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The Treasury
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Dear Sir / Madam

SUBMISSION - TAX INCENTIVES FOR EARLY STAGE INVESTORS

Thank you for providing the opportunity to comment on the Policy Discussion Paper entitled "Tax incentives for early stage investors" (**"Discussion Paper"**).

We see great potential for Australian innovation in the tax incentive outlined in the Discussion Paper (**"Proposed Incentive"**) and in the broader initiatives to be introduced by the government's Innovation Statement.

As a legal advisor to technology companies and investors internationally, we have been able to draw on day to day experience advising startups and technology investors in Singapore and the United Kingdom to support this submission. From that experience, we have set out below some key points which we consider the Proposed Incentive will benefit from.

We have also explained some aspects of what is common practice for a pre-seed, seed and seed-AA capital raising by a technology company, as influenced by our international and local work with fast growth technology companies and with many of the world's largest venture capital funds. We hope this is useful to reflect on the type of investment which we consider the Proposed Incentive should be structured to promote.

We would welcome the opportunity to further discuss our submission with you. Please contact Joel Cox on 03 9274 5181 to discuss any aspect further.

Yours sincerely

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1. INTRODUCTION TO DLA PIPER

1.1 DLA Piper is a global law firm with approximately 4200 lawyers in more than 30 countries. Internationally, DLA Piper is a leading advisor to many fast growth technology companies and to venture capital and corporate venture capital funds.

1.2 Our team of global technology experts have worked with some of the world's fastest growing technology companies on scaling disruptive businesses around the world. With a presence in all the key technology markets, including Silicon Valley, Tech City in London, Israel and other major technology centres across Europe and Asia Pacific, we are able to keep abreast of global trends as they relate to early stage companies and venture capital.

1.3 In Australia, our technology practice involves us assisting fast growth tech companies with capital raisings (everything from a seed round through to an IPO), sell and buy side tech M&A and global growth. We also work with many of the most active Australian venture capital funds and many overseas investors, including US venture capital funds.

1.4 Further, the nature of our technology practice involves us assisting tech companies with entry to new markets internationally. This has enabled us to gain valuable experience in respect of startup incentives in place in Singapore and the UK and with regard to startup practice and support in the US and Israel markets. We work closely with colleagues from those jurisdictions on a regular basis and have spoken through their experiences in preparing this submission.

1.5 Our experience from both the early stage company side and the investor side provides a unique insight into what is commercially desirable from both types of stakeholders who will benefit from the Proposed Incentive.

2. AUSTRALIAN INNOVATION COMPANY

The definition of "innovation company" should be broader than what applies in the UK

2.1 A key aspect of feedback from our UK colleagues on the Seed Enterprise Investment Scheme is that the narrow definition of innovation company in the UK has caused difficulties, particularly by excluding eligibility for many financial services and insurance startups.

2.2 Banking, insurance, money-lending, debt-factoring, hire-purchase financing or other financial activities should not be expressly excluded. We recognise the integrity risk that this presents, and suggest that for start-ups in such sectors, provided at least a threshold percentage of funds raised are utilised for technology development or purposes other than money-lending, the supply of insurance, debt-factoring or hire-purchase financing, the start-up should be eligible.

2.3 Providing legal or accounting services, or the provision of services or facilities for another business, should similarly not be expressly excluded. Similar to our comments above on financial activities being excluded, we consider that Australia's service economy is an area in which innovation should be promoted. Again, we think that these sectors should not be excluded provided that at least a threshold percentage of funds raised are utilised for technology development. Innovation in these areas is essential to ensure new modes of operation of professional services to support the Australian start-up ecosystem, as well as other sectors of the economy.

2.4 We note that the start-up ecosystem internationally has changed significantly since the United Kingdom first introduced its Seed Enterprise Investment Scheme and that eligibility under Singapore's regime is available to a much broader set of companies. We consider that the Proposed Incentive should be designed to reflect that change, and provide flexibility in order to reflect future change that is likely to happen in the start-up ecosystem going forward.

Pre-seed, seed and seed-AA rounds should be eligible for the Proposed Incentive where possible

2.5 From our experience, the following are common scenarios for a tech startup undertaking a capital raising at an early stage. This is informed by our local experience in Australia, and also draws on our experience in the US market:

2.5.1 Many startups will want to first build and trial a minimum viable product (**"MVP"**) prior to raising any capital externally. This will ensure they have a key team of founders who have worked together and demonstrated their commitment to the venture. The startup will also have key metrics from the trial, which will help the startup to attract experienced tech sector investors and potentially a venture capital fund to invest at seed stage. The trial will lower the risk of investment for investors.

