Encouraging Innovation? How Effective Are the 2016 'Tax Incentives'?

Abstract

Data from tax returns lodged in 2016-17, the first year in which tax incentives for investments in early stage innovation companies were available, reveal that only about $300 million was invested in some 340 early stage innovation companies by a total of around 3400 'angel investors'. The data does not however indicate how much of that was invested directly because of the availability of the incentives and how much would, in all probability, have been invested anyway. The incentives, a non-refundable carry-forward tax offset of 20% of the value of the investment (up to a maximum tax offset cap of $200,000) and a 'modified CGT treatment' (which disregards any capital gains realised when the shares are disposed of – provided they have been held for between one and ten years), are, on their face generous. There are, however, a number of downsides to the legislation which make the 2016 reforms administratively more complex than they should be and practically less attractive than they could be. One of the problems, a practical clawback of the benefits of the modified CGT treatment if the initial investment was made through a fixed trust, has already been identified and rectified but others remain. This paper examines the reasons for the reforms, their object and the extent to which eligibility restrictions and other practical constraints and limitations are likely to affect the probability that the legislation will achieve its aims.

1. Introduction

The *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* (Cth) came into effect in Australia on 1 July 2016. Its aim, as described by the Treasurer in his Second Reading Speech, was to 'foster a shift towards a culture of innovation, whereby entrepreneurial risk-taking is encouraged and rewarded'. That aim was to be achieved by implementing some of the measures that the government announced in the *National Innovation and Science Agenda* on 7 December 2015 – and which were included in its *Mid-Year Economic and Fiscal Outlook 2015-16* released on 15 December 2015, just over a week later.

Those measures included:

- Providing new tax breaks for early stage investors in innovative startups;
- Building on already existing measures to encourage venture capital investment in Australia;[1]
- Permitting companies to attract financing through crowd-funding;[2]
- Relaxing the 'same business test' to ensure that companies (and certain trusts) are not denied a deduction for carry-forward tax losses just because they change their business activities. Businesses that fail the continuity of ownership test will be able to write off past year losses and claim a deduction for bad debts by meeting either the 'same business test' or a more flexible 'similar business test' (collectively referred to as the 'business continuity test');[3]

[1] See Sch 2 to the *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* (Cth)
[2] See the *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) which took effect on 29 September 2017. See also the Corporations Amendment (Crowd-Sourced Funding for Proprietary Companies) Bill 2017, passed by the House of Representatives on 26 February 2018, which will allow proprietary companies, as well as public companies, to access crowd-sourced funding.
[3] See Treasury Laws Amendment (2017 Enterprise Incentives No 1) Bill 2017

- Removing the rules that limit depreciation deductions for some intangible assets (notably patents) to a statutory life and allow them, instead, to be depreciated over their economic life – as is presently the case for other assets[4];
- Reforming Australia's insolvency laws to encourage greater entrepreneurial risk taking;[5] and
- Making the existing employee share scheme rules more user-friendly by allowing companies to offer shares without having to reveal commercially sensitive information which could, thereby, be accessed by competitors.[6]

The measures that were announced in the *National Innovation and Science Agenda* were merely the latest of a number of tax and other incentives that Australia has introduced to assist innovating enterprises, especially in their startup phase.

The current suite of taxation incentives really commenced with the *Venture Capital Act 2002* (Cth) (and the associated amendments to both the Commonwealth's taxation legislation and the individual state and territory Partnership Acts) to facilitate non-resident investment in the Australian venture capital industry.[7]

The incentives that are currently available include: the R&D Tax Offset under Div 355 of the ITAA97[8] (jointly administered by AusIndustry and the ATO[9]); the amended Div 83A of the ITAA97 which provides, *inter alia,* a 'startup' concession for shares and options that eligible small startup companies issue their employees (in lieu of the higher salaries that they might otherwise have to pay to attract talent to their enterprises); and the immediate write off for certain defined expenses that are incurred in setting up a proposed small business.[10]

The 2016 tax breaks for early stage investors in innovative startups (referred to as 'angel investors') are contained in Subdivision 360-A of the ITAA97. They were specifically introduced to augment the other already-existing measures, in particular, the incentives that are available to venture capital funds (ESVCLPs and VCLPs) which 'typically focus on companies that have already developed a

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[4] ibid

[5] See Bankruptcy Amendment (Enterprise Incentives) Bill 2017

[6] See *Treasury Laws Amendment (2016 Measures No 1) Act 2017* (Cth) amending, in particular, *Corporations Act 2001* (Cth) s 1274

[7] Tax incentives are available for making 'early venture capital investments' (ECVIs) through specific forms of investment vehicles – Venture Capital Limited Partnerships (VCLPs), Early Stage Venture Capital Limited Partnerships (ESVCLPs) or Australian Venture Capital Funds of Funds (AFOF). The available incentives include an exemption from CGT on ECVIs that have been held for at least 12 months and an exemption from income tax on any profits (though losses on both capital and revenue account are also disregarded).

[8] Div 355 replaced the formerly available 'R&D Tax Concession' with effect 1 July 2011. It allows eligible R&D entities that incur eligible R&D expenditure on defined 'core' or 'supporting' R&D activities to a self-assessed tax offset, the nature and extent of which depends on the size of their turnover and the amount of their eligible expenditure. The offset is in lieu of a tax deduction.

[9] AusIndustry has responsibility for registration and administration of program activities (via Part III of the *Industry Research and Development Act 1986* (Cth)). The ATO has responsibility, under Div 355, for administration of the tax offset for expenditure on eligible R&D activities.

[10] Section 40-880(2A) ITAA97, applicable since 1 July 2015. There are limitations to the expenses that can be immediately deducted. In particular, the cost of acquiring assets that may be used by the business, the direct costs of acquiring startup capital itself, such as interest, dividends or capital repayments, expenses the business may incur for the operation of a proposed business (such as travel costs while assessing locations for a business) and expenditure relating to taxes of general application, such as income tax are not included.

concept that is anticipated to attract capital and [where] the company is generally seeking higher amounts of capital to grow'.[11]

This timing problem is addressed by the 2016 provisions, which are designed to allow Early Stage Innovation Companies (ESICs) 'to attract seed and pre-commercialisation equity at an earlier stage of their development'[12] by offering 'early stage investors' both a tax offset and a capital gains tax exemption (similar to that which is already available to 'early venture capital investments').

The Act also amended the existing ESVCLP and VCLP rules[13] to improve access to venture capital investment in the next phase of an ESIC's development, by making those regimes more attractive to investors – again, to support innovation, risk-taking and an entrepreneurial culture.

This paper analyses Subdivision 360-A's 'tax incentives for early stage investors' (TIFESI)[14] to assess their likely effectiveness – especially given the threshold, equity interest and reporting requirements that affected companies are required to meet to ensure that their 'angel investors' qualify for the concessions.

