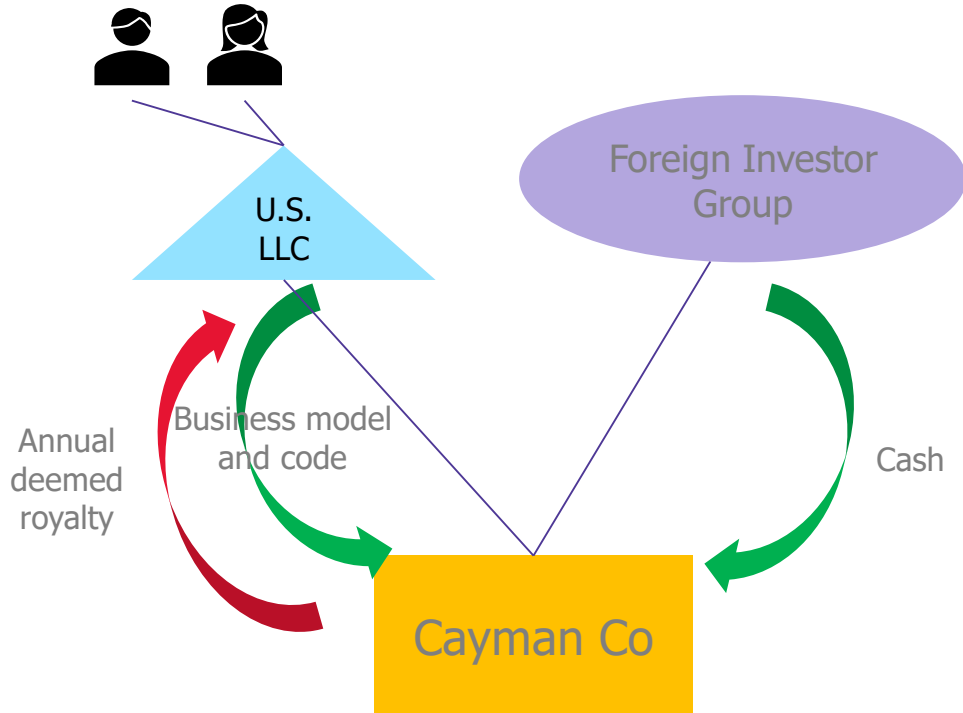
- The contribution of property in exchange stock in a domestic C-corporation, where the transferor(s) have “control” immediately after the exchange, is generally tax-free (no gain or loss recognized) for the transferor(s) pursuant to Sec. 351
- The corporation is not subject to tax on the issuance of its stock for money or property
- The exchange of stock for services (past or future) is generally taxable to the recipient as ordinary income

# Section 367(d) Considerations



- Section 367(d) causes the cross-border transfer of “intangible property” in exchange for stock of a foreign corporation to give rise to an annual deemed royalty for the transferor
- Royalty is characterized as ordinary income and is not limited to any ownership threshold
- Royalty continues until intangible property is subject to a disposition (directly or indirectly)

# Section 367(d) Considerations

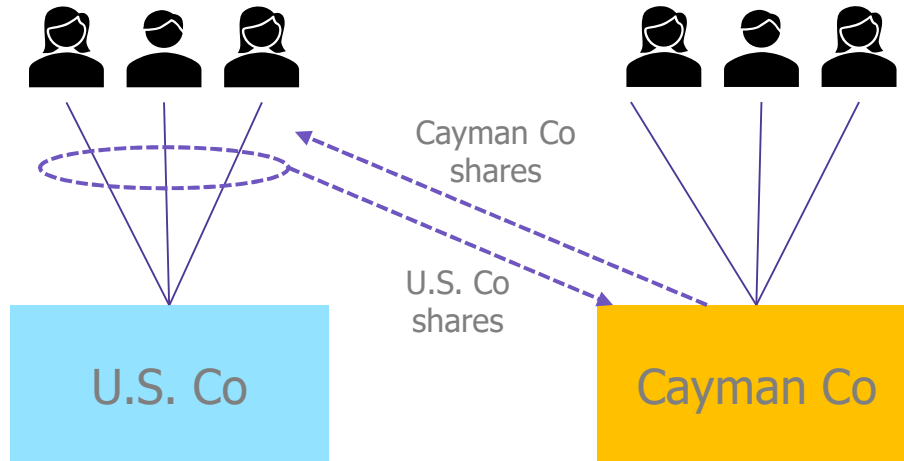


- Section 367(d) applies through partnerships – transfers by the partnership are attributed to the partners

