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Structuring Investments in Tech, Life Sciences and Other Private Companies

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AGENDA

- Primary investments - different forms, characterizations and stakes
- Additional QSBS Considerations
- Investments Attached to Secondary Transactions

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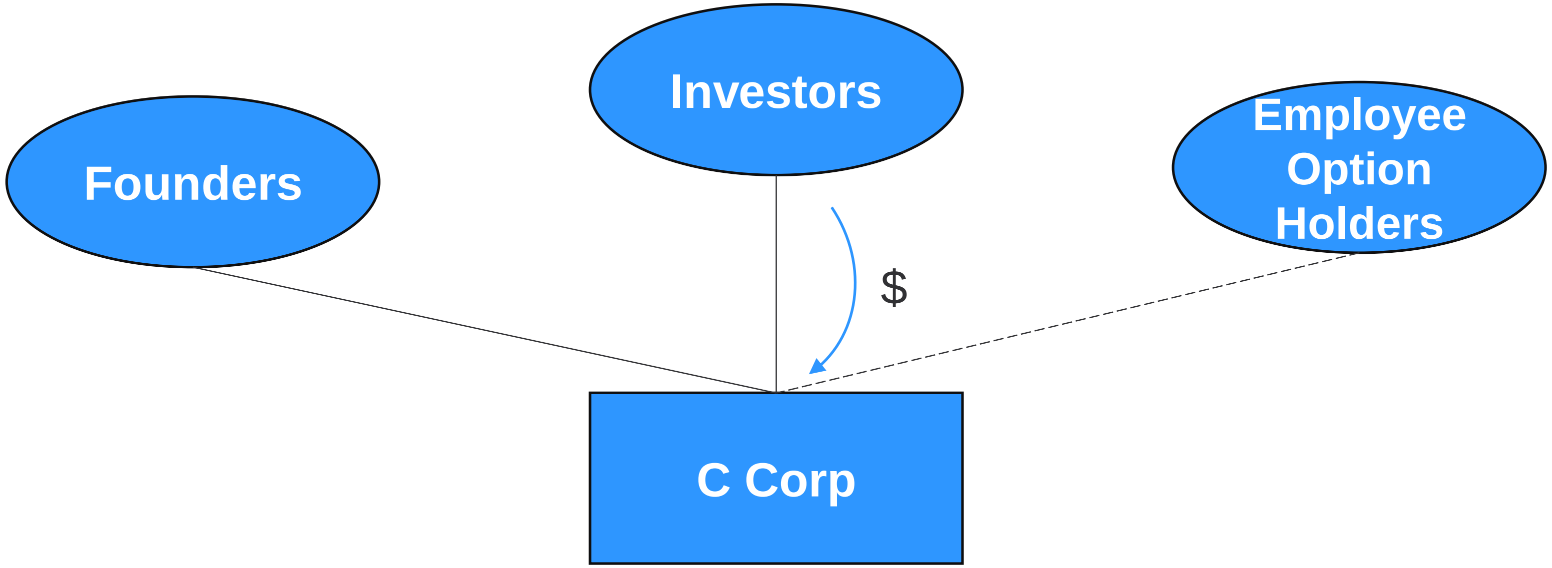
Primary investments - different forms, characterizations and stakes

The Illustrative Fact Pattern



- Some notable features of the investment:
  - High risk, high return. Liquidation preference serves to protect the downside.
  - Company will never pay dividends. It probably will not generate positive taxable income over the life of the investment.

Classic VC Preferred Stock

Key Terms:

- Convertible preferred at a fixed conversion price.
- No dividends, except dividends as priority to payment of dividends on common stock.
- “Greater of” liquidation preference or as-converted on an exit.
- No redemption rights, call rights, etc.

Tax Considerations:

- Straightforward equity investment.
- Section 305(b) issues rarely arise for several reasons:
  - Almost universally constitutes “tax common”
  - No dividend yield or accretion
  - No maturity date or redemption / call features.

