

# LEGAL PERSPECTIVES FOR THE NANOTECH START-UP: BUSINESS AND TAX ISSUES INVOLVING CHOICE OF ENTITY, CAPITAL FORMATION, AND COMPENSATION

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# Topics Covered

- Choice of Entity
- Capital Formation
- Compensation
- Related Issues
  - Top “10” Reasons for Failure
  - Business Plan
  - Other Tax Considerations, including IP and Exit

# Choice of Entity



- **Type of Entity**
- **Characteristics of Entity**
- **Considerations in Choosing Entity**

# Type of Entity



- **Sole Proprietorship**
- **General Partnership**
- **Limited Partnership**
- **Limited Liability Partnership**
- **Limited Liability Company**
- **C Corporation**
- **S Corporation**

# Characteristics of Entity



- **Sole Proprietorship**
  - No set-up
  - No or few employees
  - Good for temporary position, e.g., consulting, or part-time business
  - General liability
    - Consider additional insurance, e.g., errors and omissions
  - Schedule C on tax return

# Characteristics of Entity (continued)



## ■ **General Partnership**

- Like sole proprietorship, including liability issues, but for two or more partners
- Requires partnership agreement
- Files IRS Form 1065; passes all income/gains and deductions/losses to partners as reported on Schedule K-1 to Form 1065; income reported on Part II of Schedule E.

# Characteristics of Entity (continued)



## ■ **Limited Partnership**

- One general partner with unlimited liability
  - Usually corporation – capitalization requirements
- Balance of partners are limited partners with limited liability, except for tortious acts
- Taxation like general partnership

# Characteristics of Entity

## (continued)



- **Limited Liability Partnership**

- A form of general partnership in which no partner is liable for acts or omissions of the partnership, aside from the partner's own tortious acts. Used particularly for professional service providers, such as accountants, doctors, and lawyers, although they may also use a professional corporation

# Characteristics of Entity

(continued)



## ■ **Limited Liability Company**

- Liability protection of corporations
- Tax pass-through of sole proprietorships and partnerships
- Management is by one or more members or by a non-member manager, as specified in the operating agreement
- One-person LLC disregarded as tax entity; two or more person LLC taxed as partnership, unless check-the-box election as corporation
  - Caveat: Foreign entity, if not a corporation but where all members or shareholders have limited liability, will be treated as a corporation unless it elects to be treated as a partnership
- State law requires articles and operating agreement; some states require published notification
- Partnership may generally convert to LLC. Member of partnership who was personally liable on a particular item will be personally liable on the item in the LLC.
- LLC may generally convert to C corporation

# Characteristics of Entity

## (continued)



### ■ **C Corporation**

- Legal existence separate and distinct from shareholders
- Centralized management
- Sell stock to raise capital or use it to make acquisitions
- Full range of capital structure
  - Common stock
  - Preferred stock and variations, including hybrids
- Convertible preferred stock
- Debt
  - Hybrid – some states allow debt with voting rights
  - Convertible debt
  - Nonconvertible or “straight” debt

# Characteristics of Entity (continued)



## ■ **C Corporation (continued)**

- Transferability of stock from one owner to another
- Image, substantiality
- Tax-free mergers, stock acquisitions
- Formalities: annual document filings and fees, formal directors' meetings and minutes
- Carrying over start-up costs as NOLs. E.g., start-up expenses, R & D
  - May lose carryover on “takeover”
- “Double” taxation – corporate and shareholder
- Form 1120 tax return
- Dissolution raises complex tax issues
- Illusory corporate benefits?

# Characteristics of Entity

## (continued)



### ■ **S Corporation**

- Maximum 75 shareholders; all of whom must be U.S. citizens or alien permanent residents or small business or certain tax-exempt organization, and trusts under certain circumstances.
- One class of stock, except if the only difference between the classes is in voting rights
- IRS Form 1120S informational tax returns; K-1s to stockholders, which they report on Form 1040, Schedule E, Part II supplemental income and loss

# Considerations in Choosing Entity



- **Liability**

- **Tax**

- Top individual rate 38.6% in 2002 and 2003, 37.6 in 2004 and 2005, and 35% in 2006 and after.
- Top corporate rate 35% (34% for taxable income above \$75,000 and up to \$10,000,000).
- Tax rate “plays”

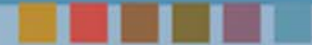
- **Capital Formation**

- Seeking equity capital from private sources or from a public offering, or both

- **Control**

- Degree of control over management, governance, and financial matters that the owners wish to have

