Anchin
ACCOUNTANTS & ADVISORS

2023 Year-End Tax Planning Guide

Consumer Products Group

The Consumer Products Industry has been known to be stable and consistent, historically. With the challenges of COVID in the rear-view mirror, it is fair that founders and investors expected favorable tailwinds within the industry. However, a potential recession, supply chain issues, labor shortages, global conflicts, climate change, record inflation and ever-changing consumer behavior has required a significant reset. The days of exponential top-line growth being the foundation of success is no longer sound. Investors now demand healthy revenue channels, robust contribution margins and viable paths to profitability.

The considerations mentioned above have also influenced the complex analysis of year-end tax planning. Tax planning requires multi-year modeling to match the goals of the company and/or investors to the complexities of the Internal Revenue Code. This tax guide covers the most common considerations we are analyzing and working through with our Anchin clients. However, every company and investor's situation is unique. So, we urge you to meet with your tax advisors to provide you with a comprehensive review of tax saving strategies for your specific situation.

*If you would like to discuss any of the techniques or planning ideas covered within this guide, please contact **Brent T. Lessey, John Ingrassia, Raymond Haller, Richard Stieglitz**, or any member of Anchin's Consumer Products Group at your earliest convenience.*

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Table of Contents

Entity Selection

Selecting the appropriate business entity is a pivotal decision for entrepreneurs and business owners, laying the foundation for a company's structure, taxation, liability, and overall operational framework. The analysis is generally dependent upon many factors, such as business objectives, type of business, cash needs, and ease of obtaining new capital. The Tax Cuts and Jobs Act (TCJA) of 2017 included many changes that affected this analysis. One of the headline changes was the top C corporation tax rate "permanently" decreased from 35% to a flat 21%. Taxpayers should keep in mind that current tax proposals would raise tax rates and make other changes to the federal income tax system for corporations and high-net-worth individuals. These proposals should be monitored, and their potential effects should be considered when evaluating the short- and long-term benefits of a particular entity choice.

C Corporation: When choosing a C corporation as your business entity, several factors should influence your decision. A C corporation is often seen as an attractive option for a business looking to raise capital by selling stock to investors. It can issue different classes of stock, which can be appealing to potential investors. If you have plans to go public, seek venture capital investment, or eventually sell the business to a larger corporation, a C corporation structure can be more favorable. This is discussed in-depth in the qualified small business stock (QSBS) Tax Exemption section below.

Of course, one of the disadvantages of a C Corporation is double taxation where earnings are taxed at the corporate level and then again at the shareholder level upon the distribution of dividends. While the TCJA reduced the federal corporate rate from 35% to 21%, it did not change the tax rate on distributions from a corporation to its shareholders. Qualified dividends received by non-corporate taxpayers are still taxed at a maximum rate of 20% (plus an additional 3.8% for taxpayers subject to the net investment income tax). The combined effective federal tax rate for non-corporate shareholders on distributions classified as ordinary dividends from a C corporation can go up to 40.8%.

As a reminder, TCJA eliminated the carryback of net operating losses (NOLs) for individuals and corporations for tax years ending after December 31, 2017. Starting as of January 1, 2021, NOLs arising in tax year 2021 and beyond may be carried forward indefinitely but are not eligible for carryback. In addition, a NOL may not exceed 80% of taxable income computed without regarded to the NOL deduction.

Pass-Through Entity: Pass-through entities, such as partnerships, S corporations, and LLCs elected to be taxed as a pass-through entity, do not pay Federal income tax at the entity level. Instead, the income flows-through to the owners and is reported on their respective income tax returns. The TCJA also provided a rate reduction for non-corporate taxpayers on income from flow-through entities.

The TCJA reduced the top non-corporate tax rate on ordinary income from 39.6% to 37% while also providing a 20% deduction (via IRC Section 199A) for certain business income for non-corporate taxpayers that own flow-through entities. This 20% deduction reduces the effective federal tax rate on flow-through income from 37% to 29.6%. To the extent the owners of a flow-through entity have included these amounts as taxable income, the cash can generally be distributed from the flow-through entity without additional tax. There are various other factors that need to be weighed when planning for the 20% deduction, such as the limitation of the deduction, which is subject to 50% of the payroll expense. In addition, not all pass-through income is eligible for the 20% deduction; therefore, taxpayers should consult their tax advisors to verify, discuss and analyze the potential for utilizing the deduction.

Another factor to consider when choosing entities is the state Pass-Through Entity Tax (PTET) regime. The TCJA limited the state and local tax (SALT) deduction for individuals to $10,000, which increased federal income taxes for many individual owners. In response to the TCJA SALT cap issue, many states implemented a PTET workaround which essentially is an electable tax regime that permits pass-through entities to pay income tax to states at the entity level and pass these taxes through as a credit which partners and shareholders can claim on their personal state income tax returns. PTET regimes aim to provide relief to business owners affected by the SALT deduction limitation by allowing them to benefit from deductions at the entity level rather than at the individual level. However, each state has its own method for electing and paying the PTET. Please refer to PTET section below for more details.

Individual partners in a partnership may also be subject to self-employment taxes or the 3.8% net investment income tax, depending on how the partnership is structured (general partnership versus limited partnership) and on their involvement with the business. In addition, shareholders of S corporations who work in the business are required to pay themselves reasonable compensation, which is taxable at ordinary income rates. This compensation is not eligible for the 20% deduction for certain business income. An S corporation is responsible for paying half of the employment taxes, and the S corporation shareholder pays the other half. Accordingly, the effective rate of tax on income from a flow-through entity will depend on whether the income is subject to self-employment taxes, employment taxes or the net investment income tax.

Factors to Consider When Making the Decision

When modeling this out and comparing different effective tax rates, entity distributions should be considered. If a business plans to reinvest all of its after-tax proceeds and not make any distributions, a C corporation would likely provide a greater opportunity for growth because the after-tax proceeds (which are subject to federal tax at a 21% rate) generally are higher than those of a flow-through entity (assuming the flow-through entity makes distributions to enable its owners to pay taxes). Conversely, if a business plans to distribute all of its income, a flow-through entity likely is more tax efficient. However, unwinding a C corporation can be “tax” expensive so one needs to take into account what Congress may do in the future regarding tax rates when choosing an entity type.

