Private & Confidential

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Dear Jodie and Phil

Policy discussion paper: Tax incentive for early stage investors

We refer to your policy discussion paper released for public comment on 15 February 2015.

PricewaterhouseCoopers (**PwC**) is grateful for the opportunity to provide a submission in relation to the matters set out in your discussion paper and welcomes the opportunity for continued involvement throughout the consultation process.

A submission provided by Mr Kel Fitzalan of PwC has been made on behalf of our Private Clients Services team, which represents high net wealth individuals and small to medium enterprises.

This second submission is made on behalf of our Tax and Legal Services team, which represents larger enterprises.

1. Overview of the new tax incentive

We welcome the new tax incentive and recommend considering the following changes and clarifications for the proposed tax incentive framework:

- We recommend the mechanics for calculating the $200k tax offset annual cap be revisited. Instead of investors being limited to claiming a $200k tax offset for eligible investments each income tax year, we recommend investors be limited to claiming no more than $1m in tax offsets over any 5 consecutive income tax years, tested at the end of the income year in which the offset is being claimed. This would enable greater flexibility in accessing the tax offset, so that investors can better match the funding requirements of innovation companies, whilst still limiting the total tax offset available to investors. For instance, an innovation company may require $2m of funding from an investor in one income tax year in order to invest upfront in innovation activities. The current structure for the proposed tax offset would fail to encourage that upfront $2m investment and instead encourage an upfront investment of $1m and a delay in further contributions until the next income tax year.

- We recommend the enabling legislation clarify at what point, or points, in time a company must be classified as an 'innovation company' in order for investors to claim the tax incentive. We recommend an assessment be made at the point in time an investor invests capital. That assessment should then be maintained until the investor disposes of their investment, subject to any fundamental change in the activities undertaken by the company.

2. Australian innovation company

We welcome the new tax incentive and recommend considering the following changes and clarifications for the proposed requirements that must be satisfied in order to be an eligible 'innovation company':

- Consistent with our earlier submission, we recommend the innovation company expenditure thresholds be revisited. In addition to increasing the innovation company expenditure thresholds, we welcome any change that brings about greater flexibility in when an innovation company can incur expenditure. For example, similar to the mechanics we have recommended above for calculating the tax offset annual cap, instead of innovation companies being limited to expenditure of $1m in the prior income year, we recommend innovation companies be limited to no more than $3m of expenditure over a 3 year period. This approach recognises the potential variability of expenditure that may be incurred by start-up companies in their early stages of development and prevents investors in these companies from being disqualified from the regime by virtue of this variability alone.

- Consistent with our earlier submission, we consider the requirement that a company be incorporated during the last three income years to be overly restrictive. This requirement places too much emphasis on the period that has elapsed since the establishment of the investee entity, which has no substantive connection to the objectives that the regime is designed to achieve. This requirement could result in the regime not applying to investments in companies, such as shelf companies or previously dormant companies, that have only just commenced innovative activities but have been in existence for longer than a three year period. We therefore recommend removing this requirement or modifying it so that the three year period is measured by reference to a more relevant variable, such as the commencement of the activities that make it qualify as an innovation company.

3. Method 1 – Principles-based

We welcome a principles-based approach that defines the term 'innovation' in the enabling legislation.

We are supportive of the introduction of a points-based system to assessing whether an activity should satisfy the definition for 'innovation'. We envisage that under a points-based system, an activity will be awarded a pre-determined number of points for each 'innovation' criteria it meets; provided a pre-determined threshold of points is reached, the activity will be deemed as satisfying the definition for 'innovation' under the enabling legislation. We believe this approach will be easy for stakeholders to apply and will provide clarity in how potential innovation companies and eligible investors should objectively self-assess whether an activity satisfies the definition for 'innovation' under the principles-based approach. However, we do recognise that the initial design of such a points-based system that is fair and appropriate may require significant up-front work for Treasury's legislative draftsmen and other Government and public service stakeholders.

We suggest that a measure is included in the enabling legislation to allow for additional types of activity to be deemed by regulation to generate points, in order to incorporate new policy initiatives as they may emerge.

We recommend the following concepts raised in the discussion paper be clarified:

- Whether it is possible for activity undertaken to bring about a new way of operating, new product, new service, new platform or new method in a specific country or area can satisfy the definition for 'innovation' even if that way of operating, product, service, platform or method already exists somewhere else in the world. In this case, we believe that the activity can still involve innovation where the product, service or platform is tested, calibrated, refined or varied to better suit the Australian market. We note that integrity measures would be required to ensure that such activities were not viewed as innovative if a franchising or distribution agreement (or indeed any type of agreement) were in place between overseas providers and the local innovator.

- Whether it is possible for activity to be undertaken solely in Australia, without a view of global expansion, to satisfy the definition for 'innovation'. The discussion paper suggests all innovation companies will need to pursue global or broader opportunities rather than having a focus only on local markets. We consider this requirement unnecessarily restrictive and the companies should be classed as eligible to meet the requirements for an 'innovation company' regardless of whether the company has intentions to expand globally or the company is intending to deploy its innovative technology offshore.

