



# New Ventures BC

## *Introduction to Corporate, Securities and Tax Issues for Start-Ups*

### May 25, 2022

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## ▼ About Fasken Martineau DuMoulin LLP

- A Canadian leader in the practice of business law and litigation representing clients nationally and internationally
- We offer customized legal advice in over 30 practice areas, our greatest value to any client is achieved through our commitment to understand their business, culture, and people.

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## ▼ Overview

There are two areas we will focus on:

- Corporate Structure
- Legal Agreements

# ▼ Corporate Structure

- How and where to set up your company
- Equity ownership
- Attracting and retaining team members
- Attracting and closing financing

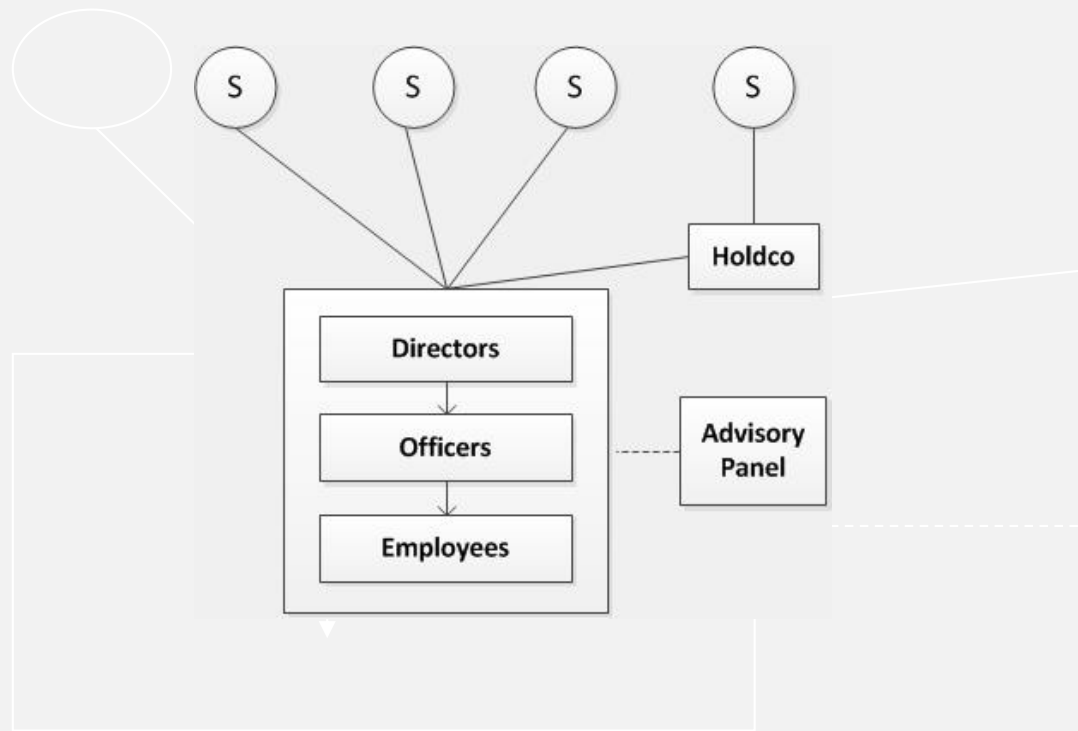
## ▼ Legal Agreements

- Documenting the foundation and development of your venture.
- Internally: Shareholders' Agreement, IP Assignment Agreements, Consulting Agreements, Employment Agreements, Reverse Vesting Agreements, etc.
- Externally: Term Sheet, Non-Disclosure Agreements, License Agreements, etc.

## ▼ Options for Association

- Proprietorships
- Partnerships
- Limited Partnerships
- Joint Ventures
- Companies
  - Provincial
  - Federal
  - International

# ▼ The Structure



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# ▼ Shareholders

- Anybody can be a shareholder
  - individuals
  - companies
  - partnerships
- As many as you want
  - rules change at 50 “people”
  - rules on how you find your shareholders (ie: see a lawyer!)