Major issues can arise under various state and local tax and/or foreign country tax systems that would need to be factored into any choice of entity analysis. It is also important to note that a C corporation cannot avoid paying shareholder distributions (dividends) without having a reasonable business need to retain the cash. Otherwise, it risks becoming subject to a 20% Accumulated Earnings Tax. Such reasonableness of anticipated cash needs should be assessed based on the facts existing at the close of the tax year as the burden of proof rests with the taxpayer. As such, proper documentation is recommended.

Each entity offers a unique set of advantages and drawbacks. The decision-making should be driven by your specific business goals, risk tolerance, tax considerations, and long-term vision. As you weigh the options and navigate the complexities of entity selection, it's imperative to seek professional guidance to ensure that your business structure aligns with your growth objectives in mind.

Interest Deductibility

In 2017, Congress substantially revised the business interest deduction limitations rules of Internal Revenue Code (IRC) Section 163j to discourage businesses from excessive borrowing. These sweeping changes have spotlighted interest deductibility in the recent years. While there are several IRC sections that limit the deduction of interest, this article will be focused on the most relevant to the Consumer Products industry.

Section 163

Section 163a allows the deduction of "all interest paid or accrued within the taxable year of indebtedness." However, this general ability to deduct interest is subject to various restrictions depending on the type of interest at issue.

Convertible Debt Interest Expense

Convertible debt is a loan from an investor which under certain circumstances may be converted into company equity. It is a very popular and cost-effective vehicle for raising capital for several reasons. Convertible debt is simple, fast, understandable, well-established, offers operating flexibility, and delays valuation, which can be time-consuming and challenging. However, convertible debt presents potential tax pitfalls as its hybrid features of debt and equity offers much ambiguity. It has the legal form of debt at issuance, but its future conversion feature bears resemblance to equity in economic substance.

OBSERVATION: The debt or equity classification is fundamental in determining the tax consequences. If convertible debt is classified as debt for tax purposes, the question becomes the timing of interest expense by the issuer and interest income of the holder. If convertible debt is classified as a "disqualified debt instrument" under IRC Section 163L or equity, at the outset for tax purposes, the interest expense is disallowed as a deduction by the issuer and there is no corresponding interest income to the holder. While IRC Section 385 governs the debt versus. equity classification, there is little other statutory or administrative guidance. Thus, the classification relies mainly on the evaluation of case law. However, the lack of specific criterion to establish debt or equity, and lack of point system or hierarchical rating in case law, makes the analysis very difficult and proper tax treatment elusive. All these factors lead to a higher degree of professional interpretation and judgement in its tax treatment which can be a breeding ground for IRS scrutiny and result in tax exposure.

CAUTION: Convertible debt interest expense can be a material financial statement item so the classification can create material tax exposure. Many businesses report the convertible debt on their balance sheets and undoubtedly deduct the related interest expense on tax returns but may be unaware of the many considerations and risks discussed above. Moreover, companies may overlook the corresponding required interest income reporting on a Form 1099 to investors as this "phantom income" is often a surprise to businesses and investors alike. This oversight could result in the loss of a tax deduction.

PRACTICE TIP: As such, it is important to involve tax advisors in real time to identify and quantify the risks associated with using convertible debt to ensure the positive aspects outweigh the potential tax consequences.

Business Interest Expense

The new Section 163j applies more broadly to all debt, whether between related parties or incurred by a corporation, other entity, or individual, regardless of the taxpayer's debt-to-equity ratio. In general, the business interest expense deduction is limited to:

- the sum of business interest income,
- 30% of the taxpayer's adjusted taxable, which is taxable income allocable to a trade or business without regard to business interest or business interest income;
- Net-operating-loss deductions;
- Sec. 199A deductions; and
- for tax years beginning before Jan. 1, 2022, any deduction for depreciation, amortization, or depletion, and floor plan financing interest.

Any disallowed interest expense may be carried forward indefinitely to subsequent taxable years.

However, some types of taxpayers are exempt from Sec. 163j's deductibility limit. An exemption is generally available for small businesses — defined as businesses whose average annual gross receipts for a three-year period do not exceed $27 million (the inflation-adjusted amount for tax years beginning in 2022; see Sec. 448(c) and Rev. Proc. 2021-45).

For partnerships, the business interest limitation applies at the partnership, and not the partner, level. The amount of excess business interest expense is excluded from non-separately stated income or loss and passed through as a separately stated item to the individual level where it is carried forward until it can be utilized. For S-Corporation and C-Corporations, the excess business interest expense and carry forwards remain at the entity level.

CAUTION: These rules can significantly reduce the amount of tax-deductible interest expense for highly leveraged businesses that do not meet the small business exemption in one year and create excess interest deductions in other years, so they are important tax planning components that require annual monitoring and analysis.

Bonus Depreciation & Section 179 Expense

As the 2023 year end nears, a part of your year-end tax planning should be to review fixed assets placed in service during the year to ensure you are claiming the most favorable depreciation deduction, and, if considering additional fixed asset purchases, to acquire and place the assets in service before the end of the year. Most businesses should benefit from the rules increasing the amount of fixed/capital assets that can be expensed.

Below is a discussion on some of the methods available for taxpayers to accelerate depreciation. There are several options and scenarios Consumer Product businesses need to consider when assessing which is the most beneficial for them.

Bonus Depreciation

Bonus depreciation enables taxpayers to accelerate the depreciation of property purchased that has a recovery period of 20 years or less and is depreciated using the Modified Accelerated Cost Recovery System (MACRS).

For consumer product businesses, this typically includes, but is not limited to, assembly equipment, packaging equipment, labeling equipment, plant improvement, computer software, and office equipment. Notably leasehold improvements also qualified for bonus depreciation.

Currently, any qualifying assets placed into service on or after January 1, 2023 are eligible for bonus depreciation equal to 80% of the purchase price. The percentage of bonus depreciation is scheduled to be reduced to 60% in 2024 and 20% each year thereafter until completely phased out for assets placed in service on or after January 1, 2027.

