Tax Aspects of VC Investor Financings

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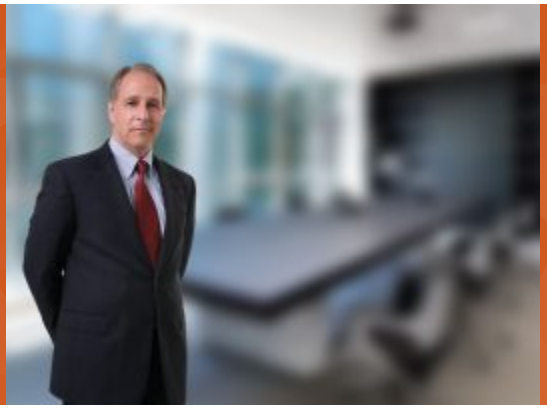

Business entities often look to outside investors for funds they need to achieve their objectives. For better or worse, tax considerations often factor into preparing for, structuring and effecting an investor financing. This article considers how various tax rules may bear on financings.

I. Entity of Choice.

a. Venture Capital Funds.

Venture capital ("VC") funds typically prefer that operating companies they invest in be C corporations. Historically, the preference for C corporations has in large part been driven by tax issues arising from investments by VC funds in "pass-through" entities. Although VC funds generally are not able to invest in S corporations (because the VC funds are partnerships and want preferred equity positions), they can invest in limited liability companies ("LLCs") and other tax partnerships. If a VC fund invests in an LLC that engages in a U.S. trade or business, however, the operating income from the LLC flowing through the VC fund to investors in the VC fund constitutes (i) "unrelated business taxable income" (sometimes referred to as "UBTI") in the hands of tax-exempt investors in the VC fund and (ii) income that is effectively connected with a U.S. trade or business (sometimes referred to as "ECI") in the hands of non-U.S. investors in the VC fund.[1] The expansion of the "qualified small business stock" exclusion discussed below (given that VC funds tend to hold their investments for long periods of time) and, more recently, the reduction of the top corporate tax rate to 21% (given that companies VC funds invest in tend to retain any earnings they have) have further enhanced the C corporation as the operating company of choice for investing VC funds.[2]

1. Change of S corporation or LLC to C corporation. A VC fund will typically require an S corporation or LLC in which it wants to invest to become a C corporation as a condition of its investment.[3]

A. S to C. An investment by a VC fund in an S corporation automatically terminates the corporation's S status under Code Section 1362(d)(2) on the date on which the investment is made (because the VC fund is not a qualifying S corporation shareholder and because, if the VC fund acquires preferred stock, the corporation now has more than a single class of stock). If an S corporation taxable year of the corporation has begun, the last day of the S corporation year is the day before the investment by the VC fund. The remainder of what would have been the S corporation taxable year is a short C corporation year. The tax items for the year of the termination are allocated between the short S and C portions on a pro rata basis (by numbers of days in each portion) under Code Section 1362(e) unless (i) all of the shareholders consent to the application of normal tax accounting rules to the two periods or (ii) there is a sale or exchange of 50% or more of the stock in the corporation during the year. For a limited period of time after the termination of a corporation's S status (the period is referred to as the "post-termination transition

period"), the corporation may make (under Code Section 1371(e)) tax-free cash distributions to its shareholders with respect to their shares to the extent of its accumulated adjustments account.

