TREASURY LAWS AMENDMENT (2017 MEASURES NO. #) BILL 2017

EXPOSURE DRAFT EXPLANATORY MATERIAL

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
ABR	Australian Business Register
AFOF	Australian venture capital fund of funds
Bill	Treasury Laws Amendment (2017 Measures No. #) Bill 2017
CGT	capital gains tax
ESVCLP	early stage venture capital limited partnership
fintech	financial technology
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MIT	managed investment trust
VCLP	venture capital limited partnership

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Chapter 1
Fintech and venture capital

Outline of chapter

1.1 Schedule # to the Bill amends the venture capital and early stage investor tax concession provisions in the ITAA 1997 to:

- ensure that start up fintech businesses can access the venture capital investment tax concessions; and
- make minor changes to ensure that the provisions operate as intended.

1.2 All legislative references in this Chapter, unless otherwise stated, are to the ITAA 1997.

Context of amendments

1.3 As part of the 2016-17 Budget the Government announced reforms to the tax incentives for venture capital and early stage investors.

1.4 Australia has a sophisticated, competitive and profitable financial sector underpinned by a strong regulatory system. As financial services become more globalised and technological disruption increases it needs to keep pace with innovation in banking and finance to stay competitive.

1.5 The Government is creating an environment to make Australia's fintech sector more internationally competitive. However, the fintech sector is currently restricted as the existing tax incentive for investors does not provide concessional tax treatment for VCLPs and ESVCLPs investing in start-up fintech firms.

1.6 Currently, for the purposes of the venture capital tax concessions, both finance (to the extent it consists of banking, providing capital, leasing, factoring and securitisation) and insurance are ineligible activities. This means there is uncertainty whether investments in companies and unit trusts that, broadly, have such activities as part of their predominant activities are eligible venture capital investments. This uncertainty prevents VCLPs and ECVLPs making such investments and therefore limits sources of venture capital for start-up fintech firms.

1.7 There are also some minor technical issues with the venture capital and early stage investor tax concession provisions that need to be addressed to ensure that they operate as intended.

Venture capital

1.8 Venture capital is a mechanism for financing new, innovative enterprises at the seed, start up and early-expansion stages of commercialisation. Venture capitalists invest funds in such enterprises in return for an equity share. The funds are used to develop an enterprise's ideas to the stage where their commercial potential is sufficient for the venture capitalist to sell its equity to another party

1.9 The Commonwealth provides various tax concessions to support Australian venture capital investments; specifically the VCLP and ESVCLP programs.

VCLPs

1.10 The VCLP regime supports investment in venture capital entities at the high-risk, start-up and expansion stages that would otherwise have difficulty in attracting investment through normal commercial means.

1.11 A VCLP is taxed on a 'flow-through' basis rather than being treated as a company for tax purposes like other limited partnerships resulting in the partners rather than the 'partnership' being taxed. One of the key benefits is that certain foreign partners are exempt from income tax on capital and revenue gains from disposals of eligible investments made by the VCLP, with corresponding losses also being disregarded. In addition, amounts received by certain partners for their successful management of the partnership's investments ('carried interests') are taxed on capital account, thus entitling them to the CGT discount where they have been a partner for over 12 months.

ESCVLPs

1.12 The ESVCLP regime provides additional tax concessions for high-risk start-up entities (with a value of no more than $50 million).

1.13 Like VCLPs, ESVLPs are taxed on a 'flow-through' basis. However, the tax concessions are more generous than for VCLPs given the higher degree of risk involved. Both Australian and foreign investors are exempt from income tax on capital and revenue gains from disposals of investments made by ESVCLPs, with corresponding losses also being disregarded. Income derived from the partnership's investments, such as dividends, is also exempt from income tax.

Early stage investors

1.14 A separate incentive was also introduced for early stage investors outside of the venture capital framework. Broadly, this incentive allows eligible investors that acquire shares in an innovation company in an income year to receive a carry forward tax offset for that income year equal to 20 per cent of the amount paid for the shares. However, the total

amount of this offset to which an entity and its affiliates is entitled in an income year cannot exceed $200,000.