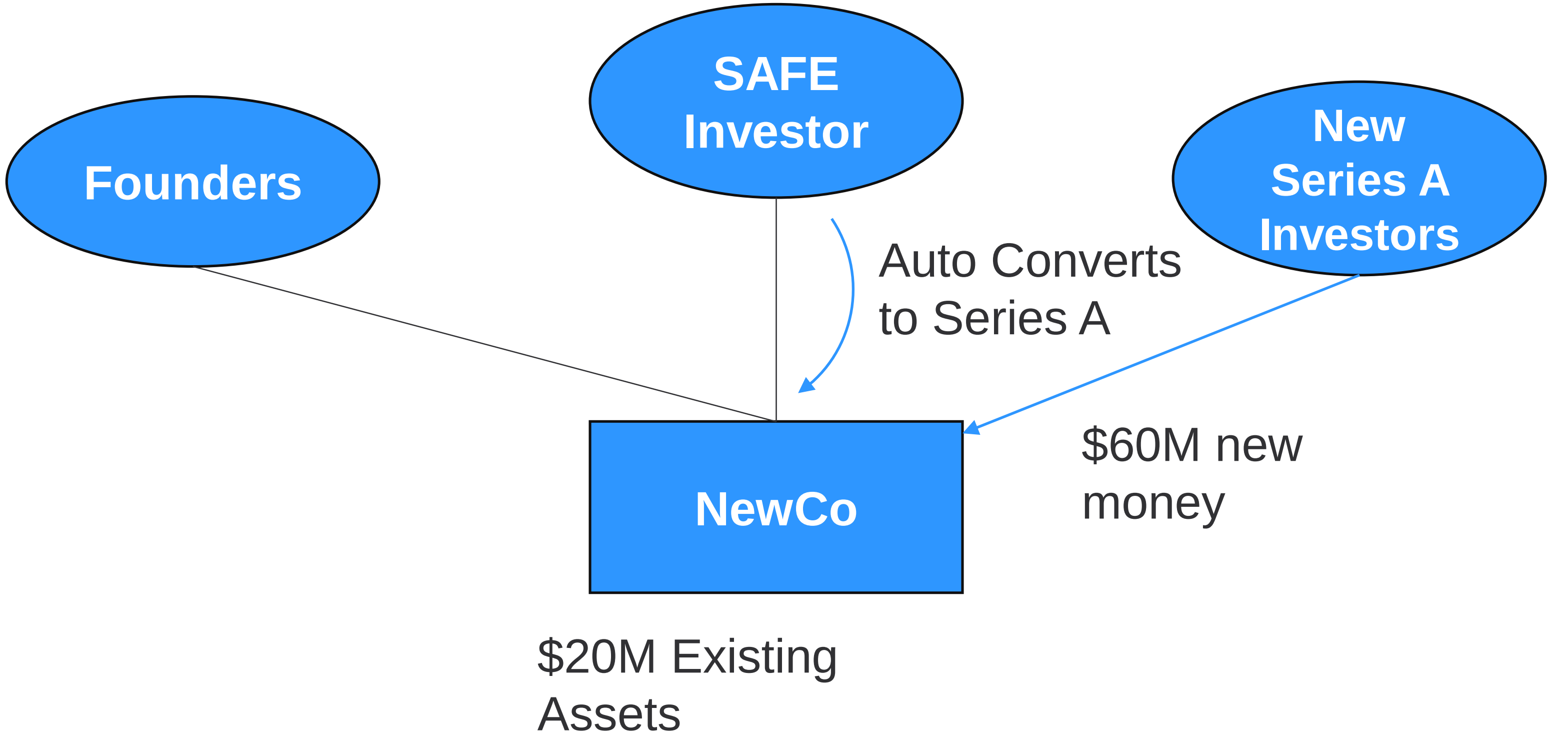
Convertible Promissory Notes & Safes

- Fills a market need of a company issuing equity capital in anticipation of a future VC Preferred Stock round without pegging a conversion price.
- Instead, investors put in money upfront for a right to receive a variable number of shares in the future, at options, or on certain contingencies such as a qualified equity financing.
- Investors receives inducements for early investment, such as a cap on conversion price, a discount on the conversion price, and/or, in the case of a note, a stated interest rate.
- Legal form:
  - Convertible promissory note = debt instrument with a maturity date & creditors' rights
  - SAFE = open-ended investment contract

How to Characterize a SAFE for Tax purposes?

