THE TAX INSTITUTE

THE MARK OF EXPERTISE

24 February 2016

Ms Marisa Purvis-Smith
Manager
Individuals and Indirect Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: startuptaxincentive@treasury.gov.au

Dear Ms Purvis-Smith,

Tax Incentives for Early Stage Investors

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the *Tax Incentives for Early Stage Investors Policy Discussion Paper* (**Policy Paper**).

Summary

Our submission below addresses our main concerns in relation to the Policy Paper. In particular it is our view that:

- The definition of 'innovation' for the purpose of the first access point to the concession should be as broad as possible;
- Consideration should be given to having the ATO publish, by way of a legislative instrument or binding ruling which innovation activities are eligible or otherwise excluded, rather than legislating which activities are ineligible for the incentive;
- Alternatively, any exclusions should be similar in nature to those that apply to venture capital limited partnerships;
- There are a number of concerns with how the concession might apply where a qualifying investment is made indirectly via an innovation fund.

Discussion

The Tax Institute notes that there has been a short timeframe in which to consider the Policy Paper and is therefore limited in the amount of input able to be provided at this time. More time for consultation would have allowed for more complete consideration of the details in the Policy Paper and more comprehensive input provided to Treasury to assist with better legislative development following this initial consultation stage.

Broadly, in designing the concession, Treasury should ensure that the amount of 'red tape' to apply to determine eligibility for this tax concession be minimised as much as possible. This is in light of the fact the companies to which this concession is most likely to apply will not be in a position to spend a lot of money seeking to qualify for the concession. The more gateways and principles that are introduced, the less useful the concession will be to taxpayers.

1. Accessing the concession - definition of 'Innovation'

To access the proposed tax incentive, an investor must invest either directly in an 'innovation company' or indirectly through a 'qualifying innovation fund'. Three access points to the concession are proposed to be offered via three different 'methods'.

Part 4 of the Policy Paper sets out the way an Australian 'innovation company' is proposed to be defined for the purpose of the first access point, Method 1. Method 1 contains a set of principles that broadly define what is an 'innovation company[1]'.

The key to the definition of 'innovation' seems to be what is defined as 'innovative'. In our view, the current definition contained in Method 1 seems too narrow and is also cumulative. In this regard, it is unlikely to achieve the necessary breadth intended.

Referring to the five bullet points listed on page 4 of the Policy Paper, we suggest that where the word 'creates' is referred to that the expression 'leads to or creates' is used instead. This could be even further expanded to 'proposes to lead to or create'. This would apply to cases where the company intends to 'lead to' or 'create' a new product, platform or organisational method, but doesn't quite get there. In our view, just because an 'innovation company' does not necessarily succeed, this should not necessarily be the sole basis for denying the tax concession to the investor.

We also note that there is a proposed condition that the innovation company would need to pursue global or broader opportunities rather than just local opportunities[2]. This appears restrictive to us.

Also, the definition of 'innovation' should not be cumulative and therefore the word 'and' should also be deleted and replaced with the word 'or'. These changes will broaden the scope of the definition.

2. Direct Investment into an innovation company

As an integrity measure, we note that it is intended the $200,000 cap will apply on an affiliate-inclusive basis[3]. However, we would like Treasury to clarify who will be entitled to claim the $200,000 cap in each year - will the affiliated investors decide between themselves, or will the ATO allocate amounts pro rata (particularly if the investors cannot agree on who should be able to claim in any given year)?

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[1] Page 4 of the Policy Paper
[2] Page 4 of the Policy Paper
[3] Page 7 of the Policy Paper

3. Indirect investment via an innovation fund

A number of issues arise in relation to indirect investment in an innovation company.

a) If an investor chooses to invest via their own private company (as opposed to a collective vehicle such as an innovation fund), will the benefit of the tax offset or the capital gains tax relief flow through to the shareholders of the private company – i.e. will the tax offset generate an imputation credit which can be passed through, and can the exempt capital gain be passed through without further taxation (either by exempting the resulting dividend, or creating an imputation credit)?

b) For an entity that is an innovation fund, we assume that each investor into the innovation fund is separately entitled to the benefit of the concession and can apply the $200,000 cap separately from each other investor, though this is not explicitly stated? Could Treasury please confirm whether this assumption is correct?

c) For an innovation fund, will the capital gains tax (**CGT**) discount apply only to shares which the fund acquired after a taxpayer has invested in it, or will it depend simply on how long the fund itself has held the shares? The latter would be much more administratively simple – i.e. a taxpayer invests in the innovation fund at any time, and gets the benefits of any CGT-free treatment available on disposals by the fund while the taxpayer holds shares in it. This would presumably also be the case if a taxpayer buys shares in the fund from an existing shareholder, rather than having new shares issued to the taxpayer (although we understand purchased shares would not trigger the tax offset). Could Treasury please confirm our understanding?

d) We assume that a sale of shares in the fund would itself attract CGT, as the CGT-free benefit would then pass to the new owner of the shares. On this basis, any anti-avoidance rules should not apply to trading in shares, even though the result might be that the new purchaser can benefit from the CGT-free status immediately upon acquisition. Could Treasury please confirm whether this assumption is correct?

e) In our view, the offset should be available on investment into the innovation fund, rather than only when the innovation fund invests into the innovation company. Effectively, everything should happen at the fund level, otherwise, it will be very difficult for taxpayers to comply with the law in order to access the concession.

