

# BANKI HADDOCK FIORA

LAWYERS

Level 10, 179 Elizabeth Street Sydney NSW 2000 Australia  
Telephone 61 2 9266 3400 Facsimile 61 2 9266 3455 email@bhf.com.au  
ABN 32 057 052 600

24 February 2016

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

**BY EMAIL – [startuptaxincentive@treasury.gov.au](mailto:startuptaxincentive@treasury.gov.au)**

Dear Sir / Madam

## **TAX INCENTIVES FOR EARLY STAGE INVESTORS**

Thank you for the opportunity to make submissions on your February 2016 Policy Discussion Paper, Tax incentives for early stage investors.

Our submissions are enclosed and are set out in three sections, as follows:

- About the author
- Reflections on context
- Addressing your questions.

Please do not hesitate to contact us should we be able to be of any assistance in your further deliberations.

Yours faithfully



Daren Armstrong  
Partner  
Direct line: 02 9266 3429  
email: [armstrong@bhf.com.au](mailto:armstrong@bhf.com.au)

## TAX INCENTIVES FOR EARLY STAGE INVESTORS

### POLICY DISCUSSION PAPER, FEBRUARY 2016

#### *About the author*

The author is a partner of specialist intellectual property, information technology and media firm, Banki Haddock Fiora, and a specialist in corporate advisory and fundraising matters, including for high tech and start-up ventures. Boasting perhaps the pre-eminent copyright law practice in the country (the law that principally regulates the protection of computer software and published literary and artistic works), we act for many household names and a coterie of Australia's leading universities and research and development organisations.

The author has legally assisted the Australian National University in its establishment of ANU Connect Ventures; acted on the establishment of the Green Building Council of Australia; for Babcock & Brown's environmental investment fund; and on the first significant investment into Australia by the Bill and Melinda Gates Foundation backed, Global Health Investment Fund, into Medicines Development Limited for clinical trials and US FDA registration of a pharmaceutical that should alleviate the suffering of 37 million Africans who are afflicted by river blindness. The author also acts as Australian legal adviser to Springboard Enterprises US, that country's pre-eminent accelerator and network for women leading or owning high growth companies.

#### *Reflections on context*

The Australian Government's own National Innovation & Science Agenda website discloses two very telling facts:

- Australia's rate of collaboration between industry and researchers (at 2-3%) is currently the lowest in the OECD; and
- Australia is ranked 70<sup>th</sup> of 140 countries on how its Government procurement spend goes on to foster innovation.

How could this possibly have come to pass? Are they emanations of a cultural cringe, the tall poppy syndrome, dry economic policy purity, our historical branch economy, narrow public access to investment in these opportunities, supposedly expensive labour force, geographical and perhaps too ideological distance between our principal centres of public and private endeavour, or suspicion of the intangible and the intellectual, rather than the tangible, accessible from which returns can be readily earned: for example, property development and investment.

This position too has arisen at a time when Australia's pool of funds for retirement and superannuation purposes has grown to such an extent that Australia now has approximately \$2 trillion under management<sup>1</sup>, representing the highest per capita retirement savings pool in the world<sup>2</sup> and the fourth largest such pool in the world

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<sup>1</sup> Association of Superannuation Funds of Australia (ASFA), *Superannuation Statistics*, December 2015.

<sup>2</sup> Towers Watson, *Global Pension Assets Study 2015*, February 2015.

by absolute quantum<sup>3</sup>. This represents a staggeringly large resource for Australia and Australians to leverage and from which to prosper.

This position must change. And the best people to help this position change must be Australians. Government has the central role to play in redressing this position. We submit that Government should not be backward in doing so. The parameters Government sets to foster such innovation could well define the era. They should in our view be generous to that end; the greatest danger is if they are not.

### *Addressing your questions*

#### **Australian innovation company**

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

We consider that principles used to define an innovation company should be measured against objects, intentions and activities. We recommend that specific objects be included in the company's Constitution to innovation ends. This would be similar to the position for charities and not-for-profit organisations, and would, noting s125 of the *Corporations Act 2001*, better ensure that the company pursue these objects over the longer term.

It will be important to know whether a company is characterised as an innovation company or not from its registration as a company and perhaps earlier, from its first promotion. At that stage, actual activities and capabilities will not be evident to assist in the characterisation. Objects, intentions and plans will however exist. These should be the primary criteria with reference to which the characterisation is made.

