Russian Start-ups
Forming a Holding Company in the United States

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KEY CONSIDERATIONS

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This Q&A outlines the following important factors to be considered by a Russian start-up company wishing to attract U.S. investors and to gain access to U.S. customers: (i) benefits of forming a company in the United States, (ii) formation and other corporate matters, (iii) tax and (iv) intellectual property protection. This Q&A represents a general discussion of the above points that arise in a typical transaction. Particular situations may differ.

BENEFITS

Q: What benefits could forming a company in the United States bring to a Russian start-up?

A: There are many benefits.

A Russian company may greatly benefit by forming a holding company in the United States if the Russian company seeks to enter the U.S. markets and to attract U.S. investors.

- **Access to U.S. Customers**. Organizing a company in the United States greatly simplifies gaining access to U.S. customers. (Note that if the goal of entering the U.S. market is simply to gain access to U.S. customers rather than to attract U.S. investors, forming a direct or an indirect subsidiary of a Russian company may suffice. However, this Q&A focuses on forming a holding company in the United States in order not just to sell products to U.S. customers but also to attract U.S. investors.)
- **Better Sources of Financing**. In the United States, where financial markets are highly developed, it is generally easier to find financing for start-ups. Although a number of non-Russian venture capital funds ("VCs") are willing to invest in Russian start-ups – most commonly through off-shore holding companies organized in Cyprus or other tax-efficient off-shore jurisdictions (such as the Netherlands, Luxembourg, British Virgin Islands and Ireland) – many U.S. VCs, without a particular focus on Russia, would only invest in a top-tier company that is organized in the United States.
- **Start-Up Communities**. Start-up communities that serve as a source of financing, networking, mentorship, exchange of information and other guidance, have developed in major start-up hubs in various parts of the United States (e.g., Silicon Valley and New York for technology companies).
- **Protection of Shareholder Rights**. Each U.S. state has laws that govern shareholder rights, and such laws offer a great deal more flexibility in structuring relationships among shareholders in comparison to what is currently available to shareholders of Russian companies under Russian law. Puts, calls, drag-along rights, tag-along rights, change of control clauses and waivers of certain rights are widely used and are generally enforceable in the United States. The same provisions are either specifically unenforceable under Russian law (e.g., waivers of rights) or their enforceability in Russian courts is subject to great uncertainty.
- **Enforceable and Tax-Efficient Incentive Instruments**. Unlike in Russia, where neither restricted stock grants nor stock options can be used in a legally protected manner as a tool to incentivize founders and employees to remain with the company, in the United States the use of restricted stock grants and stock options that vest based on time and/or performance is commonplace and legally enforceable. Moreover, while under current Russian law a grant of stock options to founders or employees in itself may give rise to tax obligations, from the U.S. tax laws perspective, depending on the type of the stock option, the grant of stock options itself has no tax consequences for the grantee until options are exercised or sold or until shares purchased pursuant to an exercise of an option are sold. (See discussion of stock options below.)
- **Protection of Intellectual Property**. The United States has a well developed body of law that provides robust protection of intellectual property rights. In addition, the intellectual property laws in the United States offer great flexibility to parties in structuring licensing relationships. For example, licenses may be perpetual and may cover existing intellectual property as well as intellectual property developed in the future.

Russian intellectual property law has significantly improved over the past years, but still contains a number of deficiencies. For example, under Russian law, perpetual licenses are not possible, and licenses covering patents must be registered with Rospatent, expire upon expiration of the patent and cannot automatically apply to further patents developed and registered in the future.

- **Exit markets**: For successful start-ups, the United States offers highly developed "exit markets" both for the so-called "trade sales" and for IPOs.
- **Note of caution**: Depending on the particular economic sector in which your company operates and where the primary market for the distribution of your company's product will be located, forming a company in the United States may or may not be the optimal strategy for your company. While there may be significant benefits for a high-tech start-up that is looking to enter global markets to seek financing in the United States, European markets may currently be more active in other sectors of the economy. For a start-up that intends to focus solely on the Russian markets, organizing a holding company in another tax-efficient off-shore jurisdiction could help address some of the points that are still under development in the Russian corporate governance laws. This issue should be discussed with your financial and legal advisers.

BASIC FORMATION QUESTIONS

Q: Where should I form a company in the United States?

A: Delaware.

In the United States, most companies are formed at the state level.

Forming a company in the State of Delaware is easiest and most efficient. Since Delaware is the state of incorporation for more than 60% of Fortune 500 companies, it has developed a practical and easily navigable system of corporate laws. VCs are generally familiar with the laws of Delaware and rarely object to incorporation in that state. Most early-stage companies that VCs invest in are Delaware corporations. Delaware law generally favors management and the company's majority stockholders over minority stockholders and provides significant flexibility in other areas of corporate governance and takeover defenses. Forming a company in Delaware will neither require any office of the company to be located in Delaware, nor will it restrict a company's ability to open offices in other states.

Also, from a practical perspective, the Secretary of State of Delaware offers expedited processing of filings and requests for various certificates (e.g., good standing certificates). On certain matters, even a one-hour service is available.

