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Attention: Jodie Wearne/Phil Akroyd

Dear Sir/Madam

Submission

Tax incentives for early stage investors

We understand that you are the Contact Officers for the Treasury – Individuals and Indirect Tax Division, in relation to the discussion paper on tax incentives for early stage investors (**Discussion Paper**).

We enclose our submission on the Discussion Paper. Please note that our comments focus on the taxation aspects of the discussion paper and how we believe those should be aligned with the intended policy outcomes behind the proposed measures. The economic and commercial issues raised by the Discussion Paper, including those concerned with who should be able to benefit from the measures and what restrictions should apply to the actual investments, will no doubt be covered in other submissions you will receive.

We would welcome an opportunity to discuss the contents of our submission with you in due course.

Yours faithfully

Arnold Bloch Leibler

Clint Harding

Partner

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Arnold Bloch Leibler

Lawyers and Advisers

SUBMISSION TO TREASURY

TAX INCENTIVES FOR EARLY STAGE INVESTORS

MELBOURNE
SYDNEY

1 Introduction

1.1 Thank you for the opportunity to comment on the discussion paper entitled "tax incentives for early stage investors" (**Discussion Paper**).

1.2 Arnold Bloch Leibler provides strategic and commercial advice nationally to a range of leading Australian corporations, high-net worth individuals, large family businesses, international corporations and Australian and international funds. Many of our clients are entrepreneurs and are involved in start-up ventures across numerous industries, including biotechnology, information technology, medical devices, science, retail and property. We also act for a range of investors who provide debt funding and capital to a range of start-up and innovative companies in Australia.

1.3 The proposed new tax incentives for early stage investors (**TIESI**) regime to encourage innovation and growth is of significant importance and concern to Arnold Bloch Leibler and its clients.

2 Overview

2.1 Whilst we have given very careful consideration to all of the issues and questions outlined in the Discussion Paper, the submission will only deal with certain taxation-related aspects of the terms of reference, issues and questions.

2.2 There is no doubting that continued government support is paramount to increasing innovation in the Australian economy. The Government's initiative to institute a scheme similar to that of the United Kingdom's (**UK**) Seed Enterprise Investment Scheme (**SEIS**) is therefore very welcoming. Continued support of this nature will assist in freeing up some of Australia's abundant capital resources and in turn this will allow innovative, high-growth companies to be established and grown

here rather than looking immediately to overseas for funding. The flow-on effects of this would be substantial, and multi-layered:

(a) increased funding would attract more entrepreneurial talent, both local and international;

(b) faster growing companies lead to rapid large-scale job creation and economic growth; and

(c) an increase in seed-stage investment and investors would grow and diversify our pool of angel investors, leading to a more experienced, sophisticated cohort which would in turn lead to a proliferation of experienced mentors for start-ups.

2.3 Angel investors are pivotal to the success of many start-ups. Before considering access to venture capital, it is important to discuss the availability of angel investment, since many start-ups need to raise an initial "angel" round before they are ready to raise venture capital. Australia needs a healthy angel sector if companies are going to progress to a point where they can go to market and raise venture capital funding.

2.4 Accordingly, we strongly support incentivising investment in innovative companies that will enhance the growth and international competitiveness of Australia's start-up company sector.

2.5 Notwithstanding this, some of the proposed measures set out in the Discussion Paper seem inconsistent with the stated policy objective:[1]

> *The tax incentives are designed to encourage investment into Australian innovation companies (innovation companies) at earlier stages, where a concept has been developed, but the company may have difficultly accessing equity finance to assist with commercialisation.*

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[1] Discussion Paper, Pt 1.

2.6 Therefore, we make the following recommendations:

(a) Capital losses should continue to be available in respect of qualifying investments as part of these tax incentives.

(b) Shares issued as part of these tax incentives should receive deemed capital account status from the date of issue, or alternatively, an equivalent exemption should be made available for shares held on revenue account or as trading stock.

(c) An "innovation company" or "innovation fund" should not be limited to a company structure.

(d) The tax treatment of indirect investments should be clarified to ensure it is aligned accurately to the treatment of direct investments.

(e) The test time for qualification as an 'innovation company' (and therefore eligibility for the tax concessions) should be at the time of investment only.

(f) Additional incentives for non-residents should be considered because the proposed regime effectively offers no incentive for non-residents to invest in Australian innovation companies.

2.7 Each of these recommendations is explored in further detail below.

3 Availability of capital losses

3.1 It is of particular note that capital losses will be unavailable for shares issued as part of these tax incentives for early stage investors. Instead, immediate tax offsets will be available to investors subject to the income year offset cap. It is our view that the availability of a non-refundable offset and a Capital Gains Tax (**CGT**) exemption will together not be sufficient to attract the desired level of investment unless capital losses are also allowed to be claimed.

3.2 Generally speaking, a start-up will have two important defining characteristics:

(a) the potential for high growth – professional investors recognise the high risk of failure in start-ups and therefore will only invest in opportunities capable of generating high returns to compensate for this risk; and

(b) disruptive innovation – start-ups are reshaping the way entire industries work by displacing established competitors through the use of technology and business model innovation.

