



## This paper is provided in response to a Policy Discussion Paper dated February 2016 in relation to Tax Incentives for Early Stage Investors

As a retail backed Venture Capital Company, Fat Hen Ventures Ltd, is keen to see the best taxation models deployed in Australia for early stage investment.

We have spent a great deal of time evaluating various platforms and tax models for early stage investment around the world, plus we have been actively engaged in the proposed CSF regime and have responded to all Treasury feedback requests, the CAMAC paper and recommendation 18 from the Financial System Inquiry Final Report released 28th November 2014.

We trust this submission is helpful in your deliberations.

This paper is addressed to:  
Manager  
Individuals and Indirect Tax Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

And lodged online and emailed to : [startuptaxincentive@treasury.gov.au](mailto:startuptaxincentive@treasury.gov.au)

Signed on behalf of the board of Directors of **Fat Hen Ventures Ltd** as an authorised release dated 22 February 2016,

A handwritten signature in blue ink, appearing to read "Broun".

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Our comments are in relation to:

# Tax incentives for early stage investors

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Policy Discussion Paper – comments by

Fat Hen Ventures Ltd

22 February 2016

Question & answer summary

## Australian innovation company

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

We agree with the approach proposed to broadly define an innovation company. Principles provide flexibility which is required when talking about future innovation. We also agree that in the short term, to provide certainty to investors and innovation companies, a set of gateway criteria (safe harbours) will be set and made available. There will need to be efficiency and proactive handling of the final access point i.e. the determination by the ATO before the investment is made into an eligible innovation company (“EIC”), at the instigation of the company or a potential investor. From past experience where the ATO needs to issue an EIC certificate or ruling it can take some time for this to occur and can sometimes jeopardise the investment window.

### **We see Innovation as a significant positive change.**

Innovation is generally considered to be the result of a process that brings together various novel ideas in a way that they have an impact on society – innovation that creates a positive outcome should be supported and should be an agreed principle behind an innovation company. An invention or idea is not innovation by itself. The act of creating something, even if it may solve a perceived problem, should not be considered an innovation until it is adopted by a broad cross section or group of people. This can make it difficult then to back or provide tax concessions for “ideas” where they have not as yet been adopted by a particular market. Who can judge or predict which early stage ventures will have a significant positive change or not?

I might have an idea or proof of model to create a 100-barreled stacked projectile volley gun or a plastic gun to avoid aviation security measures but are these inventions that in principle should attract tax concessions for investors? We feel provided the principles enshrine Innovation as a significant positive change for society then that can provide the flexibility of what is an EIC or not without fear nor favour.

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

Our comments are in yellow alongside each suggested criteria:

- companies with a proportion of research and development claims to other expenses above a particular percentage threshold – the thing to be careful here about are those companies who “waste” money by R&D projects that never see the light of day and certainly do not end up being Innovation as a **significant positive change**. Whilst it is a possible guide it should only be used as a guide and not a tick in the box to being an EIC;
- companies that have completed or have been accepted into an approved accelerator programme (a regulatory process of registering approved accelerators may be considered to facilitate this test) – possibly but many accelerators are private funders looking to fund (say \$50k) across many projects with the majority using their \$50k and never gain any further funding or attention or benefit and fold / fail. We believe an eligible innovation company in this situation would be ONLY where they graduate from an approved accelerator AND attract sufficient funding to be able to commercialise the idea or process ;
- companies that have one or more existing third party financial investors that have previously subscribed for equity interests, subject to specific integrity rules – yes possibly but again WHERE is this companies on the run way and will they ever be able to deliver a significant positive change to the community? Pouring money into a black hole should not attract government funded tax concessions ;
- companies that have been supported through Commonwealth or State Government programmes such as the Accelerating Commercialisation element of the Entrepreneurs’ programme – yes BUT with the caveat that the AC manager MUST sign off a statement of opinion that the company has a defined pathway / ability to being able to deliver something capable of making a significant positive change
- companies that have, within the last three years, developed, acquired or licensed an idea that has been filed as a patent in multiple jurisdictions – possibly but just because they have filed a patent does not mean they are on the threshold of innovation – there must be something more than this – we suggest an expert needs to assess whether their patent application or patent has a clear pathway to commercialisation that is likely to lead to significant positive change as a result of this IP patenting – otherwise people will patent an idea that has no value simply to tick the box to government funded tax concessions

The common thread to the above is that there must be something more than a good idea, a patent, some initial funding etc – it has to clearly demonstrate a pathway that is likely to lead to a significant positive change in the short to mid term.

Also once a company is granted EIC status it must report on its progress and KPI’s to the ATO each year. They should also be audited.