B. LLC to C. Revenue Ruling 84-111, 1984-2 CB 88 describes three methods of incorporating a partnership and the tax consequences of each of the three methods. Under the first method, the partnership contributes its assets to a newly formed corporation in exchange for all of the outstanding stock of the corporation (and the assumption by the corporation of its liabilities) and then distributes the stock to its partners in a liquidating distribution. Under the second method, the partnership distributes its assets to its partners (who assume the partnership's liabilities) in a liquidating distribution, and the partners then contribute the assets to a newly formed corporation in exchange for all of the outstanding stock of the corporation (and the assumption by the corporation of the liabilities). Under the third method, the partners of the partnership contribute their interests in the partnership to a newly formed corporation in exchange for all of the outstanding stock of the corporation, and the partnership then liquidates for tax purposes into the corporation (with the partnership assets and liabilities becoming assets and liabilities of the corporation). These days, the simplest way for an LLC to become a corporation is for the LLC to "convert" to the corporation under the applicable state conversion statute(s). Revenue Ruling 2004-59, 2004-24 IRB 1050 treats a conversion as an incorporation under the first method described in Revenue Ruling 84-111.[4] In any event, each of the three methods is analyzed under a combination of Code Sections 351 and 731 and their respective ancillary provisions (with neither the post-contribution distribution under the first method nor the pre-contribution distribution under the second method preventing the satisfaction of the control test applicable under Code Section 351).[5] Depending on the circumstances, however, the method chosen may affect the tax consequences of the incorporation (including the amount and character of any boot gain, the bases the former partners take in their shares of stock in the corporation, and the bases the corporation takes in the assets formerly held by the partnership). Those utilizing the second method should also beware Code Sections 704(c)(1)(B) and 737 if the distributed assets include any that have been contributed to the partnership during the prior 7 years.[6]

2. Investment structure. If continued S corporation or LLC status for a portfolio company is desirable and agreeable to an investing VC fund, structuring an investment by the VC fund as debt with equity-like features (such as contingent interest or convertibility) and/or a warrant might be worth considering. In that case, though, care needs to be taken to ensure that the form of the arrangement will be respected for tax purposes.[7] If the operating company is an LLC, it might also be possible to have the VC fund make an equity investment in the LLC through a wholly owned C corporation formed by it to make the investment (such a C corporation is sometimes referred to as a "blocker" corporation).[8]

b. Angels.

Individual investors (sometimes referred to as "angels") may be more willing than VC funds to invest in pass-through entities.[9] U.S. resident individuals can hold shares in S corporations. If the existing entity is an S corporation and the investors want preferred shares, however, their acquisition of preferred shares will terminate the corporation's S status. In that case, assuming continued pass-through tax treatment is desirable, an acceptable alternative may be for the investors and the S corporation to form a new LLC to which the S corporation contributes its assets (and which assumes the S corporation's liabilities) and the investors contribute their investment amounts.[10] Unfortunately, because Code Section 336 applies to liquidating distributions by S corporations, the S corporation will likely have to remain in existence as the entity through which the existing owners hold their interests in the LLC (unless the liquidation can be effected with certainty as to the absence of built-in gain).[11] The continued existence of

the S corporation may complicate the investment documents among the various stakeholders (particularly with regard to transfer restrictions and also possibly with regard to voting).

II. Qualified Small Business Stock.

Code Section 1202 allows a non-corporate taxpayer who has acquired "qualified small business stock" (or "QSBS") after September 27, 2010 and who has held the QSBS for more than five years to exclude 100% of the gain recognized on a sale of the stock.[12] For stock to be QSBS, it must have been acquired upon original issuance for cash, other property (excluding stock) or services (other than as an underwriter) from a C corporation that, among other things, satisfies certain "qualified small business" and "active business" requirements.[13] The "qualified small business" requirement limits the applicability of Section 1202 to stock issued by corporations with aggregate gross assets of $50 million or less. The "active business" requirement limits the applicability of Section 1202 to corporations most of whose assets are used in one or more "qualified trades or businesses" (which exclude, among other things, providing professional services such as law, engineering, accounting and actuarial science). In addition, the corporation may not have redeemed more than de minimis amounts of its outstanding stock within specified periods of time before or after the issuance of the stock in question. "Look-through" rules can allow an S corporation or partnership to pass the benefits of Section 1202 through to its owners.[14]

When Section 1202 was originally enacted in 1993, only 50% of the gain on a sale of QSBS held for more than five years was excludible. Any gain that was not excludible due to the percentage limitation was taxable at a maximum rate of 28%. In addition, a portion (7%) of any excluded gain was a preference item under the alternative minimum tax. With the maximum excludible portion of the gain on a sale of QSBS limited to 50% and the non-excludible portion of the gain taxable at a 28% rate, Section 1202 lost much of its luster in 2003 when the maximum rate generally applicable to long-term capital gains from stock sales was reduced to 15%. The American Recovery and Reinvestment Tax Act of 2009 breathed some new life into Section 1202 by increasing the maximum excludible portion to 75% for QSBS acquired after February 17, 2009 and, as enacted, before January 1, 2011. Subsequent legislation increased the maximum excludible portion to 100%, and exempted excluded gain from the alternative minimum tax, for QSBS acquired after September 27, 2010.