2.5.2 In some instances, to fund development of an MVP, a startup will undertake a pre-seed capital raising of in the order of $200,000 to $500,000. This will often be funded by the founders themselves, together with them foregoing some salary in the early stage. Beyond the founders, family or friends often participate in a pre-seed round. Early revenue will also be used to fund early development, and credit card debt and other boot strapping measures are common also.

2.5.3 A seed round is traditionally in the order of $200,000 to $1 million in value, however, this has increased significantly over recent years in both Australia and in the US. For cost intensive startups like fintech, consumer hardware and enterprise software, seed rounds will be significantly greater in value. We advised on several seed rounds in Australia in 2015 in the $1 million to $6 million range. It is generally accepted that startups who raise more than $500,000 at seed stage are more likely to succeed than those that raise less than $500,000.

2.5.4 If a startup has founders with pedigree (i.e. they are repeat entrepreneurs or former employees of reputation with a tech multi-national or Australian platform company), or with considerable domain expertise (i.e. financial services background for a fintech), they will be able to raise capital without an MVP provided they have a sophisticated business model and pitch, and can find the right people to invest. These founders will often do larger seed rounds and obtain a higher valuation.

2.5.5 In the Australian market, many seed rounds are taken up by high net worth individuals because of the limited number of institutional investors participating at seed stage. We are starting to see more seed focused venture capital funds, which is promising. A repeat entrepreneur who has a "natural affiliation" with the startup's business model and who is willing to back the model and founders

because of that affiliation, will often lead a seed round and other high net worth individuals will back the judgement of that repeat entrepreneur.

2.5.6 In the US, there are a lot more venture capital funds participating at seed stage than in Australia. It is difficult in our experience for an Australian startup to raise from the US, however, prior to series A stage. A US VC investor also commonly requires the startup to re-domocile to the US in our experience, but R&D teams can remain in Australia.

2.5.7 A series A raise ideally follows a seed round within 12 to 24 months and is typically between $4 million and $10 million in size. Ideally for a startup, a series A investor will take between 15% to 30% equity, so that demands a significant enterprise value to justify a series A round. In our experience, it is commonly the case that good Australian startups run out of capital prior to getting large enough to justify a series A round. That requires them to undertake a seed-AA round, which is typically between $1 million and $5 million in value and often structured as a convertible note so as to provide a "bridge" to get the startup to series A stage. There is a significant lack of seed AA funds in the Australian market in our experience, and this is an area which the Proposed Incentive should seek to encourage in our opinion.

2.5.8 Of the series B funding rounds that we have advised on recently in Australia, it is more common than not that they have a large number of shareholders (in 2015 we advised on three series B rounds by startups with more than 100 shareholders and on three more with 30-50 shareholders). This illustrates the startup has needed to raise multiple times prior to a series B and often this is done from a large number of investors at seed and seed AA stage. This is time consuming and expensive, with significant compliance costs.

2.5.9 The average life of a fast growth technology company prior to an investor realising a return on their investment is generally expected to be 8 to 12 years. In that time dividends will not usually be paid. Many Australian investors who do not have a history of investing in early stage tech companies or venture capital do not appreciate this timeframe in our experience and it can become a point of contention between founders and investors.

2.6 It would be ideal for startups and innovation if the Proposed Incentive could make a pre-seed, seed and seed-AA round broadly eligible, and that funding rounds undertaken by founders with pedigree and in cost intensive areas like fintech were also sought to be made eligible as much as possible. While we appreciate the Proposed Incentive cannot be designed to cover the field on such funding rounds, we consider some aspects of the Proposed Incentive could be tailored to ensure broader application of the Proposed Incentive for these various funding rounds and startup scenarios. This will ensure the Proposed Incentive promotes the right type of investment that good Australian startups need in our experience.

2.7 We therefore consider the $200,000 assessable income limit to determine eligibility is low. This is especially the case for start-ups who have built their MVP and proved key metrics by generating revenue and boot strapping in early days, as they will most likely have generated greater assessable income. It is also low for any startup seeking to raise at seed-AA stage, which will almost certainly have generated greater than $200,000 in assessable income.

