



Australian Government

Tax incentives for early stage investors

Policy Discussion Paper

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INNOVATION STATEMENT: TAX INCENTIVES FOR EARLY STAGE INVESTORS

1. INTRODUCTION AND POLICY INTENT

On 7 December 2015, the Government announced the National Innovation and Science Agenda (NISA), [including new tax incentives for early stage investors](#).

The tax incentives will provide concessional tax treatment for investors through a non-refundable tax offset and a capital gains tax (CGT) exemption on investments that meet certain eligibility criteria.

The tax incentives are designed to encourage investment into Australian innovation companies (innovation companies) at earlier stages, where a concept has been developed, but the company may have difficulty accessing equity finance to assist with commercialisation. Separate initiatives have been announced relating to investment at later stages, including [reforms to early stage venture capital limited partnerships \(ESVCLP\) and venture capital limited partnerships \(VCLP\)](#). These separate reforms will apply from the 2016-17 income year.

The tax incentives for early stage investors measure is being developed in a way that is cognisant of these different stages of financing and the availability of other initiatives specifically targeted at companies at a later stage of development. The Government is mindful that innovation companies beyond a certain size should still be able to benefit from Australia's existing venture capital regime.

The approach taken for the incentives has been informed by the work of other jurisdictions including the United Kingdom and Singapore, however the approach that has been developed is specific to the Australian economy and adapted to suit the Australian tax system. The Government is developing a principles-based approach to the design of the legislation for this measure that will help to ensure that the incentives continue to encourage investment into the future as technologies and business activities change.

2. CONTEXT TO CONSULTATION

The incentives announced by the Government will be available according to a number of key qualifying definitions: for investors; funds which pool investors' equity; and innovation companies. The Government wants to further develop the principles for eligibility for the incentive to ensure it is appropriately targeted.

A cornerstone of this consultation is the definition of an innovation company. The Government is keen to hear from stakeholders on the appropriate definition of an innovation company and how the eligibility principles and criteria can leverage off existing industry concepts and business practices.

The Government is aware that some investors may contemplate deferring their equity funding in startups in order to wait until the incentive is available. Therefore it is important to undertake this process as quickly as possible, but to also give stakeholders the chance to provide their input and ensure the incentive is accurately targeted.

2.1 CONSULTATION PROCESS

This discussion paper seeks to draw on the knowledge and expertise of stakeholders to establish the parameters on specific aspects of the policy. To enable the draft legislation to be as well developed as possible we are seeking stakeholder views and written input on the appropriate model to implement this policy.

The Government is interested in hearing about any experiences of stakeholders with the approaches taken in other jurisdictions, with a particular emphasis on how this could be adopted in the Australian context.

It would be particularly helpful to have concrete examples of issues and concerns in written submissions, to assist in developing appropriate and useful legislative solutions. Where submissions focus on technical issues, these will be used to inform the drafting of the final legislation to be considered by the Parliament.

Following this discussion paper process, the Government intends to release exposure draft legislation for further consultation, including resolving any outstanding technical issues.

3. OVERVIEW OF THE NEW TAX INCENTIVES

These incentives will provide eligible investors with a 20 per cent non-refundable tax offset for the amount paid for newly issued shares in an innovation company, where the amount is paid either directly to the innovation company or indirectly through a qualifying innovation fund. An investor can invest in innovation companies; innovation funds; or into both. As the offset is non-refundable, it will only be of immediate benefit where the investor has a tax liability. However, where an investor cannot use the tax offset in the relevant income year they may carry it forward to use in a future year. The tax offset will be available to both residents and non-residents.

Investors will receive a non-refundable tax offset of up to \$200,000 (on an affiliate-inclusive basis) for investments (direct or indirect) in eligible innovation companies in an income year. This means that for investments up to \$1 million, investors receive the full 20 per cent non-refundable tax offset. Where the offset is carried forward and further eligible investments are made, the offset that may be claimed in any one year is capped at \$200,000. Investment amounts greater than \$1 million in an income year do not increase the amount of the offset available. Investments over \$1 million still benefit from exempt capital gains, see below. The cap applies on an affiliate-inclusive basis in order to prevent entities entering into arrangements to circumvent the cap.