Note: many states do not conform to federal bonus depreciation. At the state level, there is typically an addition adjustment passed through to the owners that reverse the bonus depreciation enjoyed at the federal level.

Despite the many benefits of bonus depreciation, consumer product businesses need to be aware of the below scenarios when making the decision.

Accelerated Depreciation Causing Basis Limitation for Founders and Investors

Under Internal Revenue Code (IRC) Section 704(d), a partner's distributive share of a partnership loss is deductible only to the extent of the partner's outside basis in his or her partnership interest at the end of the partnership year. The excess of loss must be suspended and carry forward indefinitely until such time as the partner has sufficient basis to deduct the loss. Accelerating the deduction through bonus depreciation may cause a loss suspension at federal level but still result in income tax from the depreciation adjustments at the state level. This often unintended consequence can impact cash flows if distributions are required to cover the state income tax expense for the owners.

Depreciation Recapture in the Sale of a Business

In today's rapidly evolving business world, the decision to sell a business, particularly for established brands in the consumer products industry, has become a strategically significant and often complex undertaking. The motivations behind selling a business can vary, ranging from adapting to market changes to pursuing growth opportunities or even responding to financial considerations. Selling a business can have significant tax implications, which vary depending on factors such as the structure of the sale, the type of business, the assets being sold, and the applicable tax laws in your jurisdiction. If you are thinking of selling your business in the next 12 to 24 months, it's important to understand that a portion of your sales price is allocated to fixed assets under a sale of asset deal. All or a part of the gain as a result of sales price allocation on the fixed assets is subject to depreciation recapture, to be reclassified from long-term capital gain to ordinary income.

IRC Section 179 Deduction

Under Section 179, eligible taxpayers may elect to expense qualifying property up to certain dollar limitations. To be eligible, property must be purchased for use in a trade or business. Unlike bonus depreciation, it cannot create a net loss for the business. Tangible personal property, such as equipment, machinery, and furniture, are eligible for this deduction.
For tax year 2023, the maximum deduction under Section 179 is $1,160,000 with a dollar-for-dollar phase out once the amount of qualified Section 179 property placed in service exceeds $2,890,000. For example, if a taxpayer has $3,000,000 of qualifying property, the maximum deduction, they can claim for tax year 2023 is $1,050,000 ($3,000,000 less $2,890,000 ceiling). The deduction is completely phased out if $4,050,000 of qualifying property is placed in service during 2023. This limitation is potentially calculated twice: once at the business level and then again at the owner level if the business is a passthrough entity (e.g., partnership or S-Corporation).

In addition to the limitations discussed above, Section 179 expensing is limited to the trade or business income of an activity. Unlike bonus depreciation, it cannot create a net loss for the business. For purposes of this deduction, trade or business income is calculated before factoring in any deduction under Section 179. Businesses need to consider their owners or investor base before electing to utilize Section 179. Trusts and estates are ineligible to utilize the deduction (grantor trusts are eligible for the deduction). Unlike bonus depreciation, the Section 179 deduction has been made permanent in the tax code and will not phase out over time.

As with bonus depreciation, businesses also need to understand the state tax implications. There could be significant state impact on owners and investors depending on the location of the property. For example, if your business would be eligible for the New York State investment tax credit, taking the section 179 on the property would make you ineligible for the investment tax credit.

Excess Business Loss Limitations

The Tax Cuts and Jobs Act of 2017 (TCJA) limited the deductibility of business losses for individual, trust and estate taxpayers, effective for tax years from 2018 to 2025. However, the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 suspended the limitation retroactively for tax years 2018, 2019 and 2020, and the Inflation Reduction Act of 2022 further extended the limitation through 2028.

Accordingly, 2023 marks the third year in which this limitation is in effect. For the 2023 tax year, the inflation adjusted business loss deduction limitation is $578,000 for joint filers and $289,000 for a single filer. Any excess business loss that is not deductible in the current year is carried forward as a net operating loss which can be used to offset income from a future period. The excess business loss rule applies after application of the following limitations: Tax Basis, At-Risk and Passive Activity Losses.

Tax Consideration for Investors

As we head into end of 2023, there are several considerations related to the excess business loss limitation rule that investors and their tax advisors need to be mindful of to avoid unforeseen tax consequences.

CAUTION: Taking enhanced depreciation deductions for new fixed assets might sound like a good idea to accelerate expense deductions for businesses. However, investors might not be able to utilize the deduction in the current year due to the loss limitation.
Investors might also have excess business losses in prior years that became net operating losses in the current year. Therefore, general techniques in accelerating business deductions might not be a prudent strategy for this particular year. Counter-intuitively, deferring deductions to a future year might yield better tax saving results.

PRACTICE TIP: In projecting business losses for excess business loss limitation purposes, investors need to note that losses from sales or exchanges of capital assets are not included in the calculation of the total deductions from one's trade or business. In addition, gains from sales or exchange of business assets is limited to lesser of (1) such gain attributable to a trade or business, or (2) capital gain net income.

Investors also must be mindful of states that decouple from the limitation rule, meaning there may be state adjustments needed in calculating one's state tax liability.

Making the Most of Losses

The best laid plans sometimes go awry, and when business stakeholders and investors find that efforts do not materialize as hoped or expected there may come a point that they begin to assess ownership value as completely worthless.

When an owner determines that a business holding or investment shifts in status from diminished value to total worthlessness, there could be an option to relinquish all rights to ownership as opposed to continuing to hold them.

PLANNING OPPORTUNITY: The benefit provided by abandonment, as opposed to disposition at a loss, can be twofold: First, it can provide acceleration of a loss on an earlier year tax return than would otherwise be possible. And secondly, and more importantly, there is potential for the loss upon an abandonment of a business or investment holding to be considered an ordinary loss, as opposed to a capital loss. However, this rare and taxpayer-friendly result that can afford ordinary loss treatment to what would otherwise be treated as capital losses, requires complex and careful analysis.