2.8 We note that such a limit is in line with the Seed Enterprise Investment Scheme which is a 50% tax offset for smaller investments. The limits of the Australian regime could be more in line with the Enterprise Investment Scheme (30% tax offset) which has a limit of £15 million in gross assets. Further, we note that there is no revenue limit for a start-up to qualify for the similar Angel Investors Tax Deduction scheme in Singapore.

2.9 We also consider the limit on $1 million expenditure is low, especially in the context of cost intensive startups and startups trying to raise money at the seed-AA stage. We suggest this should be $3 million.

2.10 The low thresholds will motivate startups to raise capital earlier, which is likely to increase the risk for investors.

The principles based approach to defining an innovation company should not require new products or services, but be satisfied if existing products or services are supplied, marketed or operated in new innovative ways

2.11 Much of the innovation we are seeing in Australia and globally is about finding innovative ways of delivering old products. This is particularly the case in fintect, SaaS and network effects businesses, which make up a large part of the tech ecosystem in Australia. Many startups are also ‘fast follows’ of models in other countries. Those startups work well in Australia and they are prime candidates for pre-seed and seed investment. They should be promoted by the Proposed Incentive.

A start-up should not be required to "pursue global or broader opportunities" for it to be considered an innovation company:

2.12 Many of the fastest growing Australian startups that we work with are focused on the Australian market only, at least initially. This is particular so in fintech, data analytics and ecommerce. It is also common for our institutional investors to require that a startup first executes well in the Australian market, prior to international expansion. We see no basis why an innovation company should need to have a global focus.

"The capability to commercialise or bring to market and generate value from an idea" or having "high growth potential" should not be factors when determining if a start-up is an innovation company as they are too difficult to assess

2.13 It will be difficult to ascertain whether a start-up has the capability to commercialise or bring to market and generate value from an idea, and to substantiate if a start-up has high growth potential through a management team being able to successfully scale the business as it grows and maintain competitive advantages over incumbents or new competitors.

2.14 This is particularly so for emerging technologies like for example artificial intelligence, new modes of transportation, the internet of things and new energy technology. It is also the case for fintech startups that face considerable regulatory hurdles at the outset and for network effects businesses that need to grow scale before they become valuable.

2.15 We consider that the market (i.e. investors) should be able to dictate whether a start-up satisfies the criteria of capability to commercialise, and accordingly that the Proposed Incentive criteria be silent on these aspects.

The Proposed Incentive should be informed by Singapore as a start-up friendly jurisdiction

2.16 We see good reason for Australia to compare its support for start-ups to Singapore. We are increasingly asked to advise on the benefits of starting up in Australia versus Singapore and are seeing more founders with "pedigree" select Singapore as the location for their startup. Other startups that we work with want to incorporate a subsidiary in Singapore to benefit from Singapore government support which extends to subsidiaries also.

2.17 The start-up incentives provided by Singapore are more inclusive than those provided by the UK. It would be beneficial for the Proposed Incentive to more closely mirror Singapore than the UK in our experience.

3. DIRECT INVESTMENT INTO AN INNOVATION COMPANY

Convertible Notes should be included as an eligible direct investment vehicle:

3.1 The Proposed Incentive does not exclude preference shares. We consider this to be a positive step as preference shares are largely the mode of investment by investors experienced in tech investment into early stage companies as they promote a fair risk balance between founders and early stage investors. We agree that such risk sharing should be encouraged.

3.2 In addition to preference shares, however, we consider it important that a convertible note qualifies as an eligible direct investment for the Proposed Incentive. In our experience, we have found that the use of a convertible note to invest at pre-seed, seed and seed-AA stage into start-ups is common practice in the US, and an increasing trend we have recognised in Australia.

3.3 A convertible note motivates innovation and the adoption of a best practice strategy for start-ups, because it enables a start-up to raise capital early in order to speed up the start-up's development, but without excessive dilution that disincentives founders. A convertible note also strikes a good balance of risk sharing between investors and a start-up, as a discount conversion on a convertible note or an interest coupon, which is commonly provided to investors, rewards an investor for taking more risk by investing in the note before the start-up is ready for an equity raise. Finally, a convertible note incentivises a company and founders to grow to the level required for an equity funding round quickly, usually within 12 months, as a redemption event or penalty conversion will result otherwise. This means that start-ups must adopt a best practice strategy to grow, usually requiring them to employ a large development team and have a well-considered business model to ensure success.