In addition to receiving a tax offset, investors (including a qualifying innovation fund) will not pay any CGT on gains from the disposal of shares in an innovation company provided those shares are held for at least three years. This applies to both resident and non-resident investors.

Where shares are held for more than 10 years, any incremental gain in value after 10 years will be subject to CGT and deemed to be on capital account. In this situation, the entity receives a first element of the cost base (or reduced cost base) equal to the market value calculated on the tenth anniversary of the date of acquisition.

Capital losses will be unavailable for shares issues as part of these tax incentives for early stage investors. In place of capital losses, immediate tax offsets are available subject to the income year offset cap. In order to achieve this result, the investor will initially treat the acquired shares as having a CGT reduced cost base of nil.

Further discussion of direct and indirect investment is covered in Sections 5 and 6, respectively.

4. AUSTRALIAN INNOVATION COMPANY

There are a number of ways to define an innovation company. Adopting a principles-based approach will provide a conceptual framework and ongoing flexibility. This, in turn, will be supported by specific eligibility criteria (safe harbours or gateway criteria) to provide greater certainty for potential investors and innovation companies. It is also anticipated that specific exclusions will apply to activities that do not align with the policy intent of the tax incentives.

An eligible innovation company must meet the following criteria:

- was incorporated in Australia during the last three income years;
- had assessable income of \$200,000 or less in the prior income year;
- had expenditure of \$1 million or less in the prior income year; and
- is not an entity listed on any stock exchange.

Beyond these criteria, the entity must meet the definition of a qualifying innovation company, see discussion below.

4.1 TOPICS FOR CONSULTATION

Successful targeting of these incentives requires a clear definition of a qualifying innovation company. While it may be easy to identify innovative products or ideas once they have been developed, designing legislation that targets innovative activities before the impact of an idea has been realised is more challenging.

In order to make these incentives as effective as possible, it is expected that the legislation will consider three methods of access to the incentive and a list of exclusions which explicitly disqualify a company from being an innovation company.

The first access point is a set of principles that will broadly define an innovation company. These principles will seek to provide flexibility which is relevant to future innovation. Over time, these incentives will be used and an understanding of what constitutes innovation will develop. In the short term, to provide certainty to investors and innovation companies, a set of gateway criteria (safe harbours) will be available. A company that meets a specific number or configuration of these criteria will be eligible for classification as an innovation company provided they do not engage in excluded activities. The final access point will be through determination by the ATO before the investment is made into an innovation company, at the instigation of the company or a potential investor.

Method 1 – Principles-based

The Government intends to include a set of principles that defines innovation in the enabling legislation. Principles are less prescriptive than a set of rules about what can and cannot be characterised as innovative. Prescriptive rules and tests can only accommodate the types of activities and ideas that are foreseen, however innovation is also about the creation, disruption or improvement that has not been foreseen or achieved by others.

A principles-based definition is intended to be intuitive and draw upon established industry terminology which will allow the law to accommodate new innovative entities not yet envisioned at this point in time. In addition, companies should be able to utilise existing documentation, such as a business plan, to determine whether they would qualify.

Principles that could be used to define innovation could, for example, include the following; the company would need to be the developer of a new idea or significantly improve upon an existing idea, that:

- changes the way an organisation, service delivery or process operates;
- creates a new product or service that other organisations or consumers could use;
- creates a new platform for the delivery of products and services;
- changes the way an organisation, service delivery or process operates; and
- creates a new organisational or marketing method.

These definitions of innovation were considered in line with the [Oslo Manual](#) published by the Organisation for Economic Co-operation and Development, however consideration of stakeholder views will ensure that current and future types of innovation can also be accommodated.

Under this definition, the innovation company would need to have the capability to commercialise or bring to market and generate value from the idea. Further, the innovation company will need to pursue global or broader opportunities rather than having a focus on only local markets.

The definition would also require the innovation company to exhibit high growth potential through a management team being able to successfully scale the business as it grows and maintain competitive advantages over incumbents or new competitors.

Method 2 – Gateways and Safe Harbours

It is important that innovation companies and investors have as much certainty as possibly regarding eligibility requirements. The Government will consider including some clear rules to assist companies in determining if they qualify as an innovation company. Due to the variety of startups and the broad range of industries in which they operate, there will need to be a number of gateways for determining which companies are considered to be innovation companies.