However, if you do not plan on working with VCs in the future, you may choose to incorporate in the state where you expect to have the majority of your operations. You should discuss this issue with your legal advisers.

Q: Should I form a corporation or a limited liability company (LLC)?

A: A corporation.

The advantage of both legal forms is that generally neither shareholders of a corporation nor members of an LLC have personal liability for the obligations of the corporation or the LLC, respectively.

However, it is much easier to obtain financing for a corporation than for an LLC. Most venture capital and other investment funds will not invest in an LLC because of tax restrictions applicable to pension and profit-sharing trusts and other tax-exempt entities that are a significant source of capital for such funds. It is also much more difficult to manage the capital structure (e.g., issue traditional stock options) of an LLC. Similarly, an LLC is not a viable structure for an IPO.

Note that from the tax perspective an LLC is generally considered more tax efficient since it is a pass-through entity (i.e., for federal tax purposes the entity is deemed not to exist); therefore, there is only one level of taxation. The owners of an LLC (i.e., its members) pay taxes on their respective share of the profits of the LLC. In comparison, shareholders of corporations are essentially taxed twice: once at the corporate level and then each individual shareholder pays an additional tax on distributions made by the corporation to such shareholder.

However, start-ups generally do not generate a lot of taxable income and if the ultimate goal is to obtain financing and then do a "trade sale" or an IPO, the preferred legal form is a corporation.

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Note that although several types of corporations exist in the United States, a corporation with non-U.S. shareholders will have to be registered as a "C-Corporation." (You may, however, also want to discuss with your counsel whether from a governance perspective a relatively new type of corporation, a "benefit corporation" (otherwise known as a "B-Corp") would be appropriate for your start-up. Benefit corporations are to be managed for the benefit not only of stockholders (as in case of traditional corporations), but also for other people and community interests. From the tax perspective, however, a corporation with non-U.S. shareholders will have to be treated as a "C-corporation".)

Q: How much does it cost to incorporate in Delaware?

A: Basic organization filing fees and other miscellaneous expenses are set forth below.

Sample of fees charged by the State of Delaware may be found at:
http://corp.delaware.gov/Aug09feesch.pdf

In addition, one typically uses a service agency that files documents on one's behalf. The above amounts also do not include legal fees. Depending on the particular set of facts, our firm offers a variety of fee arrangements and "all-inclusive packages" to its clients that wish to incorporate in the United States.

Q: Is it physically necessary to be in the United States in order to incorporate an entity in Delaware?

A: No.

All the necessary filings may be done via facsimile or electronically.

Q: Do I need to appoint a registered agent?

A: Yes (for entities formed in Delaware).

Delaware law requires that every business entity have and maintain a registered agent in the State of Delaware. Registered agents serve as agents for receipt of service of process as well as other communications. Appointment of an agent is an easy process.

Q: What happens if I incorporate an entity in Delaware but will be doing business in another state in the United States or in more than one U.S. state?

A: The corporation may need to "qualify" to do business in those states.

If the corporation has offices or employees located in U.S. states other than the state of incorporation or otherwise conducts business in another U.S. state, the corporation may need to qualify to do business in those other states and to pay franchise taxes, income taxes and the like in those states. You should discuss with your legal adviser whether or not the company needs to "qualify" in another U.S. state.

You should also discuss with your legal adviser whether a particular U.S. state or a location in a particular state (a township) in which your corporation will do business has any additional registration or licensing requirement. For example, additional licenses may be required to conduct a particular type of activities or to have an office in a particular area.

Q: Do I need to reserve a name in Delaware?

A: It is not required, but it is recommended.

It is recommended (though not required) that before forming an entity one reserves the desired name in the state of organization. It is also recommended that one checks if the name is available in the state where the company is planning on conducting business and reserves a name in that state. (In Delaware one can reserve a name for 120 days.) Some states may not allow an entity from another state with the same name as an entity organized in that state to use the same or a very similar name.

Q: What basic documents do I need to incorporate in the United States?

A: See www.orrick.com/startuptoolkit.

The main standard form documents necessary to incorporate a Delaware corporation, which we generally recommend for start-ups, are available free of charge at the above website. Reviewing forms of such documents could be useful before discussing your individual situation with your legal advisers. Note, however, that certain adjustments to the standard documents are required to address particular situations, especially for companies that also have operations in Russia.

Q: Does a company organized in the United States have to report ownership in the company by non-U.S. persons?

A: You may need to report the ownership of the company's shares to the U.S. federal government.

If a non-U.S. person acquires a 10% or greater ownership interest in a company organized in the United States, the company is required to file Form BE-605 with the U.S. Department of Commerce to report the acquisition.

Q: What is an Employer Identification Number (EIN) and do I need to obtain it?

A: Generally all corporations are required to have an employer identification number.

It is now possible in many cases to obtain EIN online.

See http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-(EIN)-Online.

Note that the application for EIN requires a social security number (a number issued to U.S. citizens, U.S. permanent residents and temporary working residents). If one is not eligible to obtain such number, one may obtain an individual taxpayer identification number (ITIN) instead.