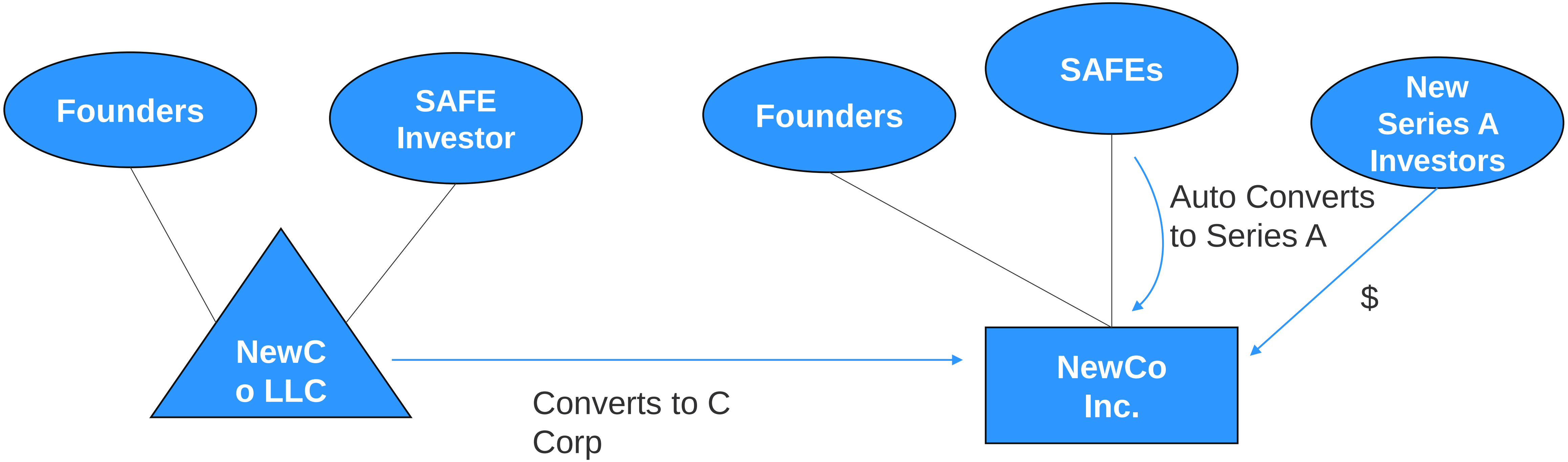
Forward Contract	**Equity**	**Indebtedness**	**Warrant**
Legal form of the instrument is a pre-paid forward contract.	Probable outcome under instrument is an automatic conversion into shares or failure of the business.	Lacks a definite maturity date or right to be repaid on demand (the “sine qua non” of debt) – *See Jewel Tea Co v. United States*, 90 F.2d 451 (2d Cir. 1937).	Prefunded nature makes warrant characterization difficult. *See* Rev Rul. 82-150.
Lacks voting rights or other shareholder rights (although note that dividend rights are now often included).	Indefinite contract term – *See* Reg. 15A.453-1(c)(4); Cf. Rev. Ruls. 2003-7 & 2003-97.	No interest is paid or accrued. Note – discount factor on conversion may adjust over time.	Conversion in most likely cases is automatic, rather than elective by the holder.
	Current dividend rights often are support equity treatment, even if no dividends are expected to be paid. *See* CCA 201433013.		

Impact of Characterization - Example 1



- If SAFE is already equity for tax purposes, SAFE investor already had a QSBS-eligible investment. Exchange into actual shares should have no impact. See Sec. 1202(f)(1).
- If SAFE is a contract, SAFEs like the Series A Investors comes in at a time when company has more than $75M of gross assets and is no longer eligible for section 1202.

Impact of a SAFE Characterization - Example 2



- Should the tax analysis of the SAFE depend on whether the issuer is under Subchapter K vs. Subchapter C?
- Treating a SAFE as debt vs. equity has an impact both on LLC operations and on the tax treatment of the conversion to a Corp.

Other Issues With SAFEs

- Treatment in an acquisition of the Company that is intended to be a tax-free reorganization
- S Corp Status / Second Class of Stock and Impact on 280G Exception
- Giving a SAFE Holder its Money Back
- Modification of SAFEs
- Impact of SAFEs on Common Stock Valuation (i.e., for IRC Sec. 409A purposes)

Convertible Note Characterization

- Governed by classic “debt equity” case law.
- Section 385(c) also is an important consideration: the Company’s “characterization” by the issuer is binding on the Holders absent a tax return disclosure of inconsistent treatment.
- There can be additional tax issues at stake with whether a note is debt or equity for tax purposes:
  - Treatment of accrued interest converted into shares
  - Interest deductibility (in theory)
  - COD
  - Section 305(b) issues depending on what type of “stock” the note is deemed to be

