

24 February 2016

The Manager  
Individuals and Indirect Tax Division  
The Treasury  
Langton Crescent  
Parkes ACT 2600

## **Submission – Tax incentives for early stage investors**

We refer to the Policy Discussion Paper in relation to the proposed introduction of tax incentives for early stage investors and the request for submissions made in that paper. CST Tax Advisors is pleased to submit our feedback on the topics for consultation and related matters.

### **Part A- Responses to Topics for Consultation**

In this Part A, we set out below our responses to the topics for consultation set out in the Discussion Paper. Part B of this letter deals with other matters that we believe required consideration.

#### **Australian Innovation Company**

##### **4.1 Are there any additional principles that should be included in defining an innovation company?**

##### **Comments on the Principles-Based Method**

The Discussion paper states that the Government intends to establish a principles-based approach to defining innovation and *inter alia* the Innovation Company.

The Discussion Paper indicates that an innovation company ***‘would need to have the capability to commercialise or bring to market and generate value from the idea’***. It is also noted that the innovation company ***‘will need to pursue global or broader opportunities rather than having a focus only on local markets’***.

While we agree that Australia should foster successful innovative companies that have the ability to expand internationally, we do not believe it is possible to sensibly and systematically determine, as

part of these tax measures, which companies have the capability to actually commercialise a product and which do not, and in so doing, determine eligibility for the tax incentives.

The reason for this is that many companies in their early stages often have no **demonstrable ability** to bring to market and generate value from the idea. Typically, the founders of such early stage enterprises will not display any previous track record which can be objectively assessed by a government agency in order to determine whether they have the 'ability to commercialise'.

Often the founder of an innovative company is an entrepreneur with a brilliant idea who has devoted his or her efforts and financial resources to designing an innovative concept or technology.

Likewise, it **should not be** a qualifying principle for the purposes of the tax incentives that an innovation company '*should need to pursue global or broader opportunities*'. That approach seems to assume that the innovation company has already developed its product or service to state of global market readiness. That will rarely be the case.

In fact, in the early stages of a business, innovative companies will often restrict their roll-out to a local market in order to test its success and further develop a product. It is the story of Facebook that that company grew in its local geographic market first (albeit it at a rapid rate) and only initially in one segment of that local geographic market.<sup>1</sup> With the lessons learnt from its local growth it expanded internationally.<sup>2</sup>

Clearly those companies that have success with their innovative products and services will pursue global or broader opportunities as they are able to and as and when those opportunities become clear. That is part of the normal life cycle of a commercial enterprise, which would seek to enhance returns for shareholders.

Another principle identified under Method 1 of the Discussion Paper is that the definition of innovation company would '**require the innovation company to exhibit high growth potential through a management team being able to successfully scale the business as it grows and maintain a competitive advantage over incumbents or new competitors.**'

There are some difficulties with this approach.

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<sup>1</sup> Source: Greenstein, S., Iansiti, M., & Snively, C. (2015) *Facebook: The First Ten Years*, HBS No 9-616-012, Boston, MA: Harvard Business School Publishing

<sup>2</sup> Initially available only to Harvard University students, the site expanded to including over 800 college networks in the United States and later to high schools. Facebook expanded internationally in October 2005. Source <https://newsroom.fb.com/company-info/>

Firstly, we find the use of the word 'require' to be curious. It seems to suggest that the Government expects to pre-qualify whether a company can be considered an 'innovation company' based on the size and qualifications of its management team.

We think it should be recognised that investors already make an assessment about the ability of the Company's management team (however small it may be) to succeed. That assessment, would be effectively be made by Investors as part of their own investment due diligence and should not also need to be made by Government. The criteria private investors make about the value and quality and prospect of success of a management team would be quite different from a Government Investor

We believe the Government's role should be to ensure that the applicant company can be considered to be an innovation company, which is a task which will be complex to assess. It is also not clear what would be gained by the Government devoting the resources necessary to assess the management teams of innovation companies. That should be left for the 'market place'

Secondly, when designing the measures for the tax incentive we would encourage the Government to focus more on the typical life cycle of an early stage innovation company. Companies in their early stages of development will rarely have experienced management teams. That is particularly the case if one is considering, as we are, companies that meet the criteria of being incorporated in the last 3 years, having income less than \$200,000 of income, and having expenditure of \$1M or less in the prior income year.