III. Rights of Preferred Stockholders.

a. Terms.

Holders of shares of preferred stock of a C corporation may have, among other things, (i) rights to an accruing dividend (which may be expressed as a percentage per annum of their investment amounts), (ii) rights to receive their investment amounts plus their accrued but unpaid dividends upon the corporation's liquidation before common stockholders receive anything,[15] (iii) rights (and obligations, typically in connection with an initial public offering by the corporation that meets specified parameters) to convert their preferred shares to common shares, (iv) rights to have the corporation redeem their preferred shares after a specified date (typically at a price at least equal to the amount they paid for their preferred shares plus their accrued but unpaid dividends), and/or (v) anti-dilution protection triggered by subsequent issuances by the corporation, usually with certain exceptions, of shares at a price per share that is lower than the price per share they paid for their shares (with the mechanism being a favorable adjustment to the price at which their preferred shares convert to common).

b. Section 305.

Code Section 305(a) provides generally that a stock distribution by a corporation is not taxable to the recipient. Section 305(b), however, provides exceptions to the general rule. Any distribution that falls within one of the Section 305(b) exceptions is treated as a distribution to which Section 301 applies (so that the value of the distributed stock is taxable to the recipient to the extent of the corporation's current or accumulated earnings and profits).

1. Redemption premium/accruing dividends. Code Section 305(b)(4) provides that stock distributions on preferred stock are taxable. Among other things, Section 305(b)(4) and the Regulations thereunder require a holder of preferred stock that is redeemable by the issuing corporation or puttable by the holder to the corporation (that is, which the holder has a right to have redeemed) to accrue the "redemption premium" on the preferred stock (the amount payable on redemption of the stock over the amount paid to the corporation for the stock) as if it were original issue discount (to the extent of the corporation's current or accumulated earnings and profits). Thus, a holder's right to have his or her preferred stock redeemed at a price that includes accrued but unpaid dividends may require the holder to report the dividends as they accrue. Fortunately, under Regulations Section 1.305-5(a), if the holder's stock participates in the corporation's growth to any significant extent, the stock is not "preferred stock" for purposes of Section 305(b)(4).[16]

2. Change in conversion ratio. Code Section 305(c) and Section 1.305-7 of the Regulations provide that a change in the ratio at which convertible preferred stock converts to common may be deemed a distribution of stock.[17] Such a deemed distribution is taxable if it has a result described in one of the Section 305(b) exceptions. Under Section 305(b)(2), a distribution is taxable if it (or a series of distributions of which it is a part) results in (i) the receipt of money or other property by some shareholders (in a distribution to which Section 301 applies) and (ii) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Distributions are related for purposes of the rule if they occur within 36 months of each other or if they are part of a plan. Fortunately, bona fide reasonable adjustments to prevent dilution do not cause deemed distributions of stock for purposes of the rule.

3. Conversion. The actual conversion of preferred to common is generally treated as a non-taxable recapitalization under Code Section 368(a)(1)(E).[18] Under Sections 1.305-7(c) and 1.368-2(e) of the Regulations, however, a recapitalization can result in a deemed distribution for purposes of Section 305 if (i) it is part of a plan to periodically increase a shareholder's proportionate interest in the corporation's assets or earnings and profits or (ii) a shareholder owning preferred stock with dividends in arrears exchanges the preferred stock for other stock and thereby increases his or her proportionate interest in the corporation's assets or earnings and profits (with the deemed distribution being equal to the lesser of (a) the amount by which the greater of the fair market value or the liquidation preference of the stock received in the exchange exceeds the issue price of the stock surrendered in the exchange or (b) the amount of the dividends in arrears).[19]

IV. Warrants.

Investors sometimes acquire options (often referred to as "warrants") to purchase additional shares or other units of equity in connection with their investments.

a. Corporations.