# Considerations in Choosing Entity



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# Considerations in Choosing Entity

(continued)



- **Continuity of existence**
- **Compensation**
  - Corporations allow compensation in stock. Also greater advantages when providing fringe benefits, such as health insurance.
  - Corporation generally more flexible, but depends also on size, number of employees and other services providers
- **Investment**
  - Corporation more flexible. Allows different classes of stock, with different rights, such as:
    - Common stock – voting shares to the initial owners who will be working in the business
    - Non-voting shares for key employees to keep them loyal to the business.
    - Non-voting preferred shares to outside investors, giving them a preference if dividends are declared or the corporation is sold.

# Considerations in Choosing Entity

## (continued)



- **Long-Term Goals – Sale, Going Public, etc.**
  - No tax consequences converting Partnership or LLC into a C; tax consequences the other way
  - C corporation can be sold to or merged into another corporation with a tax-free exchange of stock, but a flow-through cannot
- **Location of owners and operations:**
  - All in U.S. or some or all outside U.S.
- **State Law Considerations**
  - State laws govern setting up entities
  - State taxation may also vary
- **Goals**
  - Product
  - Persons Involved – taxes, compensation, ownership
  - Capital Formation
  - Exit Plan

# Capital Formation

- **Personal and Angel Financing**
- **Venture Capital**
  - VC Fund profile
  - VC Fund expectation
  - Alert - Be on the lookout for scams. Do not give upfront fees or deposits to venture capital finders.
- **Grants**
  - Usually for non-profits. Available also for “for profit” companies.
  - Review grant announcements in the Federal Register
  - State and local
- **SBA**
  - The Small Business Administration serves both as guarantor on loans to small businesses and as lender.
- **Small Business Investment Company program**
  - Privately owned and operated small business investment company that partners with the federal government to provide venture capital to small business.

# Venture Capital



- **VENTURE FIRMS SEE NANOTECHNOLOGY AS AREA THEY CAN'T AFFORD TO IGNORE**

By Alan Goldstein  
The Dallas Morning News

- **March 14, 2002 – Perennially in search of the next big thing, many people involved with the technology industry recently have turned their attention to a science that deals with the very small.**
- **Nanotechnology, a hot buzzword these days, involves the manipulation of individual molecules or groups of atoms to create a wide range of materials and devices.**
- **The name comes from the nanometer, a unit of measure that's one-billionth of a meter in size, or 10 times the diameter of a hydrogen atom.**
- **The definition is loose enough that some argue the field is nothing new. Certain synthetic coatings and adhesives have depended for decades on sophisticated chemistry.**
- **But the discussion about nanotechnology inevitably turns to exotic applications that seem to be the stuff of science fiction, such as mini-machines that digest toxic waste, molecule by molecule, or even enter the human body to fight a hostile infection.**

# Grants

- **BUSH CALLS FOR 17 PERCENT INCREASE IN SPENDING FOR NANOTECH PROGRAMS**

By Doug Brown  
Small Times Correspondent

- WASHINGTON, Feb. 5, 2002 – President Bush wants to give nanotechnology research a big boost in funding next year even as his \$2.13 trillion budget calls for cuts to programs and agencies throughout the federal government.
- If Congress gives its imprimatur to Bush's nanotechnology budget, the [National Nanotechnology Initiative](#) will balloon 17 percent from \$579 million to \$679 million. Former President Bill Clinton launched the NNI in 2000. It oversees much of the nanotechnology research being conducted by the federal government.

- **BUSH PROPOSES DEEP CUTS TO PROGRAM THAT FUNDS HIGH-RISK NANOTECHNOLOGY**

By Doug Brown  
Small Times Correspondent

- WASHINGTON, Feb. 11, 2002 – The Bush administration is seeking to nearly cut in half the funding for a federal program that bills itself as Uncle Sam's own venture capital firm for high-risk research.
- The [Advanced Technology Program](#) (ATP), which has paid for more than 30 different nanotechnology research ventures, will get its budget slashed from about \$185 million to \$107.9 million under the president's fiscal 2003 budget unless lawmakers come to its rescue during their phase of the budget process.