Capital Loss versus Ordinary Loss

Ordinary losses are considerably more favorable than capital losses because they can offset income taxed at higher ordinary rates, unlike capital losses which only have the capacity to reduce capital gains aside from an annual $3,000 allowance.

The essential element in examining an ordinary versus capital loss upon an abandonment is whether a sale or exchange is considered to have occurred. In certain circumstances, the law deems an exchange to have taken place, even if no actual exchange has actually occurred.

OBSERVATION: There are also situations in which the inability to sell or otherwise dispose of an asset that has greatly diminished in value creates issues regarding the powerlessness to take a loss until a willing buyer/seller is found, or for a formal business liquidation. In such circumstances, abandonment may be an option, and the ability to accelerate the ability to take a loss in the current year can be valuable even if ineligible for ordinary loss treatment.

PRACTICE TIP: Alternatively, if it is determined that abandonment loss is not an option, it is possible to find a willing buyer which usually is an unrelated third party who agrees to pay a nominal amount in exchange for ownership in a scenario where value is greatly diminished. This option can also help accelerate the ability to take a loss on an earlier year tax return.

Worthlessness of Business Ownership Interests, Business Property and Investments

Worthless business ownership interests are not the only items that can be abandoned when they become worthless. Business assets can also be abandoned. Some examples include:

- cancelled contracts;
- certain types of partial worthlessness;
- business debt worthlessness; and
- certain failed efforts and projects undertaken by an existing business.

Worthless investments can include uncollectible loans that are held as investments.

Sunk Costs in Early-Stage Businesses

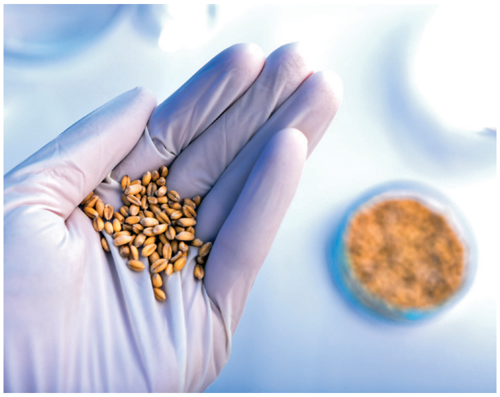
For new businesses, the entity type incurring expenses is crucial. Non-corporate taxpayers often struggle to prove that early costs are not personal, limiting their deduction potential. Forming an entity early can help in substantiating the business nature of these expenses.

Abandonment Losses in Pre-Operational Phases

Losses from abandoned projects can be claimed even before a business starts operations when it’s evident that efforts have become worthless. This includes failure of new business lines, products, or facilities, and failed business deals or abandoned projects. However, these must not be mere alternatives to an ongoing plan. For example, costs of a plan to construct a new facility are generally only deductible if the entire plan is abandoned, as opposed to that specific plan not materializing in favor of another.

PLANNING OPPORTUNITY: **Identify Sunk costs:** Sunk costs can qualify as ordinary losses, even though they were spent initially as capital investments. They are critical to identify because they may otherwise sit on the books as assets. These costs can be substantial, and the benefit of full and immediate use as a loss can markedly lessen the tax burden associated with the year of loss.

Research and Experimentation Costs



Due to changes in the Tax Cuts and Jobs Act of 2017 that went into effect beginning in 2022, immediate deductions for worthless research and experimentation costs are no longer allowed. These costs must be expensed over 5 years for domestic costs and 15 years for foreign costs, and their consequences should be considered in abandonments and other dispositions.

Analyzing Qualification for Abandonment Treatment

The process involves:

1. Establishing worthlessness
2. Determining the nature of the loss (capital or ordinary)
3. Provision of evidence of abandonment
4. Determination of the correct timing of worthlessness

1. Worthlessness – Subjective and Objective Factors:
Abandonment losses are available when the loss is related to either the business or the investments of a taxpayer. The determination of worthlessness has subjective and objective factors.

Subjectivity: An example of the subjective nature of worthlessness is when a business interest has $0 value on the books, but a shareholder may very well believe that this business interest will eventually recover, while another shareholder may reach an opposite conclusion. Worthlessness incorporates the notion that one man's trash may be another man's treasure, and therefore, worthlessness to the specific taxpayer is based on the taxpayer's vantage point. Often, interest holders of the same business will have different reasonable perspectives of its value to them based on their respective judgments, as well as with respect to the timing that worthlessness occurs. Although each circumstance has its own unique set of facts, courts have required that the judgment of worthlessness must have been made using reasonable business judgment and take the entire set of unique facts into account.

The objective element of worthlessness requires that an identifiable event must have occurred to support a change in the evaluation that occurred to cause the owner to conclude that something that held some value, no longer has any value. The taxpayer must be able to point directly to a specific event or series of events that occurred, that led to their assessment that their investment lost any value that it had prior to that occurrence. Certain examples can include the change in management of operations that cause an owner to determine that, under what they consider is a bad decision maker's power the company has lost any potential for recovery of economic circumstance changing. Other examples can be an attorney's option that debts are beyond recoupment, or the appointment of a receiver with the filing of bankruptcy.

2. Capital Loss or Ordinary Loss
The nature of the loss depends on whether the abandonment is considered a sale or exchange. Ordinary loss treatment is possible only when there is no actual or deemed sale or exchange involved. There are also certain types of assets and ownership types that can affect eligibility for an ordinary versus capital loss on abandonment.

How Liabilities can Impact Sale or Exchange

Liabilities play a crucial role in determining the nature of an abandonment loss. If abandoning an interest relieves the owner of associated liabilities, an exchange is considered to have occurred, and the taxpayer will not be eligible for an ordinary loss, resulting in capital loss treatment. The extent of liability relief can also affect the amount of loss available to the taxpayer because liability relief will reduce the capital loss accordingly.

OBSERVATION: The nature of liabilities and whether they are considered recourse or non-recourse can also affect the result. When an allocation of debt to an interest holder of a business is not considered extended to the owner in an event of default, the relinquishment of ownership also includes a relief of associated liabilities, and this factor is considered a sale or exchange, resulting in a capital loss.