Typically, a warrant issued to an investor in a corporation entitles the investor to purchase additional shares of whatever class of stock he or she purchased (at the same price per share he or she paid for the stock he or she purchased) for some specified period of time, and with the benefit of anti-dilution adjustments. Investor warrants (as opposed to compensatory options granted to service providers) generally do not present tax issues (and are not governed by Code Section 83), although (i) an amount of the price purportedly paid by the investor for the accompanying stock equal to the value of the warrant can be allocated away from the stock and treated as having been paid for the warrant (for basis allocation purposes), (ii) the investor's holding period under Code Section 1223 for stock acquired by exercising the warrant does not begin until the investor exercises the warrant (so that the investor may prefer to ultimately sell the warrant rather than exercise the warrant and sell the stock), (iii) a warrant can result in the investor's being deemed to own the underlying stock if the exercise price of the warrant upon its issuance is too low in relation to the then value of the stock (see Rev. Rul. 82-150, 1982-2 CB

110), (iv) warrants are treated as stock for purposes of Code Section 305 (so that, for example, a change in the exercise price of the warrant outside of the "reasonable antidilution adjustment" exception might result in the holder's having received a taxable stock distribution), and (v) if the corporation is an S corporation, care needs to be taken to ensure that the warrant does not create a second class of stock.[20]

b. LLCs.

Final Regulations regarding noncompensatory partnership options and convertible debt (under, among others, Code Sections 704, 706 and 721) were published in 2013. Under the Regulations, with certain exceptions, neither the issuance nor the exercise of a noncompensatory partnership option is a taxable event for the holder of the option, the partnership or the other partners.[21] Upon the exercise of a noncompensatory partnership option, the holder's capital account is credited with the amount he or she paid to acquire and exercise the option (including the fair market value of any property he or she contributed to exercise the option). The partnership's properties are to be revalued as of the time immediately after the exercise, and the unrealized income, gain, loss and deduction is to be allocated first to the capital account of the exercising holder to the extent necessary to reflect his or her right to share in partnership capital and thereafter to the capital accounts of the historic partners to reflect the manner in which they would share in the proceeds of a taxable disposition of the partnership's property at fair market value. Disparities between the partners' bases and capital accounts are to be eliminated under Section 704(c) as the partnership's properties are depreciated, amortized or sold. If the exercising holder's capital account still does not reflect his or her right to share in partnership capital after the allocations of unrealized income, gain, loss and deduction, the partnership is to reallocate capital to the exercising holder from the historic partners and make "corrective" allocations of gross income and gain or gross loss and deduction among the partners for tax purposes corresponding to the shift in capital.[22]

V. Valuation and Related Issues.

A key term to be negotiated with an investor is the valuation to be placed on the entity receiving the investment. The valuation generally determines the percentage interest in the entity to be acquired by the investor and therefore the number of shares (or other units of equity) issued to, and the price per share (or other unit of equity) paid by, the investor.[23]

a. Equity Awards to Service Providers.

1. Corporations. Equity awards by corporations to service providers generally take the form of options or restricted stock. In either case, the value of the underlying stock at the time of the award is a key factor in determining the consequences of the award. If the award is in the form of an option, the exercise price of the option must be at least equal to the fair market value of the underlying stock as of the date of the grant of the option for the option to be an incentive stock option (or "ISO") under Code Section 422 and to avoid the applicability of Code Section 409A. If the award is in the form of restricted stock, any excess of the value of the stock over the amount paid for the stock is compensation income for the year of the award if the award recipient makes an election with respect to the stock under Code Section 83(b).[24] In any event, the price paid for stock by an investor is a "data point" for purposes of valuing equity awards made by the corporation.[25]

