Deals

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**Discussion Questions # 4 (Panel 1)**

**VC Capital: Capital Structure, Incentive Compensation, and Tax Planning**

**1.** Background: Two Types of income in the U.S.

A. What are the two types of income in the U.S. tax system? Which type do taxpayers usually prefer?

B. How is income from performing services usually classified?

C. What about gains from selling a profitable investment?

D. Ann starts her own business and owns 100% of the stock. Through her hard work, the value of the stock doubles, so she sells it to a private equity firm. Is her profit taxed as ordinary income or as capital gain?

E. Ann runs Barbara’s business, and makes it much more profitable. Barbara rewards Ann with a generous bonus. Is this bonus ordinary income or capital gain?

2. Please compare the following three types of equity securities -- common stock, “plain vanilla” preferred stock, and convertible preferred stock -- using the following criteria:

1. Which would you rather have if the company’s business is doing really well?
2. What if the business is doing badly?
3. Do you think they will have the same voting and control rights?

3. Before considering the significance of these differences in a VC-backed start-up, let’s begin with another setting: a consumer products company. Proctor & Scramble (“P&S”) manufactures and sells a large portfolio of “name brands,” which are popular with consumers, including detergent, hand soup, paper towels, toothpaste, and similar products. The company has $1 billion of debt outstanding, and the value of its outstanding equity is $2 billion (suggesting that its assets are worth $3 billion).

P&S has just hired a new CEO, Alice, who comes from the “edgier” world of marketing to young people. P&S’s board is concerned that the company does not appeal enough to the younger generation, and that its image is a bit old-fashioned. In her first six months, Alice decides to acquire a company -- Millennial Mania (“M&M”) -- which markets “hipper” products to younger people.

Alice’s believes that the two companies will complement each other. M&M will help to “refresh” P&S’s brands, and will provide a pipeline of new consumers. But some market analysts worry that the two companies are not compatible at all, and that the acquisition might end badly. Alice needs $500 million in cash to buy M&M, and she reaches out to Bill, her investment banker, to consider options for raising this cash.

1. Alice asks Bill about issuing $500 M of common stock. Before answering her, Bill reads a negative story about the deal in the financial press. “M&M is a niche firm for flakey young people,” a prominent market analyst is quoted as saying, “and its employees have complete contempt for a business like P&S. If these two companies are brought together, they will be looking to part company soon.” Given this coverage, why might Bill hesitate to recommend common stock?
2. Instead, Alice asks Bill if P&S should issue $500 M of “plain vanilla” preferred stock to fund the cash acquisition. It will pay a 3% dividend (compared with the 1% dividend yield on P&S common) and has a liquidation preference. If the acquisition does not go well, how will the preferred shareholders do? How does their situation compare with that of common stockholders?
3. What if the acquisition goes well (as Alice hopes)? How will the return on the preferred compare with the return on the common?
4. Instead of “plain vanilla” preferred, Bill recommends convertible preferred, which pays only a 1.5% dividend, has a liquidation preference (only if shareholders don’t convert), and can be converted at the shareholder’s option at any time for five years; each preferred share can be converted into .9 shares of common. Why do you think he makes this recommendation?

4. Carl was your brother’s college roommate. He majored in computer science, and has been working for Apple. He and your brother meet you for coffee, and Carl mentions that he has an idea that could revolutionize digital streaming of video content, making it faster and more reliable.

You mention that you have some money saved up, and you and some friends might be interested in investing.

Carl says, “That could be interesting, but I want to be open about something. This is a risky bet. The big tech companies are working on this too. I have a better idea, but I have to work fast. If they develop something that’s almost as good before I’m done, the industry is just going to go with that, and we will miss this opportunity.” You say you understand and you and Carl begin discussing terms.