For many companies, the founders will put in place a broader management team only after they are able to demonstrate initial commercial viability of the product or service. Early promise and potential subsequently attracts a management team. With respect – the Government is at risk of putting 'the cart before the horse'.

For other companies, the \$1m test will be a problem because if they spend more than \$1M on research and development activities on the core product they may automatically disqualify themselves from being considered a qualifying innovation company - given the criteria the government has set.

It is also the case that today the very concept of a management team is changing with many start-up companies opting to seek assistance from informal 'advisory boards'. These often consist of paid and unpaid consultants but rarely employees in the traditional sense of a management team.

#### **4.2 What gateway criteria would best define an eligible innovation company?**

We believe that most of the criteria mentioned in the Discussion Paper would be sensible qualifying criteria to further develop as part of the policy.

We believe that companies that have been approved by AusIndustry for the R&D Tax Offset should be permitted to benefit under safe harbour rules provided their R&D claims account for a **majority** of the businesses total expenses.

Some criteria proposed in the Discussion Paper need to be further refined which we have address in our reply to section 4.3 below.

Additionally, we believe that other gateway criteria could include where a company is able to demonstrate a significant take up in a beta product or service. For example, if a company is able to demonstrated a high volume of app downloads or a large number of beta users for its product. Such a company is likely to be doing something innovative.

Another criterion, which could be considered in combination with others, could be where a staff equity incentive plan is offered to key personnel other than the Founder. It is often the case that high growth innovative companies offer sweat equity to key personnel, many of whom accept lower salaries to be a part of an innovation companies.

#### **4.3 Do these criteria meet the objective of attracting investment in innovation companies, without unnecessary regulatory burdens?**

It is noted under Method 2 in the Discussion Paper that a test for qualification as an innovation company could be where ***'a company has had one or more existing third party financial investors who have previously subscribed for equity'***. The Discussion Papers does not explain why this proposed measure could provide evidence that a company is an innovation company.

Another of the safe harbours identified in the Discussion Paper is where a company has ***'within the last 3 years, developed, acquired or licensed an idea that has been filed as a patent in the multiple jurisdictions'***. It is not clear why this safe harbour should refer to *multiple* jurisdictions. Presumably the obtaining a patent in one recognised jurisdiction would be sufficient to evidence innovation.

We also note that the reference to licencing of a patent (as a safe harbour) seems to contradict one of the proposed exclusions under Method 3 which refers to receiving royalties or licence fees.

On this point though it is not clear why a company that has developed or is developing an innovative product should be excluded simply if it chooses to licence its technology as a means to 'get to market'.

**4.4 What integrity risks are associated with each of these criteria? How might these risks be mitigated? For example, combining multiple tests together could mitigate risks.**

Integrity risks will usually be present in all criteria. We believe a sensible safeguard is that the investor is not able to claim a tax incentive unless they hold a Self-Certification Certificate issued by the innovation company, signed by its Directors, attesting to the company's compliance with eligibility requirements. That would be a separate check and balance to ensure that there is a positive obligation on the Director of the relevant Innovation Company to ensure their compliance with the rules. Penalty for misstatement would apply.

**4.5 Are investors open to a process that involves lodging a self-assessment declaration prior to making investments, in order to assist with assessing take up and eligibility?**

We believe the investors would be open to a process that involves a self-assessment declaration as part of the preparation of their personal income tax returns.

**4.6 In relation to a gateway requirement that is based on approved accelerator programs, which types of organisations should be included and what qualifying criteria should be specified?**

We agree that only Government regulated accelerator programs should be allowed to provide safe harbour status to an innovation companies, for the purposes of qualify investors for the new tax incentive. For example, we refer to the Incubator Support Program (<http://innovation.gov.au/page/incubator-support-programme>)

**4.7 Are there any other investment activities should be excluded?**

Provided the activities are legal there should be no other exclusions.