- Whether a novel, but not entirely new, way of operating, product, service, platform or method will satisfy the definition for 'innovation' under the enabling legislation. For example, through research, development and implementation, the way in which an existing product with an established market is developed or used may change. Whilst a new product is not created, in our view an activity that may be classified as 'innovation' has been undertaken in order to bring about change to the existing product.

4. Exclusions

The discussion paper sets out a list of activities that may be excluded from the proposed tax incentive on the basis that the activities may not satisfy the definition for 'innovation' under the enabling legislation.

We consider the proposed list of excluded activities to be too broad in nature. For this reason, we are concerned that the exclusions may result in activities that are both innovative and within the class of activities that the proposed tax incentive is intended to encourage, failing to meet the definition for 'innovation' merely because the activities are related to an area identified as an excluded activity.

For instance, item 13 of the exclusions, which deals with the "provision of services or facilities for another business" is an extremely broad category of exclusion and may inappropriately preclude some truly innovative activities from falling within the bounds of this incentive, such as recently developed ride-sharing applications and takeaway food ordering applications.

The principles-based definition for 'innovation' should be the legislative mechanism that determines whether activities fall within the scope of the proposed tax incentive. Provided that the principles-based definition applies as intended, the list of explicit exclusions should not be required and the incorporation of exclusions into the law would only serve to complicate the operation of the proposed tax incentive framework. While the proposed list of exclusions may be appropriate in the case of the UK Seed Enterprise Incentive Scheme (**UK SEIS**), the UK SEIS adopts a fundamentally different framework to that proposed in the discussion paper, in that the UK SEIS applies to a broad range of activities unless an exclusion applies. The principles-based definition for 'innovation' in the discussion paper imposes a stricter threshold for eligibility than the UK SEIS and, together with the gateway principles, should be sufficient to restrict availability of the proposed tax incentive to appropriate innovative activity.

The discussion paper also notes that the proposed list of excluded activities is aimed at preventing the promotion of schemes that are primarily about tax minimisation for established sectors and industries. We consider the opportunity for innovation exists in establish sectors and industries and that, in some respects, there is a heightened need for innovation in such industries as long standing methods of performing business can create the opportunity for disruption through research, development and implementation of new ways of operating, products, services, platforms and methods. In our view, the proposed tax incentive should be designed to encourage investment into innovation companies that seek to disrupt established sectors and industries and to create new, value adding and market leading opportunities for Australia, provided those innovation companies are at an early stage.

Notwithstanding our above comments, we acknowledge that from a public policy perspective there may be a need to exclude some sectors or industries from the scope of the incentive. However, we recommend that this list of exclusions be as short as possible to minimise distortions to capital flows and market forces.

5. Limiting the class of eligible investor through applicable of the 'sophisticated investor' test

The discussion paper considers limiting the class of investors eligible to access the tax incentive to 'sophisticated investors' as defined in the *Corporations Act 2001*. We understand the purpose of limiting the class of investors to sophisticated investors would be to ensure innovation companies have access to the commercial expertise of sophisticated investors and to limit the disclosure requirements required during fund raising. We also understand that there is a concern that the proposed tax incentive, if left open to all investors, could be open to abuse by promoters that encourage unsophisticated investors to invest into an innovation company or innovation fund without the promoter properly disclosing the risks associated with that investment and the conditions that must satisfied in order to access the tax incentive.

The need for a 'sophisticated investor' test is linked to the aim of the innovation incentive. If the Federal Government intends to encourage existing angel investors to direct more capital towards the start-up industry, this measure may be appropriate. However, if the Federal Government intends to broaden the pool of potential angel investors that choose to invest in the sector, a sophisticated investor test may be too restrictive and therefore inappropriate.

We understand that the underlying policy objective of the proposed tax incentive is to encourage investment in Australian innovation companies at earlier stages. Based on the Federal Government's press release dated 7 December 2015, we understand that the method for achieving this was to incentivise existing angel investors to continue to invest, and to encourage new angel investment from a broader pool of potential investors. For this reason, limiting the class of eligible investors to sophisticated investors appears contrary to the policy intent behind the proposed tax incentive.

If there is a concern that promotors may use the proposed tax incentive as a scheme for abuse, that concern should be addressed through integrity measures, noting that there are already provisions that may apply to that activity including the promoter penalty regime legislated in Division 290, Schedule 1, *Taxation Administration Act 1953 (Cth)*.

We caution against the use of such a restricting factor to determine eligibility and instead encourage that eligibility for the proposed incentive scheme be governed by the principles-based definition for 'innovation' and the definition of what constitutes an eligible innovation company.

6. Indirect investment via an innovation fund

We welcome the introduction of a framework that allows indirect investment via an innovation fund to access the proposed tax incentive.

We recommend the innovation fund framework be revised as follows:

- The enabling legislation should set out strict requirements governing when capital invested in an innovation fund must be deployed. The purpose of the proposed tax incentive is to encourage investment in innovation companies at earlier stages. We agree with the policy position that taxpayers should not be entitled to access the proposed tax incentive on investing into an innovation fund unless that innovation fund, in-turn, invests that capital into qualifying innovation companies.