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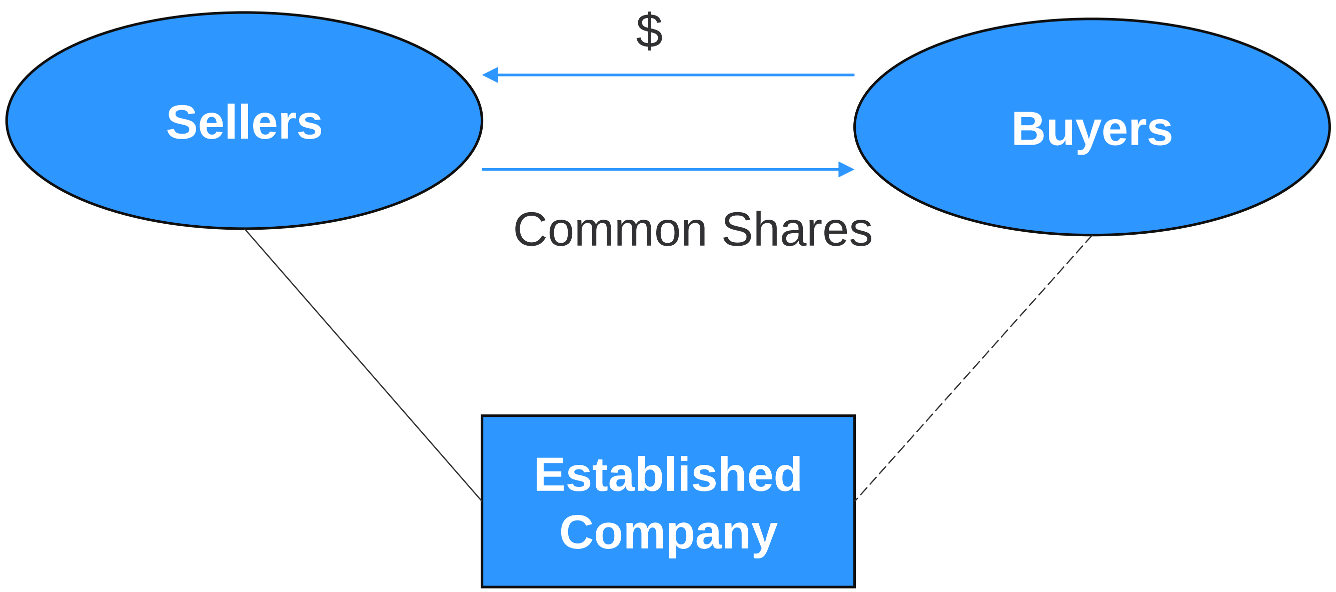
Investments As Part Of A Secondary Transaction

Secondary Transactions

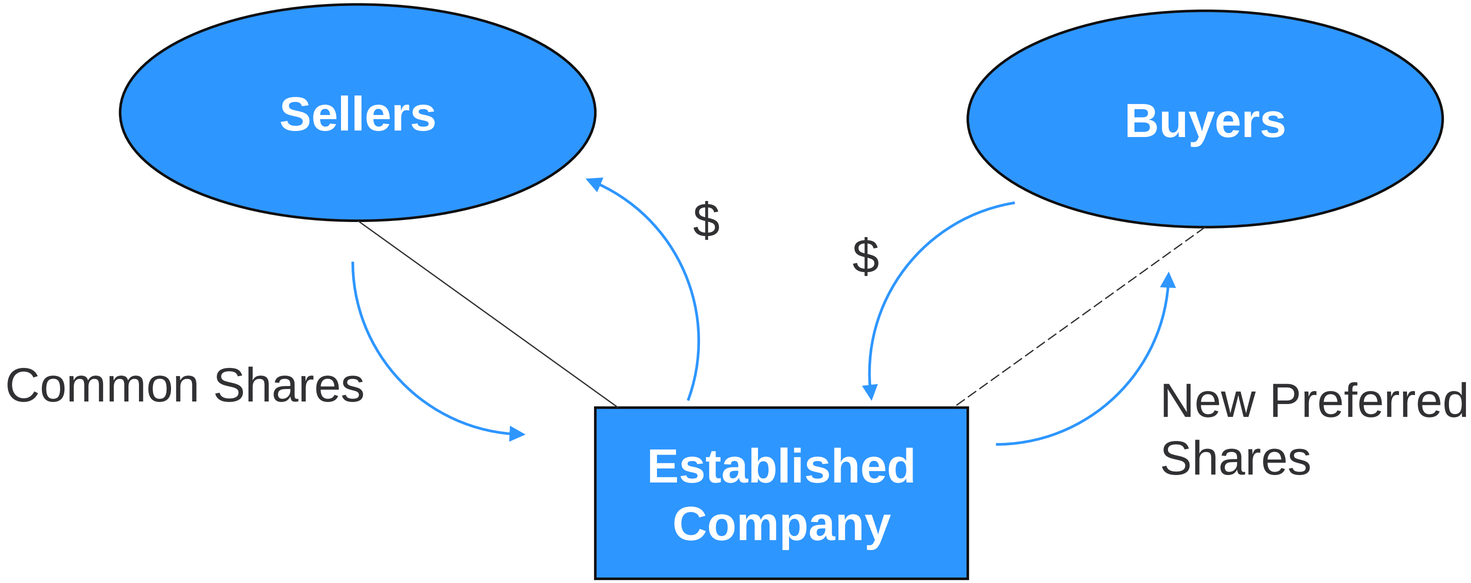
- VC equity investment also commonly is used to effect secondary transactions and provide liquidity to existing stockholders.
- This raises a number of structuring considerations and tax issues, including:
  - Whether any premium of the purchase price over the Company's section 409A valuation of its common stock represents compensation for tax purposes
  - Application of Section 302
  - Whether there is a "significant redemption" that disqualifies QSBS

