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The Treasury  
Langton Crescent  
PARKES ACT 2600

24 February 2016

Dear Sir/Madam

**Re: Policy discussion paper - Tax incentives for early stage investors**

Enclosed is a submission authored by StartupAUS in response to the Government's February 2016 discussion paper entitled '*Tax incentives for early stage investors*'.

StartupAUS is a not for profit organisation with a mission to transform Australia through technology entrepreneurship.

StartupAUS for some time advocated strongly for a scheme similar to the UK's Seed Enterprise Investment Scheme (SEIS) to be implemented in Australia. We have therefore attached, for context, our November 2015 policy proposal in which we outlined the case for, and shape of, such a scheme in Australia.

In our view, an Australian tax incentive scheme similar to the UK's SEIS would redirect capital towards startups by adjusting the early stage investment risk equation. This would address a market issue which we have repeatedly identified in the Australian startup funding landscape.

Such a scheme would also have the desirable effect of expanding the Australian pool of angel investors. Australians are prolific investors - but not enough Australians with investible capital are exposed to the potential that high-growth, innovative startups offer. Moreover, a wider base of angel investors would help to expose Australian startups to a broader spectrum of experience and expertise. This is extremely valuable, as high quality mentorship and investor advice is a key driver of startup success.

StartupAUS strongly supported the announcement of this tax incentive scheme in December as part of the National Innovation and Science Agenda. We also commend the government's efforts to design this scheme in consultation with all relevant stakeholders. We trust that the views of the sector will be given due weight, particularly given the novelty of this scheme and the speed of its design and implementation.

We note that we have already consulted both formally and informally with government on the detail of this policy proposal, including at the Treasury roundtable in Sydney on 19 February. Given those consultations, and the tight time frame for this submission, we have kept our comments brief.

I encourage you to follow up with me if you have any points you would like to clarify or discuss.

Yours faithfully,

**Alex McCauley**  
CEO, StartupAUS

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## Australian Innovation Company

- We support a principles-based approach to defining companies eligible for the scheme
- In order to satisfy the definition of an 'innovation company', we would recommend the adoption of a points system
  - A similar system is used in the Business Innovation stream of the *Business Innovation and Investment Visa* legislation (though we would caution against adopting the particular criteria outlined in that scheme)
- As part of the points system, very substantial weight should be given to a number of market-based indicators that a company is a qualifying company (such as acceptance into an approved incubator or accelerator program)
  - These 'shortcuts' should be made as clear as possible, to ensure certainty
- Where a company does not qualify for a 'shortcut', points could be awarded for elements such as:
  - Technology elements of a company's product, including patents acquired or pending
  - Potential market size addressed by the company's product
  - Scalability of the company's business model
  - Percentage of company's business activities eligible for R&D Tax Incentive
  - Whether the company has implemented an employee share scheme
- The scheme should include provision for startups or investors to apply to have a determination made as to the status of a prospective investee company
- The scheme should include room, as part of the principles-based approach, for a qualitative determination to be made as to the status of the company notwithstanding its score on the points test
- The scheme should not be restricted to sophisticated investors. To do so would substantially limit the policy outcomes and would unnecessarily limit access to a tax concession to the already wealthy

## Eligible investors

In StartupAUS's view, the policy outcomes this scheme should seek to achieve are twofold:

- 1) To increase the availability of early stage capital to startups; and
- 2) to deepen and broaden Australia's pool of angel investors.

Anecdotal and data-driven experience in the UK suggests that both of these outcomes have contributed substantially to the rapid growth of the startup ecosystem in that jurisdiction.

In our view, the restriction of the scheme to sophisticated investors is both unnecessary and reduces substantially the scheme's effectiveness in achieving both policy outcomes. A smaller pool of investors limits the exposure of a broad range of Australians to startups, and limits startups' exposure to a broad range of experience and advice. It will reduce the pool of funds available, and limit the ability of most prospective Australian investors to develop expertise and knowledge in this investment class.

We understand that this element of the scheme has been suggested as a measure to protect retail investors from an asset class that is risky. Our view is that protection is unnecessary, and, in any case, this approach would not achieve the outcomes desired.

