MassBio
MASSACHUSETTS BIOTECHNOLOGY COUNCIL

Entrepreneur's University: Entity & Equity Formation

Tuesday September 27, 2016

Upcoming MassBio Events

Forums

Oct 19: **Business Development for Nonprofits: Partnerships for Sustainability; NP**

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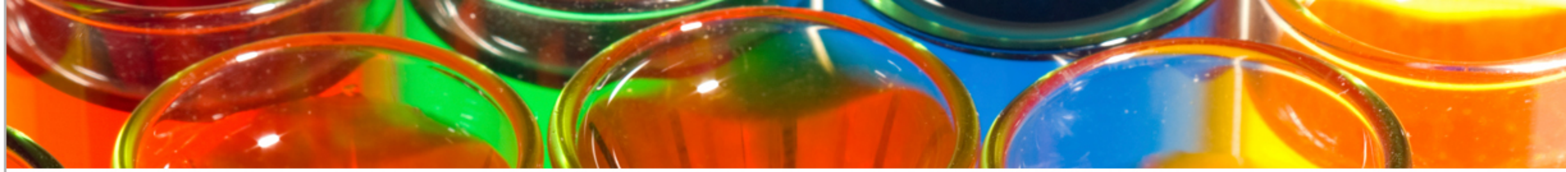
Nov 30: **What is the Value of Value Frameworks in Making Healthcare Decisions?**

Signature Events

Sept 28: **Patient Advocacy Summit 2016 - Sharing Our Stories: Building a Patient-Centered Ecosystem**



Entrepreneur's University: Entity Formation

Speakers:

- **Eric J. Evans**, MBA, Executive Committee, Mass Medical Angels
- **John Hession**, JD, Partner, Morse, Barnes-Brown & Pendleton, P.C. (co-moderator)
- **Fred Mermelstein,** PhD, Partner, Ascentia Asset Management, Inc.

Moderator:

- **Marc R. Cote**, Chief Operating Officer, Accellient Partners, LLC

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Laying the Foundation for Entity & Equity

Choice of Entity

- C Corporation (Delaware)?
- Limited Liability Company (Delaware LLC)?

Choice of Entity Considerations

- Accounting and Tax Considerations: Stock Options vs Restricted Stock ??
- Capital Gains vs Ordinary Income, or giving an extra 20% to Uncle Sam
- Flexibility, Ease of Operation, Ease of Explanation and Implementation
- What do Investors normally want???

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Practical Considerations

- The ultimate liquidity objectives of the business: investment, sale, public offering, joint venture, current return?
- The players involved as equity holders: individuals, corporate, pass-through entities, domestic or foreign players, Tax Exempts?
- Equity compensation strategies?
- Facility of Formation, Flexibility of Operation
- Cost of Organization, Operation, Compliance
- Tax & Accounting considerations
- Vesting of Control and Decision-Making

C Corporation

- Limited Liability of Stockholders
- Double Taxation at Entity & Owner Level (34% Corporate and 20% Tax on Dividends)
- Efficient Financing Vehicle for Capital Gain Oriented Investors
- Multiple Classes, Series, ISOs, Options re Stock permitted
- Efficient and Widely Adopted Equity Compensation Techniques
- No limits on types, character of equity owners

C Corporation

- **Taxable at Entity Level, Stockholder Level**
- **Distributions Taxable to Stockholders**
- **Potential Two Layers of Tax**
- **Flexible Financing Structures**
- **BUT: Corporate Losses can be used to offset future earnings**

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C Corporation

- Loss Carryforward: losses can be carried forward to shelter future profits
- Change of Ownership: Net Operating Loss (NOLs) Carryforward can be lost or reduced if stock ownership change
- Lower tax rate on ordinary income retained in business
- Owners-employees eligible for tax-free health insurance, benefits