## ▼ Shareholders (cont'd)

- No liability aside from the initial investment in the shares of the company
  - (unless a contract says otherwise - ie: shareholders' agreement, guarantee)
- Variety of share classes, rights, restrictions
  - common, preferred
  - voting, non-voting
  - dividends
  - participating/non-participating
  - pre-emptive rights
  - anti-dilution, down round protection

## ▼ Shareholders (cont'd)

- Exclusive right to elect directors
- Relationship governed by Articles, Shareholders' Agreements, Subscription Agreement

# ▼ The Policy Setters

**Directors**

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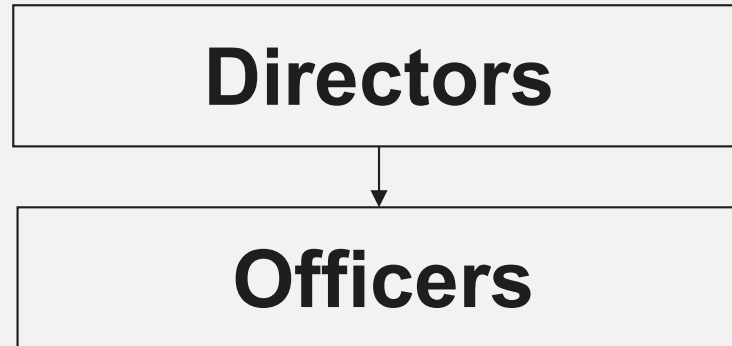
## ▼ Directors

- Elected by the shareholders
  - (but the directors can fill “vacancies” and increase number in certain circumstances)
- At least one
- If BC, no residency requirement
- Qualifications

## ▼ Directors (cont'd)

- Power to manage the affairs of the Company
  - (subject to articles, shareholders' agreements, etc.)
  - determine policy
- Duties to the Company and the “shareholders as a whole” to act fairly and diligently
- Potential personal liability
  - breaching duties
  - taxes, wages
- Appoint the Officers

## ▼ The Instructors

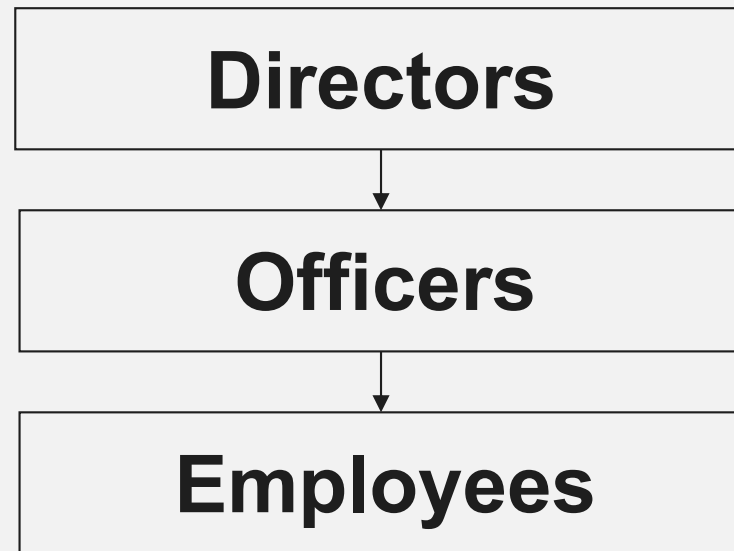


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## ▼ Officers

- Appointed by the Directors
- As many as you want, any titles at all:
  - President, Chairman, CEO, COO, CTO, VP, Secretary, etc.
- In charge of day-to-day affairs of the Company

## ▼ The Doers



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# ▼ Employees

- Master-Servant Relationship
- Entitlements
- Indefinite vs. Fixed-term
- Statutory Obligations

# ▼ Employment Agreement

- Confidentiality
- Assignment of intellectual property
- Non-competition
- Non-solicitation

## ▼ Consultants

- Not employees – not entitled to benefits or other statutory entitlements
- Generally allowed to contract with other companies at same time
- Use of own equipment
- Onus on consultant to withhold, collect and pay tax

# ▼ Consulting Agreement

- Confidentiality
- Assignment of intellectual property
- Non-competition
- Non-solicitation

## ▼ Tax implications

- Form of relationship determines how worker will be taxed
  - Consultants run their own business
  - Employee tax rules more restrictive, but they get benefits
- CRA will look at actual details of worker-payer arrangement
  - Agreement is very important in framing this analysis

## ▼ Compensation and Incentives

Three main possibilities:

