Session 11 - Corporate formation

- Discuss corporate formation rules
- Examine the tax implications of incorporating a business
- Lokk at how a start-up might be structured

Overview of Corporate Formation Rules

- Section 351: Deferring gain or loss upon incorporation
  - What rationale exists for treating a corporate formation as a nontaxable exchange?
- Specific requirements:
  - <u>Property</u> must be transferred to the corporation in an "exchange" transaction
  - The transferors of the property must be in <u>control</u> of the corporation after the transfer
  - The transferors must receive <u>stock</u> of the transferee corporation in exchange for their property

Example 1

- John and Jane form JJ Corporation. John contributes a building that he originally purchased for $50,000 for 50% of the shares. The building has a current FMV of $100,000. Jane contributes $100,000 in cash for the remaining 50%. Section 351 applies and John does not have to recognize any gain on the building.

The Property Requirement

- Nonrecognition of gain or loss applies only to transfers of property
- Courts and the government have defined property to include:
  - Cash
  - Installment obligations
  - Accounts rceivable
  - Inventory
  - Equipment
  - Patents
  - Trademarks / Trade names
  - Other intangibles
  - Computer softwareCash
  - Installment obligations
- Important exclusion: Services

The Control Requirement

- Transferors, as a group, must be in control of the transferee corporation immediately after the exchange
  - Control is defined as 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock (by class)
- Stock received by a transferor of services does not count in determining the 80%

Example 2

- John and Jane form JJ Corporation. John contributes a building he originally purchased for $50,000 in exchange for 50% of the shares. The building has a current FMV of $100,000. Jane contributes $100,000 worth of consulting services for the remaining 50%. Section 351 does not apply. John recognizes a $50,000 gain on the building (FMV of 100,000 less basis of 50,000). Jane recognizes $100,000 of ordinary income.

The Control Requirement - Both Property & Services Transferred

- If both property & services are transferred in exchange for stock, **all** of the stock received is counted in determining control
  - Property must be more than nominal value -- The IRS generally requires that the FMV of the transferred property be **at least 10%** of the value of the services provided

Example 3

- John and Jane form JJ Corporation. John contributes a building that he originally purchased for $50,000 for 50% of the shares. The building has a current FMV of $100,000. <u>Jane contributes $80,000 worth of consulting services and $20,000 in cash for the remaining 50%.</u> Section 351 applies and John does not have to recognize any gain on the building. Jane recognizes $80,000 of ordinary income.

The Control Requirement - Transfers to Existing Corporations

- Section 351 can apply to transfers of existing corporations as well as transfers to new entities. The same rules apply.
  - A transfer to an existing corp. is tax-free for a new shareholder if 80% interest is acquired or
  - Existing shareholders also contribute property so 80% requirement is satisfied
    - The value of the property transferred must be at least 10% of the value of the stock already owned

The Control Requirement - Immediately After the Exchange

- Does not require exchanges to be "simultaneously" completed
- Exchanges must be agreed to beforehand and must be executed "with an expedition consistent with orderly procedure"
- Control is only required immediately after the exchange, but transferors can't have prearranged plans to dispose of their stock

The Stock Requirement

- Any type of stock (common or preferred) of the controlled corporation may be received by the transferors
- Exceptions:
  - stock rights or stock warrants
  - nonqualified preferred stock (after 6/8/97)
  - nonqualified if any of the following apply:
    - holder can require issuer to redeem or purchase stock
    - issuer is required to redeem or purchase stock
    - issuer has the right to redeem or repurchase stock and it is more likely than not that the right will be exercised
    - dividend rate varies with reference to interest rates

Shareholders - Receipt of "Boot"(i.e., any money, debt, etc.)

- If a shareholder receives money or property other than stock, gain must be recognized to the extent of the lesser of the shareholder's realized gain or the FMV of the "boot" received
- The character of the gain recognized depends on the type of property transferred
- A loss is never recognized under Section 351 -- whether or not boot is received is irrelevant

Example 4

- John and Jane form JJ Corporation. John contributes a building that he originally purchased for $50,000 for 50% of the shares and a $20,000 note. The building has a current FMV of $120,000. Jane contributes $100,000 in cash for the remaining 50%. Transaction is partially tax free -- John recognizes $20,000 of gain.

Shareholders - Computing Basis

- A shareholder's basis in the stock received in a 351 transaction is computed as follows:

	Adjusted basis of property transferred to the corporation
Plus:	Any gain recognized by the shareholder
Minus:	FMV of "boot" received Money received Amount of liabilities assumed by the corporation
=	Adjusted basis in stock

Example 5

- Same fact pattern as example 1:
  - John and Jane form JJ Corporation. John contributes a building that he originally purchased for $50,000 for 50% of the shares. The building has a current FMV of $100,000. Jane contributes $100,000 in cash for the remaining 50%. Section 351 applies and John does not have to recognize any gain on the building.
- John:
  - basis in stock = basis in property transferred or $50,000
- Jane's basis is $100,000.