- We are concerned that measures considered in the discussion paper that enable taxpayers investing in an innovation fund to access the proposed tax offset at the time the innovation fund invests its capital in innovation companies (rather than at the time the taxpayer invests in the innovation fund) will create unnecessary complexity.

- To ensure that capital invested in an innovation fund is deployed, we recommend the enabling legislation include a requirement that innovation funds must utilise a prescribed threshold of any invested capital within a prescribed period of time (for instance, 90% of capital invested in an innovation fund must be invested in eligible innovation companies within 6 months of the innovation fund receiving the capital). Where a fund fails to meet this requirement that fund should cease to be classified as an eligible innovation fund and taxpayers investing in that fund should no longer be eligible to benefit from the proposed tax incentive. In addition, any tax offsets claimed by investors in the fund should be clawed back.

- A similar rule could also be incorporated into the regime, requiring innovation companies to spend the relevant invested capital on eligible innovation activities within prescribed period of time. This should ensure that the capital invested in innovation companies is actually used to undertake innovation activities and would help prevent abuse of the regime.

- The requirement for an innovation fund to be a company appears unnecessary, overly restrictive and incompatible with existing commercial practices. Alternative vehicles exist which also provide for limited liability and appropriate governance processes. An innovation fund should include vehicles other than companies, such as an Australian unit trust or limited partnership.

This will provide greater flexibility, making the proposed tax incentive more accessible to a greater population of investors and, in turn, increase the sources of potential funds for investment in innovation companies.

- The framework should address the concerns with existing strict tax incentive regimes, such as the Venture Capital Limited Partnerships (**VCLPs**) and Early Stage VCLPs (**ESVCLPs**), namely:

  – the enabling legislation should provide clarity as to whether investments into an innovation fund, as well as investments by an innovation fund into an innovation company, are investments on capital or revenue account. We agree with the position adopted in the discussion paper that investments in an innovation fund, as well as investments by an innovation fund into an innovation company, will generally be on capital account. However, similar to the existing and proposed Managed Investment Trust (**MIT**) regime, the enabling legislation could include an option for a capital account election that, if made, deems all investments to be on capital account. Alternatively, the enabling legislation could deem investments that are held for at least three years (the proposed holding period requirement to qualify for the proposed CGT exemption) to be held on capital account; and

  – the enabling legislation should provide clear rules for determining whether a taxpayer and another entity are affiliates and clarify common investors in an innovation fund are not affiliates merely as a result of that investment.

- We recommend increasing, or removing, the $50m cap on committed capital for innovation funds.

7. Integrity measures

The discussion paper notes that integrity measures should be included in the enabling legislation to ensure the proposed tax incentive operates in the manner intended. The specific activities raised in the discussion paper include investors accessing a tax offset that is greater than the proposed $200k cap, investors entering into arrangements in order to trade in the value of the proposed tax offset, contrived or artificial company restructures undertaken in order to meet the definition for innovation company and investors accessing the proposed CGT exemption on disposal of an innovation company that holds CGT assets that are unrelated to innovation activities.

In our view, the types of activities raised as a concern in the discussion paper and Treasury round table discussions should fall within the scope of the general anti-avoidance rules legislated in Part IVA of the *Income Tax Assessment Act 1936 (Cth)* and the promoter penalty regime legislated in Division 290, Schedule 1, *Taxation Administration Act 1953 (Cth)*. For this reason we consider it unnecessary to include specific integrity measures in the proposed tax incentive enabling legislation.

The Australian income tax system is a self-assessment system, which places the onus on taxpayers to self-assess their income tax position each income tax year. We consider that, consistent with the current operation of the Australian income tax system, taxpayers should self-assess their eligibility to benefit from the proposed tax incentive. We consider this approach reasonable as, notwithstanding that an innovation company's activities are relevant to determining whether taxpayers investing in the company can access the proposed tax incentive, it is taxpayers that will benefit from the proposed tax incentive.

We are mindful that an investor's ability to assess whether they are eligible to benefit from the proposed tax incentive may be restricted, as it is the activities of a separate legal entity, the innovation company, that are relevant to determining whether an investor can access the proposed tax incentive. We consider this to be more likely where investors are not 'sophisticated investors' as defined in the *Corporations Act 2001 (Cth)*. Whilst limiting the class of investors eligible to access the tax incentive to sophisticated investors may result in a lower risk of taxpayers failing to comply with the proposed tax incentive enabling legislation, for the reasons stated a section 3 above, we consider limiting the class of investors eligible for the proposed tax incentive contrary to the policy intent behind the proposed tax incentive.

We recommend the enabling legislative provide an optional mechanism for innovation companies to approach the administering body and obtain confirmation that their activities meet the principle-based definition for 'innovation' under the points-based system referred to in section 1 above. We envisage the confirmation process being similar in approach to Method 3 'Determination', which is proposed to be made available for companies failing to meet the criteria set out under proposed Method 2 'Gateways and Safe Harbours'. This confirmation could then be used to provide investors with certainty as to whether they are eligible to benefit from the proposed tax incentive.

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If you have any questions regarding our submission, please do not hesitate to contact us on the numbers below.

Yours sincerely

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