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THE STARTUP INVESTOR TAX CONCESSIONS – WHAT YOU NEED TO KNOW

On 16 March 2016, the Federal Government introduced a Bill into the House of Representatives that Alex McCauley, CEO of startup lobbying group StartupAUS claims is 'arguably the most generous in the world'.

The Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016, if passed, would codify the new startup investor tax concessions announced by Prime Minister Turnbull in December 2015, as part of the National Innovation and Science Agenda (***NISA***) (see our summary: Show Me The Money: Tax Reforms To Encourage Investment in Startups).

The new rules will broadly apply on and after 1 July 2016. The Government's apparent fear over the misuse of the concessions has manifested itself in a highly complex and prescriptive set of draft rules. Given the intended audience, this is most unfortunate. We hope that the Bill is amended to clarify and simplify its operation.

WHAT DOES IT DO?

The Bill is designed to encourage new investment in Australian 'early stage investment companies' (***ESICs***) by providing investors with a 20 per cent tax offset and a 10 year capital gains tax exemption for their investment into ESICs.

The Venture Capital Limited Partnership (***VCLP***) and Early Stage Venture Capital Limited Partnership (***ESVCLP***) regimes will also be amended to improve access to VC investment and make the regimes more attractive to investors.

WHAT DO THE PROPOSED REFORMS MEAN FOR STARTUPS?

1. **Timing and the funding gap** – The new offset for investment in ESICs will apply in relation to shares issued on, or after, the later of 1 July 2016 or Royal Assent. We anticipate that many eligible startups will therefore push their next funding round into the new financial year and that, in the interim, startups may face a funding gap.

   Under the current terms of the Bill, investors holding convertible notes already in existence that convert to issued shares after 1 July 2016 may be entitled to access the offset. This is probably inconsistent with the underlying policy of the measures, which is to incentivise *new* investment. Hopefully the Bill will be amended to clarify its application to existing convertible notes.

2. **Early stage thresholds** – In order to be an eligible ESIC, a startup must be an 'early stage' startup, which means that it must (among other things), have had income of less than $200,000 and incurred expenses of less than $1 million in the previous income year. When they were first announced in December 2015, these 'early stage' thresholds were criticised by the startup community for being overly restrictive and limiting the incentive to investments in very early, concept stage businesses. Unfortunately, this criticism has not yet prompted a change to these low caps, meaning that startups wanting to ensure that their investors qualify for the concessions might need to front-end their capital raising.

3. **'Innovation' requirements** – In order to be an eligible ESIC, startups will also need to pass an 'innovation' limb, through either a points-based or a principles-based test. The principles-based test requires prospective ESICs to satisfy five tests, such as having 'high growth potential' and that the company has 'competitive advantages' in relation to their type of business. Although the Explanatory Memorandum provides further detail and examples, this highly subjective language is unlikely to provide prospective ESICs with any degree of certainty that they will satisfy the criteria, even if professionally advised. In these circumstances, startups will be faced with the prospect of obtaining a ruling from the ATO to determine their eligibility, which would be both time consuming and costly.

As an alternative to this unattractive process, ESICs can self-assess their activities and determine whether they reach more than 100 points for attributes like receiving grants, participating in accelerator programs, having a certain proportion of their expenditure deductible as R&D, or having patent rights granted within the past year. Although some of these tests appear relatively straightforward to apply (eg a startup should be able to self-assess whether or not they have received an Accelerating Commercialisation Grant), some are more vague or complex and would require specialist advice. For example, it may be difficult for startups to confidently self-assess whether or not a particular accelerator program meets the necessary requirements of selecting 'entrepreneurs' in a 'open, independent and competitive manner'.

4. **Reporting obligations** – ESICs that receive investments from one or more investor entities in a financial year will need to provide certain information about those entities to the ATO within 31 days after the end of that financial year.
5. **Disclosure documents** – The consequences of encouraging retail investors means that startups looking to raise capital from retail investors will need to be wary of the prohibitions in the *Corporations Act 2001* (Cth) against offering securities to the public without an appropriate disclosure document.

