

Houston Angel Network

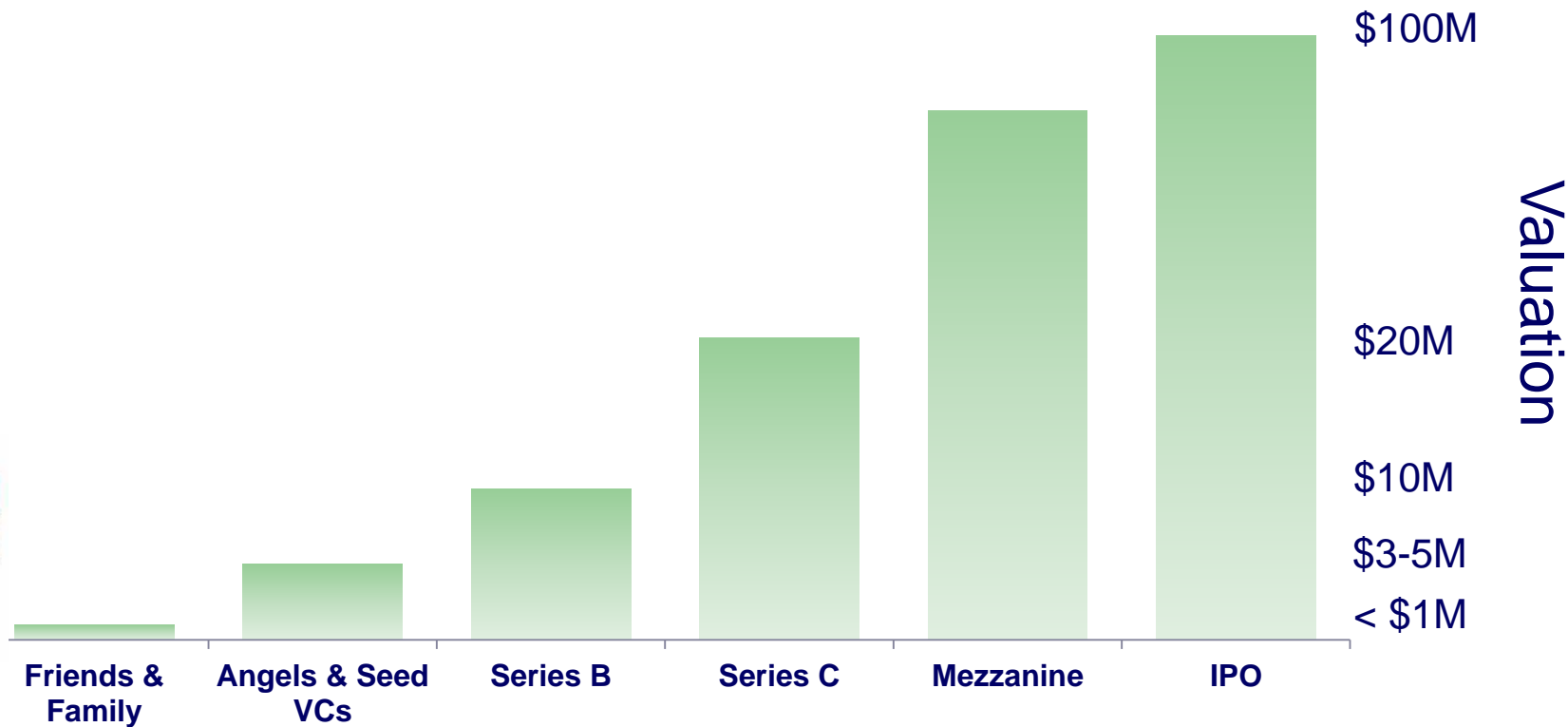


ACA Leadership Forum

Andrew Clark, Gene Betts
November, 2017

- **We Invest in Innovation but Don't Innovate Around Investment Strategy and Structuring**
- **Premise: Develop Set of Investment Strategies Rather Than Fall Into Current Standard Operating Procedure of Venture Investing**
- **Structure Follows Strategy (Form Follows Function)**

Scaling the Liquidity Mountain



- **Majority of Angel Investments are Ultimately Not Candidates for Institutional Venture Capital**

Must Consider and Plan for Alternatives

- **Angel Investments are Likely to be Held for a Long, Long Time**
- **Angel Groups are Always Challenged with Membership Churn**