2. The Problem the Incentives are Designed to Address

Backing innovative startups is inherently risky. Statistics show that over 50% of all small businesses fail in the first four years of their operation and that first time entrepreneurs have only an 18% chance of success.[15] For innovative startups the figures for failure, at about 60%, are a little worse.[16] Consequently, potential investors are naturally selective, both in the innovations they are prepared to back, especially in the very early stages of the business's existence, and in the amount of money they are prepared to risk. They also usually demand a significant equity stake to compensate them for the risks they undertake, and an associated level of control over decision-making (though if that means that the startup then has access to the investor's managerial and marketing expertise, that could be a potential positive for both the startup and the investor – and it is also an express aim of the 2016 incentives[17]).

Investor reluctance to invest in innovation, and the resulting lack of access by innovative startups to adequate financing, has been identified as 'a major contributor to poor innovation outcomes in Australia,'[18] a contention supported by the Australian Bureau of Statistics *Business Characteristics*

[11] Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.4.
[12] ibid
[13] Schedule 2 to the *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* (Cth).
[14] See the heading to the new Subdivision 360-A, ITAA97
[15] Matt Mansfield, *Startup Statistics – The Numbers You Need to Know*. Small Business Trends https://smallbiztrends.com/2016/11/startup-statistics-small-business.html accessed 7 March 2018.
[16] Erin Griffith, *Conventional Wisdom Says 90% of Startups fail. Data Days Otherwise.* Fortune. http://fortune.com/2017/06/27/startup-advice-data-failure/ accessed 7 March 2017
[17] Explanatory Memorandum to the *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.6
[18] Withers G, Gupta N, Curtis L and Larkins N '*Australia's Comparative Advantage: Final Report'* Australian Council of Learned Academies, Melbourne, August 2015, p 120.

Surveys which have consistently rated 'lack of access to additional funds' as the greatest barrier to innovation in Australian businesses.[19]

The problem is well illustrated in the *Startup Muster* Annual Reports. The *Startup Muster 2017 Annual Report* shows that while success rates for fund-raising by startups has improved over time, in 2017, only 27.5% of startups had tried to raise funds and had either raised as much as they were seeking or been oversubscribed, 10% had tried but had not raised as much as they had sought and 5.8% had tried but had not been able to raise any funding at all. Significantly, 42.8% of all startups had never tried to raise funding at all. The overall result was that in 2016-17 only 34.2% of startups had equity held by investors.[20]

Therefore, anything which encourages investors to support innovation is to be welcomed – particularly in the intermediate period between the initial (pre-concept) stage of the business's life-cycle where finance is normally provided through self-funding, family, friends and, potentially, government support and/or tax incentives, and the commercialisation stage where funding is more likely to be available through the established ESVCLP and VCLP regimes, as well as from banks and other sources of commercial finance.

This intermediate stage (commonly referred to as the 'valley of death'), where the business needs to establish the 'proof-of-concept' and the 'profit-potential' of their innovation in order to become attractive to venture capital investors and other more traditional sources of finance is where most startup innovation businesses 'fail simply because they find themselves vulnerable to cash-flow requirements.'[21]

3. The 'Normal' Funding Life-cycle for Startups

Getting a startup from initial concepts to functioning maturity usually takes somewhere between 8 and 12 years and involves a number of defined phases, each of which requires the company to raise sufficient capital to complete that phase successfully and to position itself to move to the next phase. In broad outline those phases can be identified as 'pre-seed', 'seed' and 'commercialisation (the latter phase including initial commercialisation, expansion and, perhaps, preparation for IPO or sale).

Different risks of failure attach at each stage (though they reduce as the company matures) so investors at the early stages of a company's development are more likely to demand a significant stake in the company's future success in exchange for their investments than investors who 'buy-in'

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[19] See, for example, Australian Bureau of Statistics, '*Business Characteristics Survey' 2015-16*' para 8167.0, released 17 August 2017 (available at http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/8167.02015-16?OpenDocument). It reports that for 2015-16, as for previous years, lack of access to additional funds was identified by both innovative-active businesses and businesses overall as the most common barrier to innovation: 21.3% of all innovation-active businesses rating it as the greatest barrier to innovation. For the purposes of those Surveys, 'Barriers to innovation' are defined as 'those barriers that significantly hampered the development or introduction of any new or significantly improved goods, services, processes and/or methods'.

[20] Startup Muster 2017 Annual Report available at https://www.startupmuster.com/reports/Startup-Muster-2017-Report.pdf accessed 7 March 2018. These figures were an improvement on results from earlier years where startups had reported much worse outcomes.

[21] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.7.

later. For that reason it is important that the founders clearly identify exactly how much capital they need to get their startup to the next inflection point and seek only what they need to get there (with some additional 'fat' to cover contingencies) – leaving funding for the next phase for a subsequent funding round when it is likely to be easier and cheaper to get.

Initial 'pre-seed' funding for most startups, when all that exists is still just a potentially 'good idea', is mainly derived from the '4 Fs' – founders, friends, family and fools (effectively anyone else you can convince to invest in what is effectively still 'blue sky'). Government grants may also be available[22] as may other incentives, such as the R&D tax offset and other similar stage tax incentives. Crowd-funding may also be an option at this stage.[23]

When the business matures to the stage where the founders realise that 'bootstrapping' (surviving on what is available from the '4 Fs') will not suffice if the business is to develop, the business moves into the 'seed capital' phase. The money raised during this phase is normally used for initial market research and product development and the aim is to raise enough to determine exactly what the product is and who will use it and, once that has occurred, to launch it at its target market. At this stage there is still significant risk and, therefore, significant potential for the venture to fail. The investors who are likely to become involved at this 'seed funding' stage are the so-called 'angel investors',[24] augmented perhaps by some early stage venture capital firms. Some indirect cash funding may also be available at this stage through refundable R&D tax offsets for any R&D expenditure the startup incurs.

From the 'seed capital' phase, businesses that are still on foot typically then need a further injection of funds to move into the commercialisation phase of their development. Seeking capital for this phase, normally the company's first significant institutional round of venture capital finance raising, is referred to as a 'Series A' funding round. It normally occurs after product development has concluded, when the product is ready to take to market and when the company has established some sort of track record. The money obtained during this phase is used to optimise both the product and the customer base. It may also be used to promote the product across other markets to achieve economies of scale.

The investors who are most likely to be involved in this round are the more traditional early stage venture capital and venture capital firms – though angel investors may also continue, and expand, their involvement. Investors here are traditionally looking for about 25-35% of the company in exchange for their investment[25] - though this is normally structured, at least initially, through an issue of convertible notes rather than a direct issue of shares.

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[22] All levels of government provide programs to support business development. They range from direct financial grants to the provision of assistance and mentoring through incubator and accelerator programs.
[23] The *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) is likely to make crowd-funding more common and a more significant source of funding at this stage of a startup's business.
[24] These are, often, high net wealth individuals, successful entrepreneurs or a combination of both.
[25] For example, if the business had a value of $2m before the seed capital injection (a state referred to as 'pre-money') the angel investor would normally seek a one third interest in exchange for an investment of an additional $1m. This has implications for the availability of the tax offset under Subdivision 360-A because an investor who holds more than 30% of the equity interests in the ESIC immediately after an issue of shares is not entitled to the tax offset: s 360-15(1)(f).

