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Sweat Equity as a Gift: Venture Capital Investments and Tax Law in Japan

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I. Introduction

We can observe a typical incentive bargain between human capital providers (entrepreneurs) and monetary capital providers (venture capitalists) in a venture company. If one party feels too much risk, she will hesitate to invest her capital. To maximize each party's payoff, both parties need to bargain with each other to motivate each other to invest their respective monetary and human capital. It is a typical two-sided agency problem situation. The incentive bargain will be made on control sharing and value sharing.

In Silicon Valley, such a two-sided agency problem is resolved by making entrepreneurs abandon control to venture capitalists and complementarily giving entrepreneurs additional cash-flow right as "sweat equity."

Japanese tax law is, however, hostile to the use of equity as an incentive. Particularly, the Japanese National Tax Agency might challenge the sweat equity practice as a gift and entrepreneurs would be required to pay gift tax. As a result, sharing cash-flow rights cannot be complementary to sharing of control, and the two-sided agency problem is not yet solved.

Chapter II will explain the structure of sweat equity and how and why entrepreneurs and venture capitalists share cash-flow right. Chapter III will contrast the tax treatment of sweat equity in the United States and Japan. Chapter IV will explore the reasons why the Japanese tax agency is unfriendly to sweat equity, and demonstrate that sweat equity should not be taxed. Chapter V is a conclusion.

II. The Sweat Equity Scheme: Sharing Cash-Flow Rights and Control Rights

Bargaining about sharing cash-flow rights can be complementary to sharing of control.[2] Typical schemes in Silicon Valley are sweat equity.

Usually, the first transaction between the entrepreneur and the venture capitalist is a second stage financing. The first stage financing is typically a smaller infusion of seed capital, perhaps a "friends and family" round or an

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[2] See Zenichi Shishido, Why Japanese Entrepreneurs Don't Give Up Control to Venture Capitalists (Working Paper, 2008).

"angel" round. When the venture capitalist enters the scene, it invests in a company with some business history, and the company issues new stock to the venture capitalist – typically preferred stock that is convertible into common stock.[3] The preferred stock is issued, for example, at a price of $2.00 per share to the venture capitalist, while the price of the common stock issued to the founder was $0.10 six months earlier.[4] Suppose the preferred stock provides for (1) non-cumulative dividends, (2) a liquidation preference equal to the original issue price, (3) mandatory redemption, (4) voting rights equivalent to those of the common stock, (5) convertibility into one share of common stock, (6) anti-dilution protection, and (7) automatic conversion into common stock upon a public offering.[5] These terms are fairly typical of a second-round investment. They also reflect fascinating and complex incentives. To reiterate how useful it is to examine contractual organizations with respect to the contracting parties, these terms illustrate that the venture capitalist has chosen its remedy for bad outcomes (a liquidation preference) and its control and participation rights for good outcomes.

The feature that underlies the incentive conflict is that in allocating equity the parties exchange the financial capital contribution of the venture capitalist for the human-capital contributions of the founder.[6] Because preferred stock is automatically converted into common stock upon a public offering – the common goal for both parties – the common stock and the preferred stock have comparable value if the venture is a success. Said differently, the preferred stock's seniority disappears if the venture is successful, as measured by the ability to consummate a public offering.

III. Different Tax Treatment of Sweat Equity in the United States and Japan

As I explained in Chapter II, sweat equity is a result of incentive bargain between venture capitalists and the entrepreneur. Venture capitalists allow the entrepreneur more equity than her monetary capital contribution simply because it will bring them more pay off by giving the entrepreneur stronger incentive to work hard. It is an arm's length transaction.

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[3] See Michael Halloran, et al., Venture Capital and Public Offering Negotiation 6-11 (3rd ed. 2000).

[4] The example of pricing is taken from Halloran, et al., supra note 2, at 6-12.

[5] Halloran, et al., supra note 2, at 6-6, 6-11.

[6] Strictly speaking, American start-ups do not typically issue equity for human capital investments. American entrepreneurs in fact typically pay for their equity for cash. However, the value of such equity at the time of its issuance to the founders is a nominal value, and thus the cash contribution can be very low.

Even in the United States, however, it would look strange if venture capitalists purchased the same common stock that the entrepreneur had bought only a couple months before, but at a share price twenty times greater than initial paid by the entrepreneur. One of the reasons why venture capitalists invest in preferred stock in Silicon Valley is for tax reasons. They would argue that the common stock, which entrepreneurs acquired, and the preferred stock, which venture capitalists acquired, is different stock, so their price difference is reasonable. If the firm liquidates immediately after the venture capitalists make their investments, the entrepreneur will receive only $0.10 per share in the hypothetical case of Chapter II.[7]

As a result, entrepreneurs and managers of start-up companies can avoid current taxation and enjoy tax deferral and reduced tax rates as capital gain. It has been an established practice that the IRS will not challenge such a scheme of sweat equity,[8] although the climate looks changing by IRS regulations under IRC Section 409A, which became effective as of January 1, 2009.[9]

In Japan, tax treatment of sweat equity is unpredictable.[10] The Japanese National Tax Agency might challenge the sweat equity practice as a gift in which case entrepreneurs would be required to pay gift tax.[11] Such unpredictability itself

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[7] The founders can also argue that their common stock was worth less at the time of issuance, before the company made important progress. Moreover, even in the setting that managers buy common stock or receive options at a steeply discounted price shortly before a higher priced IPO, the IRS seldom challenges valuations. See Gilson & Schizer, Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, 116 Harv. L. Rev. 874, 900 (2002-2003).