3.3 In defining an innovation company under the principle based approach, the Discussion Paper correctly identifies the above two features as forming core components of this definition. In the context of capital losses however, it is relevant to note the former characteristic, being the potential for high growth and the equal potential for failure.

3.4 As already stated, professional investors recognise the high risk of failure in start-ups. Indeed, the Discussion Paper itself states that "*investment in innovation companies is inherently risky. Many investments will lose money, while others have the potential to make large gains.*"

3.5 The reality is, that a certain number of these innovation companies will fail. Some may say that a majority of innovation companies will fail. If the company (and the investment) fails, it is necessary that the investor in the failed start-up is able to offset those losses against other gains made. The inability to claim capital losses in respect of such speculative investments will therefore likely be viewed as a penalty and present itself as a potential disincentive to invest in these companies.

3.6 For example, if I invest $1,000,000 into an innovation company under the proposed rules (assuming all of the necessary criteria are met) and that company fails, I will have had the benefit of a $200,000 offset, however the "cost" to not being able to claim a loss in respect of my investment will currently be $490,000. The question becomes am I prepared to forgo my capital loss with respect to this speculative investment, notwithstanding I will have an offset and the potential for any capital gain to be exempt from further tax?

3.7 Under the UK SEIS, the ability to claim losses was contemplated. We understand that if the chosen investment fails, the government offers loss relief which can be offset against tax on other income. The loss relief is offset at the level of the individual's highest income tax rate. The amount invested (minus 50% to take into account the income tax relief) is multiplied by the tax rate to work out the amount that can be claimed.

3.8 **In light of the above, we recommend that capital losses incurred by early stage investors remain available for use or, at the very least, are available in respect of investments disposed of, or that otherwise come to an end, within the first three years of acquisition. This latter solution is on the basis that the CGT exemption is not otherwise available within the first three years of holding the investment. An adjustment to the reduced cost base of the investment should be made to account for the non-refundable offset claimed by the investor to ensure that the investor is not obtaining a dual benefit.**

3.9 **In the alternative, we recommend that the regime is voluntary and that taxpayers can either choose to "opt in" or apply the income tax rules in their present form. The way in which a taxpayer prepares their return can itself be evidence of the choice to participate in the regime. That is, to the extent a taxpayer claims the benefit of the 20% non-refundable tax offset in the year in which the investment is made, then this will be evidence that a choice was made by that taxpayer to participate in the regime and therefore acceptance that they will not be able to claim any capital losses.**

4 Deemed capital account

4.1 We understand that investments in innovation companies will be deemed to be on capital account after 10 years. However, it is not clear from the Discussion Paper whether investments held for a period of less than 10 years will also be on capital account or whether the ordinary tax rules will apply.

4.2 In our experience, sophisticated angel investors may hold their interest on revenue account because:

(a) such investors will generally invest in companies with a view to making a profit in the short to medium term (from the disposal of the shares in the company); and

(b) start-up companies do not generally pay dividends due to insufficient profits and cash flows.

4.3 In such circumstances any gain on the disposal of the investment will be taxed as ordinary income and not as a capital gain.

4.4 This uncertainty as to whether such investments will be on revenue or capital account was especially noted early on in the introduction of the Venture Capital Limited Partnership (**VCLP**) regime and became a particular concern following the Australian Taxation Office's (**ATO's**) view in *Taxation Determination 2010/21* stating that the type of investments commonly made by a private equity fund may be taxed on revenue account.

4.5 Therefore, any proposed CGT exemption is unlikely to incentivise these investors unless they are guaranteed capital treatment. The proposed rules should remove this uncertainty for investors by clarifying that gains from investments through these vehicles would be classified on capital account for all eligible domestic and foreign investors from the date of acquisition. At present there appears to be the potential for an anomalous result to arise where an investor who holds their shares on revenue account sells their interest in year 9 and receives no revenue exemption yet had they disposed of it in year 11 it would have been

treated as being on capital account and therefore arguably received a CGT exemption due to the investor receiving an uplift in the cost base equal to the market value calculated on the tenth anniversary of the date of acquisition.

4.6 A consistent and clearly defined TIESI tax regime will give investors the certainty they require to commit private capital towards private Australian businesses. Such investment will support the broader innovation agenda by encouraging private domestic investors to invest in unlisted Australian start-ups with high growth potential. In addition, there are potential cost savings to the ATO who is responsible for monitoring compliance.

4.7 **We recommend that investments in innovation companies and in innovation funds should be deemed to be on capital account from the date of acquisition.**

4.8 **In the alternative, where such a deeming provision is not provided for, an equivalent revenue exemption should be made available.**

5 Structure of 'innovation funds' and 'innovation companies'

5.1 At present, the Discussion Paper does not provide for innovation funds or innovation companies to be constituted as anything other than a company.

