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Submission on Tax Incentives for Early Stage Investors

Ernst & Young (**EY**) welcomes the opportunity to provide our comments on Treasury's policy discussion paper "Tax incentives for early stage investors" (dated 15 February 2016) (**Paper**). The Paper sets out the background to the consultation, outlines the proposed tax incentives, and lists 17 consultation questions across four key topics.

General Comments

EY supports the Federal Government's proposal to introduce new tax incentives for early stage investors (TIESI). However, we submit that the drafting of the measures needs to ensure that the tax incentives are available to genuine innovative start-up companies, with balanced integrity rules that are not excessively burdensome on such companies.

At Appendix A, we provide further comments. Please note that our comments do not attempt to respond to every question raised in the Paper.

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Should you wish to discuss any of the issues raised in this submission further, please do not hesitate to contact any of Dragan Misic (02) 9276 9800, Tony Stolarek on (03) 8650 7654, Richard Czerwik (03) 9288 8408 or Mark Chan (03) 9655 2523.

Yours sincerely

Ernst & Young

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APPENDIX A

EY Submission on Tax Incentives for Early Stage Investors (TIESI)

Australian Innovation Company (AIC) – Section 4 of Paper

The Paper outlines:

- the definition of an "eligible innovation company", which includes the requirements in respect of the company that it must:
  - not have been in existence for more than 3 years,
  - be incorporated in Australia,
  - have less than $200,000 in income;
  - have less than $1 million in expenditure
  - be unlisted; and

- the 3 "methods of access" in defining a qualifying innovation company (Section 4.1 ff).

Eligible innovation companies

The proposed "incorporated in the last 3 years" rule is unnecessarily restrictive and there is an insufficient justification for this approach. We would recommend that this requirement be removed.

In particular, the 3 year rule is very arbitrary. This means that an enterprise that has been in existence for more than 3 years but was incorporated recently would qualify for the new regime. Contrast this with an enterprise where the founding shareholders chose to incorporate with little initial activity or purchased a pre-existing shelf company and, due to passing of time since incorporation, new investors are denied the benefit of the proposed tax concession.

We understand that it is proposed that the eligibility and qualifying tests in relation to income and expenditure will be set by reference to the amounts derived and incurred in the previous income year for income tax purposes. That is, these measures will be determined by reference to disclosures made in a prior year income tax return and that this will be conclusive evidence of the tests having been satisfied even if the tax return is subsequently amended. This position will need to be clear, to minimise compliance burdens on investee companies and to provide greater certainty for investors.

In particular, the qualification should be provided "as of right" to newly incorporated companies, which cannot demonstrate a previous trading and income tax compliance history. A failure to do so would potentially deny the ability to raise funds for a further 12 to 18 months whilst this “history” is established on lodgement of an income tax return.

We also question whether this examination of the year prior to the fundraising may lead to unintended policy outcomes. For example, a company which may have been in its infancy in an earlier year but which is a more mature enterprise in the subsequent year when the fundraising occurs, will still be able to qualify even if say its income or expenditure in that subsequent year was in excess of $200,000 (for example it may have derived income of $10 million in the year in which fundraising is occurring).

We also highlight the need for policy consideration of the potential application to mature businesses which are transferred into newly established companies.

A more equitable test, and one which would be easier to administer, would be to employ an asset based test set by reference to the most recent financial statements at the time of issue of the shares (if any). This would be consistent with the test found in the Early Stage Venture Capital Limited Partnership (ESVCLP) and Venture Capital Limited Partnership (VCLP) rules where the qualification is set by reference to assets which are recognised for financial accounting purposes. An asset based test is also used in the small business capital gains tax (CGT) concessions.

Qualifying innovation companies

The paper suggests that there may be multiple methods to determine whether an entity may qualify as an innovation company, namely:

1. a principles based definition of eligible innovation company (Method 1)
2. gateways and safe harbours (Method 2)
3. ATO determination if other gateway methods are not met (Method 3)

There is also a detailed list of exclusions.

We understand that the methods are proposed to be alternative gateways.