Using convertible notes has benefits for both parties. For the company, issuing convertible notes does not force a valuation of the enterprise at a time when there may not be a lot of 'hard evidence' on which to base a valuation, convertible notes are administratively easier (and quicker) to issue and, because the money raised is debt rather than equity (until converted), the founders retain control and do not need to cede board seats to investors.

For investors, the investment is debt and therefore, if the venture fails, they have some priority on repayment (if there are any available assets) – but they also have the potential to share in the venture's success by converting their debt into equity on a pre-determined (and advantageous) basis if the startup moves to the commercialisation stage.

Once the business has become fully operational it may require additional capital to expand, or to prepare for an IPO. At that stage it will, normally, have already achieved a measure of success but, to move to the next level, it will needs to incur additional spending on, for example, staff, business development, marketing, sales and customer support. Therefore, it may need to raise additional capital through a 'Series B' funding round. In many respects a Series B funding round is very similar to a Series A round, both in the way in which it is conducted and the people who are likely to be involved. Many of the same investors can be asked for additional funds – though it is now likely that more risk-adverse venture capital investors will want to be included,

In some cases, where the business has already proven itself but sees opportunities for further expansion, such as by taking over or merging with a competitor to take advantage of available synergies or expanding offshore, additional capital may again be needed. In such cases there is potential for a 'Series C' (or later) funding round. They too are very similar to the Series A and B funding rounds but with the difference that there is now significantly less risk and, therefore, more potential for funding from investment banks, private equity firms, hedge funds and others, as well as from those who have already been involved.

4. Where the New Tax Incentives Fit

The Subdivision 360-A 'tax incentives for early stage investors' (TIFESI), provide incentives for qualifying investors to invest in Early Stage Innovation Companies (ESICs) to allow them to get their innovations from the concept stage ('pre-seed') to the commercialisation stage,[26] providing 'seed' funding for the initial 'proof of concept' and 'proof of profit potential' phases of development before the companies start generating any significant revenue – a normally high risk period during which it is difficult to attract investors or to obtain finance, with the result that this phase normally involves a high risk of failure.[27]

5. The Incentives

[26] The tax incentives do not apply at the concept stage because one of the requirements for a company to be classified as an ESIC under s 360-40 is that it must be 'genuinely focused on developing for commercialisation one of more new, or significantly improved, products, processes, services or marketing or organisational methods': s 360-40(1)(e)(i).

[27] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.7

Subdivision 360-A provides investors with two forms of tax incentive, a tax offset and a modified CGT tax treatment for gains or losses on their investments.[28]

The tax offset is a non-refundable carry-forward tax offset of 20% of the value of the investor's investment up to a maximum tax offset cap of $200,000 (with, to protect the 'non-sophisticated', a total annual investment limit of $50,000 for retail investors).

The modified CGT treatment allows early stage investors to disregard any capital gains that they realise on shares in eligible Early Stage Innovation Companies (ESIC) where the shares have been held for between one and ten years – a tax treatment which is similar to that which is already accorded Early Stage Venture Capital Limited Partnerships, Venture Capital Limited Partnerships and Australian Venture Capital Funds of Funds under the existing Subdivision 118-F.[29] For investments in ESICs, that concession is not limited to shares within the $200,000 maximum tax offset cap though, to ensure that investments are not made and then withdrawn before the company can benefit from them, capital losses realised on shares that have been held for less than 10 years are also disregarded.

6. Pre-conditions That Must be Met to Qualify for the Incentives

The tax incentives are only available to an investor if three criteria are met:

a. the company must qualify as an early stage innovation company *immediately after* the shares are issued;
b. the shares it issues must be eligible for the tax incentives; and
c. the investor must be eligible to receive the incentives.

6.1. The Company Must Qualify as an Early Stage Innovation Company

In general terms a company will qualify as an ESIC 'if it is at an early stage of its development (the early stage limb) and it is developing new or significantly improved innovations with the purpose of commercialisation to generate an economic return (the innovation limb)'.[30]

Therefore, a company will only qualify as an ESIC if it satisfies two conditions:

a. it must be '*early stage*' – a requirement that is determined against a set of criteria involving, incorporation or registration, expenditure, assessable income and stock exchange listing.[31] If

[28] Section 360-10 ITAA97

[29] Provided the conditions in the Subdivision are met, partners in ESVCLPs, 'eligible venture capital partners' in VCLPs or 'eligible venture capital partners' in AFOFs have any capital gains or losses resulting from CGT events relating to 'eligible venture capital investments' ('EVCI') that the partnerships have owned for at least 12 months disregarded (ss 118-405, 118-407 and 118-410 ITAA97). They are also exempt from income tax on their share of any profits (ss 51-54 and 51-55 ITAA97) but are denied a deduction for any losses that arise from disposal of those interests (ss 26-68 and 26-69 ITAA97).

[30] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.61

[31] Section 360-40(1)(a)-(d). It must either have been incorporated in Australia or registered in the Australian Business Register within the last three income years (the latest being the current year) or, if not, it must have been incorporated in Australia within the last 6 years – *and* it and its subsidiaries must have incurred *total expenses* of $1 million of less across the last three years; it and its 100% subsidiaries must have incurred total expenses of $1 million or less in the income year before the current year; it and its 100% subsidiaries must have had a total income of $200,000 or less – excluding any amount of Accelerating Commercialisation Grant it

the company passes all four of those 'tests' it will qualify as 'early stage'; if it does not, it will not[32]; and

b. it must be genuinely involved in innovation, something which it self-assesses against either a principles-based test[33] (which the Explanatory Memorandum describes as 'designed to provide enough legislative flexibility to accommodate both existing and future forms of innovations while specifically targeting high growth potential companies based on the innovation company's focus and potential business capability'[34]) or the statutory '100 point innovation test' in s 360-45[35] (both of which can be modified by regulation if the government determines that the tax incentives should be more tightly targeted or if they are being used for inappropriate purposes[36]). Companies can also seek a ruling from the ATO on whether they qualify as an ESIC under either the principles-based test or the 100 point innovation test[37]– though the ATO's position is that the ruling cannot be 'used in promotional materials to imply that we guarantee or endorse investment in your company'.[38] The ATO also warns that 'the promoter penalty laws may apply if you use a ruling to encourage investors to invest in your company, when the company's circumstances at that time are materially different to those covered by the ruling'.[39]

If the company does not meet the 'early stage' criteria or does not pass either 'innovation' test it will not qualify as an ESIC and its investors will not be entitled to either the tax offset or the 'modified CGT treatment'.

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may have received – in the income year before the current year; and none of the company's equity interests must be listed for quotation in the official list of any stock exchange, in Australia or overseas.

[32] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.62

[33] Section 360-40(1)(e). The requirements are that the company is genuinely focused on developing for commercialisation one or more new, or significantly improved, products, processes, services or marketing or organisational methods (so merely customising an existing product, updating existing products, changing pricing strategy, changing goods because of cyclical or seasonal change etc are unlikely to qualify), the business relating to those products etc must have a high growth potential, the company must be able to demonstrate that it has the potential to be able to successfully scale the business, as well as the potential to be able to address a broader than local market, including global markets, through the business and that it also has the potential to have competitive advantages for that business.

