KPMG submission

Treasury Consultation Paper

Tax incentives for early stage investors

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Executive Summary

KPMG welcomes the opportunity to comment on the Consultation Paper of Tax Incentives for Early Stage Investors as published by Treasury on 15 February 2016.

Our submission focusses on three aspects of the consultation paper as follows:

Australian Innovation Company. We agree with an approach that broadly defines an 'innovation company' with a list of exclusions that are simple to apply. Our main concern is a definition of innovation company, which involves a list of considerations in determining whether the company carries on a business that is "eligible" is problematic. Our concern is that this definition may lead to similar complexity and uncertainty to that which has arisen under the VCLP rules. We are also concerned the list of exclusions that precludes an entity from being an innovation company is too broad. Exclusion no.13 exclusion "Provision of services or facilities for another business" is too broad and would cover almost any service provided to another business even though it might be considered as 'change that adds value'. A suggestion is that instead of this specific exclusion replace it with a regulation making power to enable appropriate activities to be excluded.

Direct Investment into an Innovation Company. A number of our clients are concerned with the limitation to 'sophisticated investors' as defined in the Corporations Act 2001, which essentially is defined as those earning more than $250,000 per annum or having a net worth of more than $2.5 million would exclude an important group of smaller seed capital providers and become a roadblock in accessing capital for aspiring entrepreneurs. Some have questioned whether the tax act is the right platform to limit the type and nature of investors in innovation companies. One suggestion is that the tax incentive be tied with another important innovation agenda reform, equity crowd funding (Exposure Draft legislation released 22 December 2015). The new regulatory framework and safeguards developed around that to protect investors from financial and other risks including fraud could be extended and applied to the new tax incentive. We acknowledge this is a difficult issue that requires further consideration.

Indirect investment via an Innovation Fund. Given unit trusts can achieve the same taxation outcomes as desired by the stated policy objectives, which are also understood largely by Australian and foreign investors, unit trust structures should also be eligible to facilitate the new tax incentive.

Detailed comments

1 General

1.1 KPMG welcomes the opportunity to comment on the Consultation Paper of *Tax incentives for early stage* investors as published by Treasury on 15 February 2016.

1.2 KPMG notes the critical importance of creating an economic and regulatory environment which supports innovative start-ups and ensures that Australian start-ups have access to the equity funding they need through appropriate incentives for investors.

1.3 Our experience of working within the existing regimes which were intended to support investment into early stage and innovative enterprises, such as the early-stage venture capital limited partnership ("ESVCLP") regime, is that the success of concessionary regimes depend heavily on their simplicity and ability to adapt to the fast changing circumstances of early stage businesses. As such, our comments below represent our insights on the initial proposals for a tax incentive for start-up investors based upon our experiences of what has and has not worked from previous regimes.

1.4 We recommend that the provisions be drafted in a way that minimises the burden of complying with the provisions and ensures that they are appropriate to achieve their aim of encouraging equity investment into Australian start-ups.

2. Australian Innovation Company

2.1 *Key criteria.* It needs to be clarified that this criteria applies only at the time of the investment and is not an ongoing requirement which needs to be met. From our experience with the ESVCLP regime, it can be unnecessarily burdensome and costly for investors to need to constantly monitor whether an investee company continues to satisfy valuation thresholds and to structure an exit from the ESVCLP once such thresholds are breached. Therefore, we recommend that the criteria need only be met once and is not subject to on-going monitoring.

2.3 The assessable income and expenditure amounts appear low, particularly the expenditure amount threshold. It would be helpful to understand the empirical evidence obtained by Treasury in reaching a conclusion that these threshold numbers will ensure the appropriate entities are able to access the early stage investor tax concession. In addition, it is unclear from the discussion paper whether both the assessable income and expenditure tests need to be satisfied or just one of these tests need only be satisfied for an entity to be an ‘innovation company’. Consideration should be given to whether some form of indexation mechanism or an alternative ability to review the threshold is appropriate in future years.

2.4 The interaction of the threshold tests with the tax consolidation rules also needs to be considered, in particular, how the single entity rule applies to the income and expenditure threshold tests. In our experience, the absence of clarity as to operation of tax consolidation rules to the eligible venture capital investment rules in s.118-425 (notwithstanding the operation of s.118-425(16)) has caused considerable angst in the industry and affected the success of the VCLP/ESVCLP regime. We recommend Treasury considers how the tax consolidation rules interact with the new tax incentives for early stage investors.

2.4 *Method 1 – Principles based definition.* We agree with an approach that broadly defines an ‘innovation company’ with a list of exclusions that are simple to apply.

