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Your reference: Tax incentives for early stage investors

24 February 2016

Dear Sir/Madam

SUBMISSION ON TAX INCENTIVES FOR EARLY STAGE INVESTORS - POLICY DISCUSSION PAPER DATED FEBRUARY 2016

Fintech Australia Incorporated (**Fintech Australia**) provides this submission to support the policy development work of the Australian government following the release of the above noted policy discussion paper.

Fintech Australia is an association formed in 2015 by leading Australian fintech and financial services companies seeking to advance Australia as a world class location for the establishment and development of fast growth fintech companies.

Fintech comprises new solutions which demonstrate disruptive innovation by way of development of applications, processes, products or business models in the financial services industry. Fintech includes payments, peer-to-peer models, crowd-funding, automated advice, capital markets and crypto-currency technologies, as well as businesses seeking to do banking, investment management, superannuation and other financial services in new ways that make incremental or radical differences to traditional financial services models.

Internationally, fintech is rapidly growing in terms of new technologies being developed, startups participating in fintech and dollars being invested. It is potentially the fastest growing sector of the startup ecosystem in the United States. Annual investment in fintech internationally was estimated last year to be $14 billion, which has increased by 3 times since 2010.[1]

The membership of Fintech Australia is set out in the Schedule to this submission and includes more than 30 Australian fintech and financial services companies. The members understand first hand the challenges involved with building, or investing into, an Australian early stage company and the competition Australia is facing from other technology centres in Europe, Asia and North America in attracting the best fast growth companies to set up and remain located here.

FINTECH AS A PRIORITY

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[1] Webinar, Disruption in Financial Services, lead by CB Insights CEO, Anand Sanwal, Q2 2015 and available at https://www.cbinsights.com/fintech-trends-overview

This submission is focused on the following key point. If Australia is to take advantage of the opportunities available to it from advances in technology, it must offer innovation support that is on par with that available in other key technology centres globally, and the support must align with the key strengths of Australia as a place to do business and innovation.

In particular, the financial services sector, stable economy, sophisticated regulatory environment and proximity to Asia are key strengths which innovation policy must support and those key strengths support fintech as a key focus for Australian innovation policy.

As such, and having regard to the level of innovation and investment occurring in fintech internationally, Fintech Australia is emphatically of the view that the legislation to provide tax incentives for early stage investors must be differentiated from models implemented overseas to promote fintech as a priority focus for Australian innovation and Australia as the world's best location to start a fintech company.

AUSTRALIAN INNOVATION COMPANY

The definition of an innovation company should be as broad as possible into order to promote innovation in all industries, and advancement of new ways of doing business by early stage companies whether it is incremental or radical. Australia should be ambitious in this respect and in particular we note that the startup ecosystem internationally has changed significantly since the United Kingdom first introduced its Seed Enterprise Investment Scheme in 2012.

We also note that Singapore is a closer competitor to Australia who we see selected as a head company location over Australia for startups more than any other jurisdiction. This is particularly so for startups founded by repeat entrepreneurs which are regularly located in Singapore to benefit from government tax incentives, the proximity to Asia and the capital gains tax treatment available if founders eventually migrate from Australia. As such, we see good reason for Australia to differentiate itself from the UK and compare its support for startups with Singapore.

In particular, the definition of an innovation company should encompass all current and emerging aspects of fintech and, more broadly, any advancement of business processes, technology and business models in the financial services industry in our opinion.

We also consider that two groups of startups should be a key priority for the tax incentive. Firstly, startups at seed stage who have built and trialled a minimum viable product (MVP) with some good metric success (which could include revenue). These startups do not need to be repeat entrepreneurs or well advised, with the proof of their innovation demonstrated in the key metrics they have satisfied. Secondly, we consider startups founded by repeat entrepreneurs or individuals who have worked with successful platform companies previously, who are at pre-seed stage with a well-considered business model, should be the target of the tax incentives. These founders are able to capital raise prior to building a MVP because of their past experience and so should be incentivised to capital raise in Australia as much as possible. The value raised by the second category of entrepreneur will be substantially larger on average.

Accordingly, we consider that:

- The $200,000 assessable income limit to determine eligibility is too low, particularly for fintech startups who have built their MVP and proved key metrics. This income will commonly be exceeded by fintech startups prior to a seed round in order to prove a platform works and to establish key metrics for marketing to experienced technology investors. Unless the founders are of a good "pedigree", experienced technology investors will not want to invest in a fintech startup that has below $1,000,000 in annual revenue as a general rule in our experience. For fintech startups that are formed by repeat entrepreneurs, they are likely to not capital raise until they have some revenue with that amount likely to be in excess of $200,000 in our experience. A $200,000 limit therefore risks the tax incentive stimulating investment by people who do not know tech into companies with an unsophisticated business model and approach to capital raising. 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 should be more in line with the Enterprise Investment Scheme (30% tax offset) which has a limit of £15 million in gross assets.