Summary of new law

1.15 Schedule # to this Bill amends the ITAA 1997 venture capital and early stage investor tax concession provisions to:

- ensure that start up fintech businesses can access the venture capital investment tax concessions; and
- make minor changes to the venture capital and early stage investor provisions relating to CGT transactions, MITs and the early stage investor tax offset to ensure that the provisions operate as intended.

Comparison of key features of new law and current law

New law	*Current law*
Enabling start-up fintech businesses to access venture capital investment	
ESVCLPs and VCLPs are able to invest in companies that have finance or insurance activities as their predominant activities provided that they are early stage companies.	ESVCLPs and VCLPs are unable to invest in companies that have finance or insurance activities as their predominant activities as they are not eligible venture capital investments.
Minor technical changes	
Minor technical changes are made to the venture capital and early stage investor provisions to ensure they operate as intended with respect to CGT transactions, MITs, and the early stage investor tax offset.	Not applicable.

Detailed explanation of new law

1.16 Schedule # to this Bill amends the ITAA 1997 venture capital tax concession and early stage investor provisions to:

- ensure that start-up fintech businesses can access the venture capital investment tax concessions; and
- make minor technical changes to ensure that the provisions operate as intended.

Ensure that start-up fintech businesses can access the venture capital investment tax concessions

1.17 Amendments are made to ensure that start-up fintech businesses can access the venture capital investment tax concessions (see paragraph 1.6). This is done by enabling ESVCLPs and VCLPs to invest in companies that have finance or insurance activities as their predominant activities provided that they are early stage companies. ***[Schedule #, item 3, subsection 118-425(13A)]***

1.18 Under paragraph 118-425(13)(b) activities are finance activities to the extent that they are any of the following: banking, providing capital to others, leasing, factoring and securitisation.

1.19 Further information on early stage companies is provided in paragraphs 1.22 to 1.32.

1.20 Investments in unit trusts that have finance activities as their predominant activities continue to be activities that are not eligible venture capital investments.

1.21 A consequential amendment is also made to insert a note to reflect this amendment. ***[Schedule #, item 2, note 4 following subsection 118-425(3)]***

Early stage company

1.22 The requirements for an early stage company are broadly similar to that of an early stage innovation company (see section 360-40) for the purposes of the early stage investor tax offset. A company is an early stage company if it satisfies the requirements as set out in paragraphs 1.23 to 1.32.

It has been recently incorporated or registered in the Australian Business Register

1.23 The company:

- must have been incorporated in Australia within the last three income years (the latest being the current income year at the test time); or
- if it has not been incorporated within the last three income years — then it must have been registered in the ABR within the last three income years (the latest being the current income year at the test time); or
- if it has not been registered in the ABR within the last three income years — then:
  - it must have been incorporated in Australia within the last six income years; and

- it and any wholly-owned subsidiaries must have incurred expenses of no more than $1,000,000 in total across all of the last three income years (the latest being the income year before the current income year at the test time).

[Schedule #, item 4, paragraph 118-426(1)(a)]

1.24 The company income tax return requires companies to report 'total expenses' at item six as part of the total profit or loss calculation. A company that has submitted a company tax return in the previous income year must rely on the amount reported in item six for the purposes of this test. Alternatively, if the company was not required to submit a company tax return, it may use the amount corresponding to this item. A company that does not meet any of these three requirements will not qualify as an early stage company.