Example 6

- Same fact pattern as example 2:
  - John and Jane form JJ Corporation. John contributes a building he originally purchased for $50,000 in exchange for 50% of the shares. The building has a current FMV of $100,000. Jane contributes $100,000 worth of consulting services for the remaining 50%. Section 351 does not apply. John recognizes a $50,000 gain on the building (FMV of 100,000 less basis of 50,000). Jane recognizes $100,000 of ordinary income.
- John's basis:

	Adjusted basis in property	$50,000
Plus:	Gain recognized	50,000
=		$100,000

- Jane's basis is $100,000.

Example 7

- Same fact pattern as example 4:
  - John and Jane form JJ Corporation. John contributes a building that he originally purchased for $50,000 for 50% of the shares and a $20,000 note. The building has a current FMV of $120,000. Jane contributes $100,000 in cash for the remaining 50%. Transaction is partially tax free -- John recognizes $20,000 of gain.
- John's basis:

	Adjusted basis in property	$50,000
Plus:	Gain recognized	20,000
Less:	FMV of “boot” received	(20,000)
=		$50,000

Jane's basis is $100,000.

Shareholders - Holding Period

- Property transferred to the corporation was
  - a capital asset:
    - the holding period for the stock includes the holding period for the property transferred
  - a non-capital asset (cash, inventory, A/R):
    - the holding period for the stock received begins on the day after the exchange

Corporation - Gains and losses

- Corporations do not recognize any gain or loss when they exchange their own stock for property or services
- Corporation must recognize gains (but not losses) if it transfers property to a shareholder as part of a 351 transaction

Corporations - Computing Basis

- A corporation's basis in property received in a 351 transaction is computed as follows:

	Shareholder's adjusted basis for property transferred to the corporation
Plus:	Gain recognized by the shareholder
=	Corporation's adjusted basis in property

- A corporation's basis in property received in a taxable transaction is the property's acquisition cost (FMV)

Escaping Section 351

- Section 351 is <u>not</u> an elective provision
- If you wish to recognize a loss, you must fail one or more of the 351 requirements
  - Transferors of property do not receive 80% of the voting stock
  - Section 267 (related party transaction rules) may still limit loss recognition if shareholder owns more than 50% of shares

Escaping Section 351

- Would you ever wish to recognize a gain?
  - Transferor has capital losses he can offset with the capital gains
  - Corporation would benefit from a higher basis (for example, it may have a higher MTR than shareholder)
- Gain can be recognized by the following methods:
  - shareholder can sell the property to the corporation
  - transferor can fail 351 requirements

OLD 21 Corporation - Transfer of Mortgaged Property

- If you transfer mortgaged property in a 351 transaction, you generally do not recognize any gain or loss
- Two exceptions:
  - tax avoidance or no business purpose
  - liabilities in excess of basis
    - excess liability amount is a gain taxable to the transferor