Structure 1 - Direct Secondary



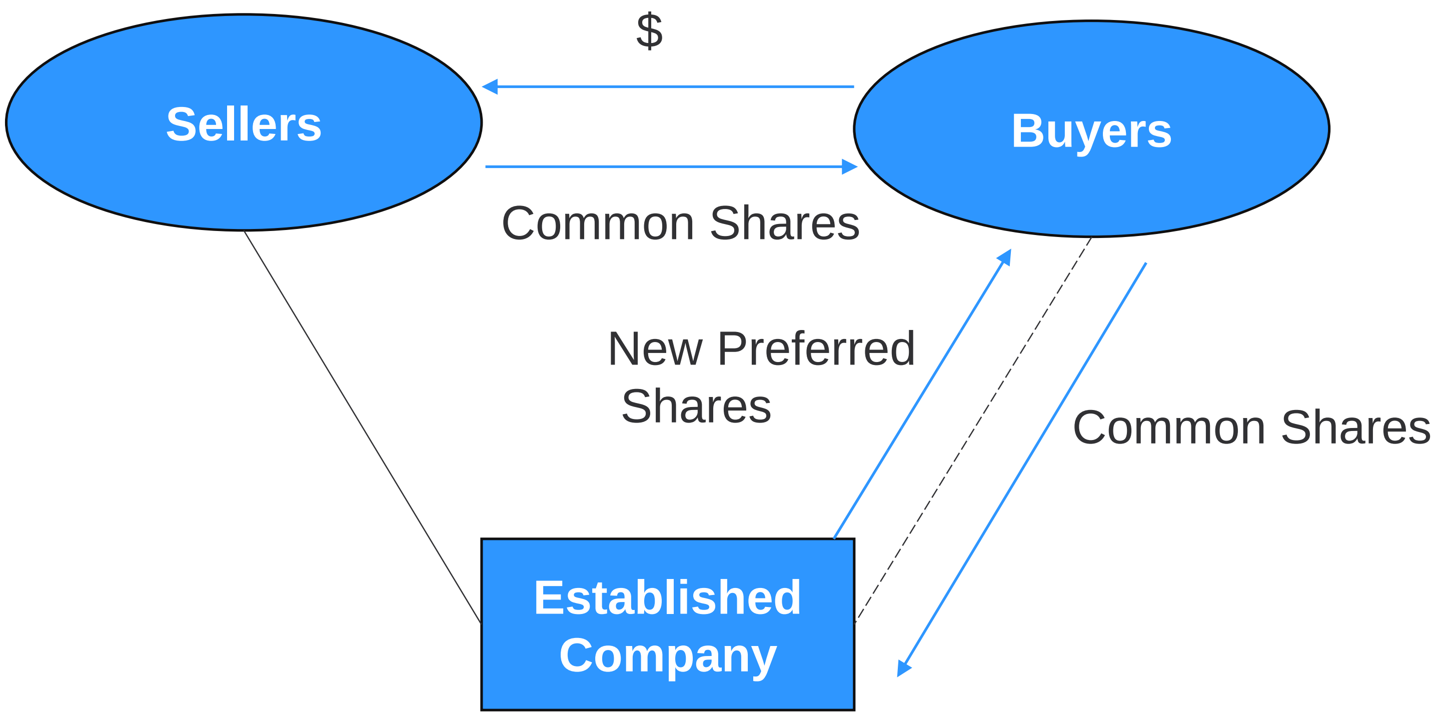
- Buyers acquire shares from Sellers in a direct sale governed by section 1001.