## Section 367(d) Considerations

- Section 367(d) is not limited to transfers of intellectual property. Rather, applicable to any transfer of “intangible property”
- “Intangible Property” includes any:
  - Patent, invention, formula, process, design, pattern, or know-how,
  - Copyright, literary, musical, or artistic composition,
  - Trademark, trade name, or brand name,
  - Franchise, license, or contract,
  - Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data,
  - Goodwill, going concern value, or workforce in place, or
  - Other item the value or potential value of which is not attributable to tangible property or the services of any individual.

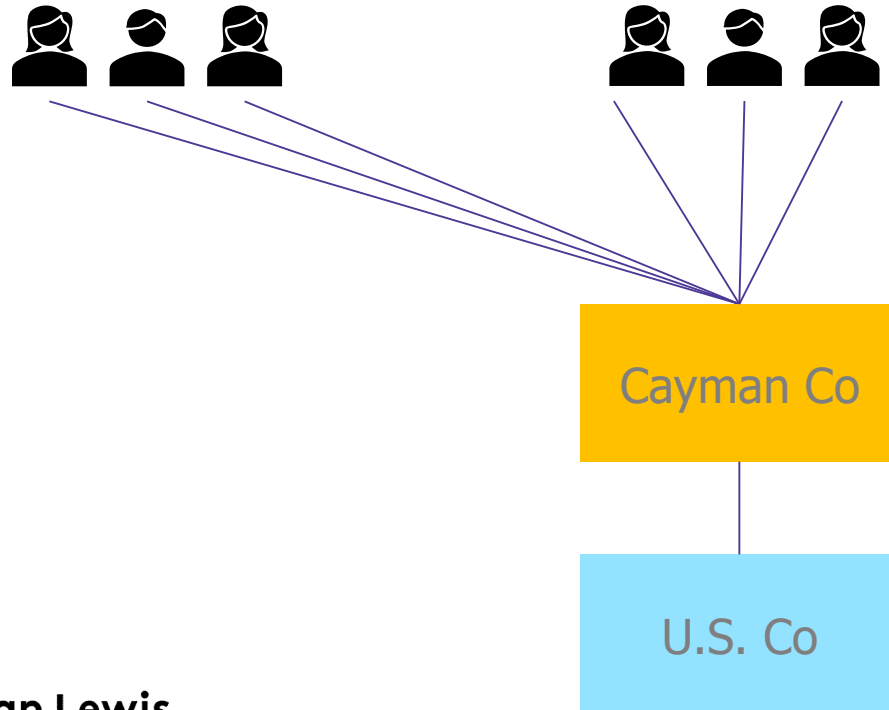
# Inversion Issues



- Acquisition of U.S. Co shares by new investor group
  - Perhaps introduction of additional cash investment or combination of two operating companies
- Potential to structure as a tax-free "reorganization" under general domestic provisions
- Cross-border acquiror introduces complexity under §§ 376 and 7874