Experience in the UK, where the SEIS is open to all investors, suggests that there hasn't been a retail stampede to invest under the scheme. Most companies receive fewer than five individual SEIS investors. Given that the UK scheme encompasses a broader range of companies than is envisioned for this scheme, it is unlikely that this scheme would attract mass uptake by retail investors who have not done appropriate due diligence.

Moreover, restricting this scheme to sophisticated investors does not 'protect' retail investors from this asset class. Rather, it restricts the *tax concession* to sophisticated investors, excluding retail investors from this benefit. Instead of protecting retail investors, the proposal would simply unfairly advantage already wealthy sophisticated investors.

One useful concept to consider, if Treasury is convinced that more protections need to be applied to retail investors, is an investment cap based on 'total investable wealth'. This is a concept used in other jurisdictions to similar effect, and would be both more equitable and less deleterious to the overall policy outcomes in this case.

## Policy proposal - Seed Enterprise Investment Scheme (SEIS)

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### **Policy objective**

To foster growth in the number and quality of Australian startups by increasing the availability of early-stage capital in the domestic funding market.

### **Recommendation**

An Australian tax incentive scheme similar to the UK's Seed Enterprise Investment Scheme (SEIS) would redirect capital towards startups by adjusting the early-stage investment risk equation. The scheme has 3 core elements:

- Immediate income tax deductions for 50% of value of eligible early-stage investments
- Full CGT exemption for eligible assets held for 3 or more years
- CGT discounts for capital gains made in other sectors but 'reinvested' in startups

If a similar scheme were introduced here, the end result will be to free up some of Australia's abundant capital resources to allow innovative, high-growth companies to be born here rather than looking overseas for funding. The flow-on effects of this would be substantial, and multi-layered:

- increased funding would attract more entrepreneurial talent, both local and international;
- faster growing companies lead to speedy, large-scale job creation and economic growth;
- an increase and diversification in seed investment would lead to a more experienced, sophisticated pool of Australian angel investors
  - which would in turn lead to a proliferation of experienced mentors for startups.

### **Details**

- Scheme applies to investments in small early-stage Australian startups in certain high-growth industries
  - Small:
    - a company whose gross assets immediately prior to seeking funding under the scheme do not exceed \$500,000
    - a company with fewer than 30 full time employees
  - Early-stage: a company which has been actively trading for less than two years
    - 'actively trading': should not include a period of up to two years spent on R&D preceding the commencement of active trading
  - Australian: company must be permanently headquartered in Australia

- High-growth industry: company must not be operating in certain industries.
- Income tax deduction for eligible investments where the asset is held for three or more years
  - Claimable on 50% of the total value of the investment
  - Up to a maximum of \$200,000 per annum
  - Claimable in the year the investment was made, but clawed back if assets disposed of within three years
  - Claimable either against tax liability in the year the investment was made or the preceding year - at the discretion of the investor
- Full capital gains exemption for eligible early stage investments held for longer than three years
- Capital gains tax reduction of 50% for CGT-eligible gains which are reinvested in eligible early-stage investments under the scheme
- Limited to investors who own, or would own after the investment, less than 30% of the company seeking investment
- A \$500,000 limit on capital raising under the scheme
  - this is a lifetime limitation for the company.

### **Vision**

Australia's investment framework does not yet support startups adequately. Investing broadly in a range of small companies is costly and risky - investors have therefore traditionally looked to larger investments in more established or capital-intensive enterprises.

Australia is not alone in this: other governments have recognised the inherent limitations of markets in this area. The limitation in supply of seed capital and 'smart money' to early stage companies inhibits the growth and proliferation of potentially extremely valuable businesses. International experience has shown that a proliferation of active angel investors is a critical element in increasing startup formation, growth, and longevity.

We need more independent, wealthy Australian angel investors to be looking to startups as an investment opportunity. Angel investors with skin in the game are often referred to as 'smart money' and have time to dedicate to helping entrepreneurs succeed. Large institutional investors are less able to mentor and guide the leaders of the companies in which they invest.

Australia is not lacking in the requisite resources for a thriving angel investor community - the country's wealthiest 1 per cent (approx 200,000 people) hold a combined \$684 billion worth of assets. Incentivised appropriately, this capital could be encouraged into high-growth startups - helping to drive a vibrant innovation economy.