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Innovation Policy: Stimulating Investment in Canadian Ventures

The National Angel Capital Organization ("NACO") is the national champion of Canada's Angel investing community. Our members include just under 2,000 individual investors, Angel groups in large and small communities across Canada and other industry partners who provide capital – and expertise - to motivated and capable entrepreneurs in starting and building profitable companies.

The recommendations provided in this document have been compiled by NACO's Research & Policy Committee, in consultation with members and other stakeholders, with the objective of promoting policy initiatives intended to increase the number of successful startup companies, jobs, and wealth creation by supporting early stage capital investment provided by Angel investors in Canada.

Canada's Innovation Strategy

The Canadian Government "wants to kick-start investment in innovation to grow our economy and create good, middle class jobs. To get our economy growing again, we need to immediately invest in helping our businesses and entrepreneurs – including those in manufacturing – become more innovative, competitive, and successful."

The Ministers of Finance and Industry, Science and Economic Development are mandated "to ensure tax measures are efficient and encourage innovation, trade, and the growth of Canadian businesses." They realize that virtually 100% of all new jobs in the last 10 years are due to new company startups.

The purpose of this paper is to point out the critical role that angel investors play in the innovation ecosystem and to offer policy recommendations to support entrepreneurs, consistent with these mandates.

The Innovation Continuum

Innovation entails the commercialization of ideas and inventions. It begins with research and education. Entrepreneurs then create companies to commercialize the results of research and the ideas that come from an educated and creative population. These companies in turn provide quality jobs and prosperity for all Canadians.

A basic innovation strategy would suggest that we invest at all stages—funding for educators and researchers and support for entrepreneurs by investing in innovation centres and increasing the pool of capital required to build successful businesses.

There are many excellent examples of this in Canada ranging from startups to small and medium sized enterprises (SMEs) to large public corporations. These companies have commercialized everything from smartphones to space shuttle robotics.

Entrepreneurs are the champions of Innovation. Entrepreneurs need people and capital to build successful companies.

In Canada, the Angel investment class is estimated to include 20,000 to 50,000 individuals who invest around $500million per year. Angels invest in 27 times more startups than the VC industry and provide vital early stage financing at the local level where it is most needed.

In Canada we tend to undercapitalize our promising companies and many entrepreneurs are struggling when it comes to finding early stage risk capital. Many leave for the USA where they can raise the capital they need to grow and prosper.

The Role of Angel Investors

Unlike banks and institutional investors, Angel investors are accomplished entrepreneurs who risk their own capital—and time—to support startups, small and medium-sized enterprises (SMEs). These innovative ventures, whether they are tackling emerging sectors like biometrics and machine learning, or new ventures bringing innovation to established sectors like finance, forestry, mining and agriculture, take many years to provide financial returns to their Angel backers, if at all.

A typical Angel investor is a successful entrepreneur who is willing to support new ventures by providing cash and expertise to nurture their development. They tend to focus on supporting local entrepreneurs and are often first to invest, when the risk is highest. While the returns of some Angel investors have been known to outperform most asset classes, the majority of these ventures fail. A seminal study[1] by Robert Wiltbank of Willamette University in Oregon showed that the rate of return generated by reporting Angel investors averaged 27%. However, the study also showed that 40% of the Angels surveyed suffered negative returns. A key finding was that negative returns resulted from portfolios that consisted of fewer than six companies. And while failures generally occur quickly—usually within their first two years—it can take a decade or more to build a viable business.

1 Robert Wiltbank & Warren Boeker, "Returns to Angel Investors in Groups", Kaufmann Foundation, Nov. 2007 (http://sites.kauffman.org/pdf/angel_groups_111207.pdf)

The challenge for angel investors: make many investments and be very patient.

The angel story is 'cash with help' for entrepreneurs to build companies. Angel investors are the main source of 'smart money' for entrepreneurs. Angels need to do more deals and recycle their capital faster. But Angels often become illiquid because they have to wait for failure to recycle that capital. We also need to recruit more investors and encourage more risk-taking. Too much capital is sitting in savings accounts. We have more deals than we can fund and with more liquidity we can be 'shovel ready' to get to work.