We submit that the preferred option would be to have a safe harbour regime where qualifying Australian Innovation Companies (AICs) would be eligible “as of right” under Method 2, complemented with a principles based application approach approved by Innovation Australia (a combination of Method 1 and 3, respectively).

We believe that any administration of the regime should cut down red tape for both the applicant companies and investors by facilitating an AIC “passport” registration regime which would certify that the applicant company meets all the relevant criteria to be classified as an AIC and draw on the various Government Agencies and regulators to certify the tests as being satisfied (e.g. incorporation by ASIC, income/expenditure by the ATO, non-listing by the ASX). We contrast this with a self-assessment regime where each investor will be required to undertake a due diligence process to confirm whether or not the investment qualifies (e.g. the income and expenditure tests (see above)) at length and cost.

The AIC registration should be available on a publicly accessible website (such as the Australian Business Register) and Innovation and Science Australia website. This will provide certainty for both investors looking to invest and the AIC.

The AIC registration should be conclusive evidence to facilitate tax compliance by investors, eg claiming the 20% tax offset and claiming a CGT exemption.

Innovation and Science Australia, being the Government Agency responsible for the administration of Australia's research and development concession, VCLP and ESCVLP regimes, would be best placed to consider the policy intent of the measures and has significant experience in reviewing and approving business and investment plans in administering those regimes. Placing responsibility for the administration of the application process for registration with Innovation and Science Australia would provide a "one-stop shop" for start-up entities.

Placing the approval role with the Australian Taxation Office (ATO) would be inconsistent with the ATO's role in ensuring compliance with tax laws, as it would effectively provide the ATO with both a policy role and a compliance role. We also question the ATO's capacity to quickly and expeditiously review business and investment plans of AICs.

Principles based definition

In determining how an 'Australian innovation company' should be defined, we believe that the focus should be on innovation and innovative activities, not merely activities that are carried out on a day-to-day basis.

In this context, we submit that it is critically important that the discussion and guidance on which entities are an 'Australian innovation company', and the examples used to illustrate that, are clear and applicable to a broad range of industries and businesses. This will allow prospective investors in innovation companies to readily determine if they are entitled to, and qualify for, the Government's proposed TIESI.

Further, we submit that the proposed TIESI should not just be limited to the more traditional research and development (R&D) intensive fields such as the software, medical, or pharmaceutical fields.

We believe TIESI should also be extended to businesses that develop and create new platforms or other innovative means to deliver their service and product offerings.

EY recommends the Government consider an approach where the ATO issues Law Companion Guides (LCGs) to deal with detailed law interpretation, as opposed to using principles based drafting. This approach was recently adopted in the proposed Attribution Managed Investment Trust (AMIT) rules and was well received by the investment community.

Gateways and safe harbours

Each of the examples of gateways and safe harbours provided in the Paper have merit and should be included as part of the proposal.

However, given that the proposed measure is targeted to relatively small start-up companies, we believe it is unrealistic to expect that more than one criterion needs to be satisfied.

Merits based approval by Innovation and Science Australia determination

The paper suggests an ATO determination would apply as an alternative gateway to other methods, but is silent on whether the determination could also remedy:

- breaches of exclusions (which could potentially have very wide scope); and
- breaches of the eligibility requirements (particularly immaterial breaches of the income/expense thresholds).

EY supports an eligibility design approach which would provide Innovation and Science Australia (as opposed to the ATO - for the reasons set out above) with discretion to register an AIC, if it does not otherwise satisfy the "safe harbour" methods.

There would be merit in providing for regulations to be developed over time that set out relevant policy matters to be considered where such a discretion was to be exercised.

We strongly support a discretion around the application of proposed exclusions and eligibility tests. Furthermore, for the avoidance of doubt, any discretion to extend the scope of the rules should only operate in favour of companies seeking to apply the rules (consistent with the design approach for the proposed statutory remedial power to be afforded the ATO).

Exclusions

We agree that, as indicated in the Paper, a simple list of exclusions covering a range of existing products, businesses or industries, could inadvertently exclude genuine innovations relating to such areas. For example the reference in the exclusions list of business to business (B2B) transactions is problematical.