[34] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.71

[35] Sections 360-40(1)(e) and 360-45. The tests allocate points for particular objective activity-based criteria. The Explanatory Memorandum notes (at para 1.72) that 'In practice, [applying these objective activity-based criteria] may be the simplest and fastest way for companies to determine if they satisfy the innovation limb of the qualifying ESIC test'.

[36] Sections 360-40(3) and (4) and 360-45(2). These provisions allow regulations to be made that exclude particular products, processes, services or methods from satisfying the ESIC requirements under the principles based test, or exclude a company from qualifying as an ESIC if it carries on a particular type of activity, or add criteria (and points) to the existing criteria under the points-based test.

[37] While it seems that companies can apply for a ruling on whether they meet either of the two tests there is some indication that rulings can only be sought in relation to the principles-based test: see para 1.73 of the Explanatory Memorandum. If they seek a ruling on whether they meet the principles-based test the ATO may consult the Department of Industry, Innovation and Science before issuing the ruling.

[38] See Australian Taxation Office 'Principles-based innovation test', https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=3#For_early_stage_innovation_companies__ESICs_, accessed 7 March 2018.

[39] ibid

6.2 The Shares Must Be Eligible for the Tax Incentives

Technically, it is not the shares that qualify for the tax incentives, it is the investor who must qualify. However unless the relevant issue of shares meets each of the criteria detailed in s 360-15(1)(b)-(f) the investor will not be entitled to the offset. Those criteria are:

a. the investment must be via 'equity interests[40] that are shares in the company';[41]
b. those shares must be new shares[42] that are issued by the ESIC on or after 1 July 2016;[43]
c. the company must be an early stage innovation company as defined in s 360-40 'immediately after' the issue;[44]
d. the investor and company may not be affiliates[45] of one another at that time;[46]
e. the issue of the shares must not be 'an acquisition of ESS interests[47] under an employee share scheme';[48] and
f. immediately after the issue the investor must not hold more than 30% of the equity interests in the company or in an entity connected with[49] the company.[50]

As investors bear the onus of determining whether they qualify for the tax incentives, they also bear the onus of determining whether the company qualifies as an ESIC at the 'test time'.[51]

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[40] Equity interests' are defined in ITAA97 ss 974-70 and 974-75. Those sections distinguish them from 'debt interests' on the basis of their economic substance rather than their legal form, as was previously the case. In very broad terms an interest that gives rise to 'contingent returns' will be an equity interest; one that gives rise to 'non-contingent returns' will be a 'debt interest'. If an interest satisfies both the debt and equity tests it is treated as a 'debt interest': ITAA97 s 974-5(4). From a practical standpoint this requirement would seem to preclude an issue of preference shares from qualifying under the section because of their debt character: see Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.27
[41] Section 360-15(1)(b). In addition to being 'equity interests' the interests must also be constitute a 'share' under the ITAA97 s 995-1 definition of 'share: 'a share in the company and includes stock' (noting though that s 245F of the *Corporations Act 2010* (Cth) prohibits Australian companies from issuing or converting shares into stock).
[42] The requirement for new shares ensures that the ESIC acquires new funding through the issue. The tax offset is not available for investments that do not raise additional funds for the ESIC: see Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.28. However, as the Explanatory Memorandum notes in para 1.29, this does not preclude equity interests arising from the conversion of convertible notes from qualifying for the tax offset.
[43] The date of commencement of the Act. See s 19 in Schedule 1 to the *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* (Cth) and Item 2 in the Table in s 2 of that Act.
[44] Section 360-15(1)(c).
[45] ITAA97 s 328-130 defines 'affiliate' as: 'An individual or a company [which] acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the business of the individual or company'.
[46] Section 360-15(1)(d). The Explanatory Memorandum notes, at para 1.34, that the affiliate test is used to target the tax incentives to new investors 'rather than merely subsidise the existing investment'. It also notes (at para 1.36) that the test is an 'integrity rule to prevent entities acting in concert to obtain the benefit of the tax offset, where the investment is not for an innovation purpose or does not attract new capital for the ESIC'.
[47] Defined in ITAA97 s 83A-10.
[48] Section 360-15(1)(e)
[49] The term 'connected with' is defined in s 328-15 ITAA97 to cover situations where either entity controls the other or both are controlled by the same third entity.
[50] Section 360-15(1)(f). The Explanatory Memorandum notes, at para 1.38, that this limitation is to encourage investors to spread their investments across more than one ESIC.
[51] Australian Taxation Office, 'Qualifying as an early stage innovation company: https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-

The fact that companies must report any issues of new shares that could give rise to an entitlement to the ESIC tax incentives to the ATO within 31 days of the end of the financial year in which the shares were issued (ie normally by 31 July of that calendar year)[52] could assist investors in this regard.

However, as the Explanatory Memorandum notes, the reporting requirement is 'so that the ATO can assess whether those investors may qualify for the tax offset and the modified CGT treatment.'[53] It is not to assist investors (the legislation does not even expressly require the company to make that information, including any ruling, available to them so they can determine whether the company did qualify as an ESIC at the relevant 'test time'. That however, would not help investors in any practical sense anyway. By the time the company reports the issue, the 'test time' for investors to determine the company's status will be well past.

6.3 The Investor Must Qualify for the Incentives

The incentives under Subdiv 360-A, unlike the incentives available through ESVCLPs, VCLPs and AFOFs 'are available to all types of investors,[54] regardless of their preferred method of investment … other than "widely held companies" … and 100 per cent subsidiaries of these companies'. [55] Consequently, investments can be made by, inter alia, individuals, trusts, partnerships, superannuation funds and non-widely held companies.[56]

There is also no residence restriction[57] so the incentives are available to both residents and non-residents (though, given that the offset is non-refundable, they are likely to be less attractive to non-residents who do not have Australian source income, and an associated tax liability against which the offset can be applied).

However there are a number of restrictions, not on who can invest but on who can receive the incentives, which, in a practical sense, may limit those who will be willing to invest.

First, recognising that investing in startups is 'inherently risky' the new Subdivision contains express provisions to ensure that 'more vulnerable investors are not over-exposed to this risk'.[58] These

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investors/?page=2, accessed 7 March 2018. The term 'test time' is used throughout the Subdivision but it is not expressly defined. From the context it appears to be immediately after the company issues an investor with the relevant 'equity interests that are shares': see s 360-15(1)(b), (c) and (f). The Explanatory Memorandum also indicates that it is 'immediately after' the time of the issue; see para 1.29.

[52] *Taxation Administration Act 1953* (Cth) Schedule 1 s 396-55 Item 10 in the Table and Schedule 1, s 396-60(1)(a). If the company is aware that a particular investor is not entitled to those incentives (for example, because the investor is an affiliate or because their interest in the company then exceeds 30% or because the shares were acquired through an employee share scheme) that issue of shares need not be reported.