Recourse liabilities are more complex. This is because sometimes liabilities would be re-allocated to existing owners, and at other times, the liabilities are not re-allocated, and the taxpayer remains on the hook in a default event even after abandoning ownership rights. If when an abandonment occurs, the liabilities are not relieved or re-allocated, then no deemed sale or exchange would have occurred relating to the relinquishment and the loss eligibility for treatment as ordinary will remain intact. However, if liabilities are extinguished at a later point on the behalf of the recourse liability holder, the corresponding amount would be considered taxable income at that point.

PLANNING OPPORTUNITY: Forgiven debt is not always taxed as income There are exceptions for cancellation of indebtedness income, and one of those exceptions occurs when the taxpayer is considered insolvent or has liabilities in excess of assets.

There are also potential measures for reconfiguration of liability allocations that can be explored if it is foreseeable that circumstances that do not change may result in worthlessness. There are times that an investment partnership may abandon a particular investment due to the fact that it simply cannot afford to continue contributing capital to grow a younger company.

If the investment partnership is also struggling, the subsequent relief of liability may not cause income recognition when debt is forgiven, if at the time of forgiveness the debtor is insolvent.

3. Evidence of an Abandonment

The facts relating to an abandonment are critical to document because there is no clear-cut action that serves as evidence for every possible scenario. The ability to substantiate worthlessness and abandonment objectively is crucial in supporting an abandonment loss if questioned by tax authorities. Essentially, the owner must:

- affirmatively intend to abandon the interest;
- perform an demonstrative act of abandonment; and
- communicate the intent to all interested parties.

Intention to Abandon: Depending on the type of ownership interest in question, different approaches may or may not work to show intent to abandon, but taxpayers who successfully take the position must generally convey a clear and unequivocal indication that they are planning to relinquish their ownership.

Formal meetings called to discuss the intent to abandon ownership and to discontinue funding business operations are examples that have successfully demonstrated this intention.

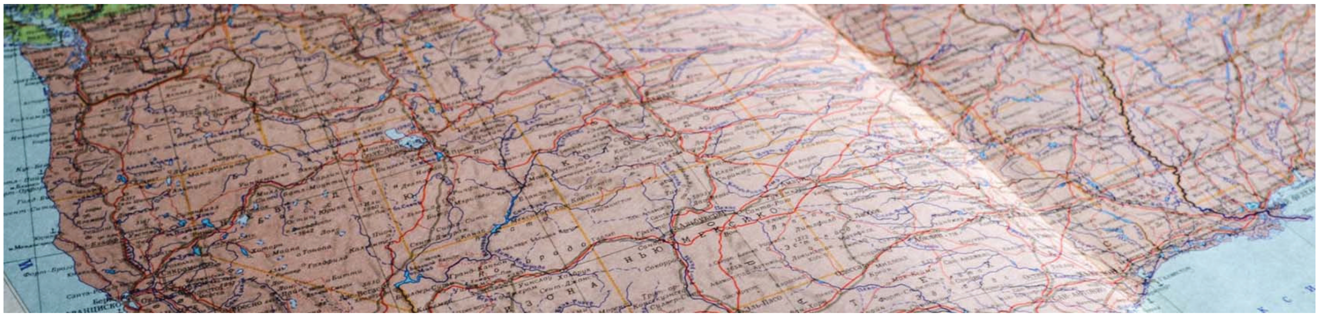
Demonstrative Act of Abandonment: The return of title of partnership interest to another partner, or the surrender or transfer of deed to property for nothing in return, the act of relinquishment of rights to stock, surrender of shares, are examples of actions that successfully evidence an abandonment. The taxpayer must have no rights to use or sell property in the future in order to have abandoned it as opposed to discontinue use. Other examples of acts or events which have reflected worthlessness have been a partnership's insolvency, a third-party developer's default, and inability of partners to restructure underlying debt.

PRACTICE TIP: It is a good idea to check the partnership operating agreement to see whether it has a process for giving up the interest and withdrawing from the partnership. If not, a letter to the general partner (and to all other partners, if practical) stating the wish to abandon the interest in the partnership, the intent to have no further dealings with the partnership and that there is no expectation of further benefits from the partnership is a good way to establish abandonment. Although not required, the letter should also ask the general partner to send a confirmation that the abandonment was accepted, and that the partnership will no longer treat the taxpayer as a partner.

CAUTION: Confirm that state law does not impose any additional requirements upon withdrawing or exiting partners.

4. Timing of Loss

A loss must be taken in the year of abandonment. However, generally, if worthlessness is established in a year before an abandonment takes place, the year of abandonment is not respected. Instead, the year that property became worthless is the year the loss is to be claimed.



What Consumer Products Businesses Need to Know about SALT as We Approach 2024

State and local taxation (SALT) is a complex area that at times resembles federal income tax and at others sharply departs. With 50 states plus the District of Columbia and a myriad of local taxing jurisdictions, generalizations are not only impossible, but dangerous. SALT is an ever-evolving landscape that attempts to keep up with the ever-evolving economy.

Two of the biggest changes to SALT in recent years are the implementation of the federal SALT deduction cap of $10,000 and the accompanying introduction of the pass-through entity tax (PTET) regimes in various jurisdictions which act as a workaround to the SALT cap.

Additionally, as a reaction to the proliferation of e-commerce, states have been shifting their taxation sights to capture broader tax bases. States also experiment with a variety of fees imposed on entities. Thus, while SALT may seem insignificant in the face of loss-making growth stage companies and nontaxpayer pass-through classifications, it can be relevant and significant in tax planning, regardless of entity type or business life stage. Outlined below are some general terms and features of SALT.

Types of State and Local Income Taxes

Entity-level income taxes – Entity-level taxes are often imposed on net income or some other base. The relatively new PTET discussed later is an elective entity-level income tax.

CAUTION: Some jurisdictions impose mandatory partnership level taxes such as New York City and Washington DC's Unincorporated Business Taxes.

Entity-level fees – A variety of entity-level fees that can be structured on a multiple bases, including but not limited to dollar amount per member, percentage of income or assets, annual fee for doing business in the state, and par value and number of issued stock shares.

CAUTION: These fees are generally not income-based so they are due even if there is a taxable loss.