Q: How many shares should I authorize?

A: 10,000,000.

The number of shares authorized in a start-up company's initial Charter is somewhat arbitrary. You may want to pick a round number equal to the fully diluted pre-money valuation of the company. For example, if you believe the company's pre-money valuation will be US$10,000,000, then you should authorize 10,000,000 total shares (to cover the founders' round and the stock option plan). If you are correct about the pre-money value and there are 10,000,000 fully-diluted shares outstanding, then the Series A will end up being priced at US$1.00 per share (which is the usual target for the Series A round). Often, however, you will want to authorize 10,000,000 shares even if you think the pre-money valuation will be lower, because it makes is easier to round off all other numbers.

Q: What should I select as the "par value" of the Common Stock?

A: US$0.00001.

A typical par value is US$0.00001. There is very little meaning to par value; however, it does still have an impact on the annual franchise tax amount for Delaware corporations, so you would want to choose a very small number. Although California (and some other states) does not have the concept of par value, it is acceptable to state a par value for a California corporation, and it is generally a good idea to do so, because it may be used by other states in which the company does business in the future to set the minimum franchise taxes for those states.

Q: What type of stock should I create?

A: Common Stock and Founders Preferred Stock.

In the United States, corporations generally issue two basic classes of stock: common stock and preferred stock. Different series of common stock and preferred stock, each with different rights, are possible.

The vast majority of the initial shares should be common stock because future investors will demand preferred stock with rights and preferences superior to the common stock (e.g., liquidation preferences and veto rights).

In addition to the common stock, you may want to designate a portion of the common stock initially issued to the founders as Founders Preferred Stock. Founders Preferred Stock is a special class of common stock, pioneered by Orrick attorneys, that founders can sell to investors in a future financing round. Once sold, those shares convert into the series of preferred stock sold by the company to investors in such financing. This can provide some liquidity for founders as a reward and as an incentive to continue to grow the company rather than push to sell the company at an early stage. Except for this conversion feature, Founders Preferred Stock is identical to common stock.

Founders Preferred Stock can usually be issued only when shares are initially issued to founders. Therefore, it is important to decide whether or not to issue Founders Preferred Stock at the time of formation. If you choose to utilize this founder-friendly feature, Orrick recommends that Founders Preferred Stock cover between 10 – 25% of the total amount of stock to be issued to any individual founder with the remaining 75 – 90% in the form of common stock. For tax reasons, Founders Preferred Stock must be fully vested at the time of grant.

Founders Preferred Stock is a recent and sophisticated development in start-up company capitalization. Therefore, it is important to consult your legal adviser before putting this special class of stock into effect.

Q: How much should founders pay for their stock?

A: Usually, par value per share of Common Stock and slightly more for any Founders Preferred Stock.

Corporate law requires every stockholder to pay adequate consideration in exchange for their shares. This means that stockholders must pay at least the par value per share. There are, however, tax and accounting implications if any stockholder pays a price per share below the “fair market value” of the shares, so you should carefully consider whether the price per share should be greater than the nominal par value of the shares. You should discuss this issue with your legal adviser if the company is beyond the raw idea stage at the time of incorporation and has gained traction on developing its product or if the company is already in talks with potential investors, etc.

Because it has additional rights and privileges, Founders Preferred Stock is worth more than Common Stock. Typically, Founders Preferred Stock is valued around 30% higher than Common Stock, but you should consult with your legal adviser before finalizing.

Q: What is “vesting” and how does it work?

A. “Vesting” is a process by which holders of “restricted stock” accrue nonforfeitable rights over the stock.

In order to incentivize founders and certain employees to stay with the company, companies in the United States issue “restricted stock.” While the founder or employee holds all of the restricted stock initially, the company has a lapsing right to repurchase such stock based on a vesting schedule. Once a portion of the stock “vests,” the company no longer has a right to repurchase those vested shares. If a founder leaves the company before all of the stock has vested, the company has the right to repurchase the unvested shares at the founder’s initial cost and the founder would keep the vested shares.

In general, there is an expectation among angel and venture investors that the founders of start-up companies will subject their shares to vesting so the founders forfeit shares if they leave the company prior to vesting. In other words, the founders’ shares will be earned over time as they provide services to the company. This incentivizes the founders to stay with the company and contribute to its success. (The same logic applies to restricted stock issued to employees.)

The standard vesting schedule is for 25% of the granted shares to vest on the first anniversary of the date of the grant. The remaining shares then vest at a rate of 1/48th of the total shares on a monthly basis thereafter. This is commonly called a “4 year vest with a 1 year cliff.” In some cases, investors may allow the founders to establish a vesting commencement date based on when the founder began providing significant services to the company so that he or she can get credit for time already served. Alternatively, vesting may be based on achievement of certain performance milestones.

“Vesting” in case of stock options means that the option holder will not be able to exercise an option until a portion of it vests. Based on the typical vesting schedule above, the option holder will be able to exercise his or her option to purchase 25% of the stock subject to the option beginning with the first anniversary of the date of the option grant.