A. "Cheap stock." The term "cheap stock" is sometimes used to refer to stock issued by a corporation to a service provider that might, when viewed in conjunction with a contemporaneous issuance of stock by the corporation to an investor for cash, have a value greater than the amount of any money and the value of any property contributed by the service provider for the stock (so that all or some portion of the stock may have been issued to the service provider for services). For example, suppose (i) that a founder forms a corporation and, upon the formation of the corporation, receives 80 shares of the corporation's stock, and (ii) that contemporaneously with the formation of the corporation, an investor purchases

20 shares of stock in the corporation for $200,000. The price contemporaneously paid by the investor may imply a value of the founder's shares of $800,000 (or even more if the founder's shares have some sort of control premium). To the extent the founder has received his or her shares for services, he or she has $10,000 (or more if there is a control premium) per share of ordinary compensation income to report. To avoid a "cheap stock" problem, founders should consider (i) forming their corporations well in advance of investments in the corporations, (ii) contributing as much property as they can under the circumstances for their shares (and fully documenting their property contributions so as to attribute as much value to their property contributions as possible under the circumstances), and (iii) if their corporations are C corporations, causing the corporations to issue common shares to them and preferred shares to investors so that discounts can apply in valuing their common shares.

2. LLCs. Equity interests awarded by LLCs to service providers are often structured so that they may qualify as "profits interests."[26] A profits interest is an interest that would entitle the holder to receive nothing if the LLC sold its assets for an amount of cash equal to their fair market value and liquidated immediately after the issuance of the interest. In general, a service provider is not taxable upon his or her receipt of, or vesting in, a profits interest.[27] To qualify an interest awarded to a service provider as a profits interest, it is generally necessary to carve the LLC's existing liquidation value off for the benefit of the other members. If, in the example in IV.a.1.A. above, the corporation were instead an LLC and the founder's interest were intended to be a profits interest, the LLC's operating agreement should provide the investor with a right to receive the first $200,000 of liquidation proceeds.[28]

b. LLC Book Adjustments.

An investment in an LLC is an event that allows for the restatement of the book values of the LLC's assets (to fair market) and the members' capital accounts (to the amounts they would receive in a liquidating distribution under the operating agreement if the LLC then sold its assets at fair market value) under the Section 704(b) Regulations. Code Section 704(c) and the regulations thereunder then apply (in "reverse" fashion) with the objective of eliminating disparities between the members' tax bases and capital account balances resulting from the revaluation.

VI. Founder Vesting.

Investors may require that some or all of the outstanding shares held by founders and other service providers be made subject to vesting. Before the issuance of Rev. Rul. 2007-49, 2007-2 CB 237, it was thought that the imposition of a vesting requirement with respect to outstanding shares might constitute a constructive exchange of unrestricted shares for restricted shares, thereby requiring the filing of a Section 83(b) election to avoid adverse consequences to the holder of the shares upon vesting. Rev. Rul. 2007-49 clarified that the imposition of a vesting requirement with respect to outstanding vested shares does not constitute a "transfer" of unvested shares to the holder for purposes of Section 83, so that a Section 83(b) election need not be made to avoid a tax event upon vesting. Of course, there may be circumstances under which outstanding shares were issued with the understanding that they would be subject to a vesting requirement (so that issuing the shares and then subjecting them to a pre-negotiated vesting requirement might not bring the shares within the facts of Rev. Rul. 2007-49).

VII. Debt Financings.[29]

Companies sometimes receive investor financing in the form of debt. Debt, particularly debt with equity-like features (such as contingent interest and convertibility), can raise a number of tax issues, including (i) whether an instrument that purports to be debt is debt or equity, (ii) interest deductibility,[30] (iii) the applicability of the original issue discount rules, (iv) the

consequences of converting or cancelling the debt,[31] (v) the consequences of modifying the debt,[32] (vi) the consequences of the assumption of the debt by an entity into which the issuer converts, and (vii) the applicability of Code Section 305 to corporate convertible debt.

Footnotes.