2.5 A definition of innovation company, which involves a list of considerations in determining whether the company carries on a business that is “eligible” is problematic. Our concern is that there are risks the complexity and uncertainty which has arisen under the VCLP rules (refer section 118-425(13)) will be replicated. Given the broad nature of activities engaged in by start-up companies, which include financial technology (“Fin Tech”), peer-to-peer services including financing, development and exploitation of intellectual property, a narrowly drafted list of eligible activities is not appropriate for a tax incentive for start-up companies. Consideration should be given to the appropriateness of other concepts of ‘innovation’ outside the OECD definition. For example, the BRW Most Innovative Companies Top 50’s adopts a broad definition of “innovation” i.e. simply “change that adds value”.

2.5 In addition, from a statutory interpretation perspective, if there are to be specific exclusions, then the definition of “innovation” should be broad as possible. The concept of “innovation” would mean different things in different contexts or industries. Given the limited resources of start-up entities, the definition should be as broad and flexible as possible to ensure that eligible entities are not deterred from accessing the concessions due to the high cost of seeking advice on compliance with the definition, or, alternatively, are not unnecessarily excluded from obtaining the concession due to their activities not satisfying a narrowly drawn concept of "innovation". Exclusion no.13 exclusion "Provision of services or facilities for another business" is too broad and would cover almost any service provided to another business even though it might be considered as 'change that adds value'. A suggestion is that instead of this specific exclusion replace it with a regulation making power to enable appropriate activities to be excluded.

2.6 *Method 2 – Gateways and Safe Harbours.* We understand from recent consultation with Treasury that a gateway or safe harbour criteria based on a points system is being considered. For example, 100 points where a start up has received a major federal grant or comes from an approved accelerator, or less points for self-assessed criteria like R&D expenditure. We believe this approach could provide certainty in determining eligibility requirements and utilise existing processes.

2.7 *Method 3 – Determination.* We also recommend AusIndustry, being a body with experience on innovative companies, should be a party to make decision as to whether company qualifies. In addition, we also query whether the ATO would also be a useful resource in making a determination as to what constitutes innovation.

3. Direct Investment into an Innovation Company

3.1 The exclusion of "affiliate investors" would appear to prevent persons related to a start up from accessing concessions which would otherwise be available. This prevents access to an initial source of a capital which might not otherwise be available from even venture capital sources. There appears to be no policy basis for the exclusion.

3.2 The numerical integrity measure as to the quantum of the offset available appears sufficient to address any integrity issues associated with this. Alternatively, investors to which the Innovation Company is an affiliate of could be, in respect of that specific investment, subject to a limited tax offset, instead of the current 20%.

3.3 For direct investors, a number of our clients are concerned about the proposal to limit the availability of the tax offset to 'sophisticated investor's as defined in the Corporations Act 2001, which essentially is defined as those earning more than $250,000 per annum or having a net worth of more than $2.5 million. We understand the principle for this limitation has the benefit of protecting ‘less sophisticated investors’ from being misguided on high risk investments and reducing extensive disclosure requirements for innovation companies. On the hand, ‘smaller’ investors will be prevented from accessing the benefit to the tax incentive.

The policy issue to be addressed is whether ‘smaller’ investors ie those with less than $2.5million net assets or earn less than $250,000 should not be encouraged to invest in innovation companies by denying them access to the tax incentive or should further consideration be given in striking the balance between allowing them access to the tax incentive with appropriate safeguards. In addition, some have questioned whether the tax act is the right platform to limit the type and nature of investors in innovation companies. We acknowledge this is a difficult issue that requires further consideration.

One suggestion is that the tax incentive be tied with another important innovation agenda reform, equity crowd funding (Exposure Draft legislation released 22 December 2015) where smaller investors can take an equity stake in a start up venture through an online portal which would allow them to diversify their risks across many ventures. The new regulatory framework and safeguards developed around that to protect investors from financial and other risks including fraud could be extended and applied to the new tax incentive.

4. Indirect investment via an Innovation Fund

4.2 There is a policy opportunity here to expand eligible investors to accommodate “crowd funding” investments which are similar to successful programs currently in place in New Zealand (see https://fma.govt.nz/compliance/role/crowdfunding-platforms/). This will require consultation with ASIC to potentially amend Corporations Law.

4.3 If Innovation Funds are to be structured as companies, consideration will need to be given as to how capital gains flow through to investors. The policy of using corporate vehicles will require a significant enactment of new legislation for innovation company taxation (i.e.: definition of dividends, returns of capital).

4.4 Given unit trusts can achieve the same taxation outcomes as desired by the stated policy objectives, which are also understood largely by Australian and foreign investors, unit trust structures should also be eligible to facilitate the new tax incentive.