One potential approach to mitigate such outcomes would be to clarify that the exclusion applies in relation to future proposed activities of the investee company (i.e. it is not retrospective).

EY also submit that the proposed list of exclusions should be as narrow as possible and be consistent with the exclusions in ESVCLP and VCLP rules (subsection 118-425(13) of the *Income Tax Assessment Act 1997* (Cth)).

Under proposed changes which were announced by the Prime Minister at the same time as the TIESI measures, it was proposed that Innovation and Science Australia could provide binding advice in relation to the definition of "ineligible activities" and other eligibility metrics that could work hand-in-hand with the merits-based approval approach outlined above.

We submit that the rules should not unfairly prejudice innovation in emerging sectors such financial technology (FinTech), clean and renewable energy (CleanTech), agriculture (AgTech) or B2B.

As noted above, we would strongly support an Innovation and Science Agenda discretion also extending to the application of any proposed exclusions.

Compliance

In order for the concession to be effective in encouraging investment in AICs, it needs to minimise red-tape which costs founders significant time and money and detracts from their focus to develop the AIC's business. Furthermore, start-ups do not have significant budget for advice from professional tax advisors.

We also agree that it is appropriate to implement a process to ensure that the regime is not abused. This requires some form of notification to the ATO.

We submit that that process should not involve any form of advance approval process such as that which exists for taxpayers claiming the R&D tax incentive/offset. Such a process, if it were to be implemented for TIESI, may potentially impose an excessive compliance cost burden on investee companies that have limited financial resources, where that capital raising may ultimately not be successful.

Instead of a pre-approval process, we submit that a notification process could include, or factor in, the following:

- First, that there should be a *de minimis* threshold for notification to the ATO in order to avoid an unnecessary compliance burden on companies and/or investors.

- Secondly, the appropriate time to notify the ATO is at or contemporaneous with the cash call/share issue time – this would tend to discourage inappropriate behaviors by investors thereby lending greater integrity to the proposed TIESI measure.

- Thirdly, by data matching between Innovation and Science Australia approval of an AIC “passport” and a particular claim for a tax offset or exemption;

- Fourthly, express question/s in income tax returns would facilitate the ATO’s ability to monitor uptake in the TIESI, and would enable Government to conduct a post-implementation review (if at all), and provide valuable information to help quantify the TIESI measure’s stimulation to Australian economic activity.

It might be argued by some that these steps represent red tape. However, we suggest that notifications of this type, which are simple and which might be done via an online portal, are consistent with innovative regulation and innovative businesses in this digital environment.

Investment - Eligibility for all taxpayers – Section 5

We disagree with the possible approach of restricting the tax concession to sophisticated investors on the basis of consumer protection.

Sophisticated investors are already able to invest in start-ups. To deny the tax concession to retail investors would be inconsistent with the policy intent of encouraging investment and delivering capital to start-ups.

Retail investors are also already able to invest in start-ups in certain circumstances.

Australia’s laws already provide comprehensive protection for retail investors in the *Corporations Act 2001 (Cth)* (Corporations Act), which require prospectuses where a broad based retail offering is intended.

In practice, we do not foresee AICs looking to raise capital from retail investors because of the prohibitive costs in doing so. However, we would expect that some retail investors may be invited to participate in capital raising consistent with the current provisions in the Corporations Act as augmented by the crowdfunding proposals.

In addition, we believe that the tax law already has sufficient protections through the promotor penalties regimes etc such that “consumer protection” should not be a design feature of the proposed tax incentive. In fact, it is hard to identify any other part of the Australian tax law which would effectively discriminate in this way against a particular group of taxpayers. Such a design feature would be inequitable and unfair.

We observe that historically one of the indicia of inappropriate promoter behaviour, is where promoters offer investors finance which is pre-packaged by the promoter, and the investee vehicle lends money back to the promoter. We suggest that the use of circular loans would be undesirable in this context.