1. UBTI is taxable to a tax-exempt limited partner under Internal Revenue Code ("Code") Section 511 notwithstanding the limited partner's tax-exempt status. Similarly, ECI is taxable to a non-U.S. partner under Code Section 871(b) or Code Section 882(a) and generally requires the filing by the non-U.S. partner of a U.S. tax return. Dividends from C corporations, and gains on sales of stock in C corporations, generally are not UBTI or ECI (although gains on sales of stock in "United States real property holding corporations," as defined in Code Section 897, are ECI, and dividends to non-U.S. persons are subject to withholding tax).

2. There may be situations in which a VC fund and other owners (e.g., founders, employees and other investors) hold their interests in a C corporation operating company though an LLC. The reasons for such a structure might include facilitating the VC fund's ability to cause the sale of the operating company. If the LLC does nothing more than hold stock in the C corporation, any income it has will be gain from the sale of stock in the C corporation and, if the C corporation pays any, dividends. As noted above, those types of income are generally not treated as UBTI for tax-exempts or ECI for non-U.S. persons. A recent First Circuit decision, however, has raised questions regarding whether income of investors from controlled C corporations can be trade or business income and therefore UBTI and ECI. See Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1st Cir. 2013).

3. The S corporation or LLC does not necessarily have to disappear. It could just contribute its assets to a new C corporation contemporaneously with an investment in the C corporation by the VC fund. In any event, because losses generated by the S corporation or LLC before the transfer of the assets and business of the S corporation or LLC to the C corporation can not be used by the C corporation, the VC fund gets no benefit, directly or indirectly, from those losses. If the entity had been formed as a C corporation in the first place, prior losses might remain available to offset income of the entity as net operating loss carryforwards subject to Code Sections 172 and 382.

4. An LLC could also convert to a corporation for tax purposes by simply electing to be classified as a corporation. The result is also an incorporation under the first method. See Regulations Section 301.7701-3(g)(1)(i).

5. Recall (i) that Code Section 351 does not apply to shares issued for services and (ii) that Code Section 357 can require the reporting of income upon an incorporation that otherwise qualifies under Section 351 as a result of the assumption by the corporation of liabilities. In addition, in the case of an incorporation effected in connection with an equity investment, care must be taken to stage the events so that the partnership or the partners, as the case may be, satisfy the control group test either together with the new investors or themselves (the new investors should not form the corporation and acquire their shares before the incorporation of the partnership's assets).

6. The use of the first method may prevent the stock in the corporation from qualifying for the benefits of Code Section 1244 in the hands of the former partners of the partnership.

7. If the entity is an S corporation, the arrangement must be structured so as to avoid creating a second class of stock. In that regard, a review of Regulations Section 1.1361-1(l) may be

warranted. It might also be necessary to review authorities distinguishing debt from equity generally. An extensive discussion of debt versus equity principles is beyond the scope of this article. Interested readers, however, may want to see (i) Kena, Inc. v. Commissioner, 44 B.T.A. 217 (1941) and Rev. Rul. 83-51, 1983-1 CB 48 in considering whether a contingent interest feature might cause a debt instrument to be treated as equity for tax purposes, (ii) Rev. Rul. 83-98, 1983-2 CB 40 in considering whether a convertibility feature might cause a debt instrument to be treated as equity for tax purposes, (iii) Rev. Rul. 82-150, 1982-2 CB 110 in considering whether a warrant with an exercise price significantly below the fair market value of the underlying equity upon issuance might be treated as ownership of the underlying equity for tax purposes, and (iv) Notice 94-47, 1994-1 CB 357 for a review of the factors considered by the Internal Revenue Service in determining the tax status of hybrid instruments.

8. With the use of a blocker corporation, the VC fund's income from the investment in the LLC is limited to gain from the sale of the stock of the blocker corporation (and dividends if the LLC makes any distributions of operating cash flow to the blocker corporation which the blocker corporation then distributes out to the VC fund). Again, gains from sales of stock in (and dividends from) C corporations are generally not UBTI for tax-exempts or ECI for non-U.S. persons (although gains from sales of stock in "United States real property holding corporations" can be ECI). The blocker corporation, of course, is subject to corporate-level tax on its income from the investment in the LLC (including gain from the sale of its interest in the LLC). C corporate taxation, however, is isolated to the VC fund and its blocker corporation and not imposed on the other owners of the LLC.