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

To a degree but we are trying to provide benefits to investors to invest into innovation not start up ideas that have no commercial or community value.

Whilst no one has a crystal ball and there is an amount of subjectivity about an eligible innovation company, there does need to be rigour around the investment proposition and commercialisation outcomes that is reviewed by the ATO to ensure the principles of the tax concessions are met.

***Investors should not be encouraged or misled into investing into a company simply because they qualify for a tax concession while the underlying R&D project is flawed, commercially unfeasible or incapable of providing a significant beneficial change.***

- 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.

Refer our comments in 4.2 above – we believe the way the criteria is currently proposed, there is a large integrity risk associated with the criteria. There needs to be a number of tests – up to ten at least with a scoring system that means across all criteria they need to score (say) at least 60 out of 100 points to be an EIC.

**We would be happy to assist in developing such a scoring sheet and criteria.**

- 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?

A self assessment declaration could work however we do not see this is required as once the ATO confirms the applicant is an EIC, then any equity investment into that EIC will be eligible for the tax concession notwithstanding whether the investor is a Sophisticated Investor (“SI”) or not.

We would be happy from an administrative point of view to make an eligible qualifying investment into an EIC to attract the tax concession say \$1,000 but **we are strongly against depriving non-SI’s of the tax concession. It undermines everything about stimulating the economy and the innovation principles if only SI’s are eligible for the tax concession. It would stifle investment in the very heart of where it is required.**

Also even though a person may be a SI, the actual entity that invests into an EIC may not be the SI.

**There would be a major public outcry if non-SI’s were excluded from this regime.**

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?

As we noted at 4.2 above there are numerous accelerators around the country and some privately funded for different agendas where they “punt” on the field of horses knowing most will not succeed but they want the services work or other outcome – this is NOT a good basis to anoint for taxpayer funded tax concessions.

Many ideas or concepts that “win” backing by an accelerator are not commercial nor on an innovation pathway so we would see a ten point checklist with a scoring system compiled by an independent assessor – we have some ideas here that we could elaborate on if requested.

4.7 Are there any other investment activities should be excluded?

Getting back to our fundamental principle of Innovation as a significant positive change we would exclude:

- gambling
- illegal activities
- high polluters

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

**Yes**

### **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?

The SI test must be excluded – provided ATO prescribed a company as EIC then all subscribers (> \$1k) attract the tax concession – simple and effective

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

**N/A**

### **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?

We feel that provided the investor into a qualifying innovation fund (“QIF”) makes the contribution to the QIF and the QIF invests into the EIC all within the same tax year then the investor gains the offset. This will make it easier for the investor and the QIF.

Also we believe there should be a three year period of grace for QIF's to build a portfolio such that it has no more than 10 per cent of its committed capital, based on total committed capital at fund close, in any single innovation company at any time during the income year.

Perhaps a phase in i.e. no more than 50% year one / 25% year two and 10% by end of year three. That would seem to make sense and not jeopardise investors if the QIF takes some time to arrive at the portfolio spread.

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

**Public unlisted company**

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

**NO – such notion undermines the whole fabric of spreading the risk across a wider audience base**

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

**Public unlisted companies**

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

**An AFSL or Auth Rep of AFSL**

- 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?

**Not really – no LP's or listed companies**

**Min Capital \$5m**

**No min holding period**

## **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?

There are various measures between the government, ATO & ASIC that can be applied to ensuring the integrity of the tax system is maintained. We have seen tax incentives in particular sectors work and some that have not. It gets back to proper evaluation first as to prescribing what is an EIC and then there needs to be strict reporting regimes by the EIC and QIF on a no tolerance basis.

It is very distressing clawing back a tax break from innocent investors who may have been misled by an EIC. Diligence, proper evaluation upfront and comprehensive periodic reporting is paramount. EIC directors may need to put a bond or personal guarantee in place in some instances to underline the importance of adhering to proper process.

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?

Refer the above – just because an applicant may “tick the boxes” for an EIC does not they get EIC status – the directors of the EIC (background and integrity is vital) as is any promoters or related parties who have a dubious background etc. Most of the failed schemes are because of “dodgy” directors or advisers or promoters OR a fundamentally flawed project, idea, patent etc.

There needs to be absolute vigilance in the approval process – many may not gain EIC status and that sends a good signal to the capital markets.

Also there needs to be clarification around convertible debt instruments and conv pref shares etc converting to common stock – when is the “newly issued shares” effective from – the company may have received the cash via a C Note two years ago and then convert into “newly issued shares” – is it the time they convert like this OR the timing of the cash receipt by the EIC?

These types of questions and instruments need to be further considered. We would be happy to assist you in this regard.

Please contact us should you require anything further

Yours sincerely,



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