[53] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.15. This seems to create an inconsistency between the ATO's stated position on onus of proof and the apparent reason for the mandatory reporting requirement – especially if the aim of the reporting requirement is to '[minimize] compliance costs for all parties involved:' ibid.

[54] See the definition of 'entity' in ITAA97 s 960-100

[55] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.16. A 'widely held company' is one that is either listed for quotation in the official list of an approved stock exchange or has more than 50 members, other than companies that met the 20/75 rule during the income year: ITAA97, s 995-1. A '100% subsidiary' is, generally speaking, a company that is wholly owned by a holding company and/or other 100% subsidiaries of the holding company: ITAA97, s 975-505.

[56] Trusts and partnerships do not have a direct entitlement to the tax offset. Instead it flows-through to the individual partners, beneficiaries or, where relevant, the trustee: ss 360-30 and 360-35.

[57] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.17

[58] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.18

protections centre around classifying investors as either 'sophisticated investors', using the tests in s 708(8), (10) or (11) of the *Corporations Act 2001* (Cth),[59] or 'other'.

There is no limit on the amount that 'sophisticated investors' can invest (provided they meet the requirements of the sophisticated investor test in relation to at least one offering of relevant equity interests in the relevant year – so they need not qualify for that status when making every investment during the year). However, because they are subject to an 'affiliate-inclusive' annual offset cap of $200,000, their tax-effective investments are, in a practical sense, limited to $1 million or less in any tax year[60] (and less if the investor has carried forward part of the available offset from a previous year).[61]

'Other investors' are limited to investing $50,000 or less, in total, in all ESICs in which they invest in any income year.[62] If they exceed that limit they lose all entitlement to the tax offset – including their entitlement to any part of it that might have applied to the amount up to $50,000. This occurs because, by investing more than $50,000 in any income year, they are deemed not to satisfy the s 360-15(1)(b) requirement that they have been issued with 'equity interests that are shares in the company'.[63] Because they lose their entitlement to the tax offset they also lose their entitlement to the 'modified CGT treatment'.[64]

Secondly, s 360-15(1)(d) specifically denies the tax offset if the investor and the company are 'affiliates' of one another. Again, this does not preclude the investment but it does make it significantly less attractive for an investor who falls within the definition of 'affiliate' – especially as they will then also be denied the 'modified CGT treatment'.[65]

Thirdly, s 360-15(1)(f) denies the tax offset (and, as a consequence, the 'modified CGT treatment') to those who would 'hold more than 30% of the equity interests in the company or in an entity connected with[66] the company' following the investment. Again, this does not preclude the investment but it does make it less attractive for an investor – especially where the investment risk is to be compensated for by requiring a significant interest in the company in return for the investment.

[59] Section 360-20. Section 708 of the *Corporations Act 2001* (Cth) exempts certain categories of investor from the disclosure document requirements of that Act, in recognition that they 'are more likely to be able to evaluate offers of securities and other financial products without needing the protection of a disclosure document': see Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.19. The investors affected are 'sophisticated investors' (CA s 708(8)), certain experienced investors acquiring securities through a financial services licensee (CA s 708(10)) and 'professional investors' (CA s 708(11)).
[60] That offset cap applies to the investor's total affiliate-inclusive investment in all ESICs in a single year – not 'per investment'.
[61] Under s 360-20(2)(b) the $200,000 offset cap is reduced by any tax offsets that the taxpayer carries forward from a prior year.
[62] Section 360-20(1)(b)
[63] ibid
[64] The 'modified CGT treatment' only applies if the issuing of the share 'gives rise to an entitlement to a tax offset under this Subdivision': see s 360-50(1).
[65] ibid
[66] n 49 above

7. The Tax Incentives

7.1 The Tax Offset

If the three pre-conditions for the incentives are met, investors will be entitled to a non-refundable tax offset of 20% of the 'total amount paid' for the shares.[67] There is no requirement that the ESIC have actually applied the funds in its business in that income year; the investor must merely have paid for the shares.[68]

Similarly, because the 'test time' for determining whether a company is an ESIC, and therefore whether the offset is available, is immediately after the shares are issued,[69] if the company subsequently ceases to be a qualifying ESIC the investor does not lose the tax-offset (or the modified CGT treatment).[70]

If the investor cannot use the available tax offset, in whole or in part, to reduce his or her tax liability in that income year (either because he or she has no tax liability or because it has already been extinguished by other offsets with a higher application priority under ITAA97 s 63-10), any excess, up to the applicable tax offset cap, can be carried forward and applied in a later income year.[71]

Where the investment is made through a trust or partnership the offset is not available at the entity level but, instead, 'flows through' the trust or partnership to the individual partners or beneficiaries[72] who therefore gain the benefit of the offset. The only requirement is that the trust or partnership would have been entitled to the tax offset for that income year 'if the trust or partnership were an individual'.[73] If a particular beneficiary, unit holder or partner is another trust or partnership the offset continues to flow through those bodies until it reaches an entity that is not a trust or partnership.[74]

Each ultimate beneficiary or partner's entitlement to share in the available offset is determined by multiplying the 'notional tax offset amount' (the amount of the tax offset under s 360-25 to which the trust or partnership would have been entitled if it had been an individual) by the 'determined share of notional tax offset'.[75] That percentage *may* be determined by the trustee or partnership[76] – unless the beneficiary or partner is entitled to 'a fixed proportion of any capital gain from a disposal' of the share were one to occur at the end of the income year. In such cases the percentage must be equivalent to that fixed proportion. In all other cases, however, the trustee or partnership is free to

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[67] Section 360-25(1).

[68] The 'paid' requirement derives simply from the reference in s 360-25(1) to the amount of the offset being '20% of the total amount *paid* for the shares to which paragraph 360-15(1)(b) applies' (emphasis added)

[69] Section 360-15(1)(f) – but see n 51 above

[70] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.30

[71] The Act has amended s 63-10(1) ITAA97 (dealing with the 'Priority rules' for tax offsets) by inserting a new item, Item 33, into the Table. It provides that any unused tax offset under Subdivision 360-A may be carried forward to a later income year.

[72] Or, if there are no presently entitled beneficiaries, the trustee: see s 360-35

[73] Section 360-15(2)

[74] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.50

[75] Section 360-30(1)

[76] Section 360-30(2)

set the percentage on any basis it sees fit[77]– potentially leaving scope for the trust or partnership to stream the offset to beneficiaries or partners who can make best use of it.