Withholding and composite taxes – Some jurisdictions require pass-through entities to withhold and remit taxes on income allocated to partners. Composite tax filings enable partnerships to elect to make their partners' lives easier by filing tax returns and paying taxes for them as opposed to paying the tax individually.

CAUTION: Due to departing tax principles and resulting state modifications, an entity can have a federal taxable loss and state taxable income.

State Income Tax Nexus

State nexus refers to the necessary level of contact between a taxpayer and a state before the state has jurisdiction under the U.S. constitution to tax an out-of-state taxpayer. While different types of taxes employ different state nexus measures, the area generally resulting in the highest tax exposure is state income tax nexus. The U.S. Supreme Court established the principle that nexus for tax purposes requires an in-state physical presence before a state can impose its tax collection responsibility on an out-of-state company. Congress enacted Public Law 86-272, which was intended to act as a framework for determining when a multistate company is subject to income tax in any particular state.

The law prohibits a state from imposing a net income tax if a company's only in-state activity is the solicitation of orders for sales of tangible personal property, which are sent outside the state for approval and are filled from outside the state.

CAUTION: Public Law 86-272's scope is limited in application. Only taxes based on net income and sales of tangible personal property fall with its purview. Thus, transactions involving sales of intangibles or services are not protected. Nor does the statue apply to taxes that are not based on net income, such entity-level fees and gross receipts based taxes mentioned above.

Physical versus Economic Nexus

In the aftermath of the Supreme Court's decision in *Wayfair*, more and more states are moving to the concept of economic nexus in the income tax area. Prior to the US Supreme Court's *Wayfair* decision, in-state physical presence was the prevailing factor in determining constitutional nexus. Post-*Wayfair*, states have enacted a number of provisions which no longer view a lack of physical presence as a bar to the imposition of their income tax jurisdiction.

Generally, state economic nexus statutes require some minimum amount of revenue linked to the particular state before nexus is established. The Multistate Tax Commission has proposed a standard economic nexus threshold of $50,000 of property; $50,000 of payroll; $500,000 of sales; or 25% of total property, total payroll or total sales. Several economic nexus states have adopted these bright-line tests or some variation for economic presence. Of these factors, the property and payroll factors would indicate a physical presence, so the crux of the matter for factor presence nexus is the sales factor. In other words, physical presence generally establishes nexus unless the state has a minimum payroll or property threshold which protects against a de minimus in-state presence. It is only when there is no physical presence that an economic nexus analysis is needed. Use of these thresholds provide for a clearer interpretation of when economic nexus is established.

It is important to remember, that the federal protection afforded by Public Law 86-272 trumps a state's economic nexus statute. Consequently, even if a business meets the economic nexus threshold, Public Law 86-272 still protects the business from a net income tax if the corporation is selling tangible personal property and meets all the other requirements.

While it is tempting to forego state income tax filings as a practical business decision when the company is generating taxable losses, it is important to remember that this is not always prudent. Filing in states even in the face of taxable losses can provide several benefits including beginning the statute of limitations, establishing NOLs to be carried forward to shelter future income, and offering tax compliance clearance during due diligence upon an exit event.

PTET Regimes

Under the Tax Cuts and Jobs Act (TCJA) of 2017, individual taxpayers face a $10,000 cap on the deduction for SALT paid. In response, certain states have devised pass-through entity tax regimes that allow pass-through entities, such as partnerships and S corporations, to elect to pay state income taxes at the entity level rather than at the individual owner level. By doing so, the businesses bypass the SALT deduction cap, as the entity-level taxes are fully deductible for federal purposes. For a vast majority of states, the pass-through entity tax passes through as a credit on the individual's return.

Deciding to make a PTET election in states where it is elective is dependent on each pass-through entity's facts and circumstances. There are federal considerations that need to be taken into account such as, determining potential federal tax savings to the partners, partnership agreements, timing of payments, and taxability of refunds.

There are also some state considerations to be aware of, such as the state's eligibility of PTEs. It is important to understand the eligibility requirements and comply with filing requirements before making a PTET election. For instance, some pass-through entities may not qualify to make the election due to their state's specific guidelines. Other state factors to consider include calculating the income base, assessing the impact on specific partners, and analyzing the impact on composite returns.

Overall, taxpayers should consider other costs including tax consequences to the partners in their resident state, increased tax to certain partners, cash flow issues, and administrative costs associated with an election.

PTETs can be a fruitful planning technique to maximize overall tax savings but a full analysis of the business and its owners is necessary to evaluate the full scope of the potential benefits.

Sales & Use Tax

Over the years, many states have adopted a quantitative threshold standard when an interstate seller is required to file sales tax returns and/or remit sales tax in the state where the customer receives goods. The threshold is either based on number of transactions or sales volume per year. This has created significant confusion for interstate sellers, especially those online, direct-to-consumer sellers when it comes to sales tax nexus.

In general, sales tax nexus is triggered when sales volume reaches $100,000 per year and/or there are 200 transactions in another state. Note, each state varies on these particular thresholds. Further, exempt sales of goods and services may count toward those thresholds in some states.

Adoption of these standards has greatly increased the need for compliance. Consequently, interstate sellers need to be mindful of several areas that could derail their tax compliance obligations.

PRACTICE TIP: Manufacturers and distributors that sell to another reseller/distributor need to keep up-to-date tax-exempt certificates of their customers for each state they deliver goods to. Additionally, if a business makes tax-exempt purchases, the business is required keep records that support the sales tax exemption. During a sales tax audit, lack of records, such as a resale certificate or tax-exemption, could be problematic and could lead to the assessment of any uncollected tax.

For direct sales to retail consumers, sellers need to make sure accurate and current sales tax rates and the appropriate taxability rules are applied for each sale.

PRACTICE TIP: It is best to have an automated solution that integrates with online shopping to deliver instantaneous and accurate sales tax computation, which is critical to customer satisfaction. Adjusting the sales tax after check-out can cause damage to customer satisfaction as well as brand image.

Participation in a trade show may have sales tax nexus implications for businesses. When attending a trade show, a business has boots on the ground, which may be problematic as this can obligate the business to begin collecting tax on its sales of goods in the state throughout the year.