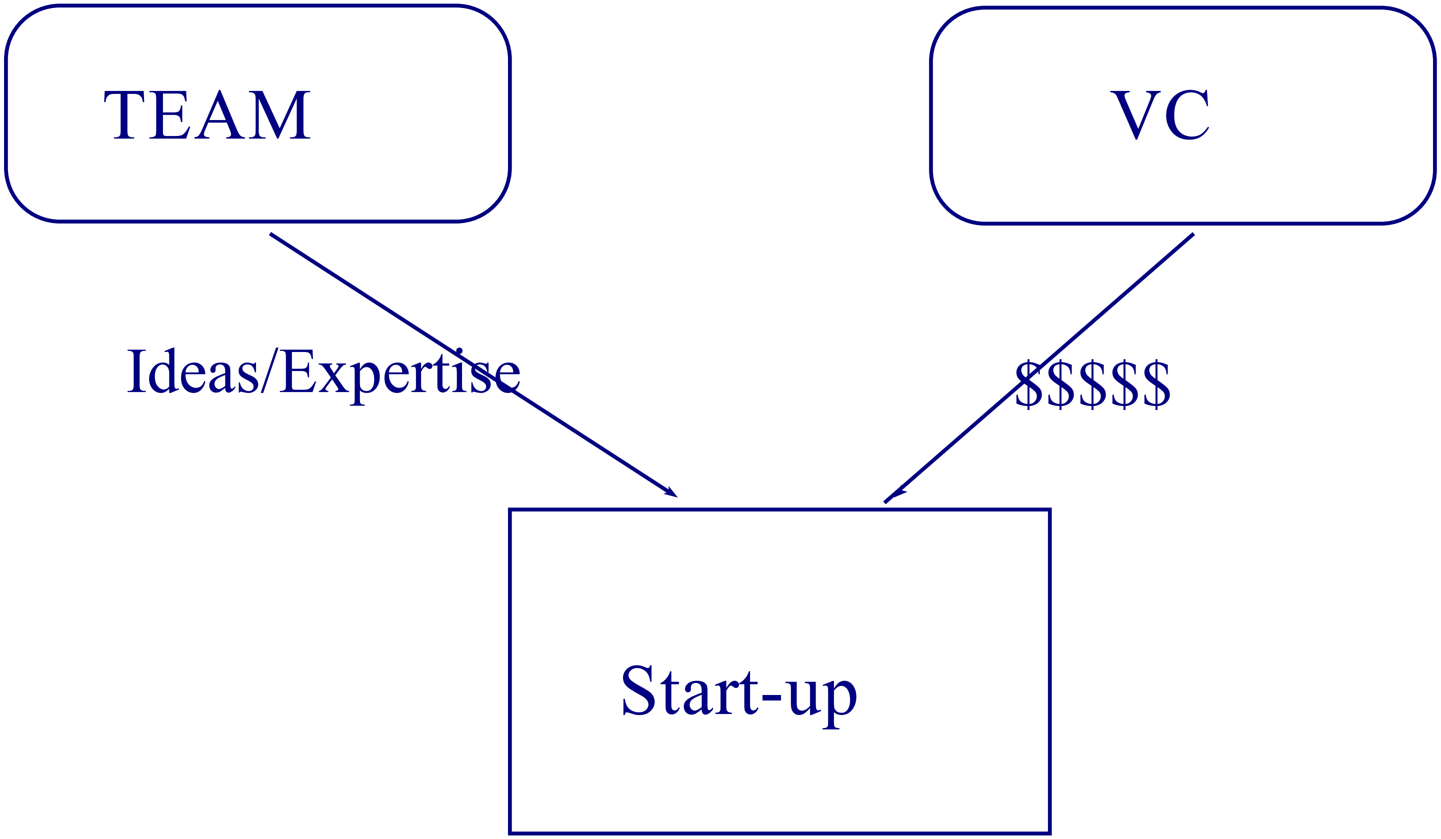
Structuring a Start-up Transaction

- All common stock deals
- Alernatives to all common stock deals
- Restricted stock
- Structuring a start-up as a flow-through entity (S corp, partnership) when venture capital money is used.

Structuring a Start-up Transaction

- Basic Setup:
  - Your team (TEAM) has just won the 50K Competition
  - A local venture fund principal impressed by your product's potential, approaches you with an offer to invest $10 million in your concept.
  - You make an appointment for the following week to go over your proposed structure for the new company.

Structuring a Start-up Transaction



Structuring a Start-up Transaction

- TEAM Proposal: All Common Stock

	VC	TEAM
Amount invested	$10 million	Ideas & Expertise
Stock received	49,000 shares	51,000 shares

- Does the VC fund accept your proposal?
- If they do, should you be pleased with your negotiated proposal?

Structuring a Start-up Transaction

- VC funds generally reject 100% common-stock structures for a new start-up.
- What happens if STARTUP fails?
  - Example: After $5 million is spent, STARTUP concludes its ideas are technologically or commercially impractical
    - VC would prefer to recover the entire remaining $5 million (not a 49% share)

Structuring a Start-up Transaction

- What happens if STARTUP succeeds?
  - Example: STARTUP is a big hit and is sold to a competitor 12 months later for $20 million
    - VC's 49% share of the company would net only $9.8 million ($200,000 less than their initial investment)
    - VC would prefer to share the "profits" only

      A return of its $10 million dollar investment

      A 49% share of the "$10 million" profit

Structuring a Start-up Transaction

- Other Considerations:
  - VC may want a portion of investment in the form of debt => a tax-deductible interest expense for STARTUP
  - VC may want TEAM to invest cash in the project => with nothing to loose, TEAM members may walk away too easily

Structuring a Start-up Transaction

- Should you be pleased?
- How much cash do you have in the bank?
  - Code Section 83(a): An individual contributing present or future services to a business enterprise in exchange for equity generally recognizes income upon receipt of the equity.
    - TEAM members may IMMEDIATELY owe tax on $5.1 million of ordinary income (at today's top statutory rates we're talking about somewhere in the neighborhood of at least $2 million). IRS may even argued that the company is worth $20.4 million based on VC's willingness to pay $10 million for 49%.

Structuring a Start-up Transaction

- Problems:
  - Taxed at higher rate: Top ordinary income rates are double the long term capital gains rate
  - Loss of deferral: Must pay taxes NOW

- STARTUP does get a deduction for the amount TEAM recognizes as compensation but who needs deductions with no income?

