Structuring Deals with Angel Investors

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We are only going to scratch the surface on the types of deals and arrangements that you might see out there. Our intent with this section is to illustrate some of the considerations. One of the common statements we get from clients at WCG is, “I have a guy who is giving me $100,000 to help me start my business.” Our next response is, “Will the guy be an investor, lender or both?” And then stunned silence… which is certainly re-assuring. Not!

There are many ways to handle this, and no one way is always the best. It depends on humans, emotions and personal objectives. Don’t forget the golden rule where the person with the gold makes the rules. Here are some ideas-

Investor is Truly a Lender

So the investor wants to get paid back first with interest. Make him or her a bank, and pay or accrue interest accordingly. Done.

Investor is a Lender with Profit Interest

Same as above, but once the loan is paid back the investor continues in an economic interest capacity and has claim to some of the profits. Perhaps this claim expires in some set time, such as five years. This is tricky since the investor is both a lender and an owner of sorts which could be conflicted.

Investor is a Lender with Interest Upon Sale

Similar to above, but the lender gets a piece of the action upon sale. Perhaps the loan is paid back as necessary, with the sale option enduring into perpetuity. The though process is, “hey I helped you get off the ground and now you owe me beyond the 8% interest I charged.”

Some caution is in order too. You might not have any control regarding the sale such as terms, timing, etc. For example, you have an agreement that upon sale you get 10% of the proceeds. Great! What constitutes a sale? What if a 100% owner sells 60% of the business but retains the remaining 40%? Hmmm. In these cases you could draft the agreement to read that upon sale or change in control, there is a payout.

These arrangements need to be stress tested with various scenarios and contingencies.

Investor is an Owner

Rather than recording a loan on the books, the injected cash is credited to the investor’s capital account. The investor may get a return of capital prior to other owners per an agreement. In other words, distributable cash goes to the investor first as a return of his or her original investment. The splits can vary; for example, the investor contributed $90,000 and you contributed $10,000. You could still own 90% of the entity while the investor only owns 10% (an exact flip-flop).

Loans Versus Capital

Most lenders want some sort of guarantee from the owners. As such, the angel investor might demand that you guarantee the loan personally which can make a failed business scenario a messy one. Ruin friendships and all that stuff. Conversely, an investor who wants to be an owner and injects capital now has a seat at the table so-to-speak, and might not fully let you run the business the way you see fit.

Front-End Back-End

There are two things to consider when bringing in another owner, or becoming that new owner yourself. Do you want to make money on the front-end, or the back-end, or both? In other words, do you want to make money along the way as an investor owner getting a return on investment from operations? Or… do you want to forego some money from operations, and put more emphasis on an eventual sale or liquidity event?

Of course your risk aversion and the risk versus reward thing are going to drive this decision including your current life-style and income needs. Are you the person who works hard trusting you'll get paid in the end? Or are you the person who wants money today and is willing to sacrifice the big payday at the end? Everyone is different. Every deal is different. You just need to find one that fits everyone involved.

Venture Capital

As we've mentioned here and there, and at the risk of over saying it, the one with the gold makes the rules. Some venture capitalists and other "professional " investors have specifications before they will entertain an investment. For example, an investor might require a C corporation domiciled in Delaware. Period. Why?

Who knows? Perhaps that is what they have always done, and why change now? Or… perhaps that is how the investor was able to raise capital and the prospectus outlined this detail such as "all equity investments will be made into C corporations domiciled in Delaware only."

By now you should have a good handle on the fact that a C corporation is a lousy tax vehicle… and that Delaware only adds to your tax filing headache if you operate in a state other than Delaware. But! If that is what it takes to receive seed money for your big idea, then that is what you do.

Nuts and Bolts of Adding Another Owner

Let's assume you have a single-member LLC, and you want to add a 20% member for $50,000. What are the accounting mechanics behind this transaction? It depends. If you personally are receiving the $50,000 then you selling a part of your interest directly to the new owner which might create a capital gain to you, as a seller.

Conversely, if the LLC is receiving the $50,000 as a capital injection and carving out a 20% interest to this new member, this is not a taxable event. This also does not mean the business is worth $250,000 (1/5 = $50,000 so 4/5 = $200,000). When a business valuation is performed, the enterprise is valued as a whole, and then discounts are taken for lack of control (minority interest) and then lack of marketability (difficulty in converting ownership into cash).

Therefore, this $50,000 is just a number the two of you came up with based on some data. When that $50,000 is received by the LLC it becomes a part of the capital account of the new owner. This is a tax-less transaction for the existing or original owner(s).

Recap of Angel Investors

Are we suggesting to avoid these situations entirely? No. At times they are the only options available. We just want to let you know of the concerns and considerations. Marriage is all about love, and divorce is all about money. Business is no different, and in some respects can be worse.

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Jason Watson, CPA, is the Managing Partner of WCG, Inc., a progressive Colorado Springs tax and consultation firm.

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