A company would be required to meet a minimum number or a set configuration of criteria to qualify. These tests may include:

- companies with a proportion of research and development claims to other expenses above a particular percentage threshold;
- companies that have completed or have been accepted into an approved accelerator programme (a regulatory process of registering approved accelerators may be considered to facilitate this test);
- companies that have one or more existing third party financial investors that have previously subscribed for equity interests, subject to specific integrity rules;
- companies that have been supported through Commonwealth or State Government programmes such as the Accelerating Commercialisation element of the Entrepreneurs' programme; or
- companies that have, within the last three years, developed, acquired or licensed an idea that has been filed as a patent in multiple jurisdictions.

Method 3 - Determination

In the absence of meeting the gateway criteria, the company could seek advice from the ATO (who could liaise with AusIndustry) on whether it qualifies.

Exclusions

In addition to the methods of access, outlined above, there is a need for explicit exclusions for certain investment activities. However, it is important when discussing exclusions that truly innovative products, services and activities are not prevented from accessing the incentive. For example, investment in property should not in itself be eligible for the incentive; but on the other hand, technology platforms that interact with the property sector may be eligible. The list below is the list of excluded activities from the UK's similar Seed Enterprise Investment Scheme:

1. Dealing in land, in commodities or futures in shares, securities or other financial instruments;
2. Banking, insurance, money-lending, debt-factoring, hire-purchase financing or other financial activities;
3. Leasing (including letting ships on charter or other assets on hire);
4. Receiving royalties or licence fees;

5. Providing legal or accountancy services;
6. Property development;
7. Holding, managing or occupying woodlands, any other forestry activities or timber production;
8. Producing coal;
9. Producing steel;
10. Operating or managing hotels or comparable establishments;
11. Operating or managing nursing homes or residential care homes;
12. Subsidised generation or export of electricity;
13. Provision of services or facilities for another business;
14. Dealing in goods otherwise than in the course of an ordinary trade of wholesale or retail distribution;
15. Farming or market gardening; and
16. Shipbuilding.

However, the intention is not to exclude the high-growth potential industries like financial technology. We would welcome feedback on the nature of excluded activities that would allow investors in truly innovative ideas to gain access to the incentive, but prevent the promotion of schemes that are primarily about tax minimisation for established sectors or industries.

Questions

- 4.1 Are there any additional principles that should be included in defining an innovation company?
- 4.2 What gateway criteria would best define an eligible innovation company?
- 4.3 Do these criteria meet the objective of attracting investment in innovation companies, without unnecessary regulatory burdens?
- 4.4 What integrity risks are associated with each of these criteria? How might these risks be mitigated? For example, combining multiple tests together could mitigate risks.
- 4.5 Are investors open to a process that involves lodging a self-assessment declaration prior to making investments, in order to assist with assessing take up and eligibility?
- 4.6 In relation to a gateway requirement that is based on approved accelerator programs, which types of organisations should be included and what qualifying criteria should be specified?
- 4.7 Are there any other investment activities that should be excluded?
- 4.8 Is it appropriate for innovation companies to be restricted to companies that are Australian residents for tax purposes?

5. DIRECT INVESTMENT INTO AN INNOVATION COMPANY

Direct investment into an innovation company is the first investment method that will attract the tax incentives. It involves an investor being issued new shares in an eligible innovation company which are equity interests for Australian income tax purposes. At the time the shares are acquired, the innovation company must not be [an affiliate of the investor](#) (see section 328-130 of the *Income Tax Assessment Act 1997* for the definition of an 'affiliate').

An investor (including their affiliates) cannot hold, nor have rights to, more than 30 per cent of the issued capital of an innovation company, tested immediately after the time shares are issued. Subsequent share purchases in the same innovation company will qualify for the incentive provided the ownership cap is not exceeded.

As an integrity measure, the \$200,000 cap on the offset available in an income year will be applied on an affiliate-inclusive basis. This ensures that taxpayers cannot enter into arrangements with related parties so that the application of the cap is circumvented. However, investments through an innovation fund will not be included in the 30 per cent shareholding limit.

