

Tax incentives for early-stage investors

Policy Discussion Paper February 2016

Submission by Andrew Macpherson

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1 Introduction

1.1 The degree of governance in countries is on a spectrum reflecting population density on one hand and the number of government organisations on the other. This means for example, that in the area of equity crowdfunding, there is significant and unnecessary detail in the JOBS legislation which is not reflected in the New Zealand legislation. Australia on that spectrum has been left and has now moved right of centre. But it seems that the “avant garde” nature of the New Zealand approach will benefit that country without the protections of investors perceived as potential harms in other jurisdictions.

1.2 Some countries are more “rulemaking” and “rule abiding” than others. Rules which are made for potential harms which are not in fact harms may be innocuous and not affect the policy objective or may on the other hand, significantly derail the policy intention. We need to therefore isolate those perceived harms which are not harms, and consider whether the proposed legislation is to the detriment of the scheme without the perceived advantages.

1.3 It is always necessary to look at “process”. This paper is well written in that the ideas are simply expressed in relatively clear language and the questions coherent. While it is harder to create and easy to criticise. It may be however, that there are fundamental misconceptions in this paper, which are in the Government commercial psyche, which may necessarily shape the responses to the paper and may thereby lead to poor legislation.

2 Time to Market

2.1 The paper makes the point, that the process of review of policy of itself may be delaying decisions to invest to Australia’s detriment because investors may refrain from investing until such time as the legislation is in place. This creates harm because the success of an idea is often related to timing as opposed to inherent quality. Examples are in IT in watches which have long been around, but is now being popularised by Apple. Also equity crowdfunding has long existed but is now taking some prominence because of expertise in Software As A Service (SAAS) and cloud computing having come of age. Prior “cloud” offerings have been insufficiently effective to be usable to the form they are now used. Ride-sharing is an example. Computing moves in stages which can be charted, commencing with general ledgers, spreadsheets, full text retrieval, telecoms etc.

2.2 Often we have announcements which date the effect of legislation to be drawn, from the time of the announcement even though the legislation is not yet in existence. An example could be legislation on money laundering or taxation legislation on transfer pricing by multinationals. In the current circumstance, we could apply this thinking in reverse. That is, a bipartisan position could be achieved, where a Committee under the Department of

Industry, Innovation and Science, with nominations from both sides of Parliament could issue a letter to a company to give it preferred investor status, such that investors will obtain the benefit of the legislation when it is passed. The investor then simply has the risk that such legislation may not eventuate. That risk may be manageable and worth taking.

3 Perceived harms

3.1 One clear misconception is the extent to which investors need protection. That is a subject too wide for this paper. However, the point is that the perceived harm and remedy may be such that they cruel the benefits of the scheme if they are incorrect on both accounts. An example is in the current equity crowdfunding bill. There the requirements of incorporation to be able to be an issuer attracting the perceived benefits of equity crowdfunding address a harm which does not exist and make the scheme more difficult for the issuers to use. It means for example, that the enterprise which we seek to benefit must be transferred to another entity simply to come within the scheme.

3.2 The misconception here is that the “disclosure” regime protects investors or protects them more than currently exists for investment by those who are exempt. The more experienced investor is more conservative and does not invest without an information memorandum. His or her investment is more cautious than that made by family, followers and friends. See

Limiting startup tax incentives could exclude an important group of early stage investors
Jason Zein - The Conversation February 19, 2016 3.15pm AEDT

<https://theconversation.com/limiting-startup-tax-incentives-could-exclude-an-important-group-of-early-stage-investors-54894>

3.3 There is no gauge of quality in the “disclosure” regime. Most disclosures are repetitive and obscure the important detail. The registration side of ASIC approves material which the “enforcement” side of ASIC would never approve. Examples are the inventory disclosures in the recent Dick-Smith debacle. Another example is the listing of Elsmore Resources Ltd <http://www.investogain.com.au/company/elsmore-resources-ltd>

3.4 And how many investors read the Medibank Private Ltd prospectus from cover to cover or understood its import? There are numerous examples over a spectrum. Often public money is sought because investors deem the promoter of insufficient expertise to mean they are willing to invest. Quality in a disclosure sense is simply the history of profitability and management in place rather than the way in which it is described. In few cases are they start-ups but usually they are mature stage companies.

4 Modelling of the scheme

4.1 Inherent in the paper is the proposition that the Government will receive and Australia will receive a net benefit from the legislation. This is undoubtedly true because innovation even if it does not succeed is a necessary requirement of the success of existing education, tourism, agriculture, and manufacturing industries. None-the-less some disclosed modelling should be used to improve drafting, persuade legislators and show the professionalism with which the Government approaches legislation of this kind.