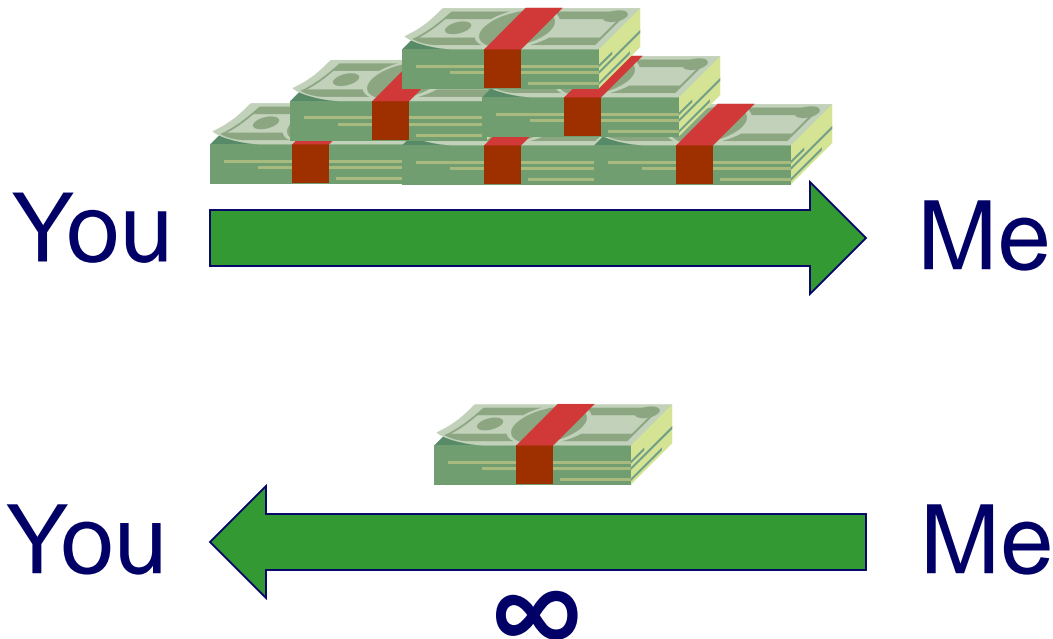
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Good News for Angels

- **Angels Do Not Need to Sell Out of Positions to Satisfy LPs and Generate Returns for League Tables**
- **Can Make Money in the Basil Peters \$10M - \$30M Early Exit Range**
- **Can Make Very Small Investments (\$5K - \$10K)**

A Possible Alternative

If you gave me \$100,000 AND I gave you back \$10,000 each year indefinitely, would you take this deal?



Traditional C Corporation

- **Formed as Delaware C Corporation or Corporation under Your State's Business Organization Code**
- **Standard Architectural Plans**
 - You can pick the color of granite in the kitchen from 1 of 5 colors
 - Standard case law
 - Robust shareholder protections and governance requirements under Delaware code

C Corporation Benefits

- **More expansive case law, explicit stockholder protections**
- **NOL (Net Operating Loss) warehouse**
- **QSBS**
 - Section 1045
 - Section 1202
 - **Small Business Corporation Section 1244**
 - **VC's and smaller PE's expect C-Corp structure**

Gene Betts on Flow-Through Entities

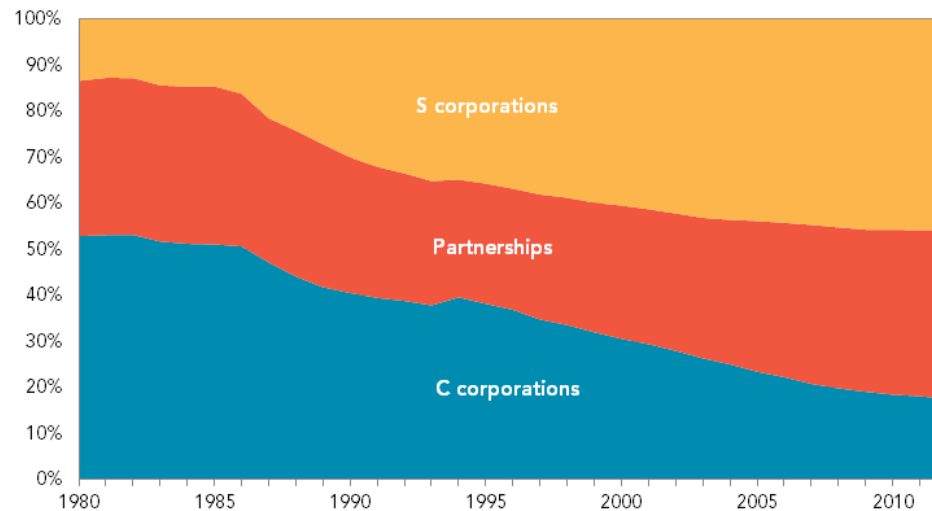
- **Partnership, LLC taxed as Partnership, or S Corp**
- **LLC most common for Angel Investments**
- **Complete discussion on the Central Texas Angel Network site @**
Centraltexasangelnetwork.com/entrepreneurs/llc-c-corp-or-s-corp/