Since the possibility of sales tax nexus exposure would significantly discourage trade show attendance and reduce a state's economic benefits from the sales of hotel rooms, restaurant meals and show tickets, many states provide nexus exceptions for trade show attendees provided certain criteria are met. These criteria include a cap on the total number of in-state days during the year or limiting the volume of sales a business can transact at the show.

State rules vary on these types of conditions and thresholds, so businesses need to pay close attention to the respective state regulations. For example, New York provides a 14-day limit on tradeshow participation before a sales tax nexus is established as long as no in-state sales are completed during that time. However, California permits up to 15 days of in-state trade show days and a $100,000 threshold on gross income activity at the show.

A common sight at trade shows is the distribution of product samples, which also require special awareness for tax purposes. While sales tax typically applies when a sales transaction occurs, thereby negating a tax obligation on a product giveaway, a business may nevertheless be liable for use tax on the promotional freebie. Use tax is the counterbalance of sales tax in that if sales tax is not paid when purchasing a taxable object, the purchaser has a responsibility to remit use tax instead. With regard to product samples, if these products were purchased as part of a business's general inventory for resale, it is likely that no sales tax was paid on the goods because of the resale exemption. Accordingly, when these items are withdrawn from inventory and given away at a trade show, they would escape sales tax. For this reason, businesses are required to pay use tax, in place of the missing sales, on product samples taken from their inventory and used for promotional purposes at the show.

PRACTICE TIP: Businesses must be thoughtful of their sales tax exposure when participating in trade shows and providing product samples. By being physically present in a state, a business is potentially exposing itself to additional tax compliance obligations, especially if state exemptions and limitations are exceeded. Furthermore, failing to properly consider the tax implications of promotional samples may lead to an unexpected and sizable tax bill if audited.

What is the Internal Revenue Code (IRC) Section 41 R&D Tax Credit?

The Research & Development (R&D) tax credit provides a dollar-for-dollar reduction to a company's tax liability. Start-up companies with gross receipts of less than $5,000,000 may be able to utilize the R&D tax credit to reduce payroll tax liabilities up to $500,000. The R&D credit is available at the federal and state level, with a large number of states providing some tax benefit. Additionally, U.S. businesses and business owners with average revenues of less than $50,000,000 may be able to utilize the R&D credit to offset their alternative minimum tax.

The credit is available to taxpayers who incur incremental expenses for qualified research activities (QRAs) conducted within the U.S. that relate to the development of new or improved products, processes, techniques, formulas or software. The credit is comprised primarily of the following qualified research expenses (QREs):

- Internal wages paid to employees for qualified services;
- Supplies used and consumed in the R&D process or used to build prototypes or pilot models; and
- Contract research expenses when someone other than an employee of the taxpayer performs a QRA on behalf of the taxpayer, regardless of the success of the research.

For activities to qualify for the research credit, the taxpayer must be able to show they meet each of the following four tests:

1. The activities must rely on a hard science, such as engineering, computer science, biological science or physical science;
2. The activities must relate to the design or development of new or improved functionality, performance, reliability or quality of a business component – a product or process used in the taxpayer's trade or business;
3. Technological uncertainty must exist at the outset of the activities. Uncertainty exists if the information available at the outset of the project does not establish the capability or methodology for developing or improving the business component, or the appropriate design of the business component; and
4. A process of experimentation (e.g., an iterative process of testing, analysis, evaluation and validation) must be conducted to eliminate the technological uncertainty.

What is the IRC Section 174 Amortization of Specified Research & Experimental (SRE) Expenditures?

For tax years beginning on or after January 1, 2022, taxpayers are required to capitalize and amortize their SRE expenditures over five years for domestic research expenditures and over 15 years for foreign research (conducted outside of the United States, Puerto Rico and any U.S. possessions). Expenses applicable to Section 174 include all costs incidental to the development or improvement of a core business product or process. Section 174 has a broader definition of applicable expenses than Section 41, extending to any activity intended to discover information that would eliminate uncertainty concerning the development or improvement of a core product or process. In addition to wages, supplies and third-party vendor expenses, Section 174 could include expenses related to overhead, rents, utilities, travel and attorney's fees for applying for or perfecting patents.

Currently, there are numerous efforts by industry groups and companies to revert Section 174 rules to the prior version which allowed for immediate deductibility of SRE expenditures. However, passing legislation will require bipartisan cooperation in the House of Representatives, the Senate and the White House. While we can remain hopeful, at the present time, taxpayers should prepare to comply with rules set forth by the IRS on Section 174 in the absence of strong stewardship of the U.S. economy on Capitol Hill.

How Do the Section 41 R&D Tax Credit and Section 174 SRE Expenditures Differ?

Expenses that qualify for Section 41 are a subset of the broader definition of expenditures that meet the definition as SRE under Section 174. Section 174 includes direct and indirect research expenses, both onshore and offshore, while Section 41 relates to direct research expenses incurred within the U.S.

While claiming the R&D Tax Credit under Section 41 is optional, compliance with Section 174 is mandatory for all U.S. taxpayers.

PRACTICE TIPS FOR VPS OF FINANCE AND CONTROLLERS: Developing a methodology to identify and quantify research expenses is key to claiming the credit and correctly amortizing SRE expenditures. Companies should ensure that they are appropriately classifying and tracking research expenditures.

Defensive Planning for Qualified Small Business Stock (QSBS) Eligibility

The QSBS Exclusion, which allows for an exemption from capital gains tax on the greater of $10,000,000 or 10 times the shareholder's basis, who dispose of originally issued qualifying stock after a 5-year minimum holding period is widely known amongst founders, investors, and employees of qualified small businesses. Owners of companies often focus greatly on ensuring eligibility on the corporate level so that their investors can benefit from stock issuances that can significantly increase an investor's rate of return.