It has total expenses of $1 million or less

1.25 The company and any of its wholly-owned subsidiaries must have not incurred 'total expenses' (as explained in paragraph 1.24) of more than $1,000,000 in the previous income year. ***[Schedule #, item 4, paragraph 118-426(1)(b)]***

It has assessable income of $200,000 or less

1.26 The company and any of its wholly-owned subsidiaries must have derived assessable income of no more than $200,000 in the previous income year. However a Accelerating Commercialisation Grant under the program administered by the Commonwealth known as the Entrepreneurs' Program should be excluded. ***[Schedule #, item 4, paragraph 118-426(1)(c) and subsection 118-426(2)]***

It is not listed on a stock exchange

1.27 The company must not be listed on any stock exchange (either in Australia or overseas). The venture capital tax incentives target companies experiencing difficulty accessing equity finance and without access to fundraising via listed securities. ***[Schedule #, item 4, paragraph 118-426(1)(d)]***

It is not connected or affiliated with an entity that does not satisfy the predominant activity requirement

1.28 The company must not be connected or affiliated with an entity that does not satisfy the predominant activity requirement. The company is:

- connected with another entity — if the connected entity test in section 328-125 is satisfied, that is the company has direct or indirect control over the other entity or both entities are controlled by the same third entity; and

- affiliated with another entity — if the affiliated entity test in section 328-130 is satisfied, that is the other entity acts, or could reasonably be expected to act:
  – in accordance with the company's directions or wishes in relation to the affairs of that other entity's business; or
  – in concert with the company in relation to the affairs of the other entity's business.

[Schedule #, item 4, paragraph 118-426(1)(e)]

1.29 The predominant activity requirement is contained in subsections 118-425(3) and 118-427(4). Broadly, to satisfy this requirement, more than 75 per cent of at least two of the following must not relate to ineligible activities in subsections 118-425(13) and 118-427(14):

- the entity's assets:
- the entity's employees; or
- the entity's income.

1.30 For further information on the predominant activity test refer to paragraphs 2.132 to 2.141 of the Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.

It is not a foreign company

1.31 Foreign companies as defined in the Corporations Act 2001 are not able to qualify as early stage companies. ***[Schedule #, item 4, paragraph 118-426(1)(f)]***

It does not undertake any of the activities specified in the regulations

1.32 Early stage companies may be prevented from undertaking certain activities. Any such activities will be prescribed by regulation for this purpose. ***[Schedule #, item 4, subsection 118-426(3)]***

Other amendments

CGT amendments

1.33 *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* amended the CGT provisions to provide for concessional CGT treatment for investments in ESVCLPs and VCLPs. Schedule # makes changes to these provisions to ensure that they operate as intended.

Clarifying the treatment of valuation year capital gain

1.34 Section 118-408 imposes a cap on the extent to which tax concessions are available to ESVCLPs disposing of investments made

once the $250 million threshold has been exceeded by the investee. If the total value of the assets of an entity (and any connected entities) exceeds $250 million at the end of an income year, and the entity does not dispose of the investment within six months of that income year, any capital gain arising in relation to the investment will only be partially exempt.

1.35 Under subsection 118-408(2) the amount of the partially exempt capital gain that is not disregarded in a later income year is:

Normal capital gain *less* valuation year capital gain

Normal capital gain — is the capital gain that would otherwise arise under the income tax law as a result of the CGT event happening excluding any disregarded capital gain that would otherwise apply under the ESVCLP tax concessions;

Valuation year capital gain — is the capital gain that would have arisen had the same CGT event occurred in relation to the same CGT asset at the end of the day six months after the end of the income year in which the $250 million threshold was first exceeded.

1.36 The law is amended to require a valuation capital gain to be determined based on what the capital proceeds would have been, and other matters relating to the amount of the gain, determined on a reasonable basis as if the events resulted in the gain happening at the end of the period six months after the end of the relevant valuation year. While this requirement is implicit in the law, the amendment removes any doubt that this requirement applies. ***[Schedule #, item 1, subsection 118-408(2)]***

Additional investment requirements for ESVCLPs

1.37 Section 118-428 sets out the additional investment requirements for ESVCLPs for pre-owned investments.

1.38 The investment cap limits the size of investments that can be made by an ESVCLP, both in total, as the capital available to the ESVCLP is limited, and in respect of particular investments, as an ESVCLP cannot invest more than a fixed percentage of its committed capital in a single investment. The fixed percentage is generally 30 per cent, or 20 per cent where the ESVCLP is acquiring an existing (that is a pre-owned) investment.

