Australian Private Equity &
Venture Capital Association Limited

24 February 2016

Ms Jodie Wearne
Individuals and Indirect Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: startuptaxincentive@treasury.gov.au

Dear Ms Wearne,

Tax incentives for early stage investment

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to respond to the Government's Discussion Paper on *Tax Incentives for Early Stage Investment* (the Discussion Paper).

AVCAL is the national association that represents the Private Equity (PE) and Venture Capital (VC) industry in Australia, which manages over $28 billion in funds on behalf of domestic and offshore investors. These funds supply capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies.

The National Innovation and Science Agenda (NISA) announced last December introduced tax incentives to help encourage high net worth investors commit more capital directly into the early commercialisation stages of the startup lifecycle. It is our understanding that this policy is intended to complement concurrent reforms to Early Stage Venture Capital Limited Partnerships (ESVCLPs) and Venture Capital Limited Partnerships (VCLPs), to address current gaps across the funding spectrum for innovative businesses.

It is therefore important that the tax incentives for early stage investment are designed to facilitate end-to-end funding for innovative startups in a seamless way, and that they do not give rise to either new funding gaps or inconsistent tax treatment for similar investments through different programmes.

These reforms are widely viewed as being important to the progression of Australia's innovation system which is critically important to the economy. We appreciate the opportunity to continue to work closely with the Government to ensure that any issues arising are identified early, and resolved in a timely way, in order to ensure that the policy objective are achieved.

AVCAL's responses to the questions posed in the Discussion Paper and our recommendations are provided in the attached submission. If you would like to discuss any aspect of this submission further, please do not hesitate to contact me on (02) 8243 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive

<u>AVCAL SUBMISSION</u>

DISCUSSION QUESTIONS

I. AUSTRALIAN INNOVATION COMPANY

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

The proposed criteria for an eligible innovation company, as set out in the Discussion Paper, requires incorporation in the last three income years, assessable income of $200,000 or less and expenditure of $1m or less in the prior income year, and unlisted status.

AVCAL is of the view that these thresholds will, in practice, prove to be extremely limiting as many startups will fail in at least one, if not all, of these criteria at the time of initial investment.

The three-year incorporation rule is particularly limiting, for the following reasons:

- These criteria will exclude most investable startups in capital-intensive, long life cycle industries such as renewable energy, advanced manufacturing, biotechnology and agritech. Angel investors form an important part of the early stage funding pool for these companies, and provide much-needed patient capital as these businesses transition through the necessary milestones before they can access further later stage funding. For example, a life sciences company usually remains "early stage" (i.e. pre-revenue to early stage clinical trials) for much longer than 3 years, as it needs to go through a structured regulatory drug development process over a period of many years in order to demonstrate safety and efficacy of use in humans. As a result, the proposed criteria will automatically exclude early stage investors in the majority of life sciences startups from this important tax incentive.
- Many startups that have pivoted from their original strategy will not be eligible innovation companies as a result of this rule alone.
- It is also possible that this rule may be circumvented, for instance where a young company that has slightly exceeded the 3-year limit may simply restructure as a new startup.

In our view, the financial tests are also too restrictive, and do not adequately reflect: (i) the wide range of financial metrics that different startups may exhibit; and (ii) the investment opportunities that angel and high-net-worth investors look for. Many startups will have assessable income of over $200,000 p.a. but still be in the very early stages of refining and developing their core product or service, and far from ready for VC funding.

In practice, many startups in angel portfolios do not currently meet these financial criteria. For example, Brisbane Angels invested in Hatchtech in the early stages when the company was pre-revenue but well exceeding the other quantitative criteria set out in the Discussion Paper. The company subsequently went on to complete two pivotal Phase 3 clinical studies, and in late 2015 signed a major commercialisation agreement with a global pharmaceutical company for $279m in what is to date one of the most successful deals for the company's Australian VC backers and other early stage investors.

In summary, the narrowness of the proposed criteria raise several critical issues of concern:

- The overarching concern is that the imposition of these thresholds may result in outcomes that deviate from the intended policy objectives, and frustrate current policy attempts to promote more effective commercialisation of research.
- Many, if not most, startups in key segments of the innovation economy such as renewable energy, advanced manufacturing, biotechnology and agritech will likely be ineligible investments. This exclusion will particularly affect the very areas where the Government is seeking to promote: (i) greater access to patient capital by private investors; and (ii) better collaboration between the research and business sectors.

- The proposed criteria may incentivise a large proportion of new capital to be concentrated in areas that are currently not facing a lack of funding capacity.
- It is also important that the thresholds do not give rise to a new funding gap as startups transition from angel to VC funding (or, in lifecycle terms, from seed to Series A funding). If the thresholds are set too low, as at the levels proposed in the Discussion Paper, there is a policy risk of causing another "Valley of Death" once the funded startups hit the prescribed thresholds (which in many cases are still too early stage for VCs to invest in).

AVCAL recommends that, to promote consistency and avoid additional red tape, the criteria for an "innovation company" should be drawn from tests and definitions already used in existing legislation.