Q: Can the vesting be accelerated?

A: Yes.

Founders often worry about what happens to the vesting of their stock if they are fired “without cause” or if the company is acquired. You can include provisions to accelerate the vesting of the founders’ or particular

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common shares if either of these events occur (single-trigger acceleration), or if they both occur (double-trigger acceleration). Each situation is described below. The same acceleration of vesting is often found in restricted stock issued to employees.

Single-Trigger

Single-trigger acceleration means that the shares vest immediately upon the occurrence of either a change of control or a termination without cause. In situations where an M&A event is considered a "success event" rather than a failure to complete an IPO or achieve profitability, some employees will argue that they should be rewarded for helping the company get to the success event. The counter argument is that the whole concept of vesting is to create an incentive to provide service into the future and that the shares that have not yet vested have not been earned.

VCs do not like single-trigger acceleration provisions for founder's stock that are linked to termination of the founder's employment. They argue that equity in a start-up should be earned, and if a founder is terminated, then the founder's stock should not continue to vest any further. Sometimes a founder can negotiate an acceleration of vesting for a portion of his or her stock (usually 6 – 12 months worth of vesting) if they are involuntarily terminated, or leave the company for good reason (i.e., they are demoted or the company's headquarters are moved). However, under most agreements, there is no acceleration if the founder voluntarily quits or is terminated for "cause." Vesting acceleration of 6 – 12 month is also common in the event of the founder's death or disability.

VCs similarly do not like single-trigger acceleration on the sale of the company. They argue that it reduces the value of the company to a buyer. Acquirors typically do not just want to purchase a company's intellectual property or assets. Acquirors also want to retain founders, and if the founders are already fully vested, the founders are not incentivized to work for the acquiror. If founders and VCs agree upon single-trigger acceleration in these cases, it is usually limited to 25 – 50% of the unvested shares.

Double-Trigger

Double-trigger acceleration means the vesting of shares accelerates only if there is first a change of control and then the founder is terminated without cause within a certain number of months of the change of control. VCs consider this a far more acceptable form of acceleration than single-trigger acceleration.

Q: How many shares should I reserve for employee stock options?

A: 10 -- 20%.

VCs typically like to see at least 10% to 20% of the fully-diluted shares of a company reserved under the stock option plan. At the early stages of corporate development, when the management team is not yet established, investors may want a larger pool to cover expected new hires. The larger the number of shares reserved under the stock plan, however, the more the founders will be diluted.

Q: How many directors should my company have?

A: Two to five for a Delaware corporation.

The board of directors is the company's key governing body, so board composition determines the balance of power between the founders and the investors. Most companies will eventually want to have five authorized directors. Initially, however, you may only have two or three founders, in which case, you would set the size of the board equal to the number of founders you want to have on the board. When investors come in later on, this number can be increased in order to give board seats to the investors.

Delaware corporations can have one or more directors.

Q: On what date should the fiscal year-end?

A: December 31st.

December 31st is typically set as the fiscal year-end. If you would like to use a different date, consult with tax and accounting advisers.

Q: Should I include transfer restrictions on shares in the company's bylaws and stock plan?

A: Maybe.

Because of the emergence of active online stock trading markets for private companies, like SharesPost and SecondMarket, some companies are including provisions in their bylaws that require approval of the board of directors of the company for any stock transfers.

The most complete coverage is to put blanket transfer restrictions into the initial bylaws that are adopted at incorporation. Some companies may choose, however, to put the transfer restrictions into their stock option plans so that the restrictions only apply to stock option grants under the plan (i.e., founders and investors would be excluded).

The conflicting view is that the shares issued to founders and employees are already subject to the company's right to repurchase, therefore, the company does not need the board of directors of the company to review each potential transfer.

You should discuss this point with your legal adviser.

BASIC TAXATION CONSIDERATIONS[1]

Q: What taxes will I and my company have to pay if I incorporate and operate a company in the United States?

Income taxes Payable by a Corporation

- **Federal taxes**. The table below sets forth the current federal tax rates. Federal tax rates start at 15% for income up to $50,000; the maximum federal tax rate is 35%.

Taxable Income (US$)	Tax Rate[2]
0 to 50,000	15%
50,000 to 75,000	$7,500 + 25% of the amount over 50,000
75,000 to 100,000	$13,750 + 34% of the amount over 75,000
100,000 to 335,000	$22,250 + 39% of the amount over 100,000
335,000 to 10,000,000	$113,900 + 34% of the amount over 335,000
10,000,000 to 15,000,000	$3,400,000 + 35% of the amount over 10,000,000
15,000,000 to 18,333,333	$5,150,000 + 38% of the amount over 15,000,000
18,333,333 and up	35%

- **State taxes**. State tax rates vary from 0% to 16%. However, state taxes are deductible in computing federal taxable income. Note that state taxes in a particular state are payable only on income allocable to operations in that state.

  For example, in California the top rate is 8.84%. In New York State, the top rate is 7.1%; small business taxpayers located in New York pay rates of 6.5%, 7.1% and 4.35% on 3 brackets of entire net income up to $390,000.