1. Carl’s annual salary at Apple is $300,000. He says he wants the same salary from you -- “or it’s not worth it to me to do this” -- and he offers you and your friends 100% of the equity in the newly-formed company. What incentive does this create for Carl? What signal do you think Carl’s proposal sends about his confidence in his idea?
2. Instead of the proposal in A, Carl says that he is giving up a $300k salary at Apple, and will work for a $75,000 cash salary -- just enough to cover rent on his studio apartment, food, and health insurance. He wants to own 51% of the equity in the newly-formed company, even though you and your friends are supplying all of the capital. What incentive does this create for Carl? What signal do you think this proposal sends about his confidence in the idea?
3. Carl’s initial proposal is that everyone gets voting common stock. Why might you be concerned about giving Carl 51% of the voting rights?
4. You tell Carl that you want 51%, and he objects. “I’m going to develop a great idea, and I don’t want you to kick me out of the company as soon as it succeeds. That’s what happened to Steve Jobs the first time he was CEO of Apple, and I won’t make that mistake!” You explain that you are comfortable giving him control once the idea proves itself, but that you and your friends need control before. Assuming he agrees, is there a way to work this out using preferred stock? Is there also a way to do it without preferred stock?
5. Carl wants you and your friends to invest $2 million for your share of the equity. He is putting in only his idea and his effort, but no capital, as noted above. He will use the $2 million to cover salaries for a small team of programmers, office space, and computers. At the “burn rate” he projects, the $2 million will last for just over 18 months. After 18 months, assume that another company wins the race to develop an idea like the one Carl is trying to implement, so Carl’s approach is unlikely to be adopted. If you have preferred stock, how valuable is your liquidation preference likely to be in this scenario?
6. Please compare this fact pattern with the one above about P&S’s acquisition of M&M. Is a liquidation preference in a high-tech start-up likely to be more or less meaningful than in a consumer products company? Why?

5. The Gilson & Schizer (“G&S”) article analyzes the economic significance of various features of convertible preferred stock in high-tech startups financed by venture capitalists.

1. What are dividend preferences? How significant are they in VC-backed firms?
2. What are liquidation preferences? How significant are they when a VC-backed startup fails?
3. How significant is a liquidation preference when a VC-backed start-up is sold to another firm? (Hint: the article focuses on what it calls a “zombie” scenario.)
4. How significant is a liquidation preference when venture capitalists sell their shares in an initial public offering?
5. Some commentators argue that giving VCs convertible preferred pushes entrepreneurs to “signal” whether they really believe in their idea. Please explain this argument. Do you agree with it?
6. Some commentators argue that giving VCs convertible preferred motivates entrepreneurs to be successful enough that VCs sell shares in an IPO, instead of a sale to another company. Please explain this argument. Do entrepreneurs have other reasons to prefer an IPO to a sale to another company?
7. Does convertible preferred give venture capitalists extra control rights? Does this explain the ubiquity of convertible preferred? Are there other ways to accomplish this goal?

6. Let’s turn to the tax planning issue, which is the key point in G&S. As we discussed in an earlier class, in the United States there are two types of income. Salary income is classified as “ordinary income” (taxed at a maximum federal rate of 37%) while profit from a risky investment is classified as “capital gain” (taxed at a maximum federal rate of 23.8%).

1. Assume that you hire Ed to run your privately-owned company, and you pay him $300,000 of cash. Is this payment ordinary income or capital gain?
2. If you pay Ed $200,000 of cash and $100,000 in gold bullion, what tax rate applies to the gold?
3. Assume you pay Ed $200,000 of cash, and you also grant Ed $100,000 of stock in the company in 2021, which will vest in 2023. Assume that in 2023, the stock is worth $500,000. Assuming Ed does not make any special tax elections, how much income does he have in 2021? Is it ordinary or capital? How much income does he have in 2023? Is it ordinary or capital?
4. The same facts as in “C,” but Ed makes a so-called “83(b) election,” in which he chooses to pay tax on the value of the stock when he receives it (even though the stock has not vested yet). This means he has $300,000 of income in 2021. Is it ordinary or capital? In 2023, this stock is worth $500,000, so Ed sells it. What is Ed’s profit on this stock in 2023? Is this profit taxed as ordinary income or capital gain?
5. If Ed expects the stock he receives as compensation to appreciate, does he increase or reduce his tax bill by making the election to pay tax when he receives the stock (instead of waiting and paying tax later when the stock vests)? Why?
6. So far, we have assumed that the value of Ed’s stock is $100,000 when he receives it. But let’s assume instead that the value isn’t clear. If Ed elects to pay tax when he receives the stock (the 83(b) election, described above), and his goal is to reduce his tax bill, is he motivated to offer a high estimate of the stock’s value when he receives it? Or a low estimate? In other words, as a matter of tax planning, does Ed want to claim that the stock is worth a lot, or very little, when he receives it?
7. Assume that at the same time that Ed receives stock, Frank -- an outside investor -- pays $100,000 for identical shares. Does Ed have any discretion in the value that he reports to the tax authorities?
8. The same as in “g,” but Frank pays $100,000 for convertible preferred shares, and Ed receives common shares. Does Ed still have to report $100,000 as the value of his stock?
9. G&S offers reasons why convertible preferred shares actually should not be worth much more than the common stock (e.g., the dividend and liquidation preferences have only limited effect). If these observations about the economics of common and convertible preferred shares are correct, does the tax strategy still work?
10. President Biden proposed to tax long term capital gains at the ordinary income rate for anyone earning more than $1 million per year. If this proposal is ever enacted, would this proposal affect this tax planning strategy?