The core criteria to limit eligibility to smaller emerging business should be drawn from existing tests of business size. These may include:

- The asset-based test found in the Early Stage Venture Capital Limited Partnership (ESVCLP) rules where eligible investments must have total assets of no more than $50m, based on the most recent financial statements at the time of the investment; or
- The *Tax Laws Amendment (Research and Development) Act 2011* which allows for a company to claim the 45% refundable R&D tax offset if the company's aggregated turnover for the income year is less than $20m (Div 355-1); or
- The criteria for a "startup company" to be eligible to use the Employee Share Schemes tax concessions for startups in section 83A-33 of the *Income Tax Assessment Act 1997* could be used. These include requiring the startup to meet a turnover test of $50m in the prior income year, have unlisted status, be incorporated for less than 10 years, and be an Australian resident taxpayer; or
- The existing ATO definition of a small business as one that has annual turnover of less than $2m, or the existing Fair Work Australia definition of a small business as one that has less than 15 employees.

The remaining criteria to ensure that a qualifying "innovation company" engages in genuinely innovative business activity can be drawn from the principles-based test and gateway criteria (see response to Question 4.2 below).

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

AVCAL is of the view that appropriate gateway criteria would be beneficial in providing innovation companies and their investors with certainty regarding their eligibility for the tax concessions. These gateways should be viewed as one of three alternative methods in defining an innovation company, with the other two methods being the principles-based method and the ATO determination method.

The proposed gateways and tests set out in p.5 of the Discussion Paper are a good starting point for consideration and further refinement. For example, the Government may wish to consider a minimum of, say, 20% of annual expenditure attributable to eligible R&D activities, as an appropriate gateway criteria for an eligible innovation company.

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

AVCAL is of the view that the proposed criteria do not meet the objective and may introduce new risks and distortions to the early stage funding landscape.

Criteria based on definitions of innovation and startups in existing legislation will be more likely to meet the objective, as this eliminates the need to create new legislative definitions for eligibility. The policy framework would be better designed using existing definitions and determinations which are now well understood. This will also help keep additional red tape for investors and startups to a minimum.

Question 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.

The proposed criteria of “an eligible innovation company” on p.3 of the Discussion Paper risks inflating tax-driven investments to certain pockets of very early stage startups where there is currently already sufficient funding, while failing to address current funding failures in other areas.

The R&D eligibility criteria are much better aligned with the policy objectives of the tax incentive than the proposed criteria in the discussion paper, as the former already define the innovation requirements in a manner that is well understood. The R&D framework also offers a more practical definition on the size and age profiles of eligible startups that has already been tested across industries with different innovation lifecycles.

Question 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?

Yes.

Question 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?

It should include organisations such as accelerators, incubators, co-working spaces and VCs that run accelerator programmes that specifically target startups. Characteristics of accelerator programmes may include the following: investment, mentorship, networks and connections, advice, training and business support.

As accelerator programmes are currently largely self-regulating, the approval process will need to be developed in consultation with stakeholders. It would be useful to better understand the accelerator/incubator approval criteria in other jurisdictions such as the UK, Canada and Singapore, for example, where acceptance into approved accelerator programmes is one of the gateways for various tax and migration programmes.

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

The principles-based test or the gateway requirements should be sufficient to ensure that the “innovation company” is making a genuinely innovative contribution, without restricting the framework too much with prescriptive definitions of activities which may not be flexible enough to keep up with emerging technologies.

However, if there is to be consideration of an explicit list of excluded activities, the definition of “ineligible activities” under the ESVCLP framework as defined by s118-425 of the *Income Tax Assessment Act 1997* could be considered.

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

Yes, if companies are Australian residents at the time of investment. Alternatively if the companies are not Australian residents but could potentially bring substantial benefits to the Australian economy in the form of employment, technology transfer and exports etc, these could be considered as well.

II. DIRECT INVESTMENT INTO AN INNOVATION COMPANY

Question 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 amount of support offered by sophisticated investors varies widely from funding to ad-hoc advice to founders, introductions to potential distribution partners, and assistance with marketing. The financial and operational profiles of startups will vary widely, particularly in the early stages. Some may grow jobs and revenues rapidly, while others will be making losses for many years in the early stages as they invest heavily in product development.

The best way of ensuring that the “right” companies are benefiting from the sophisticated investor capital is by properly defining the eligibility criteria for innovation companies. AVCAL believes that the R&D refundable tax offset eligibility criteria provide a robust framework for ensuring that investment is directed towards small, innovative startups.

It should be noted that the requirement that an eligible investor cannot hold interests amounting to more than 30% of a company, and any limitations on entrepreneur-owners from accessing the tax incentive, penalises founders who invest substantially in their own businesses, i.e. have “skin in the game”. The Employee Share Schemes rules already restrict entrepreneurs who have more than 10% of a company from tax effective options if they work for reduced or no cash remuneration. This further limits founders’ ability to invest alongside other investors. If an entrepreneur is prepared to invest alongside arm's length investors, this should be supported and not restricted.

AVCAL also recommends that the proposed requirement for the startup to “not be an affiliate of the investor” “at the time the shares are acquired” be clarified to unambiguously reflect that follow-on investments are still eligible for the tax concession.