- **Local taxes**. Some local jurisdictions levy additional local taxes on income allocable to operations in that location. For example, New York City imposes an additional 8.85% on income allocable to operations in New York City. Local taxes are generally also deductible in computing federal taxable income.

Annual Franchise Tax Payable by Delaware Corporations[3]

[1] Note that this Q&A mainly addresses U.S. tax issues. You should consult your tax adviser regarding additional Russian tax issues.
[2] http://en.wikipedia.org/wiki/Corporate_tax_in_the_United_States#cite_note-27
[3] Annual Franchise tax information and calculation are quoted from http://corp.delaware.gov/frtaxcalc.shtml

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- **Franchise Tax**. All corporations incorporated in the State of Delaware are required to file an Annual Franchise Tax Report and to pay a franchise tax based on (i) the number and par value of authorized shares of such corporation or (ii) an alternative calculation that takes into account issued shares and gross value of the assets of such corporation.
- Taxes and annual reports are to be received each year no later than March 1.
- The minimum tax is US$75 with a maximum of US$180,000. Most early-stage corporations pay less than US$1,000 Delaware franchise tax per year.
- **Annual Report**. Notification of Annual Report and Franchise Taxes due are sent to all Delaware registered agents in December of each year. Delaware has mandated electronic filing of domestic corporations' annual reports.

  A US$50.00 filing fee is required for the annual report, together with the payment of franchise taxes.

Franchise Tax Calculation

- **Non-Stock for Profit**. All non-stock, for profit entities that do not comply with the Exempt Corporation requirements will be required to pay a Franchise Tax of US$75.00.
- **Authorized Shares Method.** For corporations having no par value stock the authorized shares method will always result in the lesser franchise tax.
  - 5,000 shares or less (minimum tax) US$75.00
  - 5,001 – 10,000 shares – US$150.00
  - each additional 10,000 shares or portion thereof add US$75.00
  - maximum annual tax is US$180,000.00

  For Example:

  - A corporation with 10,005 shares authorized pays US$225.00 (US$150.00 plus US$75.00)
  - A corporation with 100,000 shares authorized pays US$825.00 (US$150.00 plus US$675.00 [US$75.00 x 9]).
- **Assumed Par Value Capital Method**. To use this method, you must give figures for all issued shares (including treasury shares) and total gross assets in the spaces provided in your Annual Franchise Tax Report. Total Gross Assets shall be those "total assets" reported on the U.S. Form 1120, Schedule L (Federal Return) relative to the company's fiscal year ending the calendar year of the report. The tax rate under this method is US$350.00 per million or portion of a million. If the assumed par value capital is less than US$1,000,000, the tax is calculated by dividing the assumed par value capital by US$1,000,000 then multiplying that result by US$350.00.

  The example cited below is for a corporation having 1,000,000 shares of stock with a par value of US$1.00 and 250,000 shares of stock with a par value of US$5.00, gross assets of US$1,000,000.00 and issued shares totaling 485,000.

  1. Divide your total gross assets by your total issued shares carrying to 6 decimal places. The result is your "assumed par".
     Example: US$1,000,000 assets, 485,000 issued shares = US$2.061856 assumed par.
  2. Multiply the assumed par by the number of authorized shares having a par value of less than the assumed par. Example: US$2.061856 assumed par x 1,000,000 shares = US$2,061,856.
  3. Multiply the number of authorized shares with a par value greater than the assumed par by their respective par value.
     Example: 250,000 shares x US$5.00 par value = US$1,250,000
  4. Add the results of #2 and #3 above. The result is your assumed par value capital.
     Example: US$2,061,856 plus US$1,250,000 = US$3,311 956 assumed par value capital.
  5. Figure your tax by dividing the assumed par value capital, rounded up to the next million if it is over US$1,000,000, by 1,000,000 and then multiply by US$350.00.
     Example: 4 x US$350.00 = US$1,400.00
  6. The minimum tax for the Assumed Par Value Capital Method of calculation is US$350.00.

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Personal Income Taxes

An individual shareholder of a company organized in the United States, who is a U.S. tax resident, would have to pay taxes (federal, state and, if applicable, local) on distributions from the company and on profits from the sale of the stock of the company.

Generally, dividends are taxed at an ordinary income rate based on the tax bracket of the individual shareholder. However, certain qualified dividends paid in respect of stock of a domestic (i.e., U.S.) corporation held for more than 60 days are subject to the long-term capital gains rate based on the tax bracket of the individual shareholder.

Generally, profits from the sale of the stock of the company would be taxed at the long-term capital gains rate if the seller held the stock for over one year and at the regular rate if held one year or less.

If a shareholder is also employed by the company or receives fees for serving as a director (as often is the case with the founders), compensation is generally taxable.

Currently, the highest ordinary federal income tax bracket in the United States can be subject to taxation at the rate of 39.6%.

Currently, the highest federal rate for long-term capital gains tax is 20%.

In addition, a new 3.8% Medicare tax was introduced in 2013.