Canada's favorable capital gains tax rewards angels for being patient investors but considering the low probability for successful outcomes, we also need incentives to encourage greater activity and investing more in each transaction. For innovative Canadian companies to continue becoming high growth commercial enterprises, we need to ensure that Angel investing becomes a sustainable source of investment capital and mentorship that can foster innovation.

As the only national industry association for Angel investors in Canada, NACO supports Angels as they help entrepreneurs turn good ideas into great businesses. Our mission is to continue to professionalize Angel investment in Canada making it even more valuable to high potential entrepreneurs. To date, we have built a national network of just under 2,000 investors and 32 formal Angel groups who invest over $100 million each year to support the development of Canada's brightest entrepreneurs.

As a long-standing partner of the government in supporting the national innovation agenda, we are recommending policy initiatives to enable angels to support the ongoing health and growth of Canadian entrepreneurs by increasing the pool of private risk capital available to entrepreneurs.

Angel and Venture Capital Investing in Canada

Obtaining meaningful data on Angel investing is difficult. Angels vary greatly in their funding capacity, styles and preferences and are far from being a readily identifiable group like banks or venture capitalists. Their activities are largely unreported because many investors prefer to operate privately and discreetly.

A good proxy, though, for determining the amount of Angel capital that is invested annually is the amount allotted through British Columbia's Venture Capital Tax credit budget. The B.C. Government[2] provides Angels with a 30% refundable tax credit on investments made by Angels in "eligible small businesses" which would capture most of the high growth potential technology deals that angels back but exclude service businesses like restaurants.

In 2014, B.C. provided $25.8 million to startups via Angel investors because they invested $86 million in eligible businesses. In other words, investors placed $60 million and the government contributed $25.8 million. Although the total budget allocation was $33 million, three of five budget categories were oversubscribed. Yet, many deals go unfunded and worse all too many are under-funded. Based on B.C.'s data and other surveys, NACO estimates that at least $500 million is invested annually by Canadian Angels.

The Canadian Government has supported the Venture Capital (VC) industry by increasing the capital under management with its Venture Capital Action Plan[3] (VCAP) announced in 2013 to provide $400 million in funding over a decade to attract $1 billion in private capital to the VC ecosystem, if fully utilized. BDC has also committed $100 million for early stage companies. Nonetheless, the VCAP still leaves a fundamental challenge to the attainment of Canada's objectives. For example, ten funded VCs with five partners each means that there are only fifty people Canada-wide to process deals. This approach, while effective in encouraging investment into and by VCs who primarily make larger investments in later stage ultra-high growth businesses, fails to address the support needed by the earlier stage companies a small portion of which will ultimately grow to become the businesses those VCs are seeking.

On the other hand, the national Angel population is three orders of magnitude larger than that of the VC population (by headcount) and is a critical input for later-stage VCs. Yet nothing has been done at the national level in Canada to address capital formation at the pre-VC stages of financing for companies. Balancing the funding ecosystem requires support across all stages of the funding continuum. A 15% tax credit would be no more expensive than what has been budgeted annually for the VCAP initiative but would be vastly more effective in improving the grass-roots availability of capital. History has shown that mega-successes tend to come via Angels who can bet on high-risk deals without having to be accountable to an investment committee.

The Policy Challenges

One of the most common factors cited by Angel investors as constraining their support of entrepreneurs is the lack of liquidity. The long waiting time for the winning companies to provide returns is one cause even when the investment is successful. Shopify Inc., Canada's latest attention-grabber, took nine years of patient capital before going public in May, 2015. Most of the "overnight" success stories that we hear about are more than ten years in the making. The overnight billion-dollar Silicon Valley dot-com stories are not the norm, although they too got their start from Angel backers.

Angels provide patient capital. Their cash is committed for many years. The taxation of capital gains at a 50% inclusion rate rewards them for being patient and being willing to lose capital in most cases in exchange for great rewards on a small number of deals. However, what is needed are incentives that will allow Angel investors to deploy more capital at the time they make their investments.