[8] It is called the 10-to-1 rule. It is not a written rule but a tax practice, which venture communities in the United States are accustomed to. See Gilson & Schizer, supra note 6, at 892, 898, 900; 1 Joseph W. Bartlett, Equity Finance: Venture Capital Buyouts, Restructurings and Reorganizations 82-83 (2nd ed. 1995).

[9] Under the final regulations under IRC 409A, the standard for fair market value will be stricter, often requiring a third party valuation. However, many practitioners predict that the "10-to-1"rule might still effective for, at least, an early stage start-up company as long as the board determines "in good faith" that the preferred stock is worth 10 times the stock.

[10] Even though it was not a case of sweat equity in the venture capital investment, the Supreme Court held that an issuing stock to a particular party at a very low price was a profit transfer and can be recognized as an "asset transfer" or "other transaction" without consideration (Corporate Income Tax Code Article 22 Paragraph 2). See in re Obunsha Holding, 219 Supreme Ct. Civil Reporter 285 (Sup. Ct., January 24, 2006).

[11] If the "gift" is sent from a corporation (many Japanese venture capital funds are corporations) to an individual (entrepreneur), the sending corporation will be restricted to deduct the "donation" as cost (Corporate Income Tax Code Article 37), and the receiving individual will be taxed as either occasional income or compensatory income.

distorts the incentive of entrepreneurs and venture capitalists to use a sweat equity scheme.[12] As a result, sharing cash-flow rights cannot be complementary to sharing of control, and the two-sided agency problem is not yet solved.

IV. Reasons for the Unfriendly Tax Treatment of Sweat Equity

1. The Risk of Tax Avoidance

It is quite natural for the Japanese National Tax Agency to view suspiciously the sweat equity practice, which is relatively new in Japan. If sweat equity were used in family companies, it would be a route for retiring founders to transfer firm value to their successor children. The tax agency views both start-up companies and family companies as closely held corporations, which commonly attempt to avoid taxation.

However, venture capitalists have no incentive to make gifts to entrepreneurs, while parent founders have a strong incentive to make gifts to their successor children. Again, the sweat equity practice in venture capital backed firms is a genuine arm's length transaction. It is not so difficult to distinguish these two different transactions and the tax agency could deny the pretended sweat equity ex post.[13] Prohibiting sweat equity in general ex ante would impose excessively heavy cost on the Japanese economy.

2. Monetary Capital Investment and Human Capital Investment

Japanese corporate law does not permit human capital investments in limited liability organizations, including both stock corporations and LLCs,[14] while in the United States, human capital investments, or services, are a form of in kind contribution and are generally permitted so long as the services have already been performed,[15] and even future human capital investments are permitted in LLCs.[16]

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[12] Japanese practitioners complain unpredictability of taxing rule in general, particularly two points. Ex ante, no-action letters are not available, and, ex post, it is hard for taxpayers to challenge the tax agency at the court because overdue interest rate is very high and plaintiffs are, in fact, forced to deposit claimed tax before going to court.

[13] Even in the venture capital area, there may be some potential for such an abuse. For example, the venture fund is run by an established company and the "entrepreneurs" are actually relatives of the company's managers. Such an abuse could, however, be prevented by a general anti-abuse or substance over form rule, ex post.

[14] See Corporate Code Article 576 Paragraph 1 Sub-paragraph 6.

[15] See California Corporations Code Section 409(a)(1); Delaware General Corporations Law Section 152.

[16] See Uniform Limited Liability Company Act Section 401.

Based on the Japanese corporate law principle of prohibiting human capital investment in limited liability organizations, one could argue that not taxing sweat equity is similar to not taxing wage income when wages are invested in the company. In other words, if human capital investment is prohibited, the sweat equity scheme must be constructed so that the company pays wages to an entrepreneur or management for her future labor, which she then invests in the company's stock. Sweat equity is, however, irrelevant to the principle of monetary capital investments, which is concerned with the protection of creditors. Sweat equity is a result of the incentive bargain among shareholders, i.e., between entrepreneurs and venture capitalists. From the corporate law perspective, there is no reason why tax law should intervene in the arm's length transaction.