State and local tax rates vary. (See http://www.taxadmin.org/fta/rate/ind_inc.pdf for a list of 2013 state tax rates.)

Note that generally a Russian tax resident shareholder (who is not a U.S. tax resident) would be taxed in the United States at the above rates on:

(i) income from employment performed in the United States, and

(ii) director's fees and similar payments from a U.S. company,

but not its income outside the United States.

In addition, a withholding tax on dividends distributed by a U.S. company will also apply at a rate of 5% or 10% based upon the U.S.-Russia double tax treaty if such Russian shareholder is not a U.S. tax resident.

Generally a Russian shareholder who is not a U.S. tax resident would not be subject to U.S. tax on the proceeds from the sale of his or her shares in a U.S. company, unless such company is a real property holding company.

If a Russian shareholder becomes a U.S. tax resident, his or her worldwide income will be taxed in the United States.

Various exceptions to the above general statements may apply. You should consult your tax adviser to determine whether you would be considered a U.S. tax resident and whether certain exception would apply to your specific situation.

Russian tax residents who intend to hold their shares in a U.S. corporation through a company organized in Cyprus or the British Virgin Islands should also consult their tax advisers regarding potential negative tax implications (e.g., a U.S. withholding tax of 30% on dividends from a U.S. company).

Q: What are U.S. tax implications of different types of employee stock options?

A: An exercise of an Incentive Stock Option will generally not result in a taxable event and the sale of stock purchased pursuant to such option may be taxed at a lower capital gains tax rate; an exercise or sale of a non-Qualified Stock Option will be taxed at ordinary income tax rates.

While under current Russian legislation a grant of stock options in itself may give rise to tax obligations, from the U.S. tax laws perspective, the grant of stock options itself is not taxable. Depending on the type of the stock option, under U.S. tax laws a taxable event generally does not occur until (i) the option holder exercises the option or sells the option and/or (ii) the shareholder sells the stock acquired pursuant to a stock option.

From the U.S. tax law perspective, the most popular option among employees is incentive stock options ("ISO"). ISOs are a form of "qualified stock option" which receives preferred status under the tax law. (Another form of qualified stock option is only available for public companies and will not be discussed here.) Upon exercise of an ISO and subject to compliance with, *inter alia*, certain holding requirements and exercise price requirements described below, an exercise of an ISO will not result in a taxable event to the employee. If a shareholder holds the shares purchased pursuant to an ISO for at least one year from the date of exercise and at least two years from the date of the grant, then any profits from the sale of such shares are taxed as long-term capital gain (see information on the rates above). (Note, if the holding period is not satisfied, the shareholder will have to pay ordinary income tax on the profits from the sale of the stock.)

One disadvantage of an ISO is that unless the employee does not meet the holding-period requirement, the employer generally cannot claim a corporate income tax deduction. (The deduction would normally equal the amount of income recognized by the employee.)

In order for stock options to qualify as ISOs, the stock option plan pursuant to which such stock options may be issued has to comply with certain restrictions, including, but not limited to, the following: (i) the options may only be granted to an employee (not to a non-employee director or an independent contractor), (ii) subject to certain exceptions in case of disability or death, the employee has to exercise options no later than three months after termination of employment, (iii) the exercise price for the option must equal or be greater than the fair market value of the underlying stock at the time of the grant, (iv) if an employee, at the time of the grant, owns stock representing more than 10% of the voting power of all outstanding stock, the option exercise price must be at least 110% of the fair market value and expire no later than five years from the grant date, and (v) the aggregate fair market value (as of the grant date) of stock acquired through the exercise of the option cannot exceed US$100,000 in a calendar year. You should discuss additional restrictions with your legal adviser.

A less popular alternative for employees is to issue non-qualified stock options. The option holder has to recognize ordinary income at the time of exercise of the option or when the option is sold, in an amount equal to the fair market value of the shares at the time of the exercise less the exercise price. The amount of income recognized by the option holder can be claimed as a deduction by the employer. The restrictions described above on ISOs do not apply to non-qualified stock options.

Note that a Russian tax resident option holder may be taxed in the United States upon exercise of a non qualified stock option granted by a U.S. company (but not upon exercise of an ISO since the exercise of an ISO is not taxable in the United States).

If your stock option plan will cover your employees in Russia or other Russian tax residents, you should consult your legal and tax adviser to discuss additional issues.

Q: What is a Section 83(b) election and what are the benefits?

A: A Section 83(b) election can be made when restricted stock is issued for services to the company. The election can result in tax benefits.

Many United States taxpayer founders whose restricted stock is subject to vesting will wish to make a Section 83(b) election in order to preserve possible future taxation benefits. A Section 83(b) election is an election to include in income the value of property which is subject to a substantial risk of forfeiture, such as a company's repurchase right in connection with restricted stock, which repurchase right lapses over time as a founder provides services to the Company. Because restricted stock is subject to a substantial risk of forfeiture, the founder does not have to pay tax on the founder's receipt of the stock until it vests. A founder may make a Section 83(b) election to pay tax on the value of the stock today (even before it fully vests) because its value is lower than it is expected to be when the repurchase right lapses. The filing of the Section 83(b) election also starts the founder's capital gains holding period. (A sale of stock held in excess of one year is taxed at a lower capital gain tax rate (maximum rate of 20%).) Note that Section 83(b) election is not limited to founder's restricted stock but can also be filed by employees who receive restricted stock subject to vesting. The 83(b) election must be filed within thirty days of the issuance of restricted stock.

