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EQUITY TAX CREDIT:
BACKGROUND AND REFERENCE MATERIAL

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September 3rd, 2020

Unlocking Private Angel Investment to Drive Innovation

Canada is in a strong position to catalyze new levels of economic growth in the digital and innovation economy. This potential can be maximized by unlocking the private capital of a growing number of angel investors who can help to support and propel the success of a constant stream of high growth startup companies. This can be achieved through low-cost, high-return, market-based tax incentives such as Equity Tax Credits (ETCs) that have a proven track record of sustainable success in multiple jurisdictions.

1. Healthy innovation ecosystems require a steady stream of promising investments, from small formation stage through to large late stage companies.

- **The formation of seed round investments from "angel investors" is crucial to health of the innovation of the entire tech sector.** Angel investors provide the earliest, highest risk capital, as well as mentoring support and access to networks that convert ideas into investable companies that venture capital investors can then accelerate. Janet Bannister, founder of Kijiji.ca and now managing partner of Canada's largest seed venture capital fund, Real Ventures, uses an education analogy to make the case:

  > *"When you start to see that the strong funding of elementary schools is producing outstanding students at the university level, you don't stop funding elementary schools – you double-down on what works. Similarly, the Canadian government funding and other support of early-stage tech companies has resulted in a strong pipeline of mid-stage tech companies that are rapidly scaling. Now is the time to double-down on that proven strategy. Otherwise, we risk losing the tremendous progress that we have made over the past five to ten years."*

- **This "defunding of elementary schools" analogy (above) is effectively what happened in the midst of the COVID crisis.** Canadian Venture Capital Association (CVCA) CEO Kim Furlong noted that, from March to June 2020, VCs were looking at their portfolio holdings and saying, *"we need 18 to 24 months of runway. We need to put this cash to these companies."* Government acted quickly, putting in place the BDC Bridge Financing Program to supplement private VC investment in companies that had previously raised at least $500,000 in equity and were about to close a new VC investment round.

  This BDC program helped to drive a record level of VC investment. According to the CVCA, VC investment rose by 23% year-over-year to $1.66 billion. As a result, later stage companies received 50% of all VC investment in 1H2020 compared to 22% in 1H2019.

  This increased level of VC investment is fantastic, but a healthy ecosystem depends on having a steady stream of VC-ready companies. Angel investment is crucial to turning ideas into companies that are capable of securing investment from VCs and/or large financial institutions. This has been the case with countless homegrown success stories including Slack, Skip the Dishes, Verafin, and Shopify.

2. A pullback in angel investment puts the companies they fund at risk.

- **The crucial seed investment provided by angel investors is increasingly being withheld due to the extreme uncertainty caused by COVID**. A recent survey of angels commissioned by the National Angel Capital Organization (NACO), found that 86% of respondents expect that angel-back companies will experience significant obstacles gaining access to capital over the next 18 months. Additionally, 67% of respondents reported an intention to decrease the total amount of funds invested by up to 75%. It was even more concerning that half of respondents believe that their average portfolio company will not make into 2021 without access to additional capital or support.

- **From January to April 2020, 24% of startup tech companies laid off staff and new jobs created by these companies fell by 78%** according to a survey commissioned by the Prospect Quarterly Report. Their report focuses on companies that are 1. globally headquartered in Canada, 2. founded after 2000, 3. comprises of between 5 and 1,000 employees, 4. operates as a private, standalone company, 5. are building innovative technology and 6. are actively hiring. An uncertainty in the length of their financial runway (revenue, investment and debt) is thought to be the primary reason.

3. When active, angel investors are powerful drivers of opportunity, jobs and prosperity, no matter where they are located.

- **Angel groups become powerful economic drivers because they enable communities to invest in themselves, even in our smaller and rural communities.** This fact that is best illustrated by the work of Northern Ontario Angels (NOA), North America's most successful angel group. In their first 15 years, NOA invested more than $155-million in Northern Ontario, creating and protecting more than 4,000 jobs across a region that had previously been disadvantaged due to a lack of venture capital and slower growth.

