

Accounting/Tax Issues for Growth Companies

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Accounting/Tax Issues for Growth Companies

Firm Overview:

- Who we are ...
- What we do ...



Accounting/Tax Issues for Growth Companies

Topics for Discussion:

- Financing Arrangements
 - Debt
 - Equity
- Stock Compensation
- Deferred Compensation
- LLC vs. C-Corp
- Section 382 loss limitations
- R&D Tax Credit



Accounting/Tax Issues for Growth Companies

- Many of the financing arrangements we see in the market have complex accounting issues surrounding them.
 - Potential derivatives (embedded or freestanding)
 - Valuation of instruments
 - Classification of instruments (equity versus debt)



Accounting Issues – Financing Arrangements

- Common issues for debt
 - **Analysis of conversion option**
 - Derivative instrument? Bifurcate and mark to market?
 - Complex analysis, users of statements and clients generally don't see value of process
 - **Beneficial conversion features**
 - Separate components, debt discount and non-cash interest expense
 - Sometimes are contingent upon future events
 - **Debt issued with warrant kicker**
 - Need to value the warrant, discount debt, non-cash interest expense
 - Could create beneficial conversion charge



Accounting Issues – Financing Arrangements

- Common issues for Preferred Stock
 - **Analysis of conversion option**
 - Derivative instrument? Bifurcate and mark to market?
 - Complex analysis, users of statements and clients generally don't see value of process
 - **Classification Issues**
 - Mandatorily redeemable - liability
 - Contingently redeemable – mezzanine level or equity
 - **PS issued with warrant kicker**
 - Need to value the warrant, classification of warrant,
 - **Redemption/liquidation value**
 - Recognize value if price is >100% of original issue price



Accounting Issues – Financing Arrangements

- Other common issues
 - **Accounting for Warrants**
 - Equity or derivative liability classification?
 - Complex analysis, users of statements and clients generally don't see value of process
 - **Put arrangements**
 - Potential derivative treatment
 - **Common stock**
 - For services, technology, etc
 - Valuation of stock



Tax Implications for Financing Arrangements

- Debt with Warrants
 - Value assigned to warrant creates Original Issue Discount (OID)
 - OID - 1099-OID reporting requirement
- Convertible Debt
 - No value assigned to conversion feature for tax
 - Unamortized debt costs become non deductible if converted
 - Debt Converted not in accordance with terms of debt instrument can have tax impact related to accrued interest



Stock Compensation – accounting issues

- Stock compensation brings many accounting issues into play:
 - Valuation support
 - Valuation to support exercise price of options
 - Valuation to support value of common stock grants
 - Support of assumptions used in option pricing model to record compensation expense for option grants
 - Measurements date and repeated valuations needed for options granted to non-employees



Stock Compensation – accounting issues

- Valuation Issues – enterprise value drives main audit issues for exercise price and common stock!
 - AICPA Guide on valuing private company securities sets guidance
 - Market and income approach most frequently used
 - Use of valuation expert or process consistent with guidance
 - Assumptions used in model need to be supported

Companies need to find right balance of cost versus value and need.



Stock Compensation – accounting issues

- Stock options
 - Other inputs into OPM need to be supported, companies need to understand concepts
 - term, volatility, discount rate, etc
 - Options granted to non-employees
 - Usually measurement date not set until vested
 - Creates variability in option expense and administrative process of revaluing



Stock Compensation – tax

- Types & Impact
 - Restricted Stock
 - Stock or LLC Units
 - 83(b) elections
 - Profits U nits
 - Rev. Proc 2001-43
 - NQSO
 - ISOs
 - RSUs
- Valuation Issues for private companies



Deferred Compensation – 409A

- Any plan that defers compensation other than qualified plan, bona fide vacation, sick, compensatory time, disability pay or death benefit plan
- Current Income Inclusion plus penalties
 - 20% of additional tax
 - Interest plus 1%
- Strict Rules for:
 - Deferral elections
 - Payment triggers
 - Acceleration of Benefits
 - Funding



Deferred Compensation – 409A

Distribution Requirements

Not distributed earlier than

- Separation of service;
- Date of disability;
- Death;
- Specified time or fixed schedule;
- Change in ownership or effective control; or
- Unforeseeable emergency



Deferred Compensation – 409A

Short Term Deferrals

- Not deferred compensation if:
 - Actually or constructively received 15th day of 3rd month after no longer subject to substantial risk of forfeiture
 - Unforeseeable events – Continues to qualify as short term deferral if:
 - Admin not practical to make payment; or
 - Making pmt would have jeopardized taxpayer's ability to continue as going concern; and
 - On date legal right to compensation arose - such impracticality was unforeseeable; and
 - Payment is made as soon as possible



Deferred Compensation – 409A

- Stock Options, SAR and other Equity Based Compensation
- Does not provide for deferral of compensation where:
 - Exercise price must be at FMV
 - Contains no other feature of deferral other than recognition of income
- Statutory Options not deferred compensation
 - Treated as NQDC where modifications, extensions, or renewal is treated as grant of new option that is not a statutory option



Deferred Compensation – 409A

- FMV – Safe harbor method
 - An **independent appraisal** that meets the requirements for valuing stock held by employee stock ownership plans and was issued no more than 12 months before the date of grant of the stock right
 - A **formula-based valuation** that would constitute a **nonlapse restriction** for purposes of §83
 - **For illiquid stock of start-up companies** (generally, those that have been in business for less than 10 years, have no publicly traded class of securities, and do not reasonably anticipate a change in control within 90 days or a public offering within the next 180 days), a reasonable, **good-faith valuation evidenced by a written report issued by someone who is qualified**, but not necessarily independent.



Structure of Entity

- LLC v C-Corp
 - Basic differences - LLC:
 - More flexibility with allocations of income/loss
 - Flow-through treatment of income/loss – i.e., single layer of tax
 - Business activity and tax consequences reflected on member's return
 - However, utilization of losses may be limited
 - No R&D Tax Credit in CT



Structure of Entity

- LLC v C-Corp (“Inc.”)
 - Basic differences – C Corp:
 - Taxed at entity level
 - Double tax when declare distributions to stockholders or on asset sale upon exit
 - State Filings stay at entity level (i.e., members do not file)
 - State credits available
 - CT exchange – 65%



Section 382

- A “new loss corporation” cannot deduct “pre-change losses” in an amount greater than “the Section 382 Limitation.”
- Ownership change - increase in aggregate stock ownership (5% shareholders) of more than 50 percentage points
- §382 Limitation is the product of multiplying:
 - the loss corporation's value (at the time of the ownership change); times
 - a published rate of return (long-term tax-exempt rate).
- Limitation is also increased by Built in Gain for 5 years after the change date



Section 382

- Testing period – generally 3 years
- 5% shareholders
- Aggregation rule – create public groups
- Segregation rule – create new 5% public group
 - two exceptions - “small issuance exception” and “cash issuance exception”
- Pure preferred stock is excluded
- Fluctuations in value – hold constant principle
- Rules of convenience and presumptions



R&D Tax Incentives

- Federal Credit (**Currently Expired**)
 - R&D Performed in the US
 - W-2 Wages, supplies consumed & consultants
 - Can not be funded
- CT Credit
 - R&D Performed in the CT
 - Federal expenses, plus fringe benefits, and overhead
 - Incremental and non-incremental credit
 - 65% buyback program