WHAT DOES IT MEAN FOR INVESTORS

Tax incentive for early stage investors

1. **20 per cent non-refundable carry forward tax offset** – Entities that acquire newly issued shares in an ESIC will receive a non-refundable carry forward tax offset of 20 per cent of the value of their investment subject to a maximum offset cap amount of $200,000 per year. An offset has been adopted rather than a deduction, meaning that the relevant amount will be subtracted from tax payable rather than deducted from assessable income. However, it cannot be used to reduce tax payable to the point it becomes negative and a return is payable. Where this would be the case, the unused portion of the offset can be carried forward to future income years. The intention is to provide all investors the same level of benefit irrespective of their marginal tax rate. Investors may disregard capital gains realised on shares in qualifying ESICs that have been held for between one and 10 years. However, the *quid pro quo* is that investors must also disregard any capital losses realised on these shares held for less than 10 years.
2. **Annual investment limit to apply to 'mums and dads'** – A total annual investment limit of $50,000 will also now apply to retail ('mum and dad') investors, purportedly to help protect inexperienced investors from being lured into risky investments. This is a less extreme measure than the original proposal to restrict the incentive entirely to 'sophisticated investors', and in our view strikes a better balance.
3. **Incentives not available to 'affiliates'** – The incentives will not be available to any investor who exerts influence over the company's actions, employee share schemes, or issues to investors who would end up with over a 30 per cent stake in the ESIC. According to the Explanatory Memorandum, this is because the measures are designed to encourage *new* investments in ESICs, not subsidise the owners of *existing* ESICs. In our view, this integrity measure is unwarranted. If a startup undertakes a funding round and a couple of investors happen to be 'affiliates', it seems to us both unnecessary and unfair for those investors to miss out on the investor tax concessions (particularly if they are investing on the same terms as other investors).
4. **Non-monetary 'payments' for shares** – The measures will give investors an offset of 20 per cent of the amount that the investor *paid for the shares*. However, it is common for startups to issue shares in return for services, such as advice or access to office space. The Explanatory Memorandum is silent on whether payments in kind would qualify for this offset. Rules for determining the value of services provided are found elsewhere in the Tax Acts, however, the purpose of these measures is to encourage *investment in* startups, not *support for* startups, and the term 'payment' ordinarily requires a payment of actual money. Transactions involving an exchange of services will require careful structuring to fit these measures. As this is a common practice in startups, we hope that the final legislation more specifically addresses this issue.
5. **Integrity measures** – The Bill inserts specific references to the tax concessions into the anti-avoidance legislation (Part IVA) to make it clear that investors cannot obtain benefits from these measures by entering into artificial or contrived arrangements. The Explanatory Memorandum provides the examples of an individual who uses an interposed entity to allow them to indirectly access the generous concessions on capital gains (if the ESIC is successful) through their ownership of the interposed entity, and also to access the tax benefit of capital losses (if the ESIC is unsuccessful) arising out of their interest in the interposed entity. In these circumstances, the Commissioner may deny the capital loss, and also impose significant administrative penalties for the intentional disregard of the law.

New arrangements for VCLPs and ESVCLPs

The Bill proposes a number of amendments to the VC investment regime to make VCLPs and ESVCLPs more attractive to investors. Very generally, the reforms include:

- providing non-refundable carry-forward tax offsets for limited partners in ESVCLPs, equal to up to 10 per cent of contributions made by the partner to the ESVCLP during an income year;
- increasing the maximum fund size for ESVCLPs from $100 million to $200 million;
- removing the requirement that an ESVCLP divest an investment in an entity once the value of the entity's assets exceeds $250 million, but restricting tax concessions for such investments; and
- allowing entities in which a VCLP, ESVCLP or an Australian venture capital fund of funds (AFOF) has invested to invest in other entities, provided certain requirements are satisfied.

CONCLUSION

The Bill (all 61 pages of it) fills in many previously unknown details regarding the startup tax concessions announced in December 2015. It also constitutes a giant leap forward in offering real incentives to help close the funding gap faced by many startups in Australia.

But, the drafting is also highly prescriptive and will require close scrutiny. The complexity of the legislation means that startups, and their investors, should obtain legal and tax advice before proceeding to apply the new rules. Given that the consequences for investors of getting this wrong are substantial, this lack of certainty would seem to undermine the purpose of the Bill. As a starting point, we would encourage the Government to simplify the points-based system by providing some clearer safe harbours for startups that should be clearly covered by the scheme (such as providing a list of approved accelerator programs).

We will keep you updated and provide you with a more detailed analysis of the new rules once they have been enacted. In the meantime, if you have any questions, please feel free to contact us.

MEET THE TEAM

TAX CONCESSION ISSUES

If you would like to learn more about the new tax concessions, get in touch with our team.

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