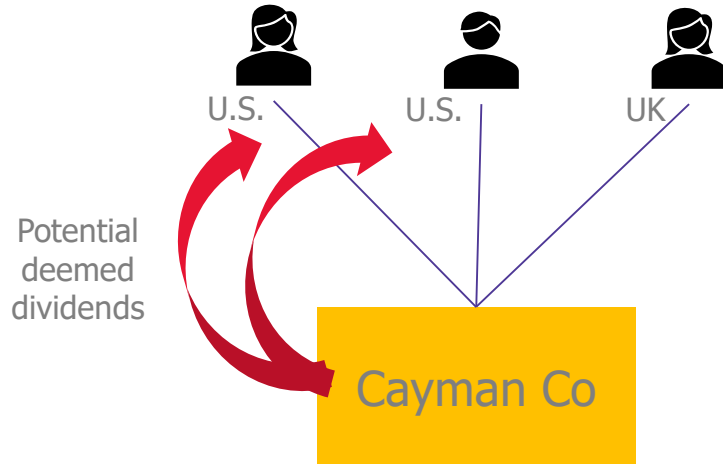


# Inversion Issues



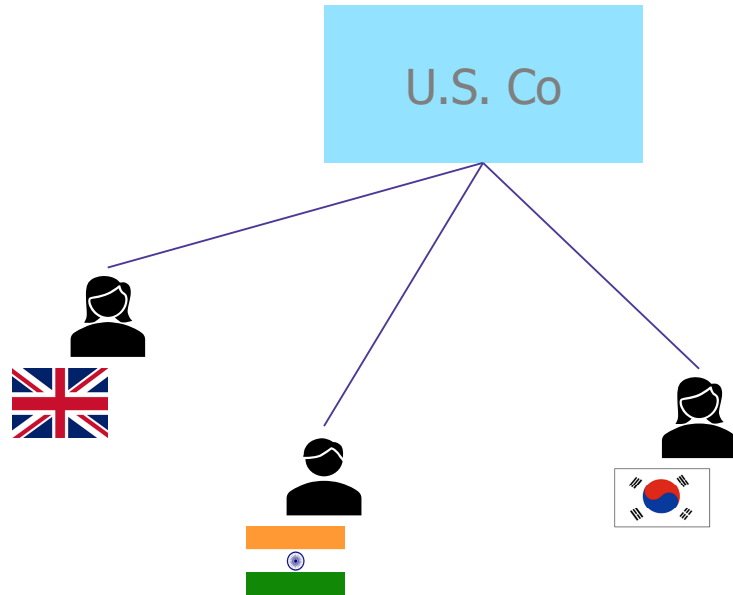
- The U.S. has two distinct sets of “anti-inversion” rules that may impact any transaction involving the introduction of a foreign owner
- Section 367 contains rules that may cause the stock-for-stock exchange to become taxable for the shareholders of U.S. Co
- Section 7874 may, depending on the collective ownership % of the ex-U.S. Co shareholders, cause the foreign acquisition corporation to be characterized as a U.S. corporation following the stock-for-stock exchange.

# U.S. Anti-Deferral Rules



- Subpart F
- Global Intangible Low Taxed Income ("GILTI")
- PFIC

# Remote Employees



- Does the presence of remote employees trigger a taxable presence for U.S. Co in the foreign jurisdiction?
- Are employee withholding taxes and/or social contributions triggered?
- Does U.S. Co need to register to do business in the foreign jurisdiction?
- Non-tax regulatory impacts?

# STATE AND LOCAL TAX CONSIDERATIONS

**Presenter:** Cosimo Zavaglia

# State and Local Tax Issues for Fintechs

- Considerations for State and Local Filing Requirements
- State Corporate Income Tax
- Other Corporate Taxes
- State Sales & Use Tax
- State Payroll Taxes
- Entity Level Taxes – Passthrough Entity Taxes

# Considerations for State and Local Tax Filing Requirements

- Potential tax filing requirements should be considered in states where the company has any of the following:
  - Owned or leased real or personal property
  - Employees, agents or independent contractors; or
  - Sales to customers located in the state

# Considerations for State and Local Tax Filing Requirements (cont.)

- Various state and local tax types
  - *e.g.*, corporate tax, gross receipts tax, franchise/capital tax, sales and use tax, payroll tax, Secretary of State registration, various local taxes
- Always raise state and local tax filing requirements as an issue when establishing an office, employees, or business registration in a new state
  - Also consider potential incentives

# State Corporate Income Tax

- Nexus
  - Physical presence
    - Employees or property
  - Economic Nexus
  - Potential income tax immunity from federal Public Law 86-272 where activity does not exceed solicitation of sales of tangible personal property
    - Online retailer issues
- Allocation and Apportionment
- Separate vs. Combined Reporting
- Treaty Conformity



## **Other Corporate Taxes**

- Gross Receipts Taxes
- Franchise/Capital Taxes
- Entity Level Taxes on Passthrough Entities
- Local Taxes