We submit that appropriate integrity can be enhanced for this incentive by:

a) An objects clause in the rules tying the incentive back to genuine innovation with the relevant indicia;
b) Appropriate comments in the Explanatory Memorandum about supervision by the ATO and feedback to Treasury and Government; and
c) Appropriate messaging on release of the law from the ATO to highlight that this is not a measure for tax-avoidance-driven transactions.

Direct investment into an innovation company

The proposed restriction to 30% of issued capital cap for an investor, tested immediately after the shares are issued, should be reconsidered. For relatively small companies, initial angel investors could technically breach this requirement depending on when they make this investment. This cap should be applied on a periodic basis, e.g. at the end of the income year.

It is also inconsistent with the ESCVLP and VCLP regime where the investing entity can take up to 100% of the ownership of any eligible entity. Those rules recognise that an investor may wish to take a significant investment so that the interests of the company and the investing entity are aligned. This would be desired for AICs where angels are required to spend significant time and effort with an AIC.

For the avoidance of doubt, the legislation and supporting guidance, should clarify whether or not the $200,000 cap on the tax offset applies to an investor in relation to all eligible investments in an income year (i.e. not for each eligible company).

Indirect investment via an Innovation Fund

Form of Innovation Fund entity

The Paper suggests on its face that the proposed ‘flow-through’ company regime is intended to be the only type of fund vehicle which would enable groups of investors to invest into AICs.

Although we welcome the introduction of such a novel vehicle in the tax law, we submit that the Innovation Fund should be able to be raised in the form of a unit trust or an incorporated limited partnership (taxed as a partnership under the exclusions to Division 5A of the *Income Tax Assessment Act 1936*) such as VCLPs and ESVCLPs.

Australian tax law already has flow through vehicles in the form of trusts and look-through limited partnerships which are well understood by investors. In the interests of achieving the policy outcome of delivering capital to AICs, these types of vehicles should not be excluded from investing in AIC and delivering the same tax outcomes as a look-through company.

We therefore request that Treasury clarify that investments through other flow-through vehicles, such as trusts and partnerships (including limited partnerships), can qualify for the TIESI, either as an innovation fund or through equivalent corresponding rules.

We note that a look-through company vehicle is yet to be designed or introduced into the Australian tax law, but we understand that it is being considered as part of the Collective Investment Vehicle (CIV) regime.

We observe that the introduction of a look-through company vehicle would significantly add lead time to the incentive being used by Innovation Funds for the reasons set out below.

- Complex drafting and ancillary changes will be needed to the *Income Tax Assessment Act 1997* to enable such a change to be introduced, e.g. there could be issues in reconciling the investor's cost base in shares in the fund company versus the fund company's cost base in the underlying AICs.

- Corporations Act amendments may be needed to ensure that the regulations dealing with corporate fundraising is not burdened by the complex regulation governing such activity. We note that this does not apply to other fund vehicles such as trusts and incorporated limited partnerships. Absent such amendments, fundraising would be prohibitively expensive and difficult from a regulatory perspective.

- Corporations Act provisions may need to be introduced to allow shareholders to demand profits be distributed to them to fund any tax liabilities (e.g. if the investment does qualify for the CGT exemption) where the proceeds are retained within the fund. That is, investors should be entitled to a dividend to be paid.

- As companies are not currently used as fund vehicles, we expect a lot of complexity in constituent documents and diligence by prospective investors grappling to understand a look-through company before choosing to commit funds to such a vehicle.

Treasury will be aware that ESVCLP and VCLP structures are common in the venture capital sector.

We submit a new vehicle called an Innovation LP (ILP) (similar in design to the ESVCLP and VCLP) should be introduced. ESVCLPs and VCLPs operate in delivering the intended tax outcomes by essentially providing a corporate-like form (being bodies corporate) but with partnership treatment for income tax purposes.

Maximum investment size

In relation to Innovation Fund eligibility requirements, we also have a concern with the following proposed eligibility rules:

- "… 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
- 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."

We believe that such limitations are inconsistent with the policy intentions and are inconsistent with the rules dealing with direct investment.

