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Levelling Up - What Startups Should Know About Venture Capital Financing

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Once a startup gains momentum, discussions often turn to venture capital funding to support its growth. As entrepreneurs explore venture capital opportunities, it's important to be aware of any legal and tax implications that could affect long-term growth. Cassels has partnered with Zeifmans, a full-service tax, accounting and business consulting firm, to author this article to guide your startup through its venture capital funding options.

Entrepreneurs can take several paths when looking for funding during their company's growth stage. They can turn to traditional or convertible debt options, or attempt to entice an angel investor or venture capital investor to purchase equity in their company.

Venture Debt/Hybrid Models

This is a traditional form of financing provided by banks that specialize in venture lending or private lending. Some startups prefer this to equity investments, largely because it doesn't dilute the existing shareholders and avoids determining a valuation. In addition, this financing option doesn't always require collateral, which is significant as most startups don't typically own substantial assets. Instead, lenders will expect a higher interest rate than conventional loans and warrants as compensation for the risk. Warrants allow the holder to buy company stock at a certain price within an agreed-upon time period. Typically, the lender is not interested in exercising the warrant and becoming a shareholder of the company, but rather is looking for a potential windfall on an exit event.

Startups that have been through several rounds of funding are usually the best candidates for venture debt/hybrid models, which works differently than regular loans. Covenants can also come into play here, and specific requirements will depend on the lender - banks tend to be less flexible than non-bank lenders.

In situations where it is difficult for the company and investor to agree on a valuation, the company can issue a convertible promissory note, a SAFE, or a similar convertible security.

A convertible promissory note (secured or unsecured) is a hybrid option where the investment is injected by way of debt and includes a conversion mechanic into equity. The note includes an interest feature that's typically paid in kind, meaning the interest is added to the principal. The term is relatively short - about six

months to two years. Generally, the debt converts into equity at the next qualified financing (which is typically a financing that is greater than $1 million) and if a qualified financing doesn't occur during the term, the holder would have the option to convert into equity at a pre-determined valuation or call the loan.

It's important to know the tax implications of convertible debt. Sometimes, when this debt is converted into equity, Canada's debt forgiveness rules - which allows a lender to forgive some or all of a loan - may apply. This could lead to adverse tax consequences, as some of the forgiven amount can be included in the debtor's income. If a company's liabilities are less than its assets, the debt forgiveness rule usually doesn't apply.

Simple Agreements for Future Equity (SAFEs) are similar to convertible debt but don't involve interest or set repayment dates, making them a much more flexible option for entrepreneurs. Depending on the agreed-upon terms and when equity is issued, the debt forgiveness rule may cause tax complications as well.

It's also important to note that residency of the holder of a convertible note or SAFE may impact a company's corporate status, which could lead to higher taxes. A company can lose its status if the corporation is controlled by a non-resident of Canada, or if it's controlled by any public corporation.

Equity Financing

Generally speaking, there are two sources of equity financing at the growth stage - angel investors and venture capital investors. Both actors in the ecosystem are often sophisticated, and are looking for some degree of control and decision-making power in their company.

In both instances, these investors will be looking to purchase convertible preferred shares in the company as opposed to common shares that are typically issued to founders and employees. The features of convertible preferred shares vary across different stages of funding but Canadian venture deals generally start with the Canadian Venture Capital Association model preferred share terms.

There can be many reasons why a preferred share is "preferred" to a common share but invariably a preferred share will rank ahead of a common share in the event of an insolvency or wind-up of the company.

Capital Gains

When conducting an equity financing, it's important to know how new or departing shareholders can benefit from the Lifetime Capital Gain Exemption (LCGE). Any investor selling shares in a qualifying Canadian business and receiving up to $900,000 in profit, can save a substantial amount in taxes through the LCGE.

The Final Word

Financing growth is an exciting period in a startup's lifecycle. Choosing the right option - whether debt or equity financing - is key to the continued success of your business. Both equity and debt financing have legal implications - decisions made today will have an impact on your startup now, and in the future. Review your options with your legal advisors to ensure your financing meets your long-term goals.

For a business and tax perspective, contact Zeifmans here or reach out directly to Ahmad Aslam, Partner at Zeifmans , at aa@zeifmans.ca.

For a legal perspective, reach out to Aly Somani, Co-Chair of the High Growth & Venture Capital Group at Cassels, at asomani@cassels.com.

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