1. Cash
2. Shares
3. Options to purchase shares for a fixed price

## ▼ Compensation and Incentives – Tax Considerations

- Different payment structures carry different tax consequences
  - Cash salary
  - Stock options/shares
  - Certain deferred salary plans
  - Dividends (for employee shareholders)
- Generally, salary and dividends have similar overall tax effect (integration of tax rates)

## ▼ Compensation and Incentives – Stock Options

- Can be issued to founders or employees
  - Align incentives of recipients with venture
  - Advantageous tax treatment
- Typically anything received from employer for services is employment (fully taxable on receipt)
  - Stock options are the key exception to this rule



## ▼ Compensation and Incentives – Stock Options for CCPCs (most start-ups)

- No tax on grant of options or shares to employee (or on vesting)
- No tax on exercise of option if shares are held for 2 years
- On sale of share, get equivalent of capital gains tax treatment (50% of gain taxable)
  - Beware stock option trap during market downturns

## ▼ Compensation and Incentives – Stock Options – Non-CCPCs

- Different tax results if company not a CCPC
- End result --  $\frac{1}{2}$  of benefit on exercise is included in income in year option exercised
  - Option exercise price must be paid in some way
- Capital gains treatment on sale of share received on exercise

## ▼ Compensation and Incentives – Stock Options – Non-employees Cont'd

- Completely different tax results for consultants who receive options (relative to employees)
- FMV of options in year of issue is business income for the consultant
- *Arguably* no tax event on exercise

## ▼ Non-resident Employees and Consultants

- Non-residents (NR) employees and NR consultants subject to special tax rules
- Employees outside Canada can cause “PE” risk
  - Generally more of an issue with NR employees
- Resident employees working outside Canada may be subject to “double withholding”
  - withholding in Canada and another state on same income
- NR employees working in Canada, subject to “reg 102”
  - i.e. usual Canadian employee source deductions
  - Potential for double withholding

## ▼ Non-resident Employees and Consultants

- NR contractors working in Canada subject to “reg 105” withholding requirement
  - At 15% withholding rate
- Note: “working inside/outside Canada” concepts are old
  - Based on physical location
  - May not adequately deal with modern virtual work environments

## ▼ The Advisors

**Advisory Panel**

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## ▼ Advisory Panel

- Non-Director Experts
  - focused on the field in question
- Advise the Board
- Option-based Compensation

## ▼ Other Issues

- Conflicts of Interest
  - within the structure - ie: your role as Shareholder v. Director
  - within other companies - ie: director of this Company and director of contracting company
  - between the Company and the educational institution
    - ie: technology transfer/pricing/time
  - between investor and inventor



# ▼ Initial Corporate Structuring

## **Incorporation – U.S. v. Canada v. Offshore; Canada because:**

- Financing Issues - Investors don't like offshore companies.
- Government grants – In most cases, only available to Canadian companies.
- Taxation and Employment issues - Are simpler if you are building the company here.

## **B.C. (BCBCA) v. Federal (CBCA):**

- Either BC Business Corporations Act (BCBCA) or Canada Business Corporations Act (CBCA) are fine and both are investor friendly.

## ▼ Initial Corporate Structuring – cont'd

### **Create a structure with:**

- Unlimited number of common shares.
- Unlimited number of “blank-cheque” preferred shares.

### **Financiers dictate financing terms:**

- Debt vs. equity, price, preferences, terms of SHAG, etc.

### **If you can, avoid:**

- Issuing secured debt.
- Using multiple share classes.
- Incorporating offshore.

## ▼ Initial Corporate Structuring – Tax Considerations

- Nature of tax issues depend on form of financing:
  - Equity or debt?
  - How to deliver equity to financier?
- Decisions depend on context
- Generally, best to start with a simple but easily adaptable structure

## ▼ Initial Corporate Structuring – Tax Considerations - “CCPC” status

- CCPC = Canadian controlled private corporation
- Important for many tax advantages, particularly for start-ups:
  - Small business tax rate
  - Lifetime capital gains exemption
  - Enhanced SR&ED benefits
  - Stock option deferral/deduction

## ▼ Initial Corporate Structuring – Tax Considerations - “CCPC” status

- Restricts who can receive equity
- Public corporations or non-residents cannot own more than 50% shares
  - And no public corporation or non-resident can have control
- VCC exception for CCPCs which may be important for some start-ups

# ▼ Founders' Shares

## **What are Founders' Shares?:**

- Large block of shares issued at a low price to position the Founders.
- To recognize their “sweat equity” contribution.