5.1 TOPICS FOR CONSULTATION

Investment in innovation companies is inherently risky. Many investments will lose money, while others have the potential to make large gains. It is important to consider whether direct investment should be restricted to certain investors or open to anyone with the available funds. One possibility is to limit the availability of the offset to 'sophisticated investors' as defined in the *Corporations Act 2001*.

The objective of the tax incentives is to direct more capital into innovation companies, to overcome the difficulties of attracting investment during the early stages and to provide the opportunity for more innovation companies to become established, successful enterprises. There is an argument that the class of eligible investors should be limited to sophisticated investors as a proxy to unlocking commercial expertise, and as a way to reduce administrative costs by limiting the disclosure requirements during fund raising.

One means of limiting the class of eligible investor is through the sophisticated investor test found in the *Corporations Act 2001*. This test is used for investment opportunities where the usual disclosure documents are not provided, on the basis that investors that meet this criteria are more likely to be able to evaluate offers of securities and other financial products without needing the protection of a disclosure document.

Questions

- 5.1 Are there any specific requirements that should be included within the sophisticated investor test to ensure that innovation companies are benefiting from both financial and technical/commercial support?
- 5.2 Other than the sophisticated investor test contained in the *Corporations Act 2001*, are there alternative tests that can achieve these same objectives?

6. INDIRECT INVESTMENT VIA AN INNOVATION FUND

An entity will be an innovation fund in relation to an income year if:

- it is a company;
- it carries on the sole business of investing in innovation companies through the purchase of shares that are equity interests for Australian income tax purposes;
- it has no more than \$50 million committed capital at fund close, and has no more than \$50 million invested in innovation companies at any time in an income year (based on the issue price of shares);
- it holds no more than 30 per cent of the issued capital in an innovation company, tested immediately after shares have been issued to the innovation fund; and
- it has no more than 10 per cent of its committed capital, based on total committed capital at fund close, in any single innovation company at any time during the income year.

6.1 TOPICS FOR CONSULTATION

An important question for the design of the tax incentive is the timing of the tax offset claimed in an investor's tax return. Providing the offset to the taxpayer in the year the investment is made is considered to be most appropriate to meet the policy objective. For investments made through an innovation fund, ideally the tax offset is claimable once the fund has made a corresponding investment in an innovation company, such that the capital has been deployed in an innovation company.

However, it would be simpler to administer if investments into an innovation fund attracted the offset in the year that a cash call is made. The activity that the Government wants to encourage is the underlying investment of funds into an innovative company. This can be done through providing offsets in the year of a cash call, although a concern arises about whether funds will be left sitting uninvested or simply returned to investors.

Consideration also needs to be given to the specific company structure of an innovation fund. It is intended that a qualifying innovation fund will be a company that is a flow through vehicle, or similar deeming to give effect to the same outcome, for the purposes of the tax incentives. We are interested in hearing from stakeholders about whether qualifying innovation funds should be proprietary limited companies, unlisted public companies, or some other company governed by the *Corporations Act 2001*.

It is intended that qualifying funds should be managed by individuals who can meet reporting requirements for investors in the fund, and also contribute commercial or technical expertise to the underlying investee innovation companies.

As discussed in Section 5.1, we would be interested in stakeholder views on eligibility for the incentive being dependent upon satisfying the sophisticated investor test or some similar requirement. Having a sophisticated investor test could reduce the need for a higher level of regulation as to who manages the fund.

Questions

- 6.1 Is it appropriate for the offset to be available in the year of a cash call in the case of indirect investments through a qualifying innovation fund?
- 6.2 Should the incentive be limited to sophisticated investors in the case of investments through a qualifying innovation fund?
- 6.3 Should qualifying innovation funds be proprietary limited companies, unlisted public companies, or some other company governed by the *Corporations Act 2001*? What Corporations Act requirements should apply to these structures?
- 6.4 Should there be requirements placed on who can manage an innovation fund?
- 6.5 Is it appropriate to adopt an approval process similar to the UK Venture Capital Trusts and Australian Early Stage Venture Capital Limited Partnerships?

7. INTEGRITY MEASURES

The tax concessions have been designed with the integrity of the tax system in mind and will remain subject to Australia's anti-avoidance laws.