   In the instance where funds are returned by the innovation fund (whether through a share buy-back or otherwise), Treasury could consider including a mechanism to reverse the tax offset at that time (i.e tax would be payable of the same amount as the offset, or if the offset has not been claimed, then the offset should be cancelled at that time). To prevent tax avoidance activity where money may be invested into an innovation fund without a genuine intention to have the funds invested in an innovation company, GIC could apply at the time the funds are returned to the investor (taxpayer). Where eligibility for the offset is based on the original date of investment in the innovation fund, this should impede the ability to trade in the tax offset as the offset will only be able to be claimed by the original investor and not by a subsequent holder of the same interest in the fund.

The Tax Institute would be happy to discuss this possible design option with Treasury further.

We also note that the Policy Paper does not consider what the tax outcome will be for an investor who invests in an innovation fund in good faith where the innovation fund subsequently invests in companies that do not qualify as 'innovation companies'. The Tax Institute would be interested in having further discussions with Treasury about this issue.

4. The 'Exclusions'

In our view, the list of 16 'exclusions' contained on pages 5 and 6 of the Policy Paper will likely exclude a number of new activities we have seen rise in the last few years (for example the development of 'applications' for use by mobile technology) because financial activities are listed as an exclusion.

Some relevant examples to consider:

- 'New economy' activities - a new platform for investment participation in the equity market should be given equivalent status to a new app, for example, controlling the power consumption in your home while away on holiday.
- We assume activities like producing steel are excluded because there are already incentives for this (it would be useful if Treasury could confirm our understanding). Based on this rationale, it would follow then that other activities which have already received other funding/incentives, such as activities previously funded under the National Health and Medical Research Council or the Australian Research Council, would also be excluded from this tax incentive. Could Treasury please confirm whether all activities that have already received other funding/incentives are excluded from this tax incentive? If only selected activities are to be excluded, what is the rationale for their selection?
- Some companies may undertake 'new economy' activities in excluded sectors, such as money-lending and may potentially be excluded from being an 'innovation company' notwithstanding the example given regarding technology platforms in the property sector.

Are 'exclusions' necessary?

Given the above, we query the retention of any exclusions. If a company is undertaking innovative activities (in accordance with the principles-based method contained in Method 1, we do not believe that it should matter what legitimate industry or sector it is benefitting[4].

[4] A similar issue arose in respect of the consultation on the employee share scheme rules for start-ups, resulting in there being no industry restrictions on the availability of the start-up concession.

However, if there must be a listing of prescribed activities by innovation companies that are eligible for the tax incentives, then such activities should be contained in a public binding ruling or by legislative instrument. In that way, as new areas of innovation activity arise, the ruling or instrument can be changed quickly, rather than through a more laborious legislative amendment process.

Alternatively, if the Government determines that there must be prescribed excluded activities that are ineligible, we suggest use of a list that is consistent with the list of 'ineligible [investment] activities' in section 118-425(13) of the *Income Tax Assessment Act 1997* (Cth)[5]. In that vein, the VCLP (and ESVCLP) provisions contain additional tests about how to determine the activities being carried on by a company that might be useful in shaping how to define a company engaged in innovation activities[6].

5. Other

a) The second sentence in the second paragraph on page 3 of the Policy Paper refers to the availability of immediate tax offsets in place of capital losses for shares issued as part of the tax incentive for early stage investors. We query the following:

- Are these the same as the tax offsets generally available, or is there some additional offset where a capital loss has resulted?
- Further, does the restriction on capital losses apply to shares held for more than 10 years, in relation to which a market value cost base is available after 10 years – i.e. is a loss available against that market value cost base?

b) We are also of the view that an 'innovation company' should be an Australian resident. We do not see there being much purpose in giving Australian tax offsets for investments in offshore companies where the policy intent is to encourage investment into Australian innovation companies at earlier stages in their lives[7].

c) Treasury needs to be careful in developing integrity measures included in this regime where other general anti-avoidance provisions may already apply.

d) Finally, consideration should be given to amending the relevant fund-raising provisions of the *Corporations Act 2001* to ensure that there is no breach of any law in relation to seeking equity investments into "innovation companies", where the investors are early stage investors and the relevant investment qualifies for the tax incentives.

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[5] In relation to a 'venture capital limited partnership' (**VCLP**) and an 'early stage venture capital limited partnership' (**ESVCLP**).

[6] For example, section 118-425(3) requires that 75% of the company's assets, employees or income – two of which must be met – must be from activities that are not ineligible activities.

[7] Page 1 of the Policy Paper

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Arthur Athanasiou
President