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Manager
Individuals and Indirect Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

24 February 2016

Dear Sir/Madam

TAX INCENTIVES FOR EARLY STAGE INVESTORS - POLICY DISCUSSION PAPER

BDO welcomes the opportunity to provide a submission on the Policy Discussion Paper for the Tax Incentives for Early Stage Investors (Discussion Paper) released by Treasury for public consultation on 15 February 2016.

We make the submissions set out below in respect of matters addressed in the Discussion Paper by providing our comments on some of the questions posed in the discussion paper. We reproduced the relevant questions together with our comments below:

Australian Innovation Company

- 4.1 *Are there any additional principles that should be included in defining an innovation company?***
- 4.2 *What gateway criteria would best define an eligible innovation company?***
- 4.3 *Do these criteria meet the objective of attracting investment in innovation companies, without unnecessary regulatory burdens?***
- 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.***

BDO Comments on Q4.1 to 4.4

Innovation Test

It is difficult to define 'Innovation' in any meaningful sense. To try to apply a legalistic definition to innovation is restrictive and an inevitable compromise. It potentially creates additional complexity, red tape and uncertainty or may even fail to capture future innovations that are within its intended scope. The investors at whom this incentive is aimed will essentially 'self-select' those ideas which are innovative, which are marketable, scalable, have a competitive advantage and thus more likely to return the level of profit they require commensurate with the risk taken.

The incentive is modelled on the UK SEIS incentive (and its longer established sister, the EIS incentive for larger or more mature companies). Neither of these UK incentives apply an innovation test and yet experience indicates that it is the innovative businesses which attract the investors claiming the reliefs. Those schemes dictate that investors are not connected with the company concerned (which correlates to a 30% equity test) and there is an exclusion for investors who are employees or associates of employees. Business Angel type investors are encouraged to participate via a specific carve out for them and they are allowed to be paid directors in certain circumstances. These people are essential for the success of many projects.

The nature of these restrictions combined with the business/investment acumen of the external investors attracted appears to contain the UK version of this incentive to the required entrepreneurial companies, without the need for further regulation.

Other tests

The following two proposed criteria are too restrictive

1. The company was incorporated during the last three years - many start-up companies take longer than three years before they are self-funding. A time frame of between 5 to 10 years would be more realistic.
2. The \$200,000 assessable income cap is very low and would discriminate against companies that are having some success but still developing their product etc. Perhaps a better approach would be to have a limit on the amount of passive income and income from business income that is unrelated to the innovative activities.

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?*

BDO Comments on Q 4.5

Experiences in the UK indicate that investors value the advance assurance available from HMRC that the company and proposed investment qualifies for the incentives (if operated in the way set out in the advance assurance application made by the company). Many investors specifically require this confirmation prior to them making an investment, as their investment decision is predicated on the availability of tax relief as part of their risk/reward assessment. Reasonable ATO turnaround times (and thus staff resource) would need to be put in place if this is to be taken up.

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

BDO Comments on Q4.7

The discussion paper lists the excluded activities in the UK SEIS, which are activities that are either not inherently innovative or where there is other tax concessions already provided. If this list is to be utilised in the Australian scheme it needs to be modified to account for Australian conditions and any other tax incentives already provided under the Australian tax provisions.

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

BDO Comments on Q5.1 and 5.2

The proposal to limit the investments to sophisticated investors is understandable to ensure the investors understand the inherent risks of these types of investments. However, there may be non-sophisticated investors that would be interested in making investments in innovative companies and perhaps they should be given the opportunity but with a lower maximum investment - say \$20,000 each.

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?*

BDO Comments on Q6.1

As mentioned in the discussion paper, the ideal situation is or the tax offset to be available once the fund has made the corresponding investment but for simplicity it is suggested that the offset claim be available in the year of the “cash call”. The term “cash call” is not defined but it is assumed that it means when the investor pays the money to the innovation fund. However, there is a concern in the discussion paper that the funds may be left uninvested by the innovation fund. We submit that the call for simplicity in this case is not warranted. It would be expected that the innovation fund should be reporting to its investors on at least an annual basis and that it should be in a position, soon after the end of the income year, to report to its investors how much of an offset each investor is entitled to for that year based on the actual investment it has made during the year.

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

BDO Comments on Q6.3

See comments above under question 5.1 about extending to non-sophisticated investors with a maximum investment of say \$20,000 or perhaps in the case of indirect investments in an innovation fund, this threshold could be increased to say \$50,000 because of the added safety of the fund managers having control of which innovation companies the Innovation Fund will invest in (this is assuming there will be appropriate requirements on who can manage an innovation fund as per question 6.5 below).

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

BDO Comments on Q6.5

As the innovation fund managers will have control over the investor's funds they should at least be subject to similar requirements that exist for other fund managers and perhaps there could be other requirements to ensure they are experienced in dealing with innovative investments.

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?
- 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?

BDO Comments on Q7.1 and 7.2

The following areas could be considered

- preventing an existing/established trade being taken over by an innovation company
- Ensuring there are no guaranteed exits available for investors once the 3 year period is up
- Preventing value being taken from the company that is non-commercial (e.g. allowing investors to access company assets/benefits on favourable terms). However this may be adequately covered by Division 7A.
- Consider whether to allow the monies raised by the entities to be used in a subsidiary of the Innovation company (e.g. where they want separate entities for different projects). We understand that this is allowable under the UK SEIS scheme.

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Should you have any questions, or wish to discuss any of the comments made in the above submissions, please do not hesitate to contact Lance Cunningham on 02 9240 9736 or lance.cunningham@bdo.com.au.

Yours sincerely



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