5.2 In our view, this is too restrictive and does not adequately reflect the range of flow-through structures that would commonly be used by such start-ups or for funds investing in such start-ups. A trust or limited partnership may in certain circumstances be a more suitable vehicle.

5.3 **We recommend expanding the type of vehicles that can qualify as innovation funds or companies.**

6 Innovation company test time and consequences of ceasing to satisfy definition

6.1 It is not presently clear the point in time at which the test for qualifying as an innovation company will be applied. That is, is it a "point in time" test or a continuity period test?

6.2 By way of example, if an investment is made in a qualifying innovation company which subsequently lists on the Australian Stock Exchange (**ASX**) in year four, are the concessions still available? Or will only the non-refundable offset be available (and not clawed back) and any capital gain derived by the investor be assessable as it will relate to the disposal of shares in a company that no longer satisfies the definition of a qualifying innovation company? What will the implications be for investors in such circumstances? What if a company ceases to qualify and then subsequently requalifies (for example, under the net income thresholds)?

6.3 A lack of clarity around these issues will create significant uncertainty at the time an investment is made.

6.4 **We recommend ensuring that the time at which the test should take place, and therefore when the concessions should be made available to the relevant investor, is from the date of acquisition only.**

7 Investments held through innovation funds

7.1 The Discussion Paper provides for a CGT exemption in respect of shares held in an innovation company by either an investor or a qualifying innovation fund as long as those shares are held for a minimum of three years. There appears to be uncertainty however as to whether investments held in an innovation fund by an investor will themselves be afforded an equivalent CGT exemption.

7.2 It is also unclear whether the CGT exemption obtained by the innovation fund on the disposal of its interest in an innovation company will retain its character as an exempt capital gain when it flows through

to the investor. Whilst we appreciate that the Discussion Paper provides for an intention that a qualifying innovation fund be treated as a flow through vehicle, requiring the fund to be a company would seem to restrict a fund to a limited number of corporate vehicles, such as a listed investment company. Even then, subdivision 115-D of the *Income Tax Assessment Act 1997* broadly speaking only allows shareholders of certain listed investment companies to obtain benefits similar to those conferred by discount capital gains. It does not allow for complete flow through treatment.

7.3 If such flow through treatment is not provided for and the innovation fund is structured as a company, then any distribution of profits to the investors will need to be in the form of a dividend. On the basis that these innovation funds are unlikely to be deriving any assessable income other than exempt capital gains, the fund will have insufficient franking credits with which to pay a franked dividend to its investors. The outcome of which will be that the relevant investor will receive an unfranked dividend and be subject to tax at the investor's highest marginal tax rate where the investor is an Australian resident taxpayer or at a withholding tax rate of 30% where the investor is a non-resident taxpayer of Australia (this rate may be lower depending on any applicable double tax treaty).

7.4 In the example provided above, there would clearly be no benefit to the investor where it invests indirectly through an innovation fund and they would seem to be at a disadvantage when compared to making an investment directly.

7.5 Addressing the above uncertainties will help remove a significant roadblock to the start-up industry in its efforts to raise capital from the private sector.

7.6 **We recommend ensuring that a wider range of structural alternatives are provided for, deemed flow through treatment to investors for any exempt gain is allowed, and that an equivalent CGT exemption is provided to investors holding their interest indirectly through an innovation fund.**

8 Incentives for non-residents

8.1 The TIESI regime is designed to be open to investment from both resident and non-resident investors. However, it can be readily observed that the scheme effectively offers no further incentive for non-residents because:

(a) unless non-residents derive other Australian sourced income they will not be able to benefit from a non-refundable tax offset; and

(b) unless the investment constitutes taxable Australian property, which is unlikely because the rules explicitly exclude dealings in land, non-residents are unlikely to be liable to CGT on the realisation of their investments.

8.2 Australia is a net importer of capital, and is reliant on offshore investment to help support the growth and expansion of our businesses, as well as the development of our domestic infrastructure capacity. Like many other sectors of the domestic economy, Australia's early stage start-up industry is reliant on both domestic and overseas investment to provide the capital needed to support the ever growing number of companies backed by the industry.

8.3 Part of the solution to addressing this unmet need in the market lies with the capacity of the tax system to deliver a simple and cohesive framework for investors. Whilst we welcome the fact that the proposed tax incentives will be open to non-residents, for the reasons discussed above, many will be unable to take advantage of them.

8.4 Accordingly, further thought should be given to the type of incentives that may be available to non-residents to ensure that foreign capital can be easily attracted.

8.5 By way of example, on 1 July 2015 a new complying investment framework for the Significant Investor Visa and Premium Investor Visa (PIV) program came into effect. The SIV complying investment framework has a specific focus on private equity investment in

emerging companies, VCLPs and ESVCLPs. In particular, it is now a mandatory requirement that all SIV applicants invest at least $500,000 in an AusIndustry registered ESVCLP or VCLP.

8.6 **We recommend considering further ways in which non-resident investors may be encouraged to participate in the new regime.**