C Corporation

- Equity compensation mechanisms well understood: ISOs, NQSOs, Restricted Stock, Phantom Stock, SARs
- Facilitates tax-free acquisitions by public company
- Facilitates public offerings, without S corporation limits on stockholders
- Facilitates preferred stock structures by venture capitalists
- Qualified Small Business Stock: IRS Sec. 1202(b) = targeted capital gain provisions

C Corporation: Sec 1202(b)

- Qualified Small Business Stock (QSB): IRS Sec. 1202(b) = targeted capital gain provisions
- Available for product companies with under $50M of assets, with an active trade or business, and stock held for minimum of 5 years
- First $10M OR 10X the basis in the stock of capital gain is without taxation
- Capital Gain above $10M is subject to tax at regular rates
- BUT: Investment Gain must be rolled over into another Qualified Small Business Stock

C Corporation: Sec 1202(b)

- Since 1993, Section 1202 provided exclusion of up to 50% of Capital Gain
- Obama's American Recovery and Reinvestment Act provided the exclusion moving to 75%, later moved to 100% exclusion of the first $10M of Capital Gain
- Available ONLY for investments by individual taxpayers in qualifying subchapter C corporations

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Limited Liability Company

- Hybrid: flow-through treatment with corporate-like limits on liability
- No restrictions on types or character of equity owners
- Multiple classes of equity permitted
- Flexible allocations of gains & losses
- Preferential returns can mirror preferred stock structures
- Different management structures
- Members have some control features

Limited Liability Company

- Taxation at owner level: no entity-level tax
- Check the Box: LLC may elect tax treatment as partnership or corporation ISOs not permitted: option-like structures not understood by employees
- Add owners through Joinder Agreement
- Operating Agreement determinative
- Can mirror most corporation charter and by-law structure re corporate governance

Limited Liability Company

- Easier to acquire assets through issuance of equity without potential tax to the seller on appreciated property (compare with exchange of corporate assets for equity, 80% rule, Sec. 351)
- Greater flexibility in granting equity to employees (profits interest)
- Permits preferences, participating preferences, carried interests, non-pro rata allocations

Various Equity Structures

Typical US Stock Plans provides:

- **Restricted Stock: buy now, subject to vesting and repurchase rights of the company, sell later, get capital gain**
- **Incentive Stock Options (ISOs): obtain now, exercise later, and wait either TWO years from grant date, and ONE year from exercise date, for favorable capital gain and unfavorable Alternative Minimum Tax (AMT)**
- **Nonqualified Stock Options (NQSOs): obtain now, exercise later, BUT get taxed at ordinary income rates when you exercise option (44% effective state / federal rate), then wait another year to obtain capital gain treatment**

Investor Concerns

- Vesting arrangements and repurchase of unvested stock, cancellation of unvested options
- Rights of First Refusal by Company, Investors
- Co-Sale and Tag-Along Rights
- Drag-Along Rights on Sale of the Company
- Right of Company to repurchase shares

Various Equity Structures

- **Note**: **BUT Only Restricted Stock provides Capital Gain treatment on sale of company!** **20+% Tax Difference !!!!!!**
- **One-Year Holding Period for Capital Gain**
- **However**: **Ordinary Income Compensation Risk at time of issuance in if issued at *less than* Fair Market Value**
- **Must pay tax (*at ordinary income rates*) on the "deemed value" of the Stock at time of issuance --- *UNLESS pay full Fair Market Value for Stock at time of original issuance***
- **Capital Gain Treatment on Later Sale of Company**

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What are the types of stock options?