5 How are sophisticated investors relevant?

5.1 All propositions in relation to “sophisticated investors” seem misplaced. Why should reference be made to them – how are they relevant to the discussion? The misconceptions are that persons of wealth have the expertise and money to have others do the due diligence for them and that the less wealthy investor will not be as skilled or as careful as an investor with more assets. This to me is a popular misconception. The quality of investment no doubt reflects a range of socio-economic factors relating to education, maths skills, interest etc. But much wealth may have come from inheritance. For example, the wealthiest woman in Australia has pursued a teaching career and has her wealth inherited from her father's publishing business. For a range of reasons, the international conception as to investor expertise should be rethought. Any thought that only sophisticated investors should benefit from this scheme is misplaced; such legislation would render the scheme otiose. Not only does it appear not substantiated, see article in paragraph 3.2 above, but in an environment where the move locally and internationally is to make investments available to “retail” investors without traditional disclosure, it makes no sense. In any event the disclosure regime in the Corporations Amendment (Crowd-sourced Funding) Bill 2015, is far stronger than the disclosure regime currently in the Corporations Act 2001.

6 The connection of the innovation company with Australia

6.1 Some concepts taken from the EIS and SEIS in the UK should be challenged. This is because they address a perceived harm which may not exist, and where the regulation of the perceived harm may affect the effectiveness of the scheme. This is the connection to Australia either by incorporation, site of the business, location of directors and “residency” of the corporation or its management for income taxation purposes. There should be the right of an independent Board to issue an investor status letter to an innovation corporation “where the net perceived benefit to Australia makes this an appropriate course” notwithstanding that the residency requirements did not apply.

7 The procedure to be used

7.1 Modelling on the current R & D benefits scheme should indicate the extent to which the R & D scheme is successful. My perception is that it is a great benefit to Australia. It operates well because the benefit is a right as opposed to a competition (which is required of government grants) and is administered by a Board separate to the ATO. Where it is difficult is in the assessment of criteria for approval. The subject paper correctly identifies this difficulty in the definition of “innovation company” which is a much better term than “start-up”. The point is that the procedure could be emulated but not the criteria.

8 The innovation company

8.1 There is significant hype about innovation. In reality “innovation” may take many years of research to emerge particularly in health. A twenty-year gestation for a Nobel Prize may not be unusual. Secondly, innovation reflects improvements in established needs such as housing, transport, food, education. In that sense it is more evolution than innovation. Thirdly innovation is often a matter of timing. There were numerous variations and similarities which preceded Uber and Air BNB but which were not as successful. GoGet has been in operation nearly 13 years. An example is the search engines which preceded Google and which were numerous and for a while successful. My Space preceded

Facebook by many years but has all but ceased to exist. Thus innovation cannot be that which is unique or which has not gone before.

8.2 A plus from this activity which affects Australia as a whole is the net and quantitative improvement in management skills and processes which is a concomitant of innovation and the vast improvement in population investment expertise.

8.3 We should target those criteria which are lowering us on the OECD indexes for innovation in Australia. These include education in STEM, collaboration between education and industry, and the linking of elements in the innovation cycle by plugging gaps and improving linkages as the Government is attempting in the paper we now discuss. These deficiencies could be innovation criteria.

8.4 In essence innovation comes about because of search for a new business model, new customers and a new product of service. It is the degree of contrast with the existing system. There must therefore be some qualitative assessment by those tasked with awarding accreditation as an innovation company provided there are basic criteria already met. As the paper says, it cannot be too uncertain or difficult to apply.

8.5 Because innovation must relate to essential human needs, namely clean air and water and food, housing and security, this means that it is inappropriate to exclude traditional environments simply because they do not of themselves support innovation without more. Accordingly, it appears inappropriate to remove real estate or retirement villages from the list of subject matter where innovation can take place. That is although it could be argued that the innovation might be the method of management as opposed to investment itself, it is a fine line and therefore appropriate to leave real estate and retirement villages in the list. If the “innovation” is too mundane or not sufficiently innovative, then it will fail approval for those and other reasons. In this situation it would not be designated and “innovation company”.

8.6 The criteria should be difference in the product or service or business model plus recognition that with appropriate management skills the innovation company should be profitable and should be able to scale locally and internationally. The management assessment is independent of the management which in fact exists.

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