In instances where the trustee of a trust is liable to be assessed, or has been assessed and is liable to pay tax under ITAA36 ss 98, 99 or 99A, on either a share of, or all of, the net income of the trust, the trustee is entitled to a tax offset.[78] The amount of the tax offset to which the trustee is entitled is the difference between the total amount of the tax offset and the amount to which the beneficiaries are entitled under s 360-30.[79]

The only real limitation is that under s 360-25(2) there is a $200,000, affiliate-inclusive annual cap on the total amount of the offset that each (sophisticated) investor can claim.[80] That cap includes not only 'the sum of the offsets under this Subdivision for the income year for which you or your affiliates (if any) are entitled'[81] but also 'the sum of the tax offsets under this Subdivision that you and your affiliates (if any) carry forward to the income year'.[82] Any potential offset that exceeds the $200,000 cap cannot be claimed in the income year in which the underlying investment was made; nor can it be carried forward into a later income year and applied then. It is simply not available at all.[83]

That cap would seem to be somewhat at odds with the Subdivision's express object 'to encourage new investment in small Australian innovation companies with high-growth potential'[84] in that, by denying the tax offset to that part of a 'sophisticated' investor's (and that investor's affiliates') total investment (in all ESICs) in any particular year which exceeds $1 million (and less if they have prior year offsets that have been carried forward), it effectively limits potential tax-advantaged investment to the amount from which the investor can expect the offset (though the modified CGT treatment is not so limited[85] and, in appropriate cases, it may provide the necessary investment incentive, even in the absence of the tax offset – a possibility hinted at in the Explanatory Memorandum[86]).

7.2 Modified CGT Treatment

The 'modified CGT treatment' only applies to shares 'if the issuing of a share to an entity gives rise to an entitlement to a tax offset under this Subdivision' (ie under s 360-15).[87]

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[77] Section 360-30(2) and (3). In particular there is no requirement to set it the level of income shares under the trust instrument or partnership agreement or in accordance with the default profit-sharing rule in the Partnership Acts
[78] Section 360-15(3)
[79] Section 360-35
[80] Other investors are limited to a total investment of $50,000 across all ESICs in any year. Any investment above that limit will result in a loss of entitlement to both the tax offset and the modified CGT treatment, in total. See n 59 above.
[81] Section 360-25(2)(a)
[82] Section 360-25(2)(b)
[83] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.47
[84] Section 360-10
[85] See the Note to s 360-50(1)
[86] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.43
[87] Section 360-50(1)

Interestingly, that simply means that the three pre-conditions to entitlement must have been met (ie the company must have been an ESIC at the time of the issue, the shares must have been eligible for the tax incentives and the investor must have been qualified to receive those incentives). Consequently, provided those three pre-conditions have been met, sophisticated investors[88] are entitled to the 'modified CGT treatment' for all the shares they are issued, not just for those that fall within the $200,000 tax offset cap.[89]

If the shares did qualify for the tax offset (ignoring the effect of the cap) then, irrespective of how they were in fact acquired, they are also taken to have been acquired on capital account[90] – so any subsequent disposal will result in either a capital gain or capital loss instead of a gain or loss of a revenue nature.

The actual taxation treatment on any disposal then depends simply on how long the shares are held:

- If the shares are 'continuously held' for less than 12 months from the date of issue any capital gain is assessed under normal principles[91] but any capital loss must be disregarded.[92]
- If the shares are 'continuously held' for at least 12 months and less than 10 years from the date of issue, any capital gain arising on the occurrence of the relevant CGT event is disregarded[93] – as is any capital loss.[94]
- If the shares are 'continuously held' for 10 years of more from the date of issue the normal CGT rules apply, so any gains or losses that are realised on any after-occurring CGT event will be determined, and dealt with, under ITAA97 s 102-5 (for gains) or ITAA97 s 102-10 (for losses) – but with the modification that the first element of the shares' cost base, or reduced cost, becomes the market value of the shares on the tenth anniversary of their issue instead of their actual cost at issue.[95]

While the term 'entity' in the section is widely defined to include individuals, companies, partnerships and trusts (among others – including superannuation funds),[96] if the investment is made by a partnership there is a problem because, under ITAA97 s 106-5, each partner's interest in each CGT asset of the partnership is deemed to be separately held with a separate cost base or reduced cost base.[97]

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[88] 'Other' investors do not qualify for the tax offset *at all* if their investment exceeds $50,000 (s 360-20(1)(b) and 360-15(1)(b)). Consequently they will not qualify for the modified CGT treatment either –even for the shares that would have been acquired with the first $50,000 of their total investment: see s 360-50(1)
[89] See the Note to s 360-50(1)
[90] Section 360-50(2)
[91] The modified tax treatment of any capital gain does not come into effect under s 360-50(4) unless the relevant CGT event occurs 'on or after the first anniversary … of the issue': s 360-50(4)(b)
[92] Section 360-50(3): *any* capital loss within the first 10 years of ownership is disregarded
[93] Section 360-50(4)
[94] Section 360-50(3)
[95] Section 360-50(5). The onus of correctly calculating 'market value' at that time rest with the taxpayer – though the ATO does provide some guidance and advice on market valuation for tax purposes which can apply to the valuation of shares that are not listed on a stock exchange: see https://www.ato.gov.au/General/Capital-gains-tax/In-detail/Market-valuations/Market-valuation-for-tax-purposes/ accessed 7 March 2018
[96] ITAA97 s 960-100
[97] Section 106-5(2)

Consequently, where the shares were issued to a partnership, it is not the 'entity' that makes the gain or loss on disposal but the individual partners within that 'entity'. Therefore, the modified CGT treatment must be directed to the partners individually instead of to the partnership as a whole. This occurs through s 360-55 which provides for an alternative modified CGT treatment for partnerships 'to ensure that the modifications made by section 360-50 apply to each partner in the partnership in a case where the partnership is the entity that is issued with the share'.[98] It does this by providing that the same tax treatment rules (dictated by when the disposal occurs), including deeming that each partner's interest in the shares is held on capital account, apply at individual partner level to any gain or loss that is derived from an CGT event in respect of their individual interests in the shares held by the partnership.[99]

There is no similar specific provision for investments that are held through trusts (including unit trusts), companies or superannuation funds, because any gain or loss sustained by those entities is accounted for at the entity level not at the individual beneficiary, unit holder, shareholder or fund member level. The standard 'modified CGT treatment' under s 360-50 therefore applies to all of those entities.

There is, however, a further, alternative modification to the 'normal' CGT rules if the originally issued shares are subject to either a 'same-asset roll-over'[100] or a 'replacement-asset roll-over'.[101] This alternative modification applies specifically 'to ensure that the modifications made by s 360-50 are not affected merely because of one or more [of those] roll-overs (other than roll-overs under Division 122 or Subdivision 124-M)'.[102] Its effect is to treat the rolled-over asset as having been issued when the original share was issued,[103] to deem the entity that now holds the assets to have 'continuously held that asset since the original share was issued'[104] and to be, itself, the original entity.[105] Its effect is to ensure that the modifications in either s 360-50 (for non-partnerships)[106] or s 360-55 (for partnerships)[107] will apply to the rolled-over assets.