- **Angel groups inspire and enable business leaders to give back to the next generation of entrepreneurs.** Consider the story of Peter Del Bianco in Sudbury. For almost 40 years, he succeeded in earning customer support against all big box competitors in the consumer electronics space. In his "retirement" he has turned his attention to investing and helping the next generation of entrepreneurs, such as the following:
    - Plan A Long Term Staffing & Recruitment (Sheri Tomchick, Founder) – The most effective and efficient staffing strategy for long term care across Canada.
    - IRegained Inc (Vineet Johnson, Founder) – Addressing the physical rehabilitation needs (primarily hand functions) of people who sustained a brain injury caused by stroke or accident and were left with an impaired ability to use their hands.

- FORTAI (Trang Tran-Valade, Founder) — An advanced technology and product manufacturer building an Amazon-like distribution model for the mining industry.
- Flosonics Medical (Joe & Andrew Eibl, founders) — Developed an ultrasound bandage that monitors patients' vitals automatically in real-time. It was recently profiled on CBC's The National.

4. Angel investment is an effective and cost-efficient economic driver.

- **Every dollar of angel investment in Canada results in $156 in revenue in a new startup** according to the National Angel Capital Association's 2020 Annual Report on angel investing . This is because angels help founders to turn their idea into a business that can reliably deliver value to customers and, as a result, create new opportunity, revenue, jobs and prosperity.

- **Angels provide a crucial market-based role at the "top of the funnel".** They assemble the seed investment, team, governance, business model and early adopters necessary to start a process that, when successful, attracts increasingly larger levels of investment from increasingly sophisticated investors.

5. The conditions are in place to produce a steady stream of global tech disruptors, benefiting Canada as whole.

- **Canada's tech ecosystem has been thriving and the country has become a top global destination for talent and entrepreneurship**. In July of this year, the C100, the pre-eminent global community of Canadians in tech, produced a White Paper outlining the globally competitive success being achieved by Canada's startup tech sector. This report highlights a remarkable amount of evidence supporting the fact that Canada is now one of the top global destinations for talent and entrepreneurship.

- **Success in digital is essential to delivering success across the economy.** This was best captured by Shopify founder and CEO, Tobias Lütke in 2018:

  "'Digital' is not an industry. It isn't a strategy. It's an essential tactic that should be embedded into every industry. The competitive advantage of any Canadian company will be connected to its digital advantage."

  The report from Canada's Economic Strategy Table on Digital Industries focused on the need to foster digital innovation and excellence in Canada by growing the number of large Canadian digital companies. They saw these high-growth firms as anchoring Canada's global leadership, and set a goal of doubling the number of businesses earning $1 billion or more in annual revenue from 13 to 26 by 2025.

- **If we are to double the number of digital companies with >$1 billion in revenue, the number of companies achieving >$100 million in revenue would need to triple** according to the authors of the economic strategy report. This is because it is impossible to pick the exceptional company that will become the next global leader. The next global leaders will emerge if we nurture the ecosystem needed to create a steady stream of exceptional companies.

- **Our traditional industries all need to develop a robust "digital strategy" if they are to be the disruptors, not the disrupted.** Before COVID, 92% of CEOs felt that their business models would need to change as a result of digitization according to McKinsey. Canada has a long history of building moats and other supports to help legacy industries to fight off global competition. Our traditional industries now need us to surround them with innovators that have the capacity to empower those that are determined to embrace competition to become the global disruptors.

- **It is estimated that the pace of digitization has accelerated 5-10 years in the last six months**, and consumer demands are expected to continue that trend according to McKinsey. The World Economic Forum and Deloitte believe that the financial sector in particular will experience a rapid acceleration in disruptive pressure due to COVID.

6. Canada can cost-efficiently double-down on its proven success in expanding its tech ecosystem by incentivizing angel investment.

- **When tax incentive systems are put in place to increase the activity of angel investors, such as 30-50% Equity Tax Credits (ETCs), the return on investment is reliable**. A study of the use of ETCs in British Columbia found that for every $1.00 of provincial tax credits issued, recipient companies generated $1.98 in provincial taxes. ETCs attract the early-stage risk capital necessary to create opportunity, jobs and prosperity. The evidence is clear that stimulating local businesses creates economic empowerment for individuals, groups and communities, to the benefit of the entire community.

- **The United Kingdom has been embracing similar programs to ETCs** called the Seed Enterprise Investment Scheme(SEIS) and the Enterprise Investment Scheme (EIS). The EIS program has been in place since 1994 and, based on its reliable success, it was expanded to include the SEIS in 2012. Additionally, there have been a variety of complementary programs implemented and studied across Europe.