9. A pass-through entity may be desirable, for example, if the entity (i) is expected to generate "qualified business income" eligible for the 20% deduction under new Code Section 199A and to make distributions of its earnings from time to time or (ii) is expected to generate losses that the owners might be able to use against income they have from other sources.

10. That the LLC will have acquired its assets by contribution will mean that Code Sections 704(c)(1)(B) and 737 may apply to subsequent asset distributions by the LLC, but those distributions may be manageable. In addition, any built-in gain or loss with respect to the contributed assets will have to be accounted for under Code Section 704(c), but Section 704(c) would have applied anyway (in the "reverse" manner) if the business had been initially formed as an LLC rather than an S corporation.

11. The gain recognized by the S corporation passes through to its shareholders (absent the applicability of Section 1374 or Section 1375), increasing their bases in their shares and thereby generally preventing a second level of gain when the shareholders receive their liquidating distributions. Sections 336 and 331 are also what prevent C corporations from converting to LLCs on a tax-free basis.

12. The aggregate amount that may be excluded by any taxpayer on sales of the stock of any issuer is in any event subject to a cap equal to the greater of (i) $10 million ($5 million for married individuals filing separate returns) or (ii) 10 times the taxpayer's adjusted tax basis in the stock. If the taxpayer acquired the stock in exchange for property other than money or stock, the taxpayer's adjusted basis is deemed to be not less than the value of the property exchanged for the stock on the date of the exchange.

13. QSBS may also be acquired by inheritance, gift or, under certain circumstances, distribution from another who acquired it upon original issuance.

14. Code Section 1045 permits QSBS that has been held for more than six months to be "rolled" into new QSBS on a tax-free basis.

15. Preferred stock is sometimes described as being either "participating" or "non-participating." Holders of participating preferred stock typically have the right to receive, on a preferential basis upon the corporation's liquidation, their money back (plus, depending on the deal, any accrued dividends on their stock) plus their pro rata share of any remaining liquidation proceeds. Holders of non-participating preferred stock, on the other hand, typically have a right to receive, on a preferential basis upon the corporation's liquidation, the greater of (i) their money back (plus, depending on the deal, any accrued dividends on their stock) or (ii) their pro rata share of the liquidation proceeds. For example, suppose that an investor pays $2 million to a corporation for preferred shares representing 40% of the outstanding shares. If the corporation sells its assets and has $8 million to distribute in its liquidation, the investor receives, assuming no right of the investor to preferential accrued dividends, (i) $4.4 million if the preferred stock is participating (its $2 million investment amount plus its 40% pro rata share of the remaining $6 million) or (ii) $3.2 million if the preferred stock is non-participating (the greater of its $2 million investment amount or its 40% pro rata share of the $8 million). Sometimes, participating preferred stock becomes non-participating if the holders would receive, in a liquidating distribution made on a non-participating basis, an agreed upon multiple of their investment amounts.

16. Section 1.305-5(a) of the Regulations provides that the determination of whether stock is preferred for purposes of Section 305 is to be made without regard to any right to convert the stock to stock of another class of the issuing corporation. Thus, under a literal reading of the Regulations, stock may be "preferred stock" if the holder has to exercise a conversion right to participate in corporate growth. Investors acquiring stock with a preference and also a right to share in liquidation proceeds on a pro rata basis (whether on a participating or non-participating basis, depending on the deal) therefore generally prefer that the corporation's charter entitle them to receive their pro rata share without having to convert.

17. Under Code Section 305(c) and Section 1.305-7 of the Regulations, a change in redemption price, issuance of stock with a redemption premium, redemption that is treated as a dividend distribution, or transaction (including a recapitalization) having a similar effect can also result in a deemed distribution to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is thereby increased. Proposed Regulations under Section 305 issued in 2016 would, when finalized, make certain clarifications regarding deemed distributions. In any event, the taxability of a deemed distribution depends on whether the distribution has a result described in Section 305(b).