Structure 2 - Primary Investment & Company Buyback



- Buyers invest capital for new preferred shares. Company then redeems shares from the sellers in a section 302 transaction.

Structure 3 - Direct Secondary with Exchange



- Buyers acquire shares from Sellers in a direct sale.
- Company then recapitalizes the purchased common into preferred stock

QSBS Considerations

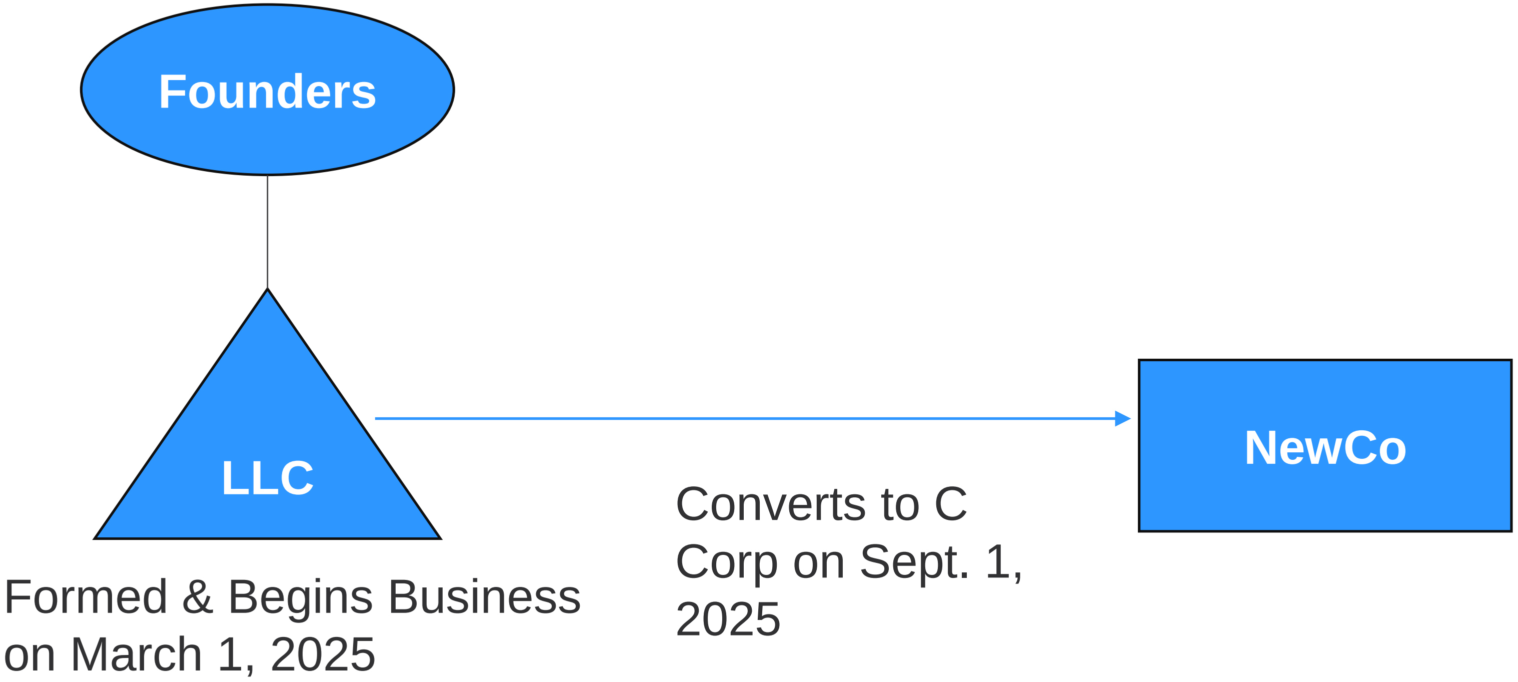
Expanded QSBS Rules Under The OBBBA

- $50mm gross assets → $75mm gross assets
- $10mm max exclusion → $15mm + inflation indexing
- Partial gain exclusion beings at 3 years, with full exclusion at 5 years

Selected issues under OBBBA provisions:

- Interplay with Section 174A and different elections
- Different treatment of shares issued on July 1 vs. July 5 2025
- Tacked holding period rule under Section 1202(a)(6)(B)

Example of Tacked Holding Period Rule



- Founders take a holding period in NewCo’s stock that tacks to LLC’s holding period in its capital assets. See Secs. 735(b); 1223.
- What impact does this have on applicability of different OBBBA provisions?