## **What class of shares should they be?:**

- Common shares.

## **At what price should they be issued?:**

- Nominal - \$0.0001 to \$0.01 per share.

## ▼ Founders' Shares – cont'd

### **To whom should they be issued?**

- Founders and senior officers.
- Not to employees or outside investors.

### **Common mistakes in allocating Founders' shares:**

- Not setting aside enough Founders' shares at time of incorporation: 4.0M – 8.0M.
- Not considering future additions to the management team: 15% - 25%?
- Not vesting the Founders' shares: 2 - 4 years, or providing for "reverse-vesting".
- Issuing them to the wrong people.

# ▼ Preparing a Financing Plan

## **Determine a “Road-Map” for financing:**

The company determines its developmental “milestones”:

- What they are.
- By when they will be met.
- How much funding is needed to meet them.

The milestones are integrated with the budget and a timeline to determine how many tranches of financing will be needed and when.

This info is used to prepare a sample capital structure table - a “road map” for the financing trail (e.g. – to raise \$5.0M).



## ▼ Sources of Financing – Debt/Grants

**Non-equity financing might come from:**

- **Government grants/credits/refunds:**
  - NRC/IRAP, SRED.
  - Telefilm Canada and other industry specific organizations.
  - Environmental/“green” grants.
- **Quasi-governmental organizations like:**
  - BCIC, BDC

# ▼ Sources of Financing - Equity

**Initial (equity) seed financing may come from:**

- The “Founders”.
- Their “Friends and Family”.

**Follow on rounds (pre-public) from:**

- Angels.
- Venture Capitalists.
- Investment bankers (both private and institutional).
- Underwriters (i.e. brokers).
- **Public financing - Initial Public Offering.**
- **Strategic Partners.**

# ▼ Sources of Equity Financing

- **Categories of Funders:**

• Founders:	Variable
• Friends and Family:	\$50K – \$250K
• Angels:	\$250K - \$2.0M
• Seed Stage VC:	\$1.0M - \$3.0M
• Series A VC:	\$2.0M - \$15.0M
• Series B/Later VC:	\$20.0M - \$100.0M
• Strategic Partners:	Variable

- **Match potential investors with your Financing Plan to maximize chance to secure investment.**

## ▼ BC Venture Capital Programs

- 30% refundable tax credit for BC resident investors
- Very popular, often drives the deal
- Company needs to register as an 'eligible business corporation' and request an allocation of tax credits
- They run out every year

▼ Break

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# ▼ Securities Legislation

## **Requirement:**

- If you distribute a security, you must:
    - File a prospectus
- OR
- Rely on exemption from prospectus requirement

## ▼ Exemptions

- Family, Friends and Business Associates
- Accredited Investor
- Private Issuer
- \$150,000
- Start-Up Crowdfunding
- Offering Memorandum
- Employee, Director, Officer & Consultant Exemption

## ▼ Family, Friends & Business Associates Exemption

Can sell securities in any amount without any disclosure to:

- Director, senior officer or control person
- Family member of a director, senior officer or control person



## ▼ Family, Friends & Business Associates Exemption (cont'd)

- Close personal friend or close business associate of a director, senior officer or control person
- No limit on number of purchasers or amount that can be raised

▼ “close personal friend” or  
“close business associate”

- Has known the director, senior officer or control person for a “sufficient period of time”
- Is in a position to assess the capabilities and trustworthiness of the director, senior officer or control person

## ▼ Accredited Investor Exemption

- “accredited investors” can purchase any securities in any amount at any time
- No limit on number of purchasers or amount that can be raised

## “Accredited Investor”

- Financial institutions
- Registered advisers or dealers
- Pension funds
- Mutual funds selling only under a prospectus or to accredited investors or persons buying at least \$150,000 of securities
- Corporations, limited partnerships, trusts or estates having net assets of at least \$5 million

## ▼ “Accredited Investor” Cont’d

- Individuals who have at least \$1 million in financial assets before taxes. (In calculating an individual's financial assets, any outstanding loans incurred to acquire those assets must be deducted.)
- Individuals whose net income before taxes exceeds \$200,000 (or \$300,000 combined income with spouse) in each of the two most recent years and who reasonably expects to exceed that net income in the current year
- Individuals who have at least \$5 million in net assets