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

We repeat that objects, intentions and plans are at least as important in an assessment of characterisation as an innovation company as present or historical activity. Characterisation is important to know at the time of the company's registration or at least promotion. Early certainty of characterisation will assist in the preparation of appropriate disclosure documents for fundraising documents, budgeting, and carrying out activity in furtherance of the stated objects and intentions.

We also consider that the criteria listed on page 3 of the Paper that companies must meet before they may be characterised as an innovation company are too restrictive. We consider that of these criteria, incorporation in Australia at the time that the company seeks to be characterised as an innovation company should alone be sufficient. The \$200,000 assessable income limit and the \$1 million expenditure limit can only but operate to paint innovation ideas on a small canvas. Given the telling collaboration and Government procurement statistics quoted above, limits of this size and nature discourage innovators from thinking big and to think of innovation as something reserved to cottage

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<sup>3</sup> Towers Watson, *Global Pension Assets Study 2015*, February 2015.

industries. These limits are demonstrative of an overly risk adverse attitude. There is a role too for big business to be innovative and to be encouraged to be so.

We also consider that the innovation agenda should exclusively support innovation activity that occurs in Australia. Thus, the 20% offset should only be available for expenditure made in Australia.

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

Supplementing our responses to questions 4.1 and 4.2, it should not be necessary for an innovation company to be characterised as such that it have at the time of characterisation demonstrated capability to commercialise or bring to market and generate value from an idea. To our mind, such a criterion would act as an unnecessary burden for the first-time innovator and would not properly allow or recognise that innovators do fail. Innovators should be encouraged to pursue their ideas and, should they fail, then move on.

A focus on patent filing in multiple jurisdictions or that an innovation company must pursue global or broader opportunities rather than having a focus on only local markets seems to us to be both burdensome and unnecessary. Is Government really wishing to dissuade innovation that has the greatest impact in Australia, or which addresses purely Australian problems? Surely not.

We consider the fact that one or more existing third party financial investors have invested in a company is not as reliable or enduring an indicium of characterisation as an innovation company to be supported as the markers discussed above.

- 4.4 What integrity risks are associated with each of these criteria? How might these risks be mitigated? For example, combining multiple tests could mitigate risks.

We consider an appropriate statement of innovation related objects should be the necessary and sufficient condition.

- 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?

We support a self-assessment declaration. There would seem to us to be no valid reason to say in this area that company officers and management are not to be trusted in this area because either the risks or rewards of a self-assessment declaration are too high that they will be abused, when compared to other areas where self-assessment is permitted.

- 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?

A current list of suitable accelerator programs should be maintained by the ATO. These programs can play a very effective sifting and educational role. A

connection with access to a tax offset regime could heighten the involvement and effectiveness of such programs. My experience with the Springboard Enterprises program has only been to see great positive steps and introductions result.

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

We are not in favour of a list of exclusions. The exclusion of innovation in the areas included in the list of excluded activities in effect leads to the picking of winners, an approach that we understand successive Australian Governments have generally avoided.

Who is not to say that some of the greatest innovation and returns could result from progress in these areas? It is not as though market practice, structure and participants in these areas of endeavour stand still. Some of the most successful long-established companies state that they owe their success to repeated periods of innovation, including in established endeavours.

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

We consider that the measure should principally be for the benefit of Australians through the Australian tax system. We agree that innovation companies should be restricted to Australian residents for tax purposes.

**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?

We consider that it should not be a precondition to availing oneself of the tax offset that both financial and technical / commercial support should be made available to the innovation company by the investor. Not all investors will have the ability to provide that support. Indeed, it would likely be counter-productive if all investors were to be required to be called upon for their skills in these areas – (too many cooks). A widespread difficulty experienced by many Australian start-ups is access to sizeable and patient capital, willing to be risked. Finding investors willing to risk such capital in such circumstances is alone difficult enough without introducing a further requirement that technical and commercial support also be given. Such support is a pleasant added bonus and should not be regarded as a pre-requisite. It is not as though the tax offset at 20% is overly generous<sup>4</sup> (Why is the Australian Government not matching the UK's 50% offset rate? Why are we effectively inviting international concerns to choose the UK over us?); the main investment decision is ultimately, as it should be, whether the 100% capital investment is appropriately put at risk, without the higher liquidation priority ranking enjoyed by a convertible note holder (pre-conversion) or preference share holders.

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<sup>4</sup> A 50% tax offset applies under the UK Seed Enterprise Investment Scheme.