Structuring a Start-up Transaction - VC Proposal

	VC	TEAM
Preferred stock	$9,500,000	
Common Stock	$350,000 (70%)	150,000 (30%)
Stock shares received	70,000	30,000
Total invested	$9,850,000	$150,000

Characteristics of Preferred Stock:

1. Liquidation Preference: Preferred stock holders have the right to receive purchase price plus unpaid dividends before any assets are distributed to common stockholders
2. Conversion Rights: Preferred stock issued in venture capital deals is convertible at the holder's option or automatically if a company goes public
3. Voting Rights: Preferred stock holders have the right to vote with the common stock holders, in proportion to their conversion ratios (e.g., if the conversion ratio is 1-to-1, then the VC fund receives 1 vote for each share of preferred stock)
4. Redemption Provisions: Allow VC to recover its investment plus a profit if a company fails to meet expectations. Some provisions can be used by a company to force conversion to common stock.
5. Anti-dilution Provisions: convertible preferred stock generally contains provisions protecting against dilution from stock splits / stock dividends
6. Dividend Preference: Preferred stock dividends must be paid before common stock dividends (may be cumulative).

Structuring a Start-up Transaction

- What are the benefits achieved with the new proposed structure?
  - VC has a senior claim to the first $9.5 million (protection against STARTUP failure)
  - STARTUP's upside is split between VC and TEAM based on returns after VC's initial investment is "recouped"
  - TEAM has no compensation issues under Section 83(a)
  - TEAM has personal wealth at risk (less likely to walk away)

Structuring a Start-up Transaction

- Vesting: Founders are generally restricted from selling their initial equity for a period of time.
  - A typical scenario may provide that 25 percent of the shares vest at the end of the first year of employment, with 2 percent of the shares vesting monthly thereafter.
    - Vesting arrangements generally accelerate the founders' vesting if the company is acquired.
- Why Have Vesting?
  - Protection for founders => All original members of a founding team may not remain with the company. If this happens in a firm without vesting, the ex-founders who keep their stock can "free-ride" on the efforts of those who continue to build the company.
  - Protection for VC => Increases commitment of founders to the company. Also forces the founders to "earn" the value

Structuring a Start-up Transaction

- Tax Implications of Restricted Stock
  - Shares which are transferred subject to forfeiture and transferability restrictions (vesting) are normally taxed to the employee when those restrictions lapse
  - Tax is based on the difference between the FMV of the stock at the point in time when restrictions are lifted and what the employee paid for the stock
    - TEAM will owe tax on "ordinary income" NOT a long term capital gain

Structuring a Start-up Transaction - Section 83(b) Election

- Section 83 (b) allows an employee to elect to accelerate tax payment to the time when shares are received rather than the time vesting occurs. If this election is made, the compensation element is closed at the time of receipt rather than vesting.
- In our example, TEAM's tax liability should be zero – the founders paid FMV for their stock
  - $5/share => the same price paid by VC

Structuring a Start-up Transaction - Section 83(b) Election

- Election must be made within 30 days after TEAM's purchase of stock
- Election must be in writing and must be filed with the IRS office at which the employee regularly files his tax returns
- The written statement must also be attached to the employee's income tax return for the year of the transfer
- The employee must send a copy of the election to the employer
- The election is irrevocable

Structuring a Start-up Transaction - Section 83(b) Election

- Section 83(b) Election Statement
  - The taxpayer's name, address, and identification number;
  - A description of the property which is the subject of the election;
  - The date of transfer;
  - The nature of restrictions attached to the property;
  - The FMV of the property;
  - The amount paid (if any) for the property; and
  - A statement that copies of the election have been filed with the employer.

Structuring a Start-up Transaction

- What about structuring STARTUP as a flow-through entity (S Corporation, Partnership, or LLC)?
  - Eliminates Double taxation
  - Allows for the pass-through of losses as they occur
  - Items of income or loss retain their character (e.g., capital gains)

Structuring a Start-up Transaction

- An "S" Corporation is generally NOT a feasible option:
  - Shareholders of an S corporation can't be a C corporation, partnership, or LLC
- Alternative: VC can supply most of STARTUP's funding in the form of "debt" with a conversion feature
  - Problem: If debt to equity ratio is unreasonable, VC debt can be re-characterized as equity

Structuring a Start-up Transaction

- A partnership is also generally NOT a feasible option:
  - General partners do NOT have limited liability protection.
- Alternative: STARTUP can be structured as a limited partnership with a corporate general partner
  - Problem: VC's exercise of decision making authority could be viewed as taking part in the control of STARTUP's business destroying LP status

Structuring a Start-up Transaction

- What about a limited liability company (LLC)?
  - LLC statutes adopted in the various states are not uniform (limited liability may not be a given in a “foreign state”=> unlikely)
  - LLC is not an optimal structure for a company that intends to go public shortly after its founding
  - LLCs may become more common for owners that want pass-through treatment and don’t intend to go public in the near future