2 B.C. Government Investment Capital Programs website: http://www.mit.gov.bc.ca/ICP/vcp/index.htm

3 Venture Capital Action Plan website: http://www.fin.gc.ca/vcap-pacr/index-eng.asp

This can be accomplished in a number of ways:

- **tax credits,**
- **direct co-investment funds, or**
- **accelerated investment write-offs.**

We are aware that the challenges in creating these incentives are in their implementation: Who is eligible for the incentives? How can abuse be prevented? Who administers the program? NACO is sensitive to these complexities. However, there are examples of how these concerns can be addressed and thus NACO is willing to engage with the Government in this regard.

NACO Call for Action

The role of Angels and VCs in the funding landscape is well established. Angels invest small amounts early and VCs invest larger amounts later. While a few VCs invest in early seed rounds, they usually do so by co-investing with Angels. VCs often complain about the lack of quality deal flow. This is another reason why more Angel capital is essential for providing not only a funnel of deals to VCs but growing companies to the point of being self-sustainable.

NACO encourages the Federal Government to implement new policy measures to provide Angel investors with mechanisms that stretch their investment dollars further. This can be done through direct investments as in the VCAP program or through taxation policies.

Another way to support startup companies is to allow them to optimize the use of available funding by reducing capital requirements for salaries, arguably their largest cost. Issuing “founders’ shares” can create an even more powerful incentive for the recruitment of top talent allowing available funding to be deployed more effectively across other business areas, optimizing company growth potential. However, tax treatment of founders’ shares precludes this in most cases.

NACO suggests the following policy initiatives:

- **Provide incentives for Angels to increase the supply of investment capital.**
- **Eliminate deemed benefit tax on issuance of CCPC shares or options to employees**

Initiative #1: Investment Incentives

Provide federal investment incentives to Canadian Angel investors to invest in Canadian companies. This could be in the form of a federal refundable tax credit, an accelerated investment write-off provision or co-investment funds.

Based on evidence from the two decades long use of tax-related incentives in British Columbia, NACO believes that the most effective way to increase the amount of patient capital that individual investors are willing to risk is by providing incentives at the time they make their investment.

National Tax Credit

NACO advocates a National Refundable Investment Tax Credit similar to the B.C. model whereby the Federal Government provides a 15% tax credit. Provinces would be encouraged to match this for a total of 30%. A refundable tax credit is attractive to Angels because it is, in essence, a co-investment and not just a basic tax credit. For example, if an Angel is willing to invest $100K into a startup, she can now invest $143K because she gets back $43K when she files her next tax return. Looked at another way, it puts more capital in the hands of Angels to invest in return for being patient and, more critically important, it puts more equity funding into companies.

A study of the British Columbia tax credits by Thomas Hellman and Paul Schure[4] provides insight into the impact of providing a 30% tax credit to Angel investors in B.C. that invest in eligible B.C. companies. This program has been running sufficiently long enough—more than 20 years—to demonstrate that program abuse has been minimal and program effectiveness has been demonstrable.

In the United States, NACO’s counterpart, the Angel Capital Association, is aggressively advocating for a national 25% investment tax credit (non-refundable) and similar tax credits already exist in many U.S. States.

Accelerated Business Investment Write Off

Most Angel-backed companies fail. However, Angels must wait many years, often more than ten years, before they can write off a failed investment based on current requirements of the Canada Revenue Agency. The write-off can be claimed as either an ABIL (deduction from income) or capital loss (depending on the company’s status).

Instead of an investor having to wait until a failure occurs, why not permit the investor to take an immediate write off? This would reduce his adjusted cost base to zero and the benefit would be re-captured in the event of a successful outcome. However, in the meantime, the investor would have more capital at his disposal to invest in other ventures. As an alternative to a tax deduction, a non-refundable tax credit would also provide investors with more capital to deploy.

In terms of the potential cost to Canadian taxpayers, the concept of permitting an earlier write-off only shifts the timing of the Angel investor’s loss claim. It does not require an additional investment by government over time.

NACO recognizes that the implementation of any tax incentives is not without challenges relating to their administration, potential abuse and determining eligibility. However, there are examples in several provinces of how investments are qualified and NACO would be willing to contribute to this process.

To build a strong innovative economy, we must not only reward patience but acknowledge the fact that more risk capital from Angels is needed to grow successful companies.