**4.8 Is it appropriate for innovation companies to be restricted to companies that are Australian residents for tax purposes?**

Yes, as the idea is to encourage Australian innovation. However, it should be noted that Australian resident companies may undertake activities related to the innovation activities through branches or offices outside Australia.

The Government will need to develop a policy response to this issue as we submit that the focus should be about fostering innovation activities that are carried on actually in Australia. If the tax incentive was available in situations where an Innovation Company deployed funds overseas in order to pay foreign employees, that would effectively mean that the Australian government would be support the development of a foreign workforce and with potentially no Australian company tax revenue derived<sup>3</sup>.

To mitigate and eliminate this risk it may be necessary for innovation companies to state, as part of a relevant annual declaration, that the activities giving rise to the innovative product or service were predominantly carried on in Australia (recognising that the global nature of commerce will likely mean that some foreigners may be involved in supporting Australian innovation). To the extent that declarations are found to be false, the relevant company directors could be subject to appropriate penalties.

### **Direct Investment into an innovation company**

#### **5.1 Are there any specific requirements that should be included within the sophisticated investor test to ensure that innovation companies are benefiting from both financial and technical/commercial support?**

We find the 'sophisticated investor test' to be one of limited significance and we do not agree that it should be used as part of the tax incentive. The Discussion Paper essentially provides two reasons for the potential use of the sophisticated investor criteria. We deal with each in turn.

Firstly, it is said that there is an argument that the class of eligible investors should be limited to sophisticated investors as a '*proxy to unlocking commercial expertise*'. We disagree with that notion. In our opinion, and from client experience, it does not follow that individuals who qualify as sophisticated investors under the Corporations Act would necessarily be able to provide commercial expertise to the relevant start-up.

By contrast, investors who would not qualify as significant investors under the Corporations Act may be able to provide sound commercial support to the innovation company. It all depends on the skill set of the investor. In summary, we do not believe that the main objective of driving an incremental investment flows to innovation companies, should be paired with what appears to be secondary objective of increasing the technical and commercial support available to start ups. Technical and

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<sup>3</sup> This could occur because of the exemption for foreign branch profits derived by an Australian resident company under section 23AH of the Income Tax Assessment Act 1936.

commercial support can be fostered by other policy measures that are outside the scope of the tax incentive.

The second stated reason why the 'sophisticated investor' approach is being considered is that it is a way of reducing administrative costs by limited disclosure requirements during fund raising. However, many private companies are already able under existing laws to raise funds without issuing a prospectus. For example, the 'sophisticated investor' criterion **already** provides a path for start-up enterprises to limit their disclosure requirements.<sup>4</sup> Therefore linking the sophisticated investor concept to the tax incentive does not seem to provide any **additional** disclosure savings for the innovation company, above what is already available under current law.

Another issue, well noted in the Discussion Paper, is that investments made in innovation companies are inherently risky. In this regard the question is posed as to '*whether direct investment in an innovation company should be restricted to certain investors or open to anyone with the available funds.*' Rightfully there is a policy concern that the tax incentive may encourage investment by those who can ill-afford to suffer a capital loss.

While this issue is important, we note that the purpose of the incentive is to encourage investment. We submit that there are already sufficient controls under the Corporations Act to require companies to issue offer documents unless exemptions can apply. One of those exemptions is already the sophisticated investor exemption, another is the exemption under for small scale offerings<sup>5</sup>.

Hence, we believe that the simplest approach is allow the benefit of the tax incentive to flow to any investor who is legally able to make an investment in a private company under current laws.

For those who are concerned about the possibility of loss on an investment in an innovation company it is important to note that the effect of the tax incentive itself would be to mitigate any loss that might arise. This occurs by virtue of the benefit of the tax-offset against current income.

There are also horizontal equity concerns with a policy that would allow an offset for certain individual taxpayers but not for others. However, to the extent that the Government wishes to retain the sophisticated investor qualification for *direct* investment in an innovation company, then a way to address horizontal equity concerns is to permit non-sophisticated investors to invest through an innovation fund, which would presumably be required to issue a full prospectus to investors.

