Sydney Angels
Sydney Angels Incorporated
NSW Incorporated Association 9896613
ABN 52 637 980 942
Suite 145, Level 1, National Innovation Centre
Australian Technology Park
Eveleigh NSW 1430
www.sydneyangels.net.au

Email: contact@sydneyangels.net.au

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Re: "Tax incentives for early stage investors" policy discussion paper

We are the management committee of Sydney Angels Incorporated, a not-for-profit member services organisation currently with 83 angel investor members mostly in Sydney. We wish to make some comments and recommendations relating to three sections of the consultation paper. So you can weigh the motives and experience behind our comments and recommendations it is important that we first give you an understanding of what Sydney Angels is and what our members do.

We established Sydney Angels in 2008 to create a supportive environment where individuals could select and invest collaboratively, and therefore more effectively, directly into start-ups. We were motivated to do this by our personal and professional experiences of the difficulties start-ups face when trying to raise capital and the no less challenging difficulties individuals face in trying to find and select good start-ups to invest in. These sentiments are core to the Objects and Vision of our Association as laid down in its Constitution. They commit us to helping our members invest in innovative high growth potential start-ups which in turn will create jobs for Australians.

Sydney Angels is run by an elected volunteer management committee and employs one part-time Operations Manager. Our members are mostly sophisticated individual investors who pay a flat annual membership fee which is currently $800. It is free for start-ups to apply to Sydney Angels for investment from our members. Through our investment filtering process and meetings our members have so far selected and invested in 41 promising start-ups, investing over $7M of their own money directly into these mostly pre-revenue but high growth potential companies. Since late 2011 their investments have also been matched 50/50 with $7.5M from the Sydney Angels Sidecar Fund, an ESVCLP that co-invests exclusively with our members. Our members are usually the first external investors in these start-ups and a typical first investment round is $200-400K. Many of the start-ups invested by our members have since made good progress and as a result attracted over $53M in follow-on investments from later stage investors. Our members are therefore catalysing large amounts of follow-on investment in high growth potential companies that are creating jobs for Australians. In total start-ups that first received investment through Sydney Angels have so far raised $68M in equity capital.

Our members are a sample of the exact constituency the start-up tax incentive is aimed at, to encourage greater investment in high growth potential start-ups, especially unproven very high risk pre-revenue ones. Our members have been making these kinds of high risk investments for over 7 years and whilst are unlikely to significantly change their behaviour much because of a new tax incentive the proposed changes may enable them to invest more funds in high growth potential start-ups. However, a new tax incentive could encourage more people to consider investing in start-ups, increasing the supply of capital available. Sydney Angels would welcome this because we are constantly encouraging investors to become members to expand the collective investment capacity with quality investors and therefore increase the number of start-ups that can get capital. Our filtering processes, meetings, collaborative team-based investment model, training and tools would help people new to investing in start-ups to learn how to do so and to assist with the ability to co-invest with more experienced members in the start-ups selected as more likely to succeed. Helping those new to investing in start-ups make better decisions would increase the chance of realising the broader economic and societal benefits the proposed tax incentive is intended to assist.

With this background we hope you will give serious consideration to the following comments and recommendations we have on three of the sections in the consultation paper:

Section 4 eligible "innovation company"

- **Using an arbitrary cut-off of three years since incorporation is problematic.** For example, it will exclude any pre-revenue start-up that has been doing R&D for a number of years. They will have had to incorporate in order to claim the R&D Tax Concession and are therefore quite likely to be older than three years by the time they are ready to raise capital from independent third party investors (i.e. not family and friends). They are likely to be exactly the kind of innovative high growth potential start-up the tax incentive seeks to encourage investment in. So why discriminate against them by denying investors the tax incentive in their case, but granting it in the case where they invest in younger start-ups in fields that require less time in R&D, such as most internet start-ups? Similarly why deny a tax incentive to investors in a start-up just because it has spent more than $1M in R&D and start-up expenses?

  We recommend that an arbitrary age limit not be used. We also don't think the $1M expenditure cut-off is helpful or necessary. The desired start-up stage selectivity can be adequately achieved by the $200K revenue limit in conjunction with a tangible assets limit (see our comments below) and common sense rules around group structures.

- **Gateways and safe harbours should also include the deal-flow filtering funnels operated by recognised investment groups.** The list of gateways and safe harbours listed under Method 2 of section 4.1 are just various kinds of filters that select for either innovation or growth potential. In the same way the multi-stage deal-flow funnels used by VCs and other organised investment groups like Sydney Angels are also selective filters and many are arguably more rigorous than some examples of the filters currently contemplated as gateways or safe harbours. For example in 2015 Sydney Angels received new applications from over 200 start-ups. These were filtered through a 3-stage merit-based process which resulted in members choosing to invest in 5 of them during the year, representing 2.5% of all applications received.

