

Can effective angel co-investment structures help increase returns?

The importance of tax-efficient co-investment vehicles for angel investors

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The angel investment sector in Australia is changing.

The increased importance of angel capital in the early stage ecosystem and the growing sophistication of angel groups globally is encouraging greater focus on angel investment strategy and structures. As co-investment between angels increases, co-investment structures will need to become more tax-effective than the humble unit trust.

In this article we propose that where a group of angel investors share a similar investment style and philosophy and wish to co-invest with each other, the ESVCLP provides the most tax-effective structure through which to do so.

Modus operandi of angels

Angel investors are motivated by more than just return on investment. Typically angel investors are high net worth individuals who have been successful in previous entrepreneurial endeavours. The experience gained equips angels with valuable practical understanding of the mechanics of business building and an acute ability to identify and resolve the pitfalls inherent in start-up businesses.

Often therefore, when an angel investor decides to invest in an early stage business, he or she will do so not only for financial gain but also in order to bring this entrepreneurial expertise to the board. If one accepts, as the authors do, that 'the execution' is more important than 'the idea', then it becomes clear that the expertise an angel investor brings to an emerging business is often just as valuable as the injection of capital.

Angels do not always invest directly but often pool their funds with other angel investors and co-invest through a special purpose vehicle, typically, a unit trust. One of the reasons for this indirect investment may be to reduce exposure to risk. Another reason may be that the value of the investment and the forecast follow-on investments necessary to execute a particular investment strategy may be greater than an individual angel is prepared to make alone.

In the current climate, there is likely to be greater levels of co-investment between angel investors who share a similar investment style and philosophy.

Often, angels cite the flexibility of unit trusts as the reason for their popularity as a co-investment structure. In reality, the appeal is less about flexibility and more about familiarity. As Australian angel investors begin to embrace global best practices, it has become necessary to reconsider the tax-effectiveness of their co-investment structures.

In the authors' view, one of the most tax-effective structures for angel group co-investment is the Early Stage Venture Capital Limited Partnership (**ESVCLP**). The ESVCLP is a tax flow through vehicle, through which distributions of income and capital gains to angel investors will be exempt from taxation.

ESVCLP myths

There are a number of myths around the complexity and perceived lack of flexibility of the ESVCLP as a structure for angel group co-investment which should be dispelled.

Myth 1: An angel investor cannot take part in the management of the business of an ESVCLP – False

In an ESVCLP, the general partner manages investment decisions. An angel investor may be appointed as an officer of the general partner (is it a body corporate) or may appoint a representative to the board, and thereby have direct involvement in investment decisions.

Myth 2: Funds are about the fund manager making money, not the investors – False

In a typical managed fund, passive investors are prepared to reward the fund manager for the expertise it brings to the investment selection and management process. The structure of this reward will be set out in the fund deed and is ordinarily comprised of a management fee (which allows the fund manager to cover the costs of operating the fund and provides a small level of guaranteed profit for services) and the carried interest (which is the fund manager's performance bonus and is ordinarily not payable until the investors have received distributions equivalent to both the capital they invested and an agreed level of return).

However, where a group of angel investors come together to co-invest through an ESVCLP and each appoint a representative to help manage investments, it may be agreed, for example, that the management fee is to be

limited to the administrative costs of the ESVCLP and that the carried interest is to be done away with altogether. This ensures the maximum possible return to the angel investors and secures a better tax outcome overall.

Myth 3: Committed capital will be trapped for the entire investment period – False

Once an investor has agreed to commit a specified level of capital to the fund, it will need to ensure that that amount is available to contribute when a call on capital is made.

However, there is no requirement to actually contribute any funds until a suitable investment is identified or to make any investment in any specific period of time. Those decisions could be made by the angel investors collectively, giving each angel investor some control over when capital calls are made.

Myth 4: An ESVCLP will need to be registered as a managed investment scheme (MIS) resulting in greater regulatory burden and increased costs – False

Whilst a co-investment vehicle structured as an ESVCLP is likely to be a 'managed investment scheme', it will not always need to be registered. It is registration that attracts the increased regulatory burden and associated costs.


There are a number of exemptions to the requirement for registration.

One example is that where a group of angel investors come together to co-invest through an ESVCLP the parties will not ordinarily be *in the business of scheme promotion* and provided the ESVCLP has less than 20 investors the ESVCLP will generally not need to be registered as a MIS. Another example is where interests in the scheme are not offered to 'retail clients'. Typically, an angel investor will not be a 'retail client' and therefore an ESVCLP made up solely of such investors will not need to be registered.

Conclusion

The ESVCLP provides angel investors with a tax-free co-investment vehicle through which to undertake group investment activity. Angels in an ESVCLP can have direct involvement in the investment activities of the fund. In a typical angel group co-investment, it will not be necessary for the fund to be registered as a MIS. Reward structures can be moulded to the needs of the investors ensuring the best possible taxation outcome. Finally, there is flexibility in the legislation which can be incorporated into the fund deed to ensure committed capital can be flexibly managed.

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