III. INDIRECT INVESTMENT VIA AN INNOVATION FUND

Question 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. If not, if some commitments are not called, there would be additional paperwork needed to arrange for a clawback of the related offset.

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

The proposed criteria set out in the Discussion Paper for an “innovation fund” are that:

(i) it is a company;
(ii) it carries on the sole business of investing in innovation companies though the purchase of shares that are equity interests for Australian income tax purposes;
(iii) it has no more than $50m committed capital at fund close, and has no more than $50m invested in innovation companies at any time in an income year (based on the issue price of shares);
(iv) it holds no more than 30 per cent of the issued capital in an innovation company, tested immediately after shares have been issued to the innovation fund; and
(v) 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.

AVCAL’s views on the proposed criteria are set out below.

Requirement for the innovation fund to be a company. AVCAL recommends that this requirement be removed, or at least expanded to include the typical collective investment vehicles used for such purposes. Most innovation funds used by high net worth investors are not companies: they are usually unit trusts, ESVCLPs, VCLPs, or unit trusts. Trusts are the most common vehicles used to structure syndicated angel investments and Fund co-investments. Some angel collective investment vehicles such as Sydney Angels Sidecar Fund and Scale Women’s Fund are structured as ESVCLPs. Furthermore, most angels currently invest directly through some form of bare/discretionary trust.

In instances where investors band together to invest in a company through a bare trust or another form of trust/limited partnership structure, eligibility for the offset should be preserved.

The benefits (of pooling angel investors’ capital) for the investee startups are that they have access to a larger pool of sophisticated investor capital (compared to the smaller pool of individual investors willing to invest a significant amount in the individual startup), only a single shareholder on their share register rather than a large number of small equity holders, and just one single shareholder interface to manage.

No more than 10% of the fund’s committed capital to be invested in a single company. Angel investors and early stage funds often use special purpose vehicles (SPV), usually trusts, for investments in individual startups. As they may set up specific SPVs for each investment, they would fail the proposed 10% test as 100% of the SPV's investments are in a single innovation company. The 10% cap is also is inconsistent with existing caps for many funds that would allow up to at least 20% of the fund to be invested in any one company. In the case of ESVCLPs, for example, there is a 30% limit.

The innovation fund to hold no more than 30% of the issued capital of a single company. Innovation funds should have the flexibility to hold more than 30% of a company, due to the need to support technologies through key inflexion points. This requirement may force the fund to resort to more complex structures involving instruments such as debt and convertible notes to avoid the 30% equity limit. AVCAL recommends that, at the very least, there should be an administrative process to allow the fund to apply for relief for individual investments to exceed this limit, e.g. as provided under the ESVCLP framework (Div 9-4 of the Venture Capital Act).

Innovation fund to not exceed $50m in committed capital. It is unclear what the objective of this requirement is. The cap on fund size, together with the 10% maximum investment cap, will limit the maximum investment of the fund to $5m for any single company. However, investors can increase their exposure by simply investing directly, or setting up a separate fund (albeit at additional cost) to increase their investment exposure to the same startup(s). In any event, even without the $50m fund size limit, the integrity of the tax incentive is still preserved as each investor’s tax benefit will still be capped at $200,000 p.a.

The flexibility to set up a fund larger than $50m is necessary for investors that take a long term view on their investments, as this will involve progressively larger investment rounds as the companies grow. The 10% and 30% thresholds above, combined with the $50m fund size cap, make the mechanics of such long term investment difficult. For example, they imply that the standalone fund can only ever invest up to $5m in a startup, which makes longer term investment through the fund very challenging.

In order to avoid unnecessary red tape and artificial distortions of the market towards one route over the other, the eligibility and investment criteria should be consistent regardless of whether investors invest directly, or through an innovation fund, in a startup that meets the criteria for an innovation company. Ultimately, the policy objective of broadening the pool of early stage capital will be met.

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

There seems little reason for the incentive to be limited to sophisticated investors for investments made through a fund, but not for direct investments. AVCAL believes that the policy objective will be better met if the requirements focus on the characteristics of the startup, rather than the means by which the investor channels his/her investment. In order to avoid artificial distortions of the market towards one route over the other, the tax incentives for early stage investors should be consistent whether the investment is made through a fund or not.

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

See response to 6.2.

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

Current ESVCLP and VCLP rules already set out a framework for manager requirements (Section 13.1(1a)(d) of the *Venture Capital Act 2002*). These rules, together with existing Innovation Australia processes for evaluating manager expertise, can be used as a basis for consideration. For self-managed funds the current sophisticated investor test should be sufficient.

Question 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, provided the required documentation is clear and the approval process is prompt.

IV. INTEGRITY MEASURES

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

Aligning the definition of the eligible innovation companies with the desired policy objective is the most important line of defence in preserving the integrity of the tax system under this policy. This will keep the process simple, and align the implementation process with the policy objectives without the need to draw up new thresholds that may result in unwanted market distortions or unnecessary workarounds.

Question 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?

See response to 7.1.