Integrity measures will be included to prevent certain outcomes such as:

- investors, through arrangements with affiliates, accessing offsets beyond the \$200,000 per income year offset cap;
- the entitlement to offsets in cases where investors enter into arrangements in order to trade the value of offsets;
- access to the incentives in cases where companies have restructured, in a way that is contrived or artificial, in order to meet the definition of an innovation company. Examples of restructuring arrangements could include re-incorporation of a business activity or splitting innovation ideas into separate entities; and
- investors adding CGT assets to an innovation company that are unrelated to the innovation or commercialisation activities of that innovation company in order to gain a CGT exemption on those assets.

Questions

- 7.1 How will the Government maintain the integrity of Australia's tax system while providing the best possible support for innovative startups?
- 7.2 How could integrity measures be designed to attract and secure investment at the right stage of innovation without creating unnecessary red tape for investors?

8. APPLICATION DATES

The new arrangements will start on the date of Royal Assent of the amending legislation, and apply to shares issued in the 2016-17 income year.

Commencement from Royal Assent will ensure that investors have certainty on the design features of the package and eligibility for incentives before they make investments.

9. CONCLUSION

Treasury has developed the broad framework of this policy and many of the specific aspects of how the law will be implemented and administered. However, in order to implement the kind of incentive that will increase investment in innovation companies, stakeholder input is essential.

To target the incentives and ensure the policy is as robust as possible, examples outlining how the policy could apply to real situations will be very useful. Noting that feedback on this discussion paper will inform the preparation of the amending legislation, identifying opportunities to base both the principles and the tests on existing Australian law, legal principles and commercial practice is encouraged to achieve successful results.

We welcome your submissions on the points raised throughout this paper and ask that these be provided by 24 February 2016.

The full list of consultation questions is below.

Question Summary

Australian innovation company

- 4.1 Are there any additional principles that should be included in defining an innovation company?
- 4.2 What gateway criteria would best define an eligible innovation company?
- 4.3 Do these criteria meet the objective of attracting investment in innovation companies, without unnecessary regulatory burdens?
- 4.4 What integrity risks are associated with each of these criteria? How might these risks be mitigated? For example, combining multiple tests together could mitigate risks.
- 4.5 Are investors open to a process that involves lodging a self-assessment declaration prior to making investments, in order to assist with assessing take up and eligibility?
- 4.6 In relation to a gateway requirement that is based on approved accelerator programs, which types of organisations should be included and what qualifying criteria should be specified?
- 4.7 Are there any other investment activities should be excluded?
- 4.8 Is it appropriate for innovation companies to be restricted to companies that are Australian residents for tax purposes?

Direct investment into an innovation company

- 5.1 Are there any specific requirements that should be included within the sophisticated investor test to ensure that innovation companies are benefiting from both financial and technical/commercial support?
- 5.2 Other than the sophisticated investor test contained in the *Corporations Act 2001*, are there alternative tests that can achieve these same objectives?

Indirect investment via an innovation fund

- 6.1 Is it appropriate for the offset to be available in the year of a cash call in the case of indirect investments through a qualifying innovation fund?
- 6.2 What is the most appropriate corporate structure for an innovation fund? What registration requirements should exist?
- 6.3 Should the incentive be limited to sophisticated investors in the case of investments through a qualifying innovation fund?
- 6.4 Should qualifying innovation funds be proprietary limited companies, unlisted public companies, or some other company governed by the *Corporations Act 2001*?
- 6.5 Should there be requirements placed on who can manage an innovation fund?
- 6.6 Is it appropriate to adopt an approval process similar to the UK Venture Capital Trusts and Australian Early Stage Venture Capital Limited Partnerships?

Integrity measures

- 7.1 How will the Government maintain the integrity of Australia's tax system while providing the best possible support for innovative startups?
- 7.2 How could integrity measures be designed to attract and secure investment at the right stage of innovation without creating unnecessary red tape for investors?

10. CONTACT DETAILS

Please direct any initial enquiries about this discussion paper to:

Jodie Wearne +61 6263 2516 policy issues; or
Phil Akroyd +61 6263 4385 law design issues.

Please send your submission to:

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