7. In tax planning, it’s important to consider the tax consequences to *all* parties to the transaction -- not just to your client, but to everyone.

1. Assume a company has $10 million of revenue, and pays $2 million of compensation (and has no other expenses). How much is its taxable income? Is compensation tax-deductible?
2. In problem #6, we saw that there is an advantage to Ed in offering a low estimate of the value of the stock he receives -- so he reports less ordinary income. Does this strategy affect the amount that the company can deduct as compensation?
3. If Ed’s planning strategy imposes a tax cost on the company, then won’t the company block this planning strategy? For example, can’t the company just force him to report a higher amount? In the venture capital context, why is the company often not concerned about its tax deduction?

8. G&S argue that the tax strategy we are discussing is, in essence, a subsidy for venture-capital backed startups.

1. What is the trigger for the subsidy?
2. For the government to put money into a transaction, who else must have “skin in the game”? If you were asked to design a subsidy for startups, would you want to include this feature?

9. Let’s review the issues we have covered with another fact pattern. Gail, who was your closest friend in college, writes software for Apple. Her dream for years has been to launch her own startup. Using her savings and a contribution from Henry, her father, she starts a business called “Gamer Gail,” which she forms as a Delaware corporation with 10,000 shares. Henry owns 5,000 shares and Gail owns 5,000 shares.

Paying herself a minimal salary and working out of her basement for two years, Gail writes code for video games. Gail has creative ideas for games and she figures out a way for her graphics to be especially vivid. Her first game, in which the player rescues penguins from global warming, gets positive reviews and modest attention in gaming circles.

After two years of struggling to stay afloat, Gail knows that she needs more capital to hire a marketing team and more programmers, so she can develop more games and bring them to market more quickly and more effectively. Gail cannot yet count on retained earnings to fund this expansion, since Gamer Gail is not yet profitable and probably won’t be profitable for at least three more years.

Gail begins a discussion with Irene, who is a managing director at Gaming Ventures (“GV”), a VC firm that specializes in funding video game startups. Irene proposes to invest $2 million. In return, she wants GV to own one-third of the company. She proposes that there should be five board members: Gail, Henry, Irene, and two of Irene’s partners from GV.

Gail is willing to let GV control the company until Gamer Gail proves itself and becomes commercially successful, but once this happens, she wants control. Since she is doing the work, she also wants more shares as compensation for this effort.

Gail’s counteroffer is that GV will get 5,000 shares on September 1, and the company will also issue 5,000 more shares to her on September 1, bringing her total share ownership up to 10,000 (with Henry and GV owning another 10,000). In principle, Irene agrees to Gail’s proposal (i.e., paying $2 million for ¼ of the company and having extra board seats and voting rights until Gamer Gail proves to be successful).

Gail knows that you are a lawyer and that you regularly represent entrepreneurs who run VC-backed startups. She asks you to represent her. Gail is a great programmer, but she doesn’t know anything about capital structure or tax planning.

1. What capital structure should Gamer Gail have? Specifically, what type of securities should GV receive in return for its investment? What type of securities should Gail receive in exchange for running the company?
2. In light of the deal that Gail and Irene have struck, how should this capital structure allocate rights in liquidation, dividends, and control rights? Which of these issues are economically significant? Which are not?
3. What tax advantages (if any) are offered by the capital structure you are recommending? Who benefits from these tax advantages? Is there an offsetting tax disadvantage to another taxpayer? If so, does it matter?