Understanding Economics

- 3 Parties to any Exit Transaction
 - Seller
 - Buyer
 - US Treasury/IRS
- Angels often fail to consider last two parties
- IRS can actually ADD \$ to an Exit for both Buyer and Seller with pass-through entity

35 Year Shift Away from C Corps – Why?

FIGURE 1
Share of Business Returns by Type
1980–2012



Source: Internal Revenue Service, Statistics of Income Division, Integrated Business Data, Table 1.

Example: Cash Return Difference

<i>Illustration of Impact of Pass-through vs. C Corp</i>				
<i>Assumes Buyer Purchase Assets, not Stock</i>				
<i>Section 1202 does NOT Apply</i>				
		Company	Company	Total
		A	B	
Investment		100	100	200
Pre-tax exit price		-	600	600
Pre-tax gain (loss)		(100)	500	400
AT gain (loss)	Pass-Through	(60)	400	340
AT Return %	Pass-Through	-60%	400%	170%
AT gain (loss)	C Corp	(80)	260	180
AT Return % C Corp	C Corp	-80%	260%	90%

Profits Interest Units (“PIU”) vs. Stock Option

- **Taxed as LTCG rather than Salary – potentially 50% tax reduction**
- **Even better than an ISO – no holding period requirement after exercise**
- **NO 409A appraisals needed**
- **Positive employee reactions**
- **Hedge funds love them, but probably losing them – not at risk for Angel companies**

C Corp Sale Dilemma

- **What is good for Seller, bad for Buyer – And Vice Versa**
- **NO way around it**
- **Section 1202 harms full tax-paying Buyer more than benefits Seller**
- **Pass Through Entity eliminates tension and creates win/win**
 - **IRS actually helps fund the transaction**

Legal Use of Tax Laws to Improve Exit

	BUYER			SELLER		IRS
		Tax		Tax		
	Pre-Tax Value	Benefits 38%	Acquisition Price	On Sale 20%	Cash In Bank	Positive (Negative)
C Corp Stock Sale	1,000	-	1,000	(200)	800	200
C Corp Stock Sale plus Section 1202	1,000	-	1,000	-	1,000	-
LLC Stock or Asset Sale	1,000	600	1,600	(320)	1,280	(280)

C Corp “Crash Landing” Scenarios

Scenario

- Distribute operating cash flow
- Sell portion, not all, of Company
- Buyer refuses to buy stock due to concerns over unasserted liabilities
- Employee impact of C Corp Stock Options vs. PIU's

Consequence

- 2-Tier taxation
- 2-Tier taxation
- 2-Tier taxation
- 2X tax rate upon exercise

Greatest Day 1 Angel Mistake

- Once a C Corp, always a C Corp – tax laws make conversion to LLC inordinately expensive
- Form as LLC, can convert any time downstream to C Corp, if desired. Maximum flexibility.
- US Treasury loves C Corps – let anyone in, no one out
- Why not form as LLC, and keep options open?

LLC Benefits

- **Typically much better cash returns for investors**
 - Tax recovery on failed Companies can be 2X better
 - Avoid 2-tier taxation on assets sales, cash distribution
 - Increase exit price by benefiting Acquirer taxes
 - Huge return lever - doubling of IRR quite possible
- **Allows creation of distribution waterfalls**
- **PIUs superior to C Corp Stock Option plan – 50% reduction in tax and no 409A Appraisals**

Additional Topics

- **May need to force distributions in slower growing yet profitable companies**
 - **Distributing dividend in C - corporations**
 - **Distribution waterfall from LLC structure**
- **Section 1244 allows angels to play micro-ball**
- **Trump tax cuts / code modification will undoubtedly have a significant impact, but too soon to say what it will be**
 - **Elimination of QSBS has been discussed**
 - **Reductions in corporate rates and pass-through rates; consolidation of individual rates**
 - **Repeal of AMT and 3.8% Obamacare tax on investment income**
 - **As far reaching as the '86 tax reform**

Potential Actions

- **Create ACA working group**
- **Extend conversation to key transaction / securities attorneys**
- **Develop model legal documents**
- **Establish contact with NVCA**

Q&A