- **There is an extremely small administrative burden associated with running the program** as the responsibility of the federal government is limited to processing the claims on investments that provincial securities commissions verify have adhered to the program requirements.

- **Government will never be capable of picking "winners" and "losers" as effectively as the market**. Moreover, the ECT process harnesses the vested interests of experienced angels who invest their own time and money to evaluate and de-risk each investment.

- **ETCs unlock private investment that fuels productivity growth, and do so in a way that democratizes access to capital.** Too often, access to capital is about who you know, not what you know. Angel investment groups help to democratize that process because they are most concerned about the potential of an entrepreneur's ideas, their character and their ability to engage customers.

7. Considerations When Creating Equity Tax Credits

- **Keep it Simple** — ETC programs exist in an estimated 39 states and provinces across North America. The uniting purpose is to incentivize the investment of private capital in high growth start-up companies. However, some of these programs have introduced constraints that make them very cumbersome and complicated, ultimately limiting their use and effectiveness. The lesson learned is, the simpler the model, the better.

- **Allow "Funds" to Qualify** — The purpose of ETCs is to grow the pool of available capital being invested in high growth potential companies. "Qualified Investors" under securities law, are very often not experienced angel investors. An easy way for them to reduce risk as they enter the market is to invest through a fund that is managed by more experienced angels who manage risk by pooling resources and conducting robust due diligence. Candidate investments provide greater benefits to the entire economy when they are "de-risked". Allowing angels who invest through a fund to qualify for ETCs furthers the objective of creating a new asset class that is appropriately and productively managed by and for qualified investors.

8. Other Tax Considerations

- **CCPC Lifetime Capital Gains Tax Exemption** — Consider expanding this benefit for those who invest in early stage startup companies. This tool incentivizes high net worth individuals to invest for the long term in businesses that will deliver long term productivity growth. This tax incentive has no immediate, and only limited long term "cost" — and the "cost" is only realized if and only if the company succeeds and is sold.

- **Stock Options in Startup & Growth Companies** — It is critical to differentiate between stock options issued by private and public companies. Privately held startup and growth companies use stock options as an essential tool to attract, retain and reward talent that could easily go to a much larger company for more pay and security. Without affordable access to talent, these high-risk startups will never succeed. Stock options in private companies are illiquid and have no markable value until the company goes public or is sold. This differs completely from stock options in highly liquid public companies that are often issued to executives as tax beneficial stock performance incentives. Unfortunately, this distinction has not been understood within Finance Canada in the past.

9. Additional Considerations

Our country desperately needs to become the home of global disrupters, not the disrupted. This means that we need to foster innovation growth companies like never before. For this reason, the Minister of Finance would benefit from creating the following:

- **Create a "Council of Entrepreneurs" at Finance Canada** — Bring in a rotating group of startup and growth company entrepreneurs who can provide the Minister of Finance and finance officials with insight into the challenges facing our current and next generation growth companies. Having this advice where funding priorities are decided will help to ensure that every department is considering how it can prioritize measures that increase productivity through its policies and actions, both within the department and the country.

- **Agile Procurement** — Consider changing how the Government of Canada procures solutions to give innovative startup and growth companies a chance to compete. Government is the largest customer in Canada. Except for past programs like the Build in Canada Innovation Program, new entrants never have a chance to bring their solutions forward. This is because government tends to spend years researching and specifying the solution it wants to buy, and then a considerable amount of time selecting the winning proposal. This approach favours incumbent vendors with traditional, known products and disincentivizes innovative new entrants whose solutions are not widely known, and who cannot afford to respond because of cost of participation is too high in terms of lost opportunity, limited resources and time.

- **Regulatory Reform** —Finance Canada needs to systematically adapt its regulatory processes to ensure that innovation and competition are prioritized. Canada has fallen to 35th out of 37 OECD countries in the 2018 Product Market Regulation Index, and is now only ahead of Turkey and Colombia. An example of the unwillingness to adapt regulations to changing technologies and competitive pressures is the area of Consumer Directed Finance (Open Banking). The perceived risks associated with change are now being overtaken by the rapidly growing risks resulting from inaction. Inaction is limiting the access to credit and early stage funding for our emerging and cash flow dependent small businesses. How we address regulated industries that are undergoing profound technical and business model disruption globally is an area of tremendous economic risk and opportunity.