1.39 The amendment clarifies that the 20 per cent limit only applies to an entity’s pre-owned investments. While this is implicit in the law, to avoid doubt, the law is amended to state this explicitly. A pre-owned investment can only be acquired by an ESVCLP if the sum of the following does not exceed 20 per cent of the partnership’s committed capital:

- the value of the pre-owned investment at the time of investment; and
- the value of all other pre-owned investments that the ESVCLP owns.

[Schedule #, item 5, subparagraph 118-428(2)(c)(ii)]

Managed investment trusts

1.40 Tax Laws Amendment (Tax Incentives for Innovation) Act 2016 amended the MIT eligibility provisions in Division 275 of the ITAA 1997 to permit MITs to invest in an ESVCLP or VCLP (refer to paragraphs 2.132 to 2.141 of the Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016). Two consequential amendments are made in relation to these earlier amendments.

Australian venture capital fund of funds

1.41 MITs will now also be able to invest in AFOFs by including them in the exception that permits them to invest in ESVCLPs and VCLPs.

1.42 The earlier amendments to the MIT eligibility provisions permitted MITs to invest in ESVCLPs and VCLPs. This was achieved by providing an exception that, for the purposes of considering whether a trust was a trading trust (making it ineligible to be a MIT), that investments in ESVCLPs and VCLPs would be disregarded.

1.43 Under subsection 118-410(3) an AFOF is a limited partnership that, at a particular time, has been registered by the PDF Registration Board established under the Pooled Development Funds Act 1992 as an AFOF and the registration under Part 2 of the *Venture Capital Act 2002* is, or is taken to be in force.

1.44 A limited partnership may be registered as an AFOF if:

- it is formed in Australia;
- every general partner is resident in Australia;
- its partnership agreement specifies that the partnership is to remain in existence for at least 5 years but not more than 20 years;
- it only carries on activities which are related to the making of eligible venture capital investments;
- its only investments are investments in a VCLP or an ESVCLP or eligible venture capital investments in a

company that a VCLP or an ESVCLP (in which the AFOF is a partner) already holds an investment;

- the only debt interests held by it are permitted loans; and
- the general partner has notified the PDF Registration Board that the AFOF has sufficient funds to begin its investment program.

[Schedule #, items 17 and 18, subsection 275-10(4A)]

Definition of public trading trust

1.45 The earlier amendments to the MIT eligibility provisions did not fully take into account the interaction between the MIT eligibility rules in Division 275 of the ITAA 1997 and the public trading trust provisions in Division 6C of Part III of the ITAA 1936.

1.46 Subsection 102T(16) of the ITAA 1936 has the effect that if a trust is a public trading trust then it cannot be a MIT.

1.47 A unit trust is a public trading trust if it satisfies the requirements set out in section 102R of the ITAA 1936. They are:

- it is a public unit trust in relation to the relevant year of income;
- it is a trading trust in relation to the relevant year of income; and
- it is a resident unit trust in relation to the relevant year of income or it was a public trading trust in relation to a year of income preceding the relevant year of income.

1.48 Under sections 102M and 102N of the ITAA 1936 a trading trust is a trust that carries on business that is not wholly an eligible investment business.

1.49 Most trusts that are MITs would satisfy the first and third conditions for being a public unit trust, meaning that the only reason they are not public trading trusts is because they are not trading trusts.

1.50 As outlined in paragraphs 2.132 to 2.137 to the Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016, due to their unique features, there are concerns that investments in ESVCLPs and VCLPs would wholly constitute eligible investment business. Therefore, a significant number of trusts that invest in ESVCLPs and VCLPs could be considered to be public trading trusts, meaning that they could not be MITs.

1.51 Therefore, the definition of public trading trust is amended to ensure that in considering if a trust is a public trading trust, investments in

ESVCLPs and VCLPs are disregarded in determining if trusts are MITs. ***[Schedule #, item 20, subsection 102R(5) of the ITAA 1936]***

Early stage investor tax offset

1.52 Division 360 of the ITAA 1997 provides for the early stage investor tax offset. Amendments are made to ensure that the provisions operate as originally intended.