# Capital Formation

## (continued)



- **Bank financing**
- **Export-Import Bank of the U.S.**
- **Small Business Innovation Research Award Program**
- **Special federal funding for nanotechnology**
- **Capital from operations – slow down burn rate**
- **Professions, VC clubs, other venues**
- **Private Placements – Alternatives to Going Public**
  - “Regulation D” - Rules §§ 504, 505 and 506.
  - Other
  - State exemptions. Small Company Offering Registration (SCOR).
- **Employee Stock Ownership Plans (ESOPs)**
  - Plan, in which employees participate, buys employer stock. Employer can make deductible contributions to ESOP, which then purchases employer stock.
  - ESOP can borrow from outside lender to purchase stock. Or, alternatively, employer can borrow from outside lender and lend to ESOP to purchase stock.
  - Often used by business owners to retire by selling out to ESOP and employees.
  - Not for start-ups. Requires size, employees, significant assets. Good in growth scenario.

# Capital Formation

## (continued)



- **IPOs**
  - Risky – of all exit strategies, it depends the most on market timing
    - Expensive to close
    - Results in running formerly entrepreneurial business under public scrutiny
    - “In play”
- **Rule 155 – private/public**
  - 33 Act registration
  - 34 Act reporting
- **Merger and Acquisition**
  - Stock
    - Sellers prefer
    - Capital gains treatment
  - Assets
    - Sellers prefer because of basis step-up
- **Strategic Alliances and Partnerships**
- **PIPEs. Private investment in public equity**
  - Company sells common stock or convertible securities to hedge funds, wealthy individuals, mutual funds, and other private investors.

# Capital Formation

## (continued)



- **Restructuring**
  - Tracking stock
  - Equity carve out, perhaps through IPO, of good unit
  - Spin off weak subsidiary
- **Stock Repurchases**
- **Successive Rounds of financing**
  - Effect of earlier rounds
  - Redemption privileges in senior securities to allow issuer to change capital structure
  - Debt vs. equity considerations
    - Thinly capitalization for tax purposes
    - Balance sheet aspects – addition to capital account vs. debt
    - Tax considerations – can control timing of dividends, but interest is deductible
    - SBIC relationship may require refinancing debt
  - Issuance of stock
    - In case of S corporation, could trigger loss of that status depending on identity of shareholders
    - In case of C corporation, could result in change in control, severely restricting use of NOLs

# Compensation



## ■ Investors

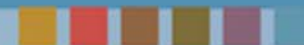
- Security, income, priority on liquidation, substantial “upside” potential for risk-taking

## ■ Entrepreneurs/founders

- Voting control
- Compensation in exchange for contribution of property or for services
- Significant value for tax purposes may be established if investors get common stock
- Preferred stock for investor
- Stock options, warrants

# Compensation

## (continued)



### ■ Key employees

- Stock options - share in growth of enterprise
  - Incentive stock options
  - Non-qualified stock options
  - Stock options considerations
    - Consider impact on earnings reporting
    - Incentive stock options
      - Specific and complex requirements and limits
    - Non-qualified stock options
      - Section 83(b) election
    - Use in S corporation
      - Options granted to employees not second class of stock if nontransferable and value not readily ascertainable
      - Options granted to non-employees may be second class of stock if substantially certain to be exercised and exercise price is substantially below stock's fair market value on date option issued, materially modified, or transferred to someone not eligible to be S corporation shareholder

# Compensation

## (continued)



- Phantom stock – has impact on earnings
- Stock plus bonus to pay tax on stock (grossing up)
- Non-cash fringe benefits
- Reimbursed expenses – taxable vs. nontaxable
- Sick pay
- Supplemental wages
- Exempt payments – e.g., sickness and injury under workers' compensation law, deductible moving expense reimbursements.

### ■ **Directors and consultants**

- Start-up entrepreneurs are generally younger, less-experienced executives who are not well-steeped in corporate governance. As a result, they need a board with proven business leaders, who can be an extension of management rather than a sounding board.
- Options to buy shares at first-round investor rate, or pre-IPO price may prove attractive and amount to less the 1% of company's total equity.

# Top “10” Reasons for Failure

- Excluding discussions of competitors. Good competition can enhance the impression of a sizable market with opportunities for new entrants.
- Stressing first-mover advantage. You must show why this is advantageous. Shows reasons other companies won't enter market and take your customers.
- Focusing too much on the future. Projected future performance supports investments and valuations for growth. However, past performance, or a venture's past track record, is the best indicator of future performance. Show what milestones and accomplishments the venture has achieved.
- Indiscriminately incorporating investor feedback into the business plan.
- Focusing too much on the venture's proprietary technology. It is more important to show how this technology satisfies a large, unfilled customer need.
- Presenting large, generic market sizes. The relevant market size is more meaningful. For example, this would equal the venture's sales if it were to capture 100% of its specific niche of the market. Defining and communicating a credible and relevant market size and a plan to capture a significant share of it is more credible to investors.
- Making financial projections too aggressive. Don't exaggerate penetration, operating margins, and revenues-per-employee estimates, or allow them to seem poorly reasoned, internally inconsistent, or unrealistic.
- Tailoring management team bios to venture's development phase. A start-up should emphasize the success of management in launching and growing ventures. A more mature business should emphasize how team members have successfully operated within the framework of larger enterprises.

