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Look Before You Leap - How to Choose the Right First Financing for Your Startup

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Securing the first round of financing for a startup can be both an exciting and overwhelming endeavor. Cassels has partnered with Zeifmans, a full-service tax, accounting and business consulting firm, to author this overview to help your startup through its first financing - from both a tax and legal standpoint.

If you're a startup business ready to expand with a market-tested, viable product or service and significant growth potential you'll need funding to take your business to the next level – and determining the right source of capital can be overwhelming.

Potential Sources of Capital

- Bootstrapping
- Friends and Family funding
- Governmental/institutional grants
- Incubators or Accelerators
- Crowdfunding
- Non-dilutive financing
- Dilutive/equity financing

It is important to seek professional advice, both from your accountant and business lawyer, before deciding on early-stage financing, as missteps could affect your company's long-term success.

Here's what you should know before signing on any dotted line.

An Accounting Perspective

When looking for first financing, it's important to understand the tax and long-term financial implications of each option.

Debt

As an entrepreneur, you typically have two debt-financing options - interest-free options (like bootstrapping and friends and family funding) and interest-bearing loans.

Imagine, in the above scenario, your company has funds saved and decides to bootstrap, that is, rely entirely on their own funds instead of seeking a third-party investor. This means you'd be taking an interest-free loan out from yourself. This seems ideal, but it comes with the risk that your business won't have the flexibility to expand as quickly as needed to react to the market.

If bootstrapping isn't an option, you could turn to those closest to you. The Friends and Family round of pre-seed funding is usually used to onboard employees, secure office space, or purchase key resources. This funding is often in the form of gifts, interest-free loans, interest-bearing loans, or equity loans.

Let's say your company chooses an interest-bearing option, either from friends and family, or from an institution like Business Development Canada (BDC). Keep in mind that you likely won't be earning taxable profits in the first few years, meaning the interest owed may result in tax inefficiencies. As the recipient of the loan, you'll have to make enough to cover interest accrued, but you may not be able to benefit from interest deduction immediately if business is not reporting profits for tax purposes.

Equity

Equity is one of the most important considerations for a growing startup. You'll want to speak to your lawyer and have a plan in place early on before issuing any equity. You can issue different classes of shares with different share characteristics to a variety of investor groups, which provides flexibility as you expand. This allows you to potentially issue dividends to certain active shareholders, for example, as opposed to dormant shareholders or provide special governance rights to certain classes of shares over others.

Another consideration is whether your corporation has a Canadian Controlled Private Corporation Status (CCPC), which provides a number of tax benefits. Companies with CCPC status must be private companies incorporated in Canada. They cannot be controlled by any non-residents or public corporations. For this reason, caution is needed when issuing shares to non-residents or public corporations.

Government Grants

Grants are a great option, and are available both federally and provincially. It's important to note that grants are taxable when received.

The Scientific Research and Experimental Development (SR&ED) grant may be worth exploring, for example. The SR&ED is a federal tax incentive that provides about $3 billion worth of research and development funding annually to businesses of all sizes in a variety of sectors.

As a CCPC, your company can earn a 35% tax credit on up to $3 million for qualified SR&ED expenditures. For businesses who don't have CCPC status, the tax credit is limited to 15% of qualifying expenditures.

To explore other grants, check out Zeifmans' cheat sheet here.

Crowdfunding

This is a quick way to receive cash without giving up any equity or dealing with interest payments. Essentially, you ask the public to believe in your product or service enough to help with your financing. There is a caveat, though. Even if your crowdfunded contributions are seen as donations or gifts, the funds may still be taxable.

A Legal Perspective

The initial funding stage is a great time to seek professional legal advice. It's tempting to jump at your first funding opportunity without considering any long-term legal pitfalls. It is important to understand the legal implications of each option.

Bootstrapping and Friends and Family Funding

While we've already discussed bootstrapping, the Friends and Family funding is worth examining. Often called the 3 Fs - the Friends, Family and Fools – this option is the easiest and most dangerous form of funding.

Let's say your close friend is interested in investing in your business. Before agreeing, make sure both parties understand what type of funding they've agreed upon and the risks associated with this venture. Otherwise, the friendship could be destroyed in the process.

Regardless of the funding type - gift, loan or equity - it's a good idea to create a formal agreement, which Cassels can assist with.

Incubators and Accelerators

This is an interesting choice for a startup, since both options increase your chances of attracting a venture capital firm later on. It's important to note that this option may mean giving up some equity. While both incubators and accelerators offer a network of mentors to help grow your business, accelerators focus on growing a company while incubators focus more on innovation.

Crowdfunding

If you choose to go this route, it's important to note that, because of Canadian securities laws, crowdfunding donors can't own an equity stake in your business. This type of funding also necessitates the need to pre-sell your product before it's ready for the market.

Non-Dilutive Financing

For a startup, this type of funding allows owners to fund the company without giving up equity. Government grants are an example of non-dilutive financing. You can also receive non-dilutive loans through organizations like BDC, though depending on your valuation, certain terms and conditions may accompany the funding.

Regardless, choosing this type of funding means you can source "free" money to stimulate growth, which could impress future investors.

Equity Financing

Securing equity funding is a huge milestone in any startup. It shows a certain level of legitimacy and is often the first major capital a business receives. But jumping at the first equity financing opportunity could be a mistake. Equity funding means giving a portion of your business to your investor - a decision that could impact your long-term success. No matter how many shares a shareholder holds, the law provides shareholders with rights and protections that you need to be aware of.

One pitfall of early equity funding involves premature valuation, which will affect the pricing of future equity rounds and acquisitions. If your business is still in its very early stages and pre-revenue, it may be best to delay setting a valuation and use other financing alternatives.

For example, a Simple Agreements for Future Equity (SAFEs) have become a common financing method that does not require a current valuation. SAFEs allow your start-up to receive money from investors now and give equity at a later date. If you're interested in a SAFE, it's important to consider these factors:

- The SAFE may include a valuation cap (a set maximum valuation at time of issue), which could determine the price per share on conversion
- Investors typically receive a pre-determined discount against the price per share in the qualified financing resulting in a conversion of the SAFE
- SAFEs often include a Most Favoured Nation clause
- SAFEs will also sometimes include pro rata rights which allows the holder to purchase additional shares to maintain their level of ownership in later financing rounds

Next Steps

Choosing a first financing option is one of the most important decisions a startup will make. While it's easy to get excited about short-term cash infusions, keep in mind that this financing will have long-term consequences for your business.

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