30% cap on investing in any single AIC

An Innovation Fund should not be prevented in having a significant investment in an AIC provided that the fund's investors do not have an indirect stake in the AIC of more than 30%.

This is because the fund should be seen as a group of investors coming together collectively as opposed to single investor.

Capping the fund's investment to 30% of any AIC does not recognise this "look-through" approach.

Take as an example, a fund constituted by 5 unrelated investors each holding 20% of the committed capital of a fund. Why should these investors be limited to investing only 6% investment in the AIC (applying a look-through approach) (i.e. the Innovation Fund's 30% investment divided by 5 investors). That is, the 30% "cap" has to be shared amongst a group of diverse investors.

Such an approach would also result in fund managers being required to establish multiple fund vehicles to facilitate investment by different groups of unrelated investors seeking greater exposure to the same AIC.

This limitation is inconsistent with that imposed on investors who choose to invest directly into an AIC where each investor could take a shareholding of up to 30% in any single AIC.

It is also inconsistent with the ESVCLP and VCLP rules which permit the fund entity to make an investment of up to 100% in the company.

The ESVCLP rules address this "concentration of investor" issue by limiting any single investor to 30% of the committed capital of the fund (except where dispensation is sought from Innovation Australia), thereby limiting the indirect ownership of the investee entity to 30% to any single investor.

We submit that this is the appropriate model for the Innovation Fund rules.

Integrity rules could be addressed through a “grouping” and “aggregation” rule which would ensure that the related investors are grouped together in determining the 30% limitation (consistent with the direct investment model).

Should the limitation over investment in any single AIC be retained, the 30% of issued capital in an innovation company should not be tested immediately after the time shares are issued. Consistent with the equivalent rule for direct investments, this should be over a reasonable period, say at the end of the income year.

10% cap set by reference to the fund’s committed capital

We also do not support the limitation where the fund cannot invest more than 10% of the fund’s committed capital in a single investment. Again this requirement does not apply to direct investors in the AIC. Secondly, we are not sure what the policy intent is in compelling the fund to make at least 10 investments.

We again contrast this with the ESVCLP and VCLP rules where the fund is able to invest up to 30% of its committed capital in any single investment and a single investor is not forced to invest in at least 10 AICs to obtain the concession.

Income and gains from AICs

The Paper is silent around the treatment of gains and returns from AICs.

We note that it is announced that capital gains will be exempt.

However, it is necessary to clarify that this also means that any gains on revenue account would also be exempt. There is considerable uncertainty around this issue given the ATO’s approach to investment funds and “professional” investors taken in Taxation Determination TD 2010/21. Accordingly, a deemed capital account treatment for investment in AICs should be legislated and the exemption should be made clear that it extends to both income and capital gains (consistent with the ESVCLP measures).

It would be appropriate from a policy perspective to exempt dividends paid by AICs consistent with the ESVCLP measures. This would ensure that there is no incentive for the AIC to retain profits which would to enable investors to realise an exempt capital gain.

It is also not clear that the proposed capital gains exemption extends only to gains occurring under CGT Event A1 (i.e. the disposal of the shares).

Furthermore, we understand that it is intended that the cost base which investors have in an AIC will be deemed to be nil, to prevent a capital loss arising.

Such an approach would mean that a return of capital would potentially be subject to tax under CGT Event G1. Therefore, in framing the exemption, it would be important to ensure that any gain related to the shares is exempt.

We submit that a much simpler mechanism is the one adopted in the VCLP and ESVCLP rules. These rules operate to simply disregard any capital gain or any capital loss in relation to the investment (see sections 118-405 and 118-407 of *the Income Tax Assessment Act 1997*) without having to employ complex cost base adjustment mechanisms.

Integrity measures

EY welcomes the proposed integrity measures as it will promote the policy intent of the measures. Treasury should also consider a measure which would prevent “capital recycling” through AICs whereby capital invested into the AIC (after an investor has claimed the 20% offset) is returned by way of a capital return, or dividend subsequently reinvested again into the AIC.