- The limit on $1 million expenditure is unrealistic, especially in the context of highly regulated areas such as fintech. Fintechs are large, robust organisations that require a significant investment prior to launch. We would suggest a cap on the gross assets of the company, at a level closer to the UK Enterprise Investment Scheme. If we are to use expenditure as a threshhold, from a straw poll of members, our view is that $5-10 million expenditure is a more accurate guide as to what should be an eligible early stage technology company.

- Where an innovation company is involved in a highly regulated area, for example fintech, it is not uncommon for that start-up to be merely navigating regulatory requirements for more than 2 income years. We have seen many truly innovative companies launch their product years after the initial company was incorporated. Such companies would miss out on being eligible for the incentive. We suggest that Innovation Australia or the ATO department determining eligibility should be able to administer extensions on 3 years post-incorporation limit for eligibility with 5 years appropriate in many instances in our opinion.

- 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. This is important in fintech as a lot of innovation is about innovative ways of delivering old products, like insurance and mortgages for example. Further, 'innovative' should not become some form of novelty test, as in many areas there are multiple startups that are executing on the same 'innovative' model. It should not be the case that only the first of these receive the tax concession, since creating a successful startup is as much if not more about execution than novelty. For example, SEEK was not the first of its kind in Australia, and accordingly would not have been eligible for the concession if it were based on a novelty test. We belive ventures like SEEK, Carsales and REA represent useful touchstones against which to test these principles since they have been some of the biggest value and job creators in Australia over the last decade or so.

- The principles based approach to defining an innovation company should not require a startup to focus on a market outside of Australia. Again, many past successes in the Australian market have focussed locally initially, particularly with network effects businesses like Seek and REA Group. Further there is appetite for institutional investors and repeat entrepreneurs to focus on businesses wanting to dominate the Australian market at an early stage, particularly in fintech due to the regulatory complexity – eg SocietyOne. Accordingly, a local focus must not be discounted in any innovation policy.

- It will be difficult to ascertain whether a startup has the capability to commercialise or bring to market and generate value from an idea, and to substantiate if a startup 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. This is particular so for fintech, which is incredibly competitive and difficult to innovate often for many years by a startup, until it finds its niche. We consider that the market (i.e. investors) should be able to dictate whether a startup satisfies these criteria and so the innovation company definition should be silent on these aspects.

- The gateways and safe harbours should expressly contemplate a company focused on fintech as an innovation company. Any startup which demonstrates innovation by way of development of applications, processes, products or business models in the financial services industry, including in banking, investment management and superannuation, should be an innovation company.

- A startup advancing new technology for payments, peer-to-peer lending, crowd-funding, automated advice, capital markets and crypto-currency technologies should be expressly listed as an innovation company.

- Banking, insurance, money-lending, debt-factoring, hire-purchase financing or other financial activities should not be expressly excluded, as a company in these areas should qualify for the incentive if it otherwise satisfies the innovation company principle based definition. We recognise the integrity risk that this presents, and suggest that for startups in such sectors, provided at least 60% 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 startup should be eligible. Any new business that launches in these areas is launching into an industry of intense competition in Australia and must innovate to succeed. Provided a startup is innovative and is allocating funds to innovation processes, it should not be excluded because it is operating in financial services. Indeed, innovation in financial services should be fostered as a key focus for Australia given our strengths in the space, making the express exclusion more important to remove from eventual legislation.

- Providing legal or accounting services, or the provision of services or facilities for another business, should similarly not be expressly excluded as an innovation company provided at least a minimum threshold of funds raised are utilised to develop technology. Innovation in these areas is essential to ensure new modes of operation of professional services to support the Australian startup ecosystem.

- Additionally, commodities or futures in shares, securities or other financial instruments should not be excluded as this would exclude further innovation in the blockchain/Bitcoin/distributed ledger space. Similar to our suggestions for banking services and legal and accounting services, in the two dot points above, provided at least 60% of funds raised are utilised for technology development, such activities should not be excluded.

- Investors should not be required to self assess, as this will result in divergent positions on the same investment and be difficult for unsophisticated investors to assess (and for reasons indicated below we believe it is important to extend eligibility to unsophisticated investors). Investors in small rounds are also not typically advised by lawyers, whereas a startup is increasingly advised by a lawyer in Australia on an early stage round. There should be an easy framework for a startup to assess eligibility and for it to warrant such to investors.

DIRECT INVESTMENT INTO AN INNOVATION COMPANY

We commend the government in not excluding an investment into preference shares, as was done in the UK Seed Enterprise Investment Scheme. Preference shares are largely the mode of investment by experience technology sector investors into early stage companies and they promote a fair risk balance between founders and investors, which should be encouraged.

In addition to preference shares, however, it is important in our experience for a convertible note to qualify as a direct investment for the tax offset. It is common practice to invest at pre-seed, seed and seed-AA stage into startups through a convertible note in the US and increasingly in Australia.

We have received feedback that this is a key shortfall of the UK Seed Enterprise Investment Scheme.