INTELLECTUAL PROPERTY CONSIDERATIONS

Q: What steps do I need to take to protect my company's intellectual property in the United States?

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A: The course of action depends on the type of intellectual property.

The summary below outlines four basic types of intellectual property that is protected under the U.S. federal or state laws.

Patents

A United States patent provides the owner the right to prevent others from making, using, offering or selling the invention within the United States or from importing the invention into the United States.

Patentable inventions in the United States include: (i) utility patents (e.g., processes, methods of doing business, machines, compositions of matter, articles of manufacture, new uses for old things and improvements in any of the above); (ii) ornamental designs for articles of manufacture; and (iii) plants.

To obtain a U.S. patent, the inventor must file an application with the U.S. Patent and Trademark Office (the "USPTO") where it is reviewed for patent eligibility. The USPTO examines whether the invention is (i) novel, (ii) useful, and (iii) non-obvious to a person of ordinary skill in the field of the invention. The registration process generally takes anywhere from two to four years and possibly longer. The USPTO will typically issue one or more rejections of the application to which the applicant will have to respond and argue for patentability. A patent does not become enforceable until it is approved and granted by the USPTO.

To ensure that one's rights are protected, patent applications should be filed prior to publication, sale, public use or other disclosure of the invention. If your invention has already been disclosed, there are still opportunities to obtain a patent in the United States if an application is filed within one year of the disclosure. You should discuss the issue with your legal adviser if you are in this situation.

An inventor could file his or her patent application first in Russia and the USPTO will afford a later U.S. application the benefit of the Russian filing date. To get the benefit of the Russian filing date, however, the U.S. patent application, or an international PCT application, must be filed within one year of the initial Russian patent filing.

The filing should be done by the then-current owner of the patent, whether it is the inventor, his or her employer or the U.S. holding company assignee.

Trademarks

A trademark is a name, phrase, symbol product shape, color or other source identifier that is used in connection with a service or product of your company. In order to be afforded protection under U.S. trademark protection laws, a trademark must be distinctive, i.e., it must be capable of identifying the source of a particular good and/or service and not be considered merely descriptive or generic.

Assuming a trademark qualifies for protection, a federal trademark registration can be acquired by filing a federal trademark application at the USPTO. Trademark rights in the United States are based on priority. Consequently, the party first to file or first to use a trademark in interstate commerce acquires the rights to that trademark with respect to the goods and/or services offered in U.S. interstate commerce in connection with that mark. A trademark application can be filed with the USPTO before the subject trademark is in use in commerce, but a registration will not issue until the mark is in use with the goods and/or services in interstate commerce. That being said, if your company has a trademark registration in Russia you may be able to file a U.S. trademark application based on your Russian registration without demonstrating use in interstate commerce in the United States.

The USPTO fee to file a trademark application is US$325 per mark per class. Once registered, the trademark is registered for 10 years, with mandatory use and renewal filings between the fifth and sixth years of registration and the ninth and tenth years of registration. There are fees associated with the use and renewal filings as well and there are six-month grace periods for late filings. A trademark can be renewed for an unlimited number of periods assuming the mark is used continuously and the appropriate filings are made and fees are paid.

In addition to federal trademark protection through the USPTO, companies can acquire common law trademark rights without a federal trademark registration. A company acquires common law rights by using the mark in interstate commerce. In this way, a company that uses a trademark in commerce can actually obtain priority over a later-filed trademark application or a later user. You should contact your legal adviser or attorney to determine what constitutes use in interstate commerce.

Until your trademark is registered, you cannot use the circle R symbol to denote registration. However, you can and should use the TM or SM superscript with your trademark to alert consumers and third parties that you are claiming trademark rights in the mark. The TM or SM superscript can be used in the upper right-hand corner of the trademark in the first and most prominent usage of the mark in collateral or on a website. Again, check with your legal adviser as to the appropriate placement and usage of the TM or SM symbols.

Copyrights

Copyright law protects an author's original work fixed in a tangible medium of expression (e.g., software code, book, course materials displayed on a web page, etc.). Although it is not necessary to file for copyright protection, it is advisable to do so in order to be able to enforce one's copyright. Owning a registration is a prerequisite to bringing an action for copyright infringement in most U.S. jurisdictions. The filings are made at the U.S. Copyright Office and the current filing fee is US$35 (if filed electronically).

Note that it is generally advisable to register copyrights of software at major revisions; however, you should discuss with your legal advisers whether certain parts of your software should be redacted before filing and be maintained as a trade secret (see below). For example, even though the Copyright Office requires a deposit of the copyrighted work to be uploaded with the application, the Copyright Office allows you to submit partially redacted software code to protect any potential trade secrets. There is also the option to pre-register your software code if you believe that there may be potential infringement of the code before it is released.