- **Incentive Stock Options ("*ISOs*") –**
  - ***generally*** **recognize Alternative Minimum Tax (AMT) on exercise**
  - ***generally*** **subject to capital gains tax when you sell the stock, as long as held the option two years from grant and one year from exercise**
- **Non-Statutory or Nonqualified Stock Options ("*NQSOs*") –**
  - ***generally*** **subject to ordinary income tax when you exercise your option**
  - ***generally*** **capital gains tax when you sell the stock**
  - **no AMT calculation – often a compelling reason for a senior executive to choose nonqualified stock options**

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Incentive Stock Options, ISOs

- **Technical Compliance with Tax Rules**
- **No Tax to Employee at time of grant or exercise**
- **Holding Period : *two years from grant and one year from exercise***
- ***Holding Period of 2 years-grant/one year exercise is virtually impossible to achieve on sale of company***
- **Spread at time of exercise subject to Alternative Minimum Tax (AMT)**
- **AMT is a huge problem for highly compensated managers, so ISOs are *not* often a good strategy**

Incentive Stock Options, ISOs

- Taxed at Capital Gain Rate at time of Sale BUT ONLY if Holding Period satisfied (i.e., two years from grant/one year from exercise)
- No Tax Deduction for Company
- Exercise price must = FMV of common stock at time of grant
- Only available for Employees who were "legitimate W-2 employees" at time of grant – not available for outside directors, non-employee officers or advisors
- Option not transferable

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Nonqualified Stock Options (NQSOs)

- **Available for <u>All Types of Recipients</u>: Employees, Consultants, Advisors, Inside & Outside Directors, Others**
- **May be granted at <u>less than</u> the FMV, *<u>but subject to some onerous tax consequences under 409A</u>***
- **No Tax at time of Grant -- if granted at FMV**
- ***<u>Taxed @ Ordinary Income Rates at Exercise</u>***
- ***Tax = difference between Option Exercise Price & Fair Market Value at time of exercise***

Nonqualified Stock Options (NQSOs)

- **Company gets Tax Deduction = Plus Income Tax Hit to Employee @ time of exercise**
- ***Income Tax = <u>difference between Option Exercise Price & Fair Market Value at time of exercise</u>***
- **Cash Flow Impact to Company on Exercise = IRS Withholding plus Social Security Tax**
- **Deductions can be *Potentially Huge* for Company**
- **But NO Special Holding Periods like ISOs (Ergo, "no two years from grant / one year from exercise" rule like ISOs)**

Quick Summary: Tax Consequences of Options

ISOs

- No tax on grant
- No income recognized on exercise
- "Spread" on exercise FMV less EP may = AMT
- No withholding
- Capital Gain on sale = proceeds realized - EP
- Disqualifying Disposition (DD) creates OI on sale
- Withholding for DD

NQSOs

- No tax on grant (usually unless)
- Ordinary compensation income on exercise on "Spread" (FMV less EP)
- Withholding required!!!!
- Capital gain realized on sale = proceeds realized over exercise point
- OI tax added to basis, gain is realized above basis

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Quick Summary: Tax Consequences

ISOs:

- **No tax on grant but MUST be granted at Fair Market Value)**
- **NO ordinary income compensation tax on exercise of ISO Option on "Spread" (FMV less Exercise Price), AS LONG AS STOCK issued under the ISO is held for (i) 2 years from grant and (ii) 1 year from exercise**
- **NO Withholding required**
- **Capital gain realized on sale = proceeds realized over exercise price *but must be held for 1 year after exercise AND 2 years from grant !!!* *People forget the two-year rule!***

Quick Summary: Tax Consequences

NQSOs:

- No tax on grant but MUST be issued at Fair Market Value)
- Ordinary compensation income on exercise of NQSO Option on "Spread" (FMV less Exercise Price)
- Withholding required!!!!
- Capital gain realized on sale = proceeds realized over exercise price but must be held for one year after exercise
- Ordinary Income is tax added to basis, gain is realized above basis

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LLC Equity Interests

- **Restricted Stock Units**: similar to Restricted Common Stock in the C corporation context, purchase of a Capital Account
- **Nonqualified Options**: similar to a nonqualified stock option in the C corporation context
- **Profits Interests**: a very different animal altogether
  - Ability to participate in the profits of the enterprise, when the company exceeds a stated enterprise valuation
  - Can be issued for services, and without consideration (or nominal consideration)
  - Can be voting or non-voting interests
  - Vesting and repurchase rights
  - Can be customized in many ways to suit special needs of the Company

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