Corporate Qualified Small Business (QSB) Qualifications

Shareholders and corporations each have eligibility requirements and rules for maintaining QSBS eligibility at both the entity and shareholder levels. The basic rules for corporate qualification are as follows:

- The entity is a domestic C corporation.
- The corporation must agree to provide reports to IRS and shareholders, monitoring and documenting its eligibility as a qualified small business.
- Qualifying stock must have been originally issued by the corporation (thereby restricting shareholder transfers).
- The type of business conducted by the corporation cannot be any of the following:
    - Service businesses generally don't qualify (e.g., doctors, engineers, accountants, lawyers, and consultants);
    - Farming;
    - Banking/insurance/leasing/investing or similar types of businesses;
    - Certain production and extraction type of businesses;
    - Hotels, motels, restaurants, or similar hospitality businesses; and
    - Certain types of businesses categorized as "sin businesses" do not qualify.
- The corporation must be considered an active business which is defined as having at least 80% of the business assets used in conduct of qualifying type of business. Stock (and other business interests) of companies owned by the corporation in many cases also can have their ratable share of assets included in this calculation. If a corporation owns less than a majority, then any ownership is considered passive. Certain exceptions exist for cash considered working capital, and for startup and technology type of companies.
- The aggregate gross assets (meaning cash and sum of all basis in non-cash property) of the corporation may have not exceeded $50,000,000at any given point. This test includes assets of certain related entities that are considered part of the "parent subsidiary-controlled group." (See below for more on this criteria)
- There are rules restricting the types of tax-free reorganizations that allow the continuing entity to qualify as a qualified small business.

- Corporate redemptions that are considered “significant redemptions” are disallowed, with certain exceptions.

Corporate QSB Eligibility Protection

When a corporation loses its eligibility status as a QSB, stock can be affected in a number of ways depending on the reason that status is lost:

- Previously issued qualifying shares can lose their eligibility, which often happens in the startup phase when too much stock is redeemed.
- New shares issued on a go forward basis can be ineligible, while status of previously issued shares remains intact.
- Existing eligible shares lose the ability to exclude further gain, while any existing gain would qualify for exclusion as of the date of status change.

$50 Million Aggregate Gross Asset Test

There are a number of requirements both for companies and their shareholders to maintain QSBS status. One test in which special attention is warranted based on legislative changes is the aggregate gross asset test. When the sum total of a corporation’s gross assets, which encompasses both liquid capital and the adjusted basis for other property, surpass the $50,000,000 mark, the capacity to distribute QSBS is forfeited. Crucially, this restriction persists even if the value drops below the $50 million aggregate gross asset threshold. Sometimes companies that don’t appear to qualify for this test still do because corporate liabilities are not incorporated into this calculation, thus fair market value (FMV) can sometimes be a red herring.

For example, a business with a FMV of $200,000, but assets of $51,000,000 and liabilities of $50,800,000would fail the test, but an otherwise eligible business with a FMV of $49 million with aggregate gross assets of $49,900,000 and liabilities of $900,000 would qualify. Another FMV red herring would be for a business with a FMV of $300 million to appear not to qualify but may. This is because appreciation of assets is also not considered in this test, unless those assets were contributed or acquired. FMV of acquired or contributed assets are incorporated into the test, but further appreciation isn’t factored into the calculation.
While a business may very well have raised over $50 million over time, the test is not cumulative, but instead is conducted as a snapshot of a corporation’s business holdings.
In circumstances where this threshold is approached and may be surpassed, some simple actions should be considered:

1. Accelerating stock issuances before this threshold is surpassed, or planning for the gradual approach of the threshold, to the extent possible, issuing stock in phases. The latter should be done under the advice of your trusted corporate and tax professionals to ensure that the IRS will respect the substance of any plan.|

2. Let holders of warrants and stock options know that they may lose QSBS eligibility if they choose not to exercise before the threshold is passed. This simple step in communication can create tremendous goodwill among investors, employees, and lenders (who have warrants or convertible notes). Warrants and options qualify as QSBS shares only upon exercise, and the status of the corporation as a QSB is considered upon exercise and not upon grant. The 5-year holding period also begins only upon exercise as well. This consideration can largely change the value to option and warrant holders in terms of when the time is right for them to exercise.

3. Can a large capital raise or the presence of new owners be staggered rather than take place immediately and at once?

   Since the test looks at snapshots in time of business aggregate gross assets, planning that can incorporate infusions of capital, or large business transactions can sometimes avoid tripping this rule when there are business expenses, or other reductions in assets before subsequent infusions. Any such plan needs to be respected by the IRS, and therefore evaluating the degree to which the form rather than the substance of any plan would be respected to avoid potential issues.

How Research and Experimentation (R&E) Tax Code Changes Affect the Aggregate Gross Asset Test

Changes to the ability to immediately expense R&E expenditures enacted by the Tax Cuts and Jobs Act of 2017 went into effect beginning in the 2022 tax year. The change created capitalization and subsequent amortization requirements over either 5 or 15 years which can substantially affect the gross asset tally, potentially impinging upon a corporation's QSBS qualification. The inability to immediately deduct expenditures inflates the value of assets considered in the $50 million threshold calculation and the effect of the legislative changes on QSBS has not been widely covered. When R&E projects are undertaken in the U.S., an annual $2,000,000 spend creates a year 1 asset that adds to this test, valued at $1,800,000 million that is added into the aggregate gross asset tally (US IRC 174 expenditures that are capitalized in the current year, are amortized by 10% in the first year). Therefore, this onerous change in the law can greatly affect the aggregate gross asset test.

In examining how resources are allocated to building prototypes, or other R&E expenditures that are unavoidable, consider making the following inquiries as the $50 million threshold is approached:

1. Can these expenditures be deferred or reduced? Anything that is undertaken abroad should be reconsidered for cost savings by moving these projects overseas to protect against the cost of losing QSB status.

2. Are the repeating expenditures still considered R&E? It is worth checking the rules for what expenditures are still considered R&E for your circumstances. Changes to the novelty of certain expenditures that may become routine over the years may not qualify any longer as R&E costs. Accordingly, there is potential to examine whether previous categorizations are still appropriate. Examples can include prototype modifications that occur over the years and become routine, or adjustments to processes as opposed to their creation may create assets that have a shorter amortization period or may result in the categorization of those amounts as immediately deductible.

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