

Venture Capital Bulletin

Co-investment among angel investors to rise – how to structure tax-effective co-investment vehicles

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As angel investors begin to re-assess their appetite for risk in the face of the opportunities available in the current climate, co-investment between angels will become more popular and co-investment structures will need to become more tax-effective than the humble unit trust.

Where a group of angel investors share a similar investment style and philosophy and wish to co-invest with each other, the Early Stage Venture Capital Limited Partnership (ESVCLP) provides a 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. This experience equips angels with a 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 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 may 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 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.

Co-investment structures

Angels often cite the flexibility of unit trusts as the reason for their popularity as a co-investment structure.

However, as the profitability of investees in a portfolio begins to plateau, angel investors are moving toward more tax-effective co-investment structures.

One of the most tax-effective structures for group co-investment is the ESVCLP.

The ESVCLP is a tax flow-through vehicle, through which distributions of income and capital gains to investors will be exempt from taxation.

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.



ESVCLP myths

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

In fact, a limited partner of an ESVCLP may be appointed as an officer of a general partner that is a body corporate or may appoint a representative to the board. The effect of this carve-out is that an angel investor may be a director of the general partner of the ESVCLP, and thereby have direct involvement in investment decisions.

Myth 2: An ESVCLP will need to be registered as a managed investment scheme (MIS) resulting in greater administrative burden and increased costs

While a co-investment vehicle structured as an ESVCLP is likely to be a 'managed investment scheme', the key issue is whether or not the MIS is required to be registered. There are a number of exemptions to the requirement for registration. For example, 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 members, 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.

Myth 3: Funds are about the fund manager making money, not the investors

In a typical 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).

The key to remember is that each of these reward structures (like everything else in the fund deed) are matters for negotiation. The most successful funds seek to achieve a win-win scenario between fund manager and investor, whereby the structure of the reward is considered by both sides to be fair consideration for the value brought to the fund by the fund manager.

Where a group of angel investors come together to co-invest through an ESVCLP and each appoint a representative to sit on the board of the General Partner, it may agree to limit the management fee to the bare costs necessary to operate the fund and to do away with the carried interest altogether. After all, the aim of the game is to ensure the maximum possible return to the limited partners. This is also a better tax outcome, since the returns to

limited partners from an ESVCLP are tax-free while the carried interest is taxable in the hands of the General Partner (albeit on capital account rather than revenue account).

Myth 4: Committed capital will be trapped for the entire investment period

Once an investor has agreed to commit a specified level of capital to the fund, it will need to ensure that level of funds is available to answer calls on capital that are made by the General Partner from time to time. However, ordinarily the fund deed will empower the General Partner to reduce the level of committed capital or to return capital to the limited partners at its discretion.

Conclusion

The ESVCLP provides angel investors with a tax-free co-investment vehicle through which to undertake group investment activity. Angels may sit on the board of the General Partner or appoint a representative to do so and thereby 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.



Venture Capital Contacts

For further information in relation to this bulletin, contact:



John Cannings
Partner
Phone: (02) 8266 6410
Email: john.cannings@au.pwc.com



Steven Maarbani
Senior Associate
Phone: (02) 8266 6834
Email: steven.maarbani@au.pwc.com

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