  We recommend that suitable investment groups (both those which exist today and which may exist in the future) that can demonstrate a sufficient volume and diversity of deal-flow and rigorous merit-based filtering processes should also be included in the list of gateways and safe harbours so as to give certainty to start-ups and investors.

- **Excluding financial services is too blunt a definition.** We completely understand not wanting to give tax breaks to investors who provide capital to businesses that would use the subsidised capital to provide credit or invest it in other assets. But financial services includes in its scope many innovative "fintech" start-ups that need to raise capital to build their technology and teams and launch their services, not to on-lend it or reinvest. In some cases initial structuring of the business may involve the business undertaking activities proposed to be excluded under the Policy Discussion Paper. This is often due to the regulatory requirements in place for financial services related businesses. Why should investors in "fintech" start-ups not benefit from the tax incentive? The same arguments can be made for other excluded sectors where start-ups with innovative new business models and platforms are emerging, like legal services and a multitude of exchanges for goods and services and matching buyers and sellers.

  We recommend not having a restriction on financial services or any other sector where innovative high growth potential start-ups may emerge. To guard against subsidised capital being on-lent or invested in other assets (whether financial or real, like property or mines), we suggest a limit on tangible asset value could be used. Most start-ups have very little in the way of tangible assets other than the cash they've raised from investors and some inventory and equipment. But a tangible assets limit would exclude all but the smallest finance and asset holding companies.

Section 5: Eligible investor for direct investment into an "innovation company"
We think the tax break should be made equally available to sophisticated and retail investors. Usually the first investors in start-ups are friends and family of the founders and many of these would be classified as retail investors. Why should they be denied the tax break when they are investing in innovating companies and are taking the greatest first risk? Sophisticated and professional investors, the first "external money from strangers", tend to invest after friends and family investors have borne risk through the very earliest highest risk stage.

Further, not all angel investors qualify as sophisticated investors. They have sufficient funds to invest, but more importantly they often bring specific expertise to the companies they invest in. Sometimes the most valuable investors to a start-up are not those with the most money to invest. It is their expertise and relationships that can bring greater value.

We recommend the tax break be available to anyone who is prepared to take the risk of investing in start-ups, provided they know how risky it is. For example, Sydney Angels' advice to people interested in joining as members is quite blunt. We tell them to only consider joining if they're prepared to lose 50% of what they choose to invest in, even after all the rigorous filtering and application of best practices for due diligence and post-investment management that we strongly encourage our members to do. We also tell them the only way to get a return on investing in start-ups is to have a portfolio of 10 or more. We explain the time commitment that will be required to be an active investor in start-ups and build up this kind of portfolio. The practical implications of these three facts tend to scare off all but those who can afford to lose $25-50K or more per year and have the time available to make and manage a sufficient number of investments.

Section 6: Indirect investment via eligible investment vehicle
Some individuals may invest personally and directly but most will have structured their financial affairs such that investments are made from their family trust or SMSF. Some individuals will have invested in ESVCLPs or other pooled funds that are mandated to invest in a portfolio of start-ups. For investment in a particular start-up it may be necessary for individual investors to set up a special purpose unit trust to pool their investment so the company only has one new shareholder to deal with instead of 5 – 10 individuals. Why should the form of the investment vehicle determine whether or

not the tax incentive is available? The money is at the same high risk regardless of how it goes into the start-up. We can see no reasons for encouraging investment via one type of vehicle over another. The best feasible choice will always be situation and investor specific. Excluding certain types of vehicle risks reducing the capital available for start-ups and would create an industry in workarounds and unnecessary costs that would add nothing to the number or success rate of funded start-ups.

We recommend that investors in eligible start-ups via family/discretionary trusts, SMSFs and special purpose unit trusts should be eligible for the same tax incentive as if they had invested directly. We also recommend that investors in an ESVCLP should be eligible for the tax incentive when they invest in each call by the fund.

As you can see there is a unifying theme in our comments and suggestions to create a level playing field and to avoid using arbitrary cut-offs and definitions that would have unintended adverse and discriminatory effects.

We would be pleased to provide further input and be involved with additional consultation if that would be of interest and will assist with this important policy area to encourage further investment in innovative companies by early stage investors.

Yours sincerely

The Management Committee of Sydney Angels Incorporated