4 An Evaluation of the Venture Capital Program in British Columbia (http://scholar.google.ca/scholar?oi=bibs&cluster=3185690782651063603&btnI=1&hl=en) T Hellmann, P Schure - 2010

Co-Investment Fund

A valuable complement and reinforcement to providing angel investors with more liquidity and capital to invest in companies is to create a fund (or funds) that would co-invest automatically with angels directly in qualified companies. For example, the Quebec Government and Quebec pension funds have provided Anges Québec (Quebec's main Angel group) with capital for a co-investment fund—Anges Québec Capital —that invests alongside Angels.

In Ontario, the Federal Government's IBI program[5] supports the activities of Angel networks by matching equity investments with loans to angel-backed companies.

One of the earliest public sector initiatives of this type was the Scottish Co-Investment Fund (SCF) which has been operating since 2004 under the management of Scottish Enterprise, the national development agency. Its key characterisitics are that it invests pari passu alongside pre-selected private sector partners (angel groups) and these partners lead the whole deal process, ensuring full market rigour is applied. Independent evaluations conducted over the lifetime of the SCF have found better than forecast performance in terms of leveraging private investment, i.e. a private : public ratio of 2.3 : 1 instead of the anticipated 1:1. Other beneficial impacts detected included a stimulus to the formation of more angel groups and an improvement in their capability as well as capacity.

Recognising these benefits, the UK government launched an Angel Co-Fund in England in 2011 with a design modified to reflect the nature and level of development of the angel market there. Similar initiatives have also been adopted and adapted in New Zealand and a number of European countries

NACO could assist with development of criteria and the details of how a national co-investment fund (or funds) could be administered to achieve the purpose of leveraging angel capital to provide increased support to entrepreneurs.

Initiative #2: Eliminate deemed benefit tax on issuance of CCPC founders' shares or stock options to employees

Allow the issuance of shares by a CCPC at nominal value, e.g. $.001/share or stock options with an exercise price of $.001/share. Remove the "deemed benefit" provision as tax will be paid when shares are sold. If the company succeeds, the employee is taxed as if he were a co-founder.

Recruiting talent is a challenge. This is especially true for startups and growing companies that find it difficult, if not impossible, to offer competitive salaries.

The best way for companies to attract talented employees is to make them co-founders' by offering them shares at nominal cost (much like how Mike Lazaridis attracted Jim Balsillie four years after he founded RIM).

The fundamental problem with this is that when a company provides shares at a low price (directly or via stock option grants), the employee is immediately taxed on the difference between his price and that price paid by recent investors.

CRA's taxation of this deemed "benefit" is a major barrier that can best be addressed by the Federal Government and its removal would decrease the costs of new firms being financed while also increasing the talent base in Canada.

Simply put, if an engineer is willing to work for a lower than market salary, it should be possible to "deal her in" as a "founder" and give her nil-valued founders' shares that may have some future value. CRA's position that these are income benefits that have been earned and thus taxable, even though they are unearned, illiquid and retractable, provides a major deterrent to recruiting and makes Canadian Companies uncompetitive.

NACO's Recommendations

- **Create a National Investment Tax Credit —a 15% refundable tax credit for investments made in qualified ventures**
- **Allow angel investors to take accelerated investment write-offs when making an investment in qualified ventures**
- **Establish funds that would co-invest with angels in qualified ventures**
- **Permit issuance of founders' shares or stock options with no tax liability until shares are sold and then only on the basis of proceeds received, not on the basis of an artificial interim deemed value**

As an organization whose members are dedicated to finding and funding the next generation of Canadian businesses[6], NACO stands ready to work with all levels of government to help craft and implement new policies that will accelerate the growth of available Angel capital in Canada, leading to greater innovation and economic prosperity.

For additional information on NACO, its membership and our activities, please visit: **www.nacocanada.com**

To comment or give feedback on this paper, please contact: **policy@nacocanada.com**

5 FedDev's Investment in Business Innovation Program (http://www.feddevontario.gc.ca/eic/site/723.nsf/eng/h_00324.html)

6 NACO's policy contributors include Mike Volker, Michael Turner, Robert Brouillette, Fred Estlin, Jim Fletcher, Peter Kemball, Ian Bandeen and Sandi Gilbert.