3. Possible Misunderstanding of Sweat Equity Practice

Although Japanese organization laws permit human capital investments by general partners in partnerships,[17] there is no tax law statute and established tax rule on human capital investments by general partners.[18] Some commentators categorize the partners' economic rights, which general partners obtain for their future human capital investments, as tow distinct rights: the right to share profits, and the right to share residual assets.[19] Then they argue that if the general partner, who invests her human capital, obtains the right to share residual assets from the beginning, it should be taxed because certain economic value is transferred. They argue, however, that if she obtains the right to share residual assets, only when the value of the residual assets exceeds the value of the monetary capital investments, no tax issue arises when she obtains equity for her future human capital investments.[20]

According to this tax law theory, sweat equity should not be taxed because sweat equity holders exactly "obtain the right to share residual asset, only when the value of the residual asset exceeds the value of the monetary capital investments."

If an arrangement let sweat equity holders obtain proportional participation right on residual asset from the beginning, they would have an

[17] See Civil Code Article 667.

[18] See Noriko Yamashita, Romu Shushi to Kazeijo no Hyoka (Human Capital Investment and Its Tax Evaluation), 295 Ritsumeikan Hogaku 801 (2004).

[19] See Tateki Watanabe, Kumiai no Zeimu Mondai to Beikoku no Patonaship Kazei (Tax Problems of Partnerships and Partnership Taxation in the United States), 2004-March Zeimu Koho 110; Yamashita, supra note 16, at 802.

[20] See Yamashita, supra note 16, at 808. Partnership tax law in the United States is basically same on this point. See Gilson & Schizer, supra note 6, at 907.

incentive to make fraudulent calls. Therefore, venture capitalists would never agree to such an arrangement. In practice, a so-called vesting process is arranged. Sweat equity holders need to vest their right to share residual assets, typically, 25% per year. In other words, they need to actually invest their human capital for four years in order to obtain full equity rights.

Additionally, the common stock, which sweat equity holders obtain, is usually restricted for transfer, and the preferred stock, which venture capitalists obtain, has a liquidation preference. Therefore, sweat equity holders will not gain from asset distribution unless the value of residual asset exceeds the value of monetary capital investments. In reality, sweat equity holders cannot liquidate their equity until either an IPO or M&A occurs.[21]

Therefore, if the tax agency challenges sweat equity, it may misunderstand the structure of the practice.

4. Possible Understanding of Option Value

Liquidation-based valuations – in which the common stocks' value is based on proceeds that hypothetically would be received in an immediate liquidation – could be criticized as economically naïve. The value of the common stock should be determined largely by its option value under modern finance theory. In a venture company, the common stock is effectively a long-term option with a high variance, so the value will be substantial.[22]

Although it is unlikely, a possible reason why the Japanese National Tax Agency might challenge the sweat equity scheme is that they recognize the option value of the common stock. Even if it is true, treating sweat equity as a gift is illogical. The value of the stock, including its option value, should constitute compensatory income.

In the United States, the IRS has not challenged the aggressive liquidation-based valuations of the sweat equity scheme. Because of the IRS's willingness to ignore the common stocks' option value, American entrepreneurs and managers of venture companies can enjoy tax deferral and lower capital gains tax rates.

Professors Gilson and Schizer justify the IRS's position on the sweat equity scheme as a good subsidy to promote high-tech startups: "the high-intensity performance incentives provided to managers of early-stage companies,"[23] although they doubt that the IRS intends to subsidize venture

[21] In a Qualified IPO situation, the preferred stock is automatically converted into common stock, so the sweat equity holders will share the residual asset thereafter on an equal basis as the former preferred stock holders. It is, however, fair to say that human capital investments result in more value in a Qualified IPO situation than their estimated value.

[22] See Gilson & Schizer, supra note 6, at 898-99.

[23] Gilson & Schizer, supra note 6, at 910.

capital in this way. Instead, they conclude that it is likely that unsophisticated auditing and administrability concerns have spawned the government's tolerance of aggressive valuations.[24]

V. Conclusion

The biggest difference in the incentive bargains between entrepreneurs and venture capitalists in the United States and Japan is that American entrepreneurs abandon control while Japanese entrepreneurs do not. While there must be many complementary reasons, such as different market situations, different social norms, different legal systems, one of the reasons is that the tax law or tax practice is restrictive about the use of sweat equity.

Sweat equity is a result of the efficient incentive bargain between the human capital provider, i.e., entrepreneur, and the monetary capital provider, i.e., venture capitalist. It is a reasonable arm's length transaction. It is arranged not to transfer value without cause. Although it may be suspicious from the tax agency point of view, it should not be taxed.

The Japanese National Tax Agency maintains an unfriendly stance towards sweat equity. The ambiguity of the tax rule on sweat equity itself distorts incentive to make an efficient incentive bargain and, as a result, turns to be a handicap for the Japanese venture industry against the American counterpart. It is an urgent policy matter to clarify the tax rule on sweat equity to reduce the risk burden for entrepreneurs in Japan.

[24] Gilson & Schizer, supra note 6, at 911.