# State Sales & Use Tax

- Nexus
- Taxability & Sourcing
  - Tangible personal property
  - Services – trend towards expanded base
  - SaaS/Cloud computing companies
  - Digital products
- Exemptions

# State Payroll Taxes

- Withholding Tax
  - Executive compensation issues
    - Nonresident allocation
    - Change of residency
  - Employee vs. independent contractor
- State Disability Insurance
- State Unemployment Insurance
- Mobile/Telecommuting employees

## Entity Level Tax – Pass Through Entity Tax

- Numerous states have adopted pass through entity (“PTE”) tax elections.
  - Response to \$10,000 SALT cap under TCJA
- PTE can pay tax at entity level & deduct
- Partners/members entitled to tax credit against personal income tax
- Issue whether resident state of partner/member allows other state tax credit

# Ukraine Conflict Resources

Our lawyers have long been trusted advisers to clients navigating the complex and quickly changing global framework of international sanctions. Because companies must closely monitor evolving government guidance to understand what changes need to be made to their global operations to maintain business continuity, we offer a centralized portal to share our insights and analyses.

**Morgan Lewis**

To help keep you on top of developments as they unfold, visit the website at [www.morganlewis.com/topics/ukraine-conflict](http://www.morganlewis.com/topics/ukraine-conflict)

To receive a daily digest of all updates, please visit the resource page to **subscribe** using the "Stay Up to Date" button.



# Biography



**Sarah-Jane Morin**

San Francisco, CA

+1.415.442.1231

[sarah-jane.morin@morganlewis.com](mailto:sarah-jane.morin@morganlewis.com)

Sarah-Jane Morin's practice encompasses a variety of transactions with a focus on representation of public and private companies, private equity funds, venture capital funds, real estate funds, portfolio companies, and alternative investment vehicles in the tax aspects of complex business transactions and fund formations, including domestic and cross-border investment strategies, sponsor investment strategies, limited partner investment strategies, mergers, acquisitions, integrations, buyouts, recapitalizations, debt and equity restructurings, and ongoing operations and tax compliance issues.

# Biography



**Barton Bassett**

Silicon Valley, CA

+1.415.442.1268

[barton.bassett@morganlewis.com](mailto:barton.bassett@morganlewis.com)

Barton W. S. Bassett counsels Silicon Valley–based and global multinational technology companies on international tax planning for the outbound operations of US companies doing business abroad, and for the inbound operations of foreign companies seeking to do business within the United States. Barton advises clients on structuring mergers and acquisitions (M&A), internal restructurings and operations, joint ventures, external and internal financings, and transfer pricing matters, including the transfers and licenses of intangible property.

# Biography



Daniel F. Carmody counsels clients on tax matters involving domestic and international transactions. In particular, his practice focuses on structuring partnerships, limited liability companies, and Subchapter S corporations. He also represents clients in audits and appeals before the Internal Revenue Service.

## **Daniel Carmody**

Philadelphia, PA

+1.215.963.4821

[daniel.carmody@morganlewis.com](mailto:daniel.carmody@morganlewis.com)



# Biography



## **Cosimo Zavaglia**

New York, NY

+1.212.309.6646

cosimo.zavaglia@morganlewis.com

Cosimo A. Zavaglia advises corporations, partnerships, and individuals on state and local tax controversy, planning, and transactional matters. Cosimo routinely represents clients in high-stakes state and local tax audits, appeals, and litigations in matters throughout the United States, including defending clients in state False Claims Act cases and sales and use tax, individual residency, withholding tax, corporate income tax, and real estate transfer tax audits and disputes. He also advises clients on developing state and local tax planning strategies for corporate acquisitions, dispositions, restructurings, and mergers.