Trade Secrets

Generally, a trade secret is information, technical or commercial (e.g., formulas, algorithms, processes, software (object code and source code), customer lists, historical pricing information, sales forecasts, marketing plans and sales strategies), that has independent economic value from not being generally known and is subject of efforts that are reasonable under circumstances to maintain its secrecy. To be afforded protection (e.g., injunctive relief or damages) under state laws, you would need to demonstrate reasonable efforts at protecting trade secrets, such as: (i) advising and informing employees what constitutes proprietary and confidential information; (ii) putting in place policies and IT procedures to limit access to and preserve the confidentiality of that information with respect to current and departing employees; (iii) requiring employees and consultants to sign a confidentiality agreement in which they are informed about what constitutes that information and what their non-disclosure obligations are; and (iv) requiring all employees to sign termination checklists upon their departure, verifying that they have not retained any company confidential information in their possession.

You should discuss with your legal adviser whether it is advisable to patent certain types of intellectual property (e.g., algorithms or formula), obtain a copyright (e.g., software) or attempt to protect such intellectual property as a trade secret. While protection for patents and copyrights expire after a particular duration, trade secret protection never expires while it remains unknown to the public. However, enforcing trade secret protection requires first proving that the information is, in fact, secret, generally placing a higher burden on the plaintiff. In addition, unlike with patent protection, trade secrets are protected only from an improper acquisition or use – not from reverse engineering. However, the remedies are broad, including injunctions, damages and, in egregious cases, attorneys' fees and costs.

Q: Should I assign intellectual property developed by me or my Russian company to the holding company in the United States?

A: It depends on the financial position of your start-up.

Customarily U.S. VCs will conduct due diligence to ensure that the U.S. holding company either owns all key intellectual property or controls an entity that owns such intellectual property. If a subsidiary of the U.S. holding company owns intellectual property, VCs would want to make sure that the subsidiary is located in a jurisdiction that, in the view of a U.S. VC, has adequate intellectual property protections, and that the subsidiary has taken the necessary steps to avail itself of the protections afforded in such jurisdiction. In addition, in case of a subsidiary ownership, depending on the type of intellectual property involved and its applicability to the business in the United States, VCs may want to confirm that necessary steps have been taken to protect such intellectual property under the laws of the United States.

Generally, it is more efficient from the tax perspective to keep the ownership of intellectual property offshore (e.g., Ireland, Luxembourg or the Netherlands) and not in the United States. However, for a start-up with limited funds, tax structuring at the initial stages of development may be too expensive.

If funds for tax structuring are not available, which would be the case with most start-ups, then in order to make your U.S. company more attractive to typical U.S. VCs, it may be advisable to assign all key intellectual property to the U.S. holding company. You should consult with your legal advisers to ensure that instruments of assignment conform to applicable law, which in some cases may have to be both the laws of the jurisdiction of the assignor and the laws of the jurisdiction of the assignee. In the United States, the assignment of intellectual property rights in recorded patents, copyrights and trademarks should be recorded. This is typically done through the execution of simple “recordable” assignment forms. This process avoids the public filing of confidential documents such as employment agreements or asset transfers.

Once your company reaches a certain value, you should discuss with your tax advisers moving the ownership of the intellectual property offshore. The lower the value of the intellectual property is when it is transferred offshore, the greater would be the tax benefits.

If intellectual property is transferred to an offshore location, subject to compliance with all applicable laws, the intellectual property can then be licensed to the U.S. entity, the license fee can be tax deductible in the U.S. and the proceeds are taxed at a lower rate (or tax free) in the relevant offshore location. The relevant tax rules are complicated and we suggest you contact your tax adviser to discuss ways in which intellectual property may be transferred and subsequently licensed.

Q: What steps do I need to take in the United States if scientists and/or developers employed by my Russian company continue to develop intellectual property in Russia after the assignment of existing intellectual property to the U.S. holding company?

In a scenario where all or key intellectual property is assigned to the U.S. holding company, a common structure could involve the U.S. holding company granting a license to the Russian subsidiary to permit the use by the Russian subsidiary of the intellectual property owned by the U.S. holding company for certain purposes (e.g., processing data, future development of intellectual property). The U.S. parent could also “hire” the Russian subsidiary, pursuant to a servicing agreement (or similar type of an agreement) to develop unrelated intellectual property for the U.S. holding company. While licenses under Russian law do not cover intellectual property created in the future, such a license or servicing agreement drafted under, for example, New York law could provide that all intellectual property created pursuant to the license or servicing agreement would be owned by the U.S. holding company. You should also consult your tax advisers regarding tax implications of such license or servicing agreement.

In the United States, unlike Russia, licenses of intellectual property do not have to be recorded and there is no time limitation on the license mandated by law.

Note that it is very important that all employees and consultants of the U.S. holding company and of the Russian subsidiary execute proper assignments of all intellectual property (including inventions) to his or her employer.

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Our cross-border team of legal experts would gladly help you at all stages of development of your business.

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