1.53 For further information on the early stage investor tax offset refer to paragraphs 1.16 to 1.109 of the Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.

Investments should not entitle an investor to both the ESVCLP tax offset and the early stage investor tax offset

1.54 An amendment is made to ensure that where an investor is entitled to the ESVCLP tax offset they do not also qualify for the early stage investor tax offset. This is done by including an eligibility requirement for the early stage investor tax offset which has the effect that an investor will only qualify for the offset if they are not an ESVCLP. ***[Schedule #, item 8, subparagraph 360-15(1)(a)(ia)]***

1.55 The ESVCLP tax offset is a non-refundable tax offset provided to limited partners in ESVCLPs in the income year in which they make contributions to the ESVCLP. The ESVCLP tax offset encourages additional investment in early stage venture capital by reducing the effective cost of such investments. For further information on the ESVCLP refer to paragraphs 2.17 to 2.47 of the Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.

30 per cent interest restriction

1.56 In order to qualify for the early stage investor tax offset, the investor must not hold more than 30 per cent of the equity interests in an early stage innovation company or any entities connected with that company. This is tested immediately after the time the relevant equity interests are issued. For further information refer to paragraphs 1.37 to 1.39 of the Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.

1.57 The 30 per cent equity interest test is amended to also require consideration of rights to receive more than 30 per cent of any distributions of income and capital in the company or entity. This is in addition to the exercise, or control of the exercise of more than 30 per cent of the total voting power in the company or entity. This change ensures that the equity interest test for the early stage investor tax offset applies in a manner that is consistent with how it is applied in other parts of the

income tax law (for example subsection 328-125(2)). ***[Schedule #, item 9, paragraph 360-15(1)(f)]***

Widely held companies and their subsidiaries should not qualify for the offset

1.58 It was intended that the early stage investor tax offset would be available to all types of investment (whether an investment is made directly by an investor that is a corporation or an individual or by that investor indirectly through an interposed trust or partnership) other than 'widely held companies' (as defined in subsection 995-1(1)) and 100 per cent subsidiaries of these companies. For more information refer to paragraph 1.16 of the Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.

1.59 Paragraph 360-15(1)(a) of the current law restricts investments through widely held companies and wholly owned subsidiaries of these companies. An amendment is made to ensure that the same restriction applies for investments made indirectly through trusts and partnerships. ***[Schedule #, item 10, subsection 360-15(2)]***

1.60 This amendment also clarifies that the early stage investor tax offset is available to a member of a partnership or trust where the investment has been made through a chain of trusts or partnerships. For example, Trust A owns an interest in Trust B which owns an interest in Trust C. Trust C has invested in an early stage innovation company. The members of Trust A will be entitled to the early stage investor tax offset. ***[Schedule #, item 10, subsection 360-15(2)]***

Amount of the early stage investor tax offset — general case

1.61 For the purposes of calculating the amount of the early stage investor offset, the offset is 20 per cent of the amount of the sum of any money and non-cash benefits received or entitled to be received by the company in return for the issue to the shareholder of the shares. The value of the non-cash benefits is their value at the time the shares were issued to the shareholder. ***[Schedule #, item 11, section 360-25]***

1.62 Non-cash benefits include any property or services that are provided or required to be provided.

1.63 There are no other changes to how section 360-25 operates. For more information refer to paragraphs 1.40 to 1.45 of the Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.

Amount of the early stage investor tax offset — members of trusts or partnerships

1.64 Two amendments are made to section 360-30 that calculates the amount of the tax offset for members of trusts and partnerships (refer to

paragraphs 1.51 to 1.56 of the Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 for guidance on how this provision operates).