# Biography



## **Kendall Keshtkar**

San Francisco, CA

+1.202.000.0000

mary.lawyer@morganlewis.com

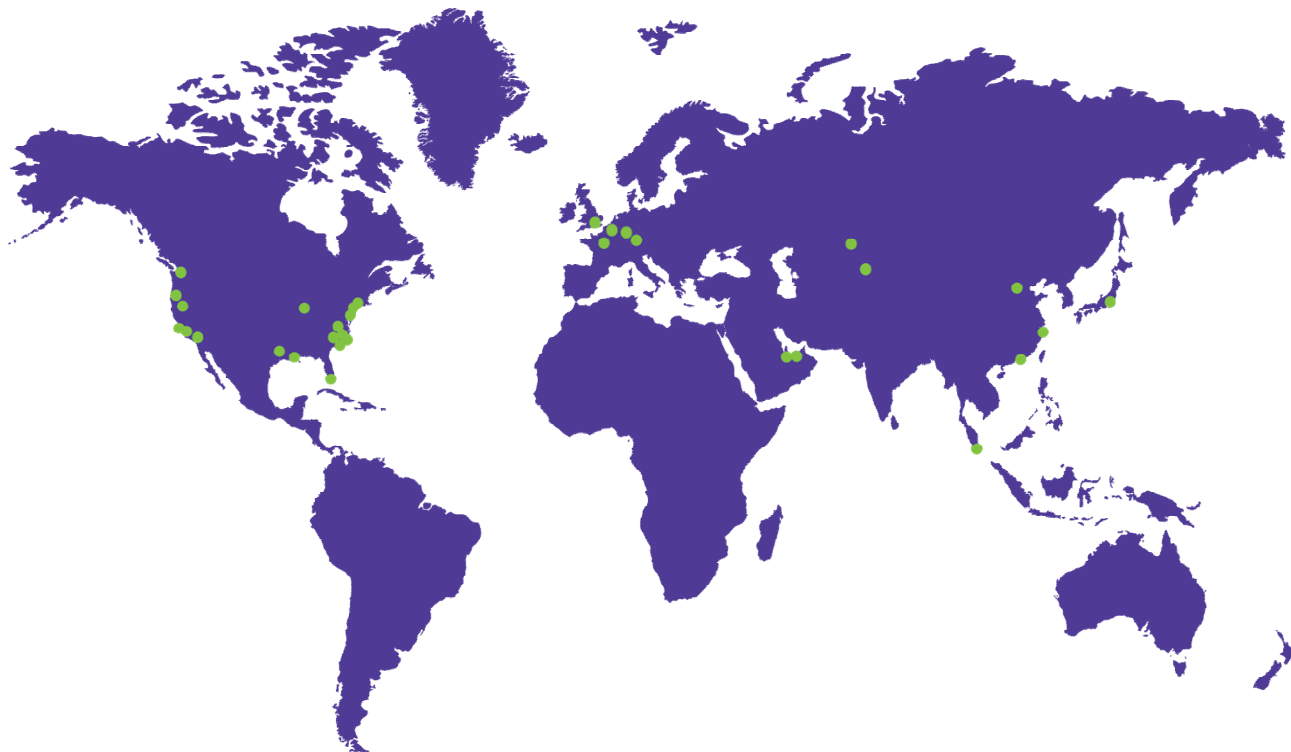
Kendall Keshtkar concentrates her practice on transactional tax matters. She advises on a wide range of domestic and international tax issues with a focus on partnerships and multinational corporations. During law school, Kendall interned at the California Franchise Tax Board, the Tax Appeals Assistance Program and a public accounting firm.

## Our Global Reach

Africa  
Asia Pacific  
Europe  
Latin America  
Middle East  
North America

## Our Locations

Abu Dhabi  
Almaty  
Astana  
Beijing  
Boston  
Brussels  
Century City  
Chicago  
Dallas  
Dubai  
Frankfurt  
Hartford  
Hong Kong  
Houston  
London  
Los Angeles  
Miami  
Munich  
New York  
Orange County  
Paris  
Philadelphia  
Pittsburgh  
Princeton  
San Francisco  
Seattle  
Shanghai  
Silicon Valley  
Singapore  
Tokyo  
Washington, DC  
Wilmington



**Morgan Lewis**

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP.  
In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong.

# THANK YOU

© 2023 Morgan Lewis

Morgan, Lewis & Bockius LLP, a Pennsylvania limited liability partnership

Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP.

In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.