Common Problems Under QSBS – "Significant Redemptions"

- QSBS for all holders is lost if the company buys back stock within one year before or after the issuance of QSBS that amounts to more than:
  - $10K and 2% of outstanding stock by value as of immediately before the redemption, AND
  - 5% of the outstanding stock as of 1 year before the issuance of stock being tested for QSBS.
- QSBS for the specific holder is lost if Company buys back more than 2% of the Holder's stock and pays more than $10K, within 2 years before and 2 years after the issuance of the stock.
- Exception for buyback of section 83 stock from an employee /director incident to termination from service.

Common Problems Under QSBS – Disqualified Businesses

- The Company must be engaged in, and use at least 80% of assets by value, in one or more qualified businesses, defined as any business *other than*–
  - any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,
  - any banking, insurance, financing, leasing, investing, or similar business,
  - any farming business (including the business of raising or harvesting trees),
  - any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and
  - any business of operating a hotel, motel, restaurant, or similar business.

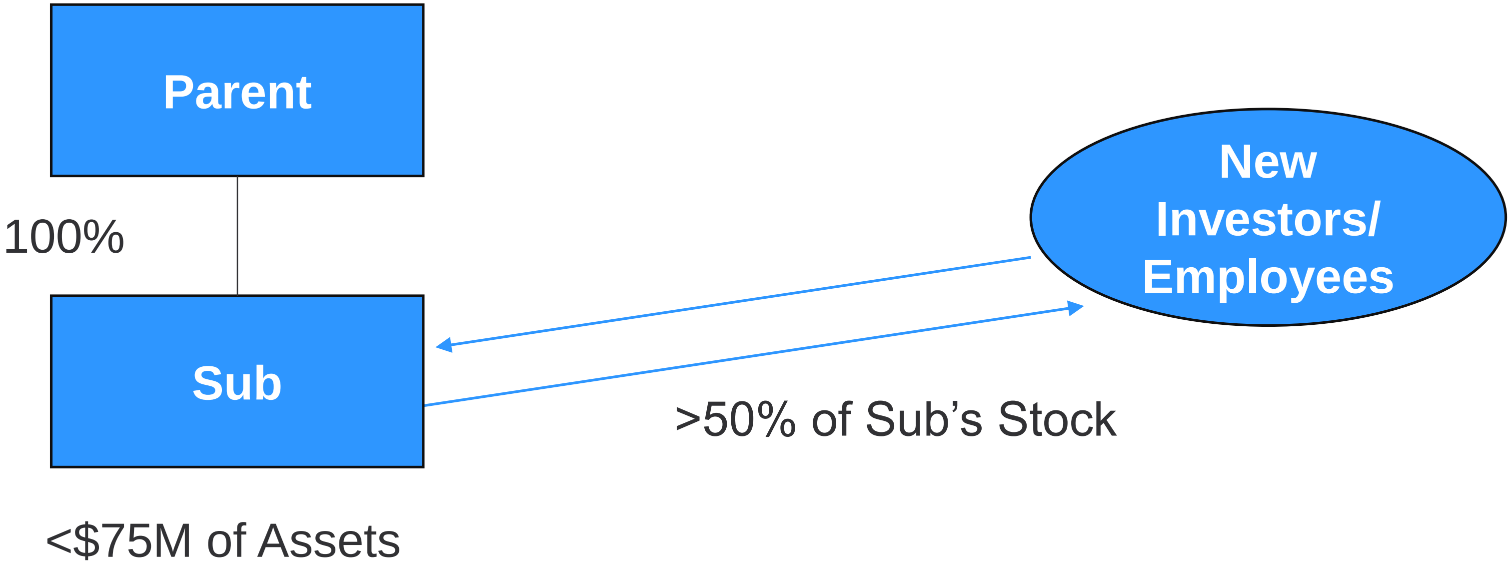
Common Problems Under QSBS – Ongoing Satisfaction Of The 80% Rule

- For substantially all of the holding period, at least 80% of the Company's assets by value must be used in the active conduct of the qualified business.
- Special rule treats cash held as working capital or for business expansion / R&D as business assets, but not in excess of 50% of the Company's total assets after 2 years of the Company's existence.
- "Stock or securities" in corporations other than 50% or greater owned subsidiaries cannot exceed 10% of the corporation's assets by value.