18. See Rev. Rul. 77-238, 1977-2 CB 115.

19. The taxability of any such deemed distribution depends on whether it has a result described in Code Section 305(b).

20. The exercise of a warrant is generally not a taxable event for the holder (assuming the warrant is not a compensatory option) or the issuing corporation. Code Section 1234 and the Regulations thereunder provide that gain or loss attributable to the sale or exchange of, or loss attributable to the failure to exercise, a noncompensatory call option is treated as gain or loss from the sale or exchange of property having the same character that the underlying property would have in the hands of the option holder.

21. Exceptions apply to (i) the receipt of a noncompensatory option in exchange for appreciated or depreciated property and (ii) the receipt of an interest in a partnership in satisfaction of obligations of the partnership to pay unpaid rent, royalties or interest (including original issue discount).

22. The Regulations also include rules for the treatment of an option holder as a partner if the option is reasonably certain to be exercised (applying tests similar to those applicable in

determining whether an option granted by an S corporation constitutes a second class of stock) or the holder has "partner attributes."

23. For example, an investor investing $2,500,000 based on a "pre-money" valuation of $5,000,000 typically acquires a number of shares (or other units of equity) equal to 1/3 of the total number of shares (or other units of equity) that are outstanding as of the time immediately after the investment (treating as outstanding, if the investment is made on a "fully diluted" basis, an agreed upon number of shares, or other units of equity, reserved for issuances to employees and other service providers under an equity incentive plan).

24. If the award recipient does not make a Section 83(b) election with respect to the stock, the recipient reports the excess of the value of the stock (as of the time of vesting) over the amount he or she paid for the stock as he or she vests in the stock. Value therefore remains important even in the absence of the election.

25. Equity awards are typically made in common stock. If the investor purchased preferred stock, the price per share used for equity awards is typically a fraction of the price per share paid by the investor. Thus, in the example in footnote 23, the common stock that is the base equity for the $5,000,000 pre-money valuation is typically not considered to have an actual value of $5,000,000 (so that the $5,000,000 merely determines the number of shares of preferred stock issued to, and the price per share paid by, the investor).

26. LLCs can grant options, but (i) there is no partnership counterpart to the ISO rules, (ii) the exercise of a compensatory option may result in the holder then being deemed to receive a capital interest for services, and (iii) Section 409A can apply to options granted by LLCs.

27. See Rev. Proc. 93-27, 1993-2 CB 343 and Rev. Proc. 2001-43, 2001-34 IRB 191. Technically, a profits interest must satisfy certain other requirements as well for these Revenue Procedures to apply. Proposed Regulations issued in 2005 will supersede these Revenue Procedures when finalized.

28. If the understanding was that the founder and the investor were to share liquidation proceeds 80/20 notwithstanding that the founder's interest would be a profits interest, any remaining liquidation proceeds could be distributed (i) 100% to the founder until the founder has received 80% of the liquidation proceeds (that is, until the founder has received $800,000) and (ii) thereafter, 80/20 as between the founder and the investor.

29. This article does not consider debt financings in any significant detail.

30. Deductibility limitations apply, for example, (i) under Code Section 163(l) to corporate debt that is payable in equity of the issuer or a related party to the issuer, (ii) under Code Section 163(i) to certain high-yield corporate debt that bears a significant amount of original issue discount, and (iii) under Code Section 163(j) to corporate debt payable to a related party that is not taxable on the interest.

31. A conversion of debt to equity is generally nontaxable to the holder of the converted debt (at least as to equity received in exchange for principal or interest that has already been accrued for tax purposes). A conversion or cancellation may, however, generate cancellation of indebtedness income for the entity. In that regard, it should be noted that the debt for equity rule of Code Section 108(e)(8) applies by its terms in both the corporate and partnership contexts while the contribution to capital rule of Code Section 108(e)(6) applies by its terms only in the corporate context. As mentioned above, the recently issued Regulations dealing with noncompensatory partnership options also deal with convertible partnership debt.

32. Under Section 1.1001-3 of the Regulations, a "significant" modification results in a deemed exchange of the modified instrument for a new instrument.