Limiting the amount of the early stage investor tax offset that can be claimed in an income year

1.65 An amendment is made to limit the amount of the early stage investor tax offset that can be claimed to $200,000 each income year where the investment is made indirectly through a partnership or trust. While section 360-25 currently includes a limit of $200,000 for investments made directly, there is no limit for indirect investments. This change ensures that the $200,000 income year limit applies as a single combined limit to both direct and indirect investments. ***[Schedule #, item 12, subsection 360 30(1A)]***

Entitlement to tax offset to reflect entitlement to a fixed proportion of any capital gains

1.66 If a member of a trust or partnership is entitled to a fixed proportion of any capital gain from investments that would result in the trust or partnership being entitled to the tax offset if that entity was an individual, then the member's share of the offset must be that fixed proportion. For example, such a fixed proportion normally exists for the holders of units in unit trusts. Where such a fixed proportion exists, the trustee must determine that the member is entitled to that amount or proportion and cannot make a contrary determination.

1.67 The provisions setting out this requirement in relation to the entitlement to the tax offset and the capital gain are amended so that they refer to the nature of the disposal that they apply to, that is the disposal of the investment that would give rise to or gave rise to the entitlement to the early stage investor tax offset. ***[Schedule #, items 7 and 13, subsections 61-770(3) and 360-30(3)]***

Early stage innovation company

1.68 Schedule # makes three amendments to the definition of what is an early stage innovation company in section 360-40.

Recently incorporated or registered in the Australian Business Register

1.69 To satisfy the recently incorporated or registered in the Australian Business Register requirement the company:

- must have been incorporated in Australia within the last three income years (the latest being the current income year at the test time); or
- if it has not been incorporated within the last three income years — then it must have been registered in the ABR within

the last three income years (the latest being the current income year at the test time); or

- if it has not been registered in the ABR within the last three income years — then:
  - it must have been incorporated in Australia within the last six income years (the latest being the current year); and
  - it and any wholly-owned subsidiaries must have incurred expenses of no more than $1,000,000 in total over the last three income years (the latest being the income year before the current income year at the test time).

1.70 The expenditure component of the ‘if it has not been registered in the ABR within the last three income years’ component has been modified so that the expenditure part of this test is applied to the last three income years with the latest being the income year before the current income year at the test time. This provides certainty to the company as it knows, at the test time, whether this component of the test is satisfied. Previously under the test one of the three years was the current income year which, at the test time, had not concluded. ***[Schedule #, item 14, subparagraph 360-40(1)(a)(ii)]***

Foreign companies are not early stage innovation companies

1.71 An amendment is made so that companies that are foreign companies as defined in the Corporations Act 2001 are no longer able to be early stage innovation companies. ***[Schedule #, item 15, paragraph 360-40(1)(f)]***

Clarification of when a company is doing something

1.72 Under paragraph 360-40(1)(e), to be an early stage innovation company, a company has to engage in certain activities or hold certain interests. The amendment confirms that this can include the company engaging other entities to hold these things or perform activities for, or on its behalf. ***[Schedule #, item 15, note following subsection 360-40(1)]***

Application and transitional provisions

1.73 The amendments made by Part 1 of Schedule # to this Bill apply as follows:

- item 1 — change to definition of valuation gain — to CGT events occurring on and after 1 July 2018; and
- Items 2 to 8 — apply in relation to investments made on or after 1 July 2018.

[Schedule #, item 10]

1.74 The amendments made by Part 2 apply to the 2018-19 and later income years. ***[Schedule #, item 16]***

1.75 The amendments made by Part 3 apply to income years commencing on and after 1 July 2018. ***[Schedule #, item 19]***

1.76 The amendments made by Part 4 apply in relation to the 2016-17 year of income and later income years. This amendment applies retrospectively to ensure that the law operates as it always was intended to operate. This ensures that trusts that acted in a manner that complied with the intended manner of operation of the law are not adversely impacted by a technical omission that was made in Tax Laws Amendment (Tax Incentives for Innovation) Act 2016. ***[Schedule #, item 21]***

1.77 Schedule # to this Bill commences on the first day of the next quarter following the day of Royal Assent. ***[Clause 2]***