Parent Subsidiary Aggregation Rule

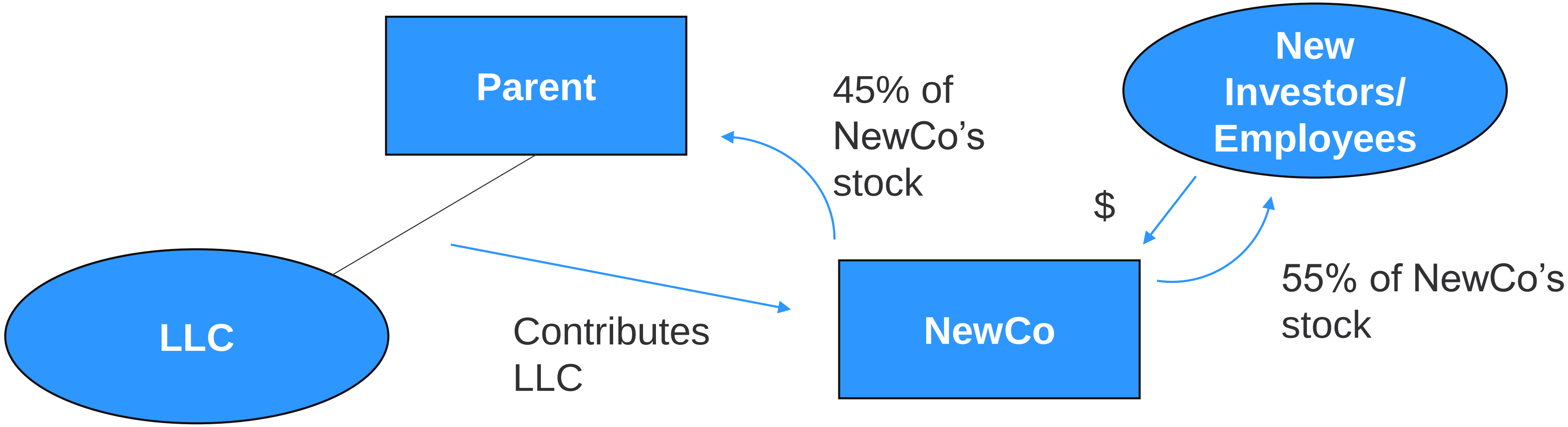
- For applying the $75 million gross assets requirement, all members of the same Parent-Subsidiary Controlled Group are treated as a single corporation. Section 1202(d)(3).
- A parent-subsidiary controlled group is defined by reference to section 1563(a)(1), except with more than 50% applied instead of at least 80% by vote or value. Section 1202(d)(3)(B).

Parent Subsidiary Aggregation - Example 1



- Since Subsidiary is 100% by Parent, Parent's gross assets are imputed to Sub so that Sub isn't a Qualified Small Business, even if it has less than $75M of gross assets immediately after it issues stock to the New Investors / Employees.

Parent Subsidiary Aggregation - Example 2



- Here, NewCo's status as a QSBS is tested solely by reference to NewCo's own assets, since NewCo is never >50% owned by Parent.
- Under in-kind contribution rule, NewCo's gross assets include the fair market value of LLC interests contributed by Parent to Sub. See section 1202(d)(2)(B).

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Will assists companies on corporate and U.S. international tax planning issues, with a focus on advising corporate transactions in the technology and life sciences industries. He has been the lead tax counsel on numerous complex and high-stakes transactions, including M&A, internal restructurings, debt and equity financings, partnerships and licensing, and IP-related transactions.

Prior to entering private practice, Will clerked for the Honorable Carlos T. Bea, on the U.S. Court of Appeals for the Ninth Circuit. He is a frequent writer and speaker, including authoring "Bloomberg BNA Tax Management Portfolio - CFCs : Sections 959 – 965 and 1248" and co-authoring a monthly *Tax Notes* column, "U.S. International Tax Review."

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- **Morphic Holdings** in its $3.2 billion acquisition by Eli Lilly
- **Smartsheet** in its $8.4 billion acquisition by Blackstone and Vista Equity Partners
- **Redfin** in its pending $1.75 billion acquisition by Rocket Companies
- **Niantic** in its pending $3.5 billion acquisition by Scopely and PIF
- **Cupertino Electric** in its $1.54 billion acquisition by Quanta Services
- **Figma** in its proposed $20 billion acquisition by Adobe (transaction mutually abandoned by both parties)
- **Symantec** in the $10.7 billion sale of its enterprise security assets to Broadcom
- **Coinbase Global** in its $1.1 billion convertible debt offering and **Bill.com** in its $1.4 billion convertible debt offering
- **CoreWeave** in its $650 million and $642 million minority investment transactions and **Metropolis Technologies Inc.** in its $1.7 billion financing for its acquisition of SP Plus

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