If the roll-over is not a 'same-asset roll-over' or a replacement-asset roll-over' but one under either Division 122 (wholly-owned company roll-overs) or Subdivision 124-M (scrip-for-scrip roll-overs), it is not covered by the s 360-60 provisions. Instead, s 360-65 provides for a completely separate modified tax treatment. Any capital gain or loss on a subsequent disposal (ie after the roll-over) is not disregarded. Instead that gain or loss is recognised for tax purposes, but 'the first element of the cost base and reduced cost base of the share just before the roll-over is taken to be its market value

98 Section 360-55(1)
99 Section 360-55(1)-(3)
100 Subdivision 112-D ITAA97. See, in particular, the 'Table of same-asset roll-overs' in s 112-150
101 Subdivision 112-C ITAA97. See, in particular, the 'Table of replacement-asset roll-overs' in s 112-115
102 Section 360-60(1)
103 Section 360-60(2)(b)
104 Section 360-60(2)(c)
105 Section 360-60(2)(d)
106 Section 360-60(2)(f)
107 Section 360-60(2)(e)

at that time'.[108] That is, it is treated in exactly the same way as a disposal by a 'normal' investor, after the tenth anniversary of the shares' acquisition, would be.[109]

8. Problems with the Subdivision's Provisions

As they are written, there are a number of issues with Subdivision 360-A's provisions which are likely to affect their practical operation. In most cases the issues arise because of the standard tension that arises whenever the tax system is used to promote particular behaviours and the revenue fears that taxpayers might in fact obtain some form of unintended tax advantage by engaging in them.

The issues arise across the provisions but, in particular they relate to:

1. The threshold tax offset entitlement requirements in s 360-15(1);
2. Determining whether a company qualifies as an ESIC (so the investment does, in fact, qualify for the incentives);
3. Determining the 'amount of the tax offset'; and
4. The operation of the 'modified CGT treatment'.

8.1 Problems with the Threshold Tax Offset Entitlement Requirements in s 360-15(1)

There are a number of problems with the threshold requirements in s 360-15(1) and they relate to both the investors to whom the tax offset (and, therefore, the modified CGT treatment) can apply and the manner in which their investments must be held.

First, the section excludes widely-held companies or their 100% subsidiaries (as defined in ITAA97 ss 995-1 and 975-505 respectively) from entitlement to the offset. If the aim of the legislation is, in fact, 'to encourage new investment in small Australian innovation companies with high-growth potential' by providing the incentives (as s 360-10 expressly provides), it is difficult to see why 'qualifying investors' should not include such entities, especially as they are more likely to have 'both the requisite funds and business experience to assist entrepreneurs in developing successful innovative companies' to which the Explanatory Memorandum refers[110] – and the financial wherewithal to accept the risks that those investments will probably entail.

Certainly, there is nothing in the legislation, the Explanatory Memorandum or the Treasurer's Second Reading speech which indicates why they have been excluded – though it is possibly because the government believed that those entities do not need additional tax incentives to invest or, perhaps, because of some other 'control' related reason.

Irrespective of the reason, the limitation is in many respects, pointless because it is so easy to circumvent. So long as the widely-held company invests through a non-100% subsidiary the tax incentives will be available through that subsidiary (absent a trigger for the operation of Pt IVA).

Secondly, 'affiliates' are excluded from entitlement to the incentives. The Explanatory Memorandum notes, at para 1.34, that this is 'to target the tax incentives to new investors in an ESIC … to

[108] Section 360-65(1) (for 'normally' issued shares) and (2) (for shares that were previously subject to a same-asset roll-over or a replacement-asset roll-over)
[109] See n 90 above
[110] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.6

encourage new investment in ESICs rather than merely subsidise the existing investment'. It goes on to note that 'If an investor exerts a degree of influence over an ESIC or vice versa, as per an affiliate relationship, it might be expected that the offset is not attracting this type of new investment'.

There are two issues with this exclusion:

a. On its face it would appear to exclude the founders from entitlement to the incentives (as well as, potentially, their family and friends – who may have already invested in the ESIC in its 'pre-seed' stage and who may be willing to advance further seed funding). That will certainly be the case if the founders invest directly but it is less clear that it will necessarily exclude other 'associates' because the term 'affiliate' is much more restricted and applies only to those who act, or could reasonably be expected to act, 'in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the business'.[111] This limitation will not apply, at least in most cases, to family, friends and other early-stage investors. In fact the Explanatory Memorandum expressly even notes (at para 1.33) that 'entities will not be considered affiliates merely because of the nature of the business relationship shared between them'. Consequently employees and even directors would not, for that reason alone, be considered 'affiliates' of the ESIC (though para 1.35 of the Explanatory Memorandum does note that 'a director-owner of an ESIC would be precluded from qualifying for a tax offset as the ESIC would be an affiliate of the director-owner.' Presumably, though, that is because that person's status of 'owner' rather than just director, would confer the required expectation that the ESIC would act in accordance with his or her directions or wishes).
b. As with 'widely-held companies or their 100% subsidiaries' exclusion, the exclusion of 'affiliates' can also be easily circumvented, even by founders. The term 'affiliate' is defined in ITAA97 s 995-1 as having 'the meaning given by s 328-130'. Section 328-130(1) notes that 'An *individual or company* is an affiliate of yours if …' (emphasis added). There is no provision for any other entity (as defined in s 960-100) to be an 'affiliate'. Consequently, provided a founder invests in the ESIC not directly but through a partnership or (with an even greater degree to separation and therefore greater protection) a trust or superannuation fund, he or she should be able to access an indirect entitlement to the incentives[112] – unless, again, Pt IVA is triggered.

Thirdly, under s 360-15(1)(f) an investor will not be entitled to the incentives if, after the issue of the shares, that investor holds 'more that 30% of the equity interests in the company or in an entity connected with the company'. The Explanatory Memorandum states (at para 1.38) that this is to 'encourage investors to spread their investments across more than one ESIC'. However, depending on the capital needs of the company at the time, and the availability of other investors (or sources of finance), this restriction may in fact prevent the ESIC obtaining the required capital and may, therefore, preclude the achievement of the Subdivision's expressly-stated object.

[111] ITAA97 s 328-130(1)
[112] This likelihood is reinforced by the notation in para 2.40 of the Explanatory Memorandum to the *Tax Laws (Small Business) Bill 2007* (Cth) (through which s 328-130 was inserted into the ITAA97): 'Only an individual or company can be an affiliate of another entity. Entities (for tax purposes) such as trusts, partnerships, and superannuation funds are not capable of being affiliates of entities

Worse, however, it too can be readily circumvented because the 30% limit is not an 'associate-inclusive' restriction. The section refers only to 'you' holding more than a 30% equity interest and the term 'you' applies only individual entities, not to them and their associates or affiliates.[113] A single investor who structures the investment through two or more vehicles would therefore seem not to breach the limitation, provided none of those investing 'entities' breach it – again, unless Pt IVA is triggered.

Finally, the s 360-15(1)(b) requirement that the investment be through 'equity interests that are shares' could prevent ESICs from issuing preference shares (because of their 'debt interest' characteristics[114]), even though experienced investors are known to prefer preference shares because of the priority dividend and capital repayment ('liquidation preference') rights they standardly confer.