A convertible note motivates innovation and the adoption of a best practice strategy for startups, because it enables a startup to raise capital early in order to speed up the startup's development, but without excessive dilution that disincentives founders. A convertible note also strikes a good balance of risk sharing between investors and a startup, 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 startup 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 startups must adopt a best practice strategy to grow and this usually means they need to employ a large development team and have a well-considered business model to ensure success within the timelines set by the convertible note.

We recognise there are a integrity risks likely to be associated with making a convertible note an eligible investment. To limit this risk, the permitted interest coupon on an eligible convertible could be limited (or it could be zero if deemed necessary, 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.

Repeat entrepreneurs and people with experience in technology investing and investing in the US market are particularly focused on raising capital with a convertible note, so by excluding this as an investment that attracts the offset, a key part of the innovation sector will be excluded from the benefits of the offset. Such exclusion would risk the tax incentive promoting the wrong type of investment which is counterproductive.

We also believe that limiting direct investment to a 30% maximum stake in a startup is too low. In particular, "captive startups" which are controlled by high net worth individuals with technology sector experience, private or public companies or repeat entrepreneurs, are a common form of innovation in fintech. It is common for example for repeat entrepreneurs out of key platform companies to seed captive startups in our experience where they hold a majority interest at seed stage and issue equity to two or three key co-founders. These startups are often the most successful in our experience, because the lead investor has being an entrepreneur before and has the network, knowledge and domain experience to make a startup work quickly. Removing such startups from participation for the offset will see capital flow away from such innovation, which would be counterproductive. This once again risks the tax incentive promoting the wrong type of investment.

Finally, we consider that the tax incentives should be made available to all and not just to sophisticated investors. We see significant use of family and friends rounds by startups at pre-seed and seed stage. These rounds take place by relying on the 20 and 12 small scale personal offer exemption to the requirement to prepare a prospectus, as provided in the Corporations Act. We don't see why these types of rounds, with unsophisticated investors participating, should be excluded from the offset. Startups will still be bound by their disclosure obligations and they are well informed of them in our experience. There is also an increasing sophistication of professional services firms working with startups, which makes prospectus requirements and qualifying for exemptions much easier for startups to understand.

In further support of this, we do not consider that limiting the tax incentives to sophisticated investors will mean that startups receive better commercial expertise from their investors. In our experience, the commercial expertise that is most important for a fintech company, and for any fast growth tech company, is the experience that comes from repeat entrepreneurs who have developed a fast growth tech company previously, or from investors who are experienced at investing in technology companies. Many sophisticated investors (as that term is defined in the Corporations

Act), who do not have past fast growth tech experience, do not provide this support any more than unsophisticated investors, and indeed can be a hindrance to innovation, particularly where they bring corporate, private equity or other investment principles and experience to influence how they control and oversee their investment. In contrast, family and friends rounds often back entrepreneurs, like a venture capital fund does, and do not look for control and oversight like is expected to satisfy corporate and private equity investment principles.

Finally, one of Australia's greatest strengths in startups, including in fintech, in our experience is our ability to see the world differently to Silicon Valley and other key tech sectors globally. Extending the tax incentives to all investors and enabling a broader set of persons who, subject to disclosure obligations that already exist, can participate in backing key people and innovation, will best position Australia to capitalise on this strength.

INDIRECT INVESTMENT VIA AN INNOVATION FUND

We expect that an innovation fund will be best structured as a unit trust with a corporate trustee. Other than for integrity reasons, we don't 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 these funds.

In particular, we expect that innovation funds focused on fintech have the ability to create a key differentiator for Australia as a destination to launch fintech startups.

INTEGRITY MEASURES

On the suggested integrity measures, we make the following comments:

- In our experience, it would be preferable for Innovation Australia to do the determinations as to whether a company qualifies as an innovation company or direct investment, rather than the tax office, given the adjudication should largely involve a technical analysis and Innovation Australia have been working in the innovation sphere (ie on ESVCLPs) for some years.

- Any exclusion of "affiliates" obtaining tax deductions should be considered carefully. This should not preclude representatives from an investor or fund who has invested in a startup from sitting on the board of the startup. The UK Seed Enterprise Investment Scheme has a "business angels" exemption to enable nominee directors which should be replicated in Australia.

- We are conscious that investment activity is already slowing at seed-AA and seed stage in the Australian market, with investors wanting to participate in the tax incentives and therefore not invest pre 1 July 2016. We recommend transitional measures be introduced so that investments from 1 January 2016 are eligible for the incentive (and that this be announced as soon as possible).

Importantly, the members of Fintech Australia themselves will mostly not benefit directly from the early stage investment support to be legislated, as they are predominantly at a later stage of development than where the tax incentives are targeted. We will benefit as investors and key supporters of startups in fintech in Australia. We will also benefit like all other Australians in the financial services we receive every day being more innovative, less expensive and more efficient, which in fintech in particular will, if innovation is promoted effectively, serve to reinforce Australia's leading global footprint in financial services.

We would be delighted to consult further with you if that will assist. Please contact Simon Cant on 0412 483 621 or at simon@reinventure.com.au to discuss any aspect of this submission further.

Yours sincerely

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SCHEDULE

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