## ▼ Private Issuer Exemption

Can sell securities in any amount without any disclosure to:

- Directors, officers, employees or control persons of the issuer
- family members (spouse, parent, grandparent, sister, brother or child) of the directors, senior officers or control persons
- Close personal friends or close business associates of the directors, senior officers or control persons
- Current security holders
- Family members of the selling security holder
- Accredited investors

## ▼ What is a Private Issuer?

- Is not a reporting issuer, mutual fund or pooled fund
- Has less than 50 security holders, excluding employees and former employees
- Has restrictions on the transfer of its securities in its articles, memorandum, bylaws or its shareholders agreement
- Has sold its securities only to the persons in the list in the last slide

## ▼ Loss of “Private Issuer” Status

- If you lose your Private Issuer status, you do not automatically “go public”
- You can still rely on the previously-mentioned exemptions
- Certain regulatory filings are now required



## ▼ \$150,000 Exemption

- Under the \$150,000 exemption, a company can sell securities to **non-individual** investors without providing any disclosure to the purchaser, provided the purchaser buys at least \$150,000 worth of securities.

## ▼ Start-Up Crowdfunding Exemption

- Can raise up to \$250,000, twice a year
- Investors can invest up to \$1,500 each
- Need to publish an offering document online that sets out certain information
- Need to raise money within 90 days of publishing that document
- Need to hit minimum goal before any money is released from trust

## ▼ Offering Memorandum Exemption

Issuer can sell securities to anyone in B.C. in any amount if Issuer:

- Delivers an offering memorandum in the prescribed form
- Obtains a signed Risk Acknowledgement from the purchaser

## ▼ Risk Acknowledgement/Liability

- Clear, blunt statement of risks of investing in exempt market securities
- Issuer must give a copy of the signed Risk Acknowledgement to purchaser prior to making investment
- If the offering memorandum contains a misrepresentation, the purchaser has:
  - A right of action for rescission
  - A right of action for damages

## ▼ Employee, Director, Officer & Consultant Exemption

- The sale cannot be based on a promise of continued employment, appointment or engagement.
- Narrow definition of consultant.

## ▼ Legal Agreements – Raising Money

- Non-Disclosure Agreement
- Term Sheet
- Subscription Agreement/  
Convertible Debt/SAFE

## ▼ Non-Disclosure Agreement

- Mutual or One-Way
- All information designated confidential, or only what is marked confidential
- Length of time information must be kept confidential

## ▼ Term Sheet

- Type of security being offered (shares, units, convertible debt, SAFE, other)
- Valuation (pre-money and post-money, non-diluted vs. partially diluted vs. fully diluted)
- Use of proceeds
- Investors' rights
- Other



## ▼ Subscription Agreement

- Agreement setting out the terms and conditions upon which an investor buys securities – usually shares
- Representations and warranties about the company and the shares being purchased – may require that the company make certain disclosures about its affairs and existing liabilities in a disclosure schedule
- Indemnification

## ▼ Convertible Debt

- Debt investment that can be converted into equity, usually upon a future financing of at least a specific size
- Repayment requirement at end of term
- General security agreement
- Inter-lender agreement
- Not eligible for EBC tax credits

## ▼ SAFE

- Simple Agreement for Future Equity
- Not debt – no interest, no maturity date
- Company does not have to settle on a valuation
- Eligible for EBC tax credits

# ▼ Stock Options

## **Recall: What are stock options?:**

- The right to purchase a number of shares at a predetermined price.
- Used to incent the team building the Company.

## **How many should be issued?:**

- 10% - 30% of issued share capital.

## **At what price should they be issued?:**

- Last round of financing or higher.

## ▼ Stock Options – cont'd

**Companies must plan for growth and make a notional allocation of their options.**

**Allocate stock options by category:**

- Senior Management: 35% - 50%
- Remaining Employees: 25% - 35%
- Board of Directors: 13% - 20%
- Board of Advisors: 2% - 5%
- Contingency: 10% - 15%

**Companies should:**

- Integrate Stock Option Plan with their HR Plan.
- Vest all options over 2 – 4 years and consider a cliff.