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

We consider that this objective should not be a pre-requisite. It is an inappropriate policy objective tied to investment. Should such an objective be desired then we suggest that it be pursued by other means. Thus, there is no need in our view to limit enjoyment of such tax offsets to sophisticated investors. Further, that someone is a sophisticated investor in *Corporations Act 2001* terms is no indicator of technical or commercial acumen when in established Sydney and other major metropolitan city suburbs house prices exceed the minimum level of assets required to qualify as a sophisticated investor.

It is our view that the tax offset be available to all investors. It is their investment, and the willingness to put their capital at risk to an appropriate end, that is the relevant consideration. There is to us no policy justification to limit access to these benefits to sophisticated investors, to whose benefit such opportunities are practically limited (and disproportionately advantaged) under the current provisions of the *Corporations Act 2001*.

Indeed, there are sensible policy reasons to require CSF offer document like disclosure to sophisticated investors investing in innovation companies. Presently, offers of securities to such persons are not required to be the subject of any mandated disclosure. Again, given the movement in established Sydney and other major city house prices, many sophisticated investors within the technical *Corporations Act* meaning of that term may be anything but.

#### **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 investment fund?

We consider it wholly appropriate that the timing of the availability of the offset match the outlay.

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

No. Please see our responses to questions 5.1 and 5.2 above.

- 6.3 Should qualifying innovation funds be proprietary limited companies, unlisted public companies, or some other company governed by the *Corporations Act 2001*? What *Corporations Act* requirements should apply to these structures?

Qualifying investment funds should be of whatever structure best elevates the likelihood of success of the underlying project or opportunity and of fundraising initiatives. Because of the different tax profiles of investors, a range of investment fund structures will appeal. From an investment perspective, we see no need to alter the structural requirements of the *Corporations Act 2001* that currently apply to the legal structures of various kinds for investments. There is a case, however, for specific disclosure content requirements for offer documents, along the lines of the approach adopted under the published

exposure draft of the *Corporations Amendment (Crowd-Sourced Funding) Regulation 2015*.

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

Appropriately qualified AFS licence holders alone should manage innovation funds. Distinctions between funds for wholesale clients and retail clients, as is currently the case for dealing in interests in management investment schemes, should be maintained.

- 6.5 Is it appropriate to adopt an approval process similar to the UK Venture Capital Trusts and Australian Early Stage Venture Capital Limited Partnerships?

We consider such a process to be appropriate. Such a process would heighten discipline in the assessment of such funds and also give Government an insight into developments in the field.

### **Integrity measures**

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

Shortcomings in Australia's support of innovation, referred to in our reflections on context above, are marked. That Australia's relative position amongst other OECD countries and other countries is wholly inconsistent with Australia's position as the 12<sup>th</sup> largest economy in the world<sup>5</sup>. Addressing this situation should, it is submitted, be of a higher-level priority than concerns as to the maintenance of the integrity of Australia's tax system. In that regard, we do not consider to be of widespread attraction to potential abuse a 20% tax offset where the underlying 100% investment could be at considerable risk.

Measures that we would suggest however should be specified as protections should be directed to the investment truly being at risk. Thus investments in preference shares that are redeemable at the option of the holder, put options whereby investors can compel others – such as related parties to the investee company – to purchase their shares or hedge arrangements against movements in value of investments should be considered. Similar protections operate in respect of executive option and share plans.

We also note that the proposed capital gains tax exemption is to operate only in respect of gains made within the first 10 years of investment and no capital loss relief is provided. In this regard the proposal is less generous than the UK Seed Enterprise Investment Scheme; to our mind, unnecessarily and uninvitingly so.

- 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?

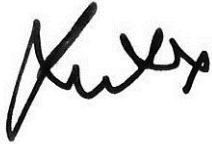
As previously discussed, it is both beneficial and important that certainty as to characterisation as an innovation fund be available to promoters and investors at

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<sup>5</sup> World Bank, *World development indicators database*, 17 February 2016.

and from the time of promotion. This will often times be at the establishment of the innovation company or innovation fund, at which time a statement of objects, intentions and plans are likely to be the principal discriminants called in aid of characterisation. An efficient, accessible system of registration at this stage would be welcomed.

With compliments

A handwritten signature in black ink, appearing to read 'Daren Armstrong', with a stylized, cursive script.

Daren Armstrong  
Partner  
Direct line: 02 9266 3429  
email: [armstrong@bhf.com.au](mailto:armstrong@bhf.com.au)