# Top “10” Reasons for Failure

## (continued)



Incautiously hiring former employees of a competitor

Doing IPO too soon

Creating a “cheap stock” problem by granting below-market stock options or restricted stock. On IPO, SEC wants difference between that price and offering price charged to earnings. Keep a record of substantiation of value.

Not adopting an appropriate employee stock option plan – either non-qualified or ISO

Blowing the Section 83(b) election

Selling securities to unaccredited investors

Asking investors to sign nondisclosure agreement. This may suggest that the venture has no barriers to competitive entry, and therefore is not sustainable. Different if information is proprietary technology.

Not properly maintaining organizational records

Can expose shareholders, members, and partners to personal liability for claims of entity’s creditors

Managerial and accounting skills – e.g., don’t bounce payroll checks Don’t use IPO as recruiting tool; use company’s products and services

IP Issues

Failing to obtain good title to intellectual property or to license technology patented by others

Failing to institute a trade secret protection program

Not conducting a timely trademark search

# Business Plan



- **20 – 25 pages**
- **Founders/entrepreneurs should write it**
- **Two to five page executive summary:**
  - Opportunity that is not being served
  - Your company’s capabilities and competitive advantage
  - Marketing and sales program to reach customer base
  - Necessary management skills and qualifications of key managers
  - Capital necessary to implement plan
  - Projection of financial results and time to exit
- **Balance of Business Plan to Cover**
  - Business history
  - Product and/or service
    - Proprietary features of the products
    - Economic or other benefits to customers that will drive their demand (e.g., better, faster, cheaper, more versatile, etc. “mouse trap”)
    - Patents and other IP protections

# Business Plan

## (continued)



- Necessary regulatory approvals and time to achieve
- If start with single product or service, discuss strategies to expand markets and product lines
- Market
  - Overview of market sector and targeted niche
  - Customers
  - Geographic target
  - Who makes and influences purchase decision for customers
  - Purchase process and product loyalty
  - Critical product characteristics (performance, reliability, durability, availability, price, service, conformance to industry standards)
  - Seasonal or cyclical industry
  - Costs of switching to your product or service

# Business Plan

## (continued)

### – Competition

- Market share and financial performance and resources of competition
- Specific products competing against you and against which you are competing
- Previous and anticipated competitive responses to your product
- Possible new competitors

### – Marketing and sales

- VCs prefer niche strategy, conservative forecasts
  - Niche could be quality, performance, geography, service, proprietary information
- Advertising, promotions, and public relations plans
- Sales strategy and organization
  - Direct mail, trade shows
- Distribution channels – intensive, selective, exclusive; basis for compensation
- Pricing strategy – premium, discount, and reasons
- Service and support requirements – revenue or expense?

# Business Plan

## (continued)

- Manufacturing and operations
  - Manufacturing, assembly, and shipping requirements
- Management
  - Experience, “trophy” players; single most important criteria
  - Background on board members, shareholders, advisors
- Significant risks – internal and external
  - Internal – technical feasibility about products and their development; key milestones and obstacles to meeting them; key resources and obstacles to obtaining them
  - External – market response by customers or competitors that could close window of opportunity; susceptibility to changing economic conditions
- Exit expectations
  - Three to seven years
- Financial projections
  - Annual income and balance sheet statements for last five years (or since inception)

# Business Plan

(continued)



- Projected income statement, balance sheet, and cash flow on accrual basis for next five years; more detailed for first and second years
- Unit sales, product margins, terms, etc.
- Summary of all critical assumptions used in forecast
- Detailed breakdown of use of invested cash
- Ability to accept a staged funding
- Key milestones to be achieved with the funding

# Other Tax Considerations



- **Intellectual Property Tax**
  - Charitable Contributions of Intellectual Property
  - Research Tax Credit
  - IP Holding Companies
- **Exit Tax**
  - Liquidation and Dissolution
  - Sale
    - of Entity
    - of Assets
  - Public Offering