3.4 We recognise there are integrity risks likely to be associated with making a convertible note an eligible investment under the Proposed Incentive. To limit this risk, the permitted interest coupon on an eligible convertible could be limited (or it could be zero if deemed essential, with the note not permitted to be debt in nature as in the ESVCLP regime), provided investors into a convertible note can benefit from a discount conversion upon close of the next funding round.

3.5 Repeat entrepreneurs and people with experience in the US market prefer to raise capital through a convertible note. By excluding this as an eligible investment, a key part of the innovation sector will be excluded from the benefits of the Proposed Incentive.

Limiting direct investment to a 30% maximum stake in a start-up is too low

3.6 Our experience has demonstrated that innovation companies often begin as "captive start-ups" that are controlled by founders, high net worth individuals, private or public companies or repeat entrepreneurs. It is common, for example, for founders who are repeat entrepreneurs or employees out of platform companies to self-fund a pre-seed or seed round, as illustrated above. This results in the founders holding a majority interest. It is also common for sophisticated technology sector investors and repeat entrepreneurs to identify key people to front a certain venture which they control. These start-ups should be encouraged by the Proposed Incentive in our opinion and not excluded. We do not consider that founders who self-fund a startup should be exempt from the Proposed Incentive provided their salaries are market or less than market rates.

The Proposed Incentive should be made available to all investors, not just to sophisticated investors

3.7 For the reasons explained above, we see significant use of family and friends money by start-ups at pre-seed and seed stage. These rounds take place by relying on the personal small scale offering exception to the requirement to prepare a prospectus (known as the "The 20/12 rule") contained in section 708(1) of the *Corporations Act 2001*. These types of rounds, with unsophisticated investors participating, should not be excluded from the Proposed Incentive. Start-ups will still be bound by their disclosure obligations and are well informed of them, in our experience. There is also an increasing sophistication of professional services firms working with start-ups, which makes prospectus requirements and qualifying for exemptions much easier for start-ups to understand.

3.8 Further, we do not consider that limiting the tax incentives to sophisticated investors will ensure that start-ups receive better commercial expertise from their investors. In our experience, the commercial expertise that is most important for an innovation company, is the experience that comes from repeat entrepreneurs who have developed a similar innovation company previously. Many sophisticated investors, who do not have past experience, do not provide this support any more than unsophisticated investors.

There should be some form of flow-through tax relief to investors who invest through a private company

3.9 On the basis that many investors will invest through a private company trustee, there should be some mechanism for the benefit of the tax offset or the capital gains tax relief to flow through to the shareholders. In order for this to occur, the tax offset can generate a imputation credit which can be passed through.

4. INDIRECT INVESTMENT VIA AN INNOVATION FUND

Innovation funds will be best structured as a unit trust with a corporate trustee:

4.1 We do not consider that an innovation fund should have to be a public company or should otherwise be regulated outside of existing financial services and disclosure regulation in Australia. We believe sufficient regulation already exists to safe guard investors in such a fund.

Further clarification is needed in respect of how CGT will apply in investment via an innovation fund

4.2 The legislation should indicate whether the capital gains discount will apply only to shares which the fund acquired after you invested in it, or whether it depends simply on how long the fund itself has held the shares. Additionally, further clarification is needed in respect of whether a sale of shares in the fund would itself attract CGT, as the CGT-free benefit would then pass to the new owner of the shares. On this basis, any anti-avoidance rules should not apply to trading in shares, even though the result might be that the new purchaser can benefit from the CGT-free status immediately upon acquisition.

The offset provided under the Proposed Incentive should be available on investment into the fund, not once the fund invests in an innovation company

4.3 We believe that everything should happen at the fund level. This would also suggest that if cash is returned by the fund (whether on a share buyback or otherwise), then the offset should be reversed at that time – i.e. tax would be payable of the same amount as the offset, or if the offset has not been claimed, it should simply be cancelled at that time. The other advantage of having the offset based on the original investment date is that it makes trading in offsets more difficult.

5. INTEGRITY MEASURES

Any exclusion of “affiliates” obtaining tax deductions should be considered carefully

5.1 This should not preclude representatives from an investor or fund who has invested in a start-up from sitting on the board of that start-up. The UK Seed Enterprise Investment Scheme and Enterprise Investment Scheme both have a “business angels” exemption to enable nominee directors. Such an exemption should be replicated in the Proposed Incentive.