## **5.2 Other than the sophisticated investor test contained in the *Corporations Act 2001*, are there alternative tests that can achieve these same objectives?**

We do not believe this is relevant given our comments in 5.1.

<sup>4</sup> Section 708(8) of the Corporations Act 2001

<sup>5</sup> Section 708(1) of the Corporations Act

## **Indirect Investment via an innovation fund**

### **6.1 Is it appropriate for the offset to be available in the year of a cash call in the case of indirect investments through a qualifying innovation fund?**

Yes, we believe it is appropriate for the offset to be available in the year of a cash call in the case of indirect investments through a qualifying innovation fund. This is to ensure simplicity and certainty for tax payers - which should be a key criteria for any tax incentive measure. The onus will be on the directors of the innovation fund or the (trustee of an innovation trust) to ensure that funds are fully invested.

In the event that the fund is not able to fully invest its pooled funds, then it would be required to return capital to investors. In turn investors would need to amend their income tax returns, which should be relatively simple to administer.

### **6.2 What is the most appropriate corporate structure for an innovation fund? What registration requirements should exist?**

The most appropriate structure for an innovation fund would be a structure that is similar to a Managed Investment Scheme regulated by the Australian Securities and Investments Commission. We do not believe that an innovation fund should be limited to corporate entities.

### **6.3 Should the incentive be limited to sophisticated investors in the case of investments through a qualifying innovation fund?**

The incentive should not be limited to sophisticated investors, for the same reason as provided in response to question 5.1.

To the extent that the government wishes to restrict the availability of the incentive for *direct* investment to sophisticated investors, a qualifying innovation fund would provide a good opportunity to address the horizontal equity concerns that that policy raises. Given that a fund could pool a significant amount of investment, an innovation fund (which should be required to issue a prospectus) would be a good way for non-sophisticated investors to provide funds to the innovation sector in a way that addresses concern about investor protection.

### **6.4 Should qualifying innovation funds be proprietary limited companies, unlisted public companies, or some other company governed by the *Corporations Act 2001*?**

In our view, innovation funds should preferably be unit trusts and should be governed in a similar fashion to a Managed Investment Scheme. Ideally - they should not be companies, as companies are not currently flow through entities for Australian tax purposes.



Capital gains made on the sale of underlying investments in innovation companies by an innovation fund cannot under current tax laws be passed on in a manner that retains its character unless a unit trust is used. If investors were to invest in an Innovation Fund that is company, then they would typically only be entitled to receive dividend income even though those dividends may effectively represent proceeds of an underlying capital gain by the Innovation Fund on a sale of an investment in Innovation Company. That is a strong disincentive as much of the gain is eroded in tax payments.

Dividends are taxable and so in order to achieve the objective set by the government of exempting capital gains on the sale of interests in Innovation Company it would be necessary to exempt dividends from qualifying innovation funds from assessable income.

Without significant changes in Australia's tax laws (for example a flow-through company similar to a U.S Limited Liability Company could be introduced) it would be difficult to see how investors could receive 'exempt capital gains' from an Innovation Fund that is a company. Capital returns and buy backs are possible but these would create significant complexities and are unlikely to be workable. For those reasons we strongly believe company is *not* a suitable structure for an innovation fund.

The use of a unit trust means that without legislative changes any capital gain made by an Innovation Fund that is a Trust should be able to retain its character as a capital gain and flow through to Unit Holders.

The use of a unit trust will also assist with the passing on of what we assume will need to be an exemption of dividend income that is effectively connected to the sale by an innovation company of its underlying business. (See below at Part B (i)).

In closing we note that the issue of tax transparency has been dealt with in the context of Early Stage Venture Capital Limited Partnerships.

However, we note that the capital gains tax exemption<sup>6</sup> in respect of interest in an ESVCLP is facilitated because of the nature of a partnership in which partners are deemed to make a capital gain according to their interest in a partnership. Shareholders in an Australian company are not considered to have any automatic share of capital gains made by the company itself.