## Capitalization Table Founders Organize Company

	No. of Shares	Price	Funds Raised
Founders (3)	6,000,000	\$0.0001	\$600
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Total:	6,000,000		\$600

FOUNDERS' OWNERSHIP INTEREST:

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## Capitalization Table

### \$400,000 Friends & Family Round

	No. of Shares	Price	Funds Raised
Founders	6,000,000	\$0.0001	\$600
Family and Friends	400,000	\$0.25	\$100,000
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Total:	6,400,000		\$100,600

PRE-MONEY VALUE: \$ 1,500,000  
 POST-MONEY VALUE: \$ 1,600,000

FOUNDERS' OWNERSHIP INTEREST: \$ 1,500,000 (93.75%)

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## Capitalization Table Stock Option Plan Added

	No. of Shares	Price	Funds Raised
Founders	6,000,000	\$0.0001	\$600
Family and Friends	400,000	\$0.25	\$100,000
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Type of Investor (?)	?	?	?
Total:	6,400,000		\$100,600
Option Plan	1,500,000	n/a	n/a

PRE-MONEY VALUE: \$ 1,600,000  
 POST-MONEY VALUE: \$ 1,600,000

FOUNDERS' OWNERSHIP  
 INTEREST (NON-DILUTED BASIS): \$ 1,500,000 (93.75%)

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## Capitalization Table \$420,000 Angel Round

	No. of Shares	Price	Funds Raised
<b>Founders</b>	<b>6,000,000</b>	<b>\$0.0001</b>	<b>\$600</b>
<b>Family and Friends</b>	<b>400,000</b>	<b>\$0.25</b>	<b>\$100,000</b>
<b>Angels</b>	<b>1,200,000</b>	<b>\$0.35</b>	<b>\$420,000</b>
<b>Type of Investor (?)</b>	<b>?</b>	<b>?</b>	<b>?</b>
<b>Type of Investor (?)</b>	<b>?</b>	<b>?</b>	<b>?</b>
<b>Total:</b>	<b>7,600,000</b>		<b>\$520,600</b>
<b>Option Plan</b>	<b>1,500,000</b>	<b>n/a</b>	<b>n/a</b>

PRE-MONEY VALUE:	\$ 2,240,000	FOUNDERS' OWNERSHIP	\$2,100,000 (79%)
POST-MONEY VALUE:	\$ 2,660,000	INTEREST (NON-DILUTED BASIS):	

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## Capitalization Table

### \$1,500,000 Series A Round

	No. of Shares	Price	Funds Raised
Founders	6,000,000	\$0.0001	\$600
Family and Friends	400,000	\$0.25	\$100,000
Angels	1,200,000	\$0.35	\$420,000
<b>Series A Round VC</b>	<b>3,000,000</b>	<b>\$0.50</b>	<b>\$1,500,000</b>
Type of Investor (?)	?	?	?
Subtotal:	<b>10,600,000</b>		<b>\$2,020,600</b>
Option Plan	1,500,000	n/a	n/a
<b>New Options</b>	<b>500,000</b>	<b>n/a</b>	<b>n/a</b>
<b>Total (Fully Diluted Basis):</b>	<b>12,600,000</b>	<b>n/a</b>	<b>n/a</b>

PRE-MONEY VALUE:	\$ 4,800,000	FOUNDERS' OWNERSHIP INTEREST	\$ 3,000,000 (47.6%)
POST-MONEY VALUE:	\$ 6,300,000	(FULLY DILUTED BASIS):	

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## Capitalization Table

### \$5,000,000 Series B Round

	No. of Shares	Price	Funds Raised
Founders	6,000,000	\$0.0001	\$600
Family and Friends	400,000	\$0.25	\$100,000
Angels	1,200,000	\$0.35	\$420,000
Series A Round VC	3,000,000	\$0.50	\$1,500,000
<b>Series B Round VC</b>	<b>5,000,000</b>	<b>\$1.00</b>	<b>\$5,000,000</b>
Subtotal:	15,600,000	n/a	\$7,020,600
Option Plan	2,000,000	n/a	n/a
<b>Total (Fully Diluted Basis):</b>	<b>17,600,000</b>	n/a	n/a

PRE-MONEY VALUE: \$ 12,600,000  
 POST-MONEY VALUE: \$ 17,600,000

FOUNDERS' OWNERSHIP INTEREST \$ 6,000,000 (34.1%)  
 (FULLY DILUTED BASIS):

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