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<sup>6</sup> See Section 118-407 of Income Tax Assessment Act 1997

#### **6.5 Should there be requirements placed on who can manage an innovation fund?**

Yes, there should be requirements placed on who can manage an Innovation Fund. The Directors or Managers of an Innovation Fund should be able to demonstrate competency in a similar manner to which a holder of an Australian Financial Services Licence must be able to demonstrate competency.

#### **6.6 Is it appropriate to adopt an approval process similar to the UK Venture Capital Trusts and Australian Early Stage Venture Capital Limited Partnerships?**

Yes, we believe it would be appropriate to adopt an approval process similar to the Australian Early State Venture Capital Limited Partnerships.

### **Integrity Measures**

#### **7.1 How will the Government maintain the integrity of Australia's tax system while providing the best possible support for innovative startups?**

Apart from the matters raised in the discussion paper, the best way to maintain the integrity of the tax system will be to ensure that proper controls are in place when it comes to claims made by investors and appropriate assessment of the status of the innovation company including annual declarations of compliance by the Directors of Innovation Companies.

It should be possible for direct investors in an innovation company to be required to use an Innovation Number when they make claims in their income tax returns for the rebate or where they make claims for an exemption from a capital gain. The number could be allocated by AusIndustry or Innovation Australia in a similar way to which R&D tax offset numbers are currently allocated.

#### **7.2 How could integrity measures be designed to attract and secure investment at the right stage of innovation without creating unnecessary red tape for investors?**

The key to attracting and securing investors is to ensure an understandable, efficient and speedy process about which companies would qualify as 'innovation companies'. Approved innovation companies should be listed on a central searchable directory which a potential investor could readily search to independently verify that the company has been approved.

It is also important that the qualifying criteria for investors are clear and unambiguous. We also believe that a **broad class** of investors should be permitted to benefit from the tax offset. For example family trusts should be allowed to qualify as Investors and the benefit of the tax offset should be able to be claimed by family beneficiaries. Integrity concerns could be addressed by ensuring that only

trust that had made a family trust election<sup>7</sup> would be able to pass the benefit of the tax incentive to their beneficiaries. Family controlled companies should also be able to be qualifying investors, with appropriate clawback if the family control changed.

## **Part B- Other matters for consideration**

We wish to make the following additional comments in relation to the proposed tax incentives for innovation.

### **Dividend income arising from the sale of an underlying business**

We note that it is often the case that a potential purchaser of an Innovation Company will not wish to acquire the shares in the Innovation Company, but would instead rather acquire the business. In this regard Innovation Company that have sold their business could be left with a distribution cash profits would typically only be paid out as a dividend to shareholders.

Noting that the Government wishes to introduce a CGT exemption for the sale of shares held for at least 3 years in an innovation company, we believe that consideration should be given to providing an exemption for dividend income arising in consequence of the sale of an underlying business by an Innovation Company.

This is to ensure that where Innovation Companies accept an offer to sell the whole of their business that in so doing they not cause Investors, who were otherwise eligible for a CGT exemption, to lose out and become taxable on the dividend paid to them arising from the profits on sale of business.

### **Ongoing status of the Innovation Company**

It would be appreciated with the Government could clarify, prior to the introduction of exposure draft legislation, how the status of an innovation company would be measured on an annual basis and how the impact of any subsequent failure to satisfy the qualifying criteria, after the year of investment would be handled.

For example, if an Innovation Company qualifies in Year 1 and investors receive a tax deduction, if in Year 2 that same company derives taxable income of greater than \$200,000 would any tax rebates be at risk of being reversed.

Further if an investor acquires shares in an innovation company in Year 1 but those shares are sold in Year 4 at a time when the company's revenue is for example \$2M. It is assumed that the capital gains tax exemption should still be available to the investor.

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<sup>7</sup> Under Schedule 2F of the Income Tax Assessment Act 1936

24 February 2016



In closing, we wish to thank the Government for the opportunity to provide feedback in relation to the Discussion Paper and we look forward to being able to provide further comments in relation to exposure draft legislation.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Matthew Marcarian', written in a cursive style.

Matthew Marcarian

Principal