There is also a possible issue if capital is raised using convertible notes, another favoured means of raising capital at this stage of an ESIC's lifecycle. Until the notes are converted into shares the Subdivision cannot apply, and the tax offset (and, therefore, the modified CGT treatment) will not be available. In most cases this will only affect the timing of the offset, not its availability, provided the notes are subsequently converted into shares – because the conversion gives rise to a new interest and is not just a continuation of the existing debt interest.[115] However, timing is critical. If the trigger event for the conversion occurs after the ESIC ceases to be an ESIC (so it no longer satisfies the s 360-15(1)(c) requirement), any right to the tax offset that may otherwise have arisen will be lost.[116]

8.2 Problems Determining whether the Company Qualifies as an ESIC

Under s 360-15(1)(c), entitlement to the tax offset (and therefore to the modified CGT treatment) only arises if 'subsection 360-40(1) (about early stage innovation companies) applies to the company immediately after [the share issue]'. There are a number of issues with this requirement.

First, companies are required to self-assess whether they are an ESIC at the relevant 'test time' and must do so by applying either the 'principles-based test' in s 360-40 or the '100 point innovation test' in s 360-45 – or by seeking a ruling from the Commissioner about whether their circumstances satisfy the principles-based test.

Self-assessment, per se, does not create a problem but the overt subjectivity of the five 'principles' of the principles-based test – all of which must be satisfied to pass the test – is such that it could well

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[113] ITAA97 s 995-1 (through s 4-5)

[114] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.27. While the statement in the EM is clearly correct in relation to redeemable preference shares that are redeemable at the investor's option, it is less certain that it applies to preference shares generally, especially if they are issued with 'rights' satisfying the 'equity interest' tests in ITAA97 Subdivision 974-C – and are not caught by the tie-breaker provision in ITAA97 s 974-5(4).

[115] See ITAA97 s 974-100(1). That consequence applies to Subdivision 360-A because 'equity interests,' as that term is used in s 360-15(1)(b), are defined by s 995-1 as having the meaning given by Subdivision 974-C.

[116] Para 1.29 of the Explanatory Memorandum notes that the 'point in time' test (for determining whether the issuing company is an ESIC) means that 'investors that acquire equity interests from the conversion of convertible notes are not precluded from qualifying for the tax offset, where the company issuing those equity interests is a qualifying ESIC at the time of the conversion into shares'.

be very difficult for a company, on a subsequent audit, to justify its determination that it qualified as an ESIC at that time. The company's problem is well-illustrated by the fact that four of the five tests require it to demonstrate that it has 'potential' at that time – for high growth, scalability, ability to address a broader than local market and ability to have competitive advantages for its business.

The ATO has issued an online 'ESIC decision tool'[117] to assist in determining both whether the company is an ESIC and whether investors are entitled to the offset, but it is very general in nature and does not seem to displace (or assist in any practical way in meeting) the obligation imposed on companies and investors to make the determination and to 'get it right'. Instead, it merely contains a series of yes/no questions and provides no real guidance on what companies must do to justify their decisions. That applies, in particular, to any determinations they make based on the 'principles-based test'.

These difficulties with the self-assessment requirement is also exacerbated by the fact that companies (and investors) must make (and be able to justify) their determinations not once but each time the company issues shares that might carry an entitlement to the incentives.

The cost of 'getting it wrong' (a complete loss of the tax incentives for its investors), is such that any company choosing to use the principles-based test would be well-advised to seek confirmation of the accuracy of their self-assessment by also applying for a ruling, despite the delay that that will involve.[118]

However, even where the company does seek certainty through a ruling it will come with the standard ATO caveat that 'the ruling is only about how the tax law applies on the facts that you have provided – if the facts change, this may lead to a different outcome under the tests.'[119] The ATO also warns that 'the ruling should not be used in promotional materials to imply that we guarantee or endorse investment in your company' and that 'the promoter penalty laws … may apply if you use a ruling to encourage investors to invest in your company, when the company's circumstances at that time are materially different to those covered by the ruling.'[120]

It is therefore perhaps unsurprising that even the ATO acknowledges that, 'In practice, if a company undertakes activities that meet the 100-point innovation test, this is likely to be the simplest way to determine its eligibility, when compared to the principles-based innovation test.'[121]

Secondly, the investor bears the onus of determining whether a company is an ESIC (and, therefore, that there may be an entitlement to the tax incentives).[122] The issuing company must report

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[117] See https://www.ato.gov.au/Calculators-and-tools/ESIC-decision-tool/ accessed 7 March 2018
[118] On 31 October 2017 the ATO did publish draft guidelines, 'A step-by-step guide to the principles-based innovation test' for public consultation. The consultation period closed on 22 January 2018 without any submissions or feedback being received. The finalised guidelines are expected to be released in June 2018.
[119] https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=3#For_early_stage_innovation_companies__ESICs_ accessed 7 March 2018. See also https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?anchor=HowdoesCGTapplytoqualifyingshares accessed 7 March 2018
[120] ibid
[121] https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=2#Qualifying_as_an_early_stage_innovation_company accessed 7 March 2018
[122] ibid

information to the ATO about their investors after they issue new shares that could give rise to an entitlement[123] but there is no commensurate obligation on either the company or the ATO to make that information available to investors. In any case, given that it occurs after the issue, it would be too late to protect investors anyway.

In reality then, if investors are to have confidence in the company's determination of its status as an ESIC there should be some binding mechanism, such as a Class Ruling, which would provide the necessary degree of certainty. Certainly, it is not good enough for the ATO simply to warn potential investors, as it has, that: 'The ruling provided to the company does not amount to financial advice or imply that we endorse or guarantee investment in the company. Investors should form their own views about whether to invest in a company and should seek independent financial advice if needed'[124] – and that they 'should keep records to support their entitlement to the early stage investor tax incentives.'[125]

Finally, a minor point, whether a company qualifies as an ESIC depends on whether it meets the s 360-40 requirements at 'the test time' – a term which is not defined. From the context (especially s 360-15(1)(b)) it appears that it is 'immediately after' the company issues the relevant shares, but it would be preferable if this were made explicitly clear by the inclusion of an express definition.

8.3 Problems Determining the Amount of the Tax Offset

Determining the amount of the tax offset involves, in the 'general case'[126] a relatively simple calculation under s 360-25 or, if the shares are held by a trust of partnership, a similarly simple modified calculation under either s 360-30 (where the offset flows to 'members' of those entities) or s 360-35 (where it flows to a trustee).

The start point for determining the relevant amount is s 360-25(1) which provides that 'the amount of the tax offset is 20% of the total amount *paid* for the shares' (emphasis added). There is however no definition of the term 'paid' and that gives rise to a question about whether, in particular, payments in kind would suffice to trigger an entitlement to the tax offset and, if so, how quantum would be determined to allow the offset to be calculated.

The definition of 'tax offset' in s 995-1 does not help.[127] Nor does the definition of 'paid' in ITAA36 s 6(1) (which only applies to 'dividends'). The provision in ITAA36 s 21 that, 'Where, upon any transaction, any consideration is given otherwise than in cash, the money value of that consideration shall, for the purposes of this Act, be deemed to have been paid or given' would seem to indicate

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[123] *Taxation Administration Act 1953* (Cth) Schedule 1 s 396-55 Item 10 in the Table and Schedule 1 s 396-60(1)(a). The Explanatory Memorandum notes, at para 1.15, that this is 'so that the ATO can assess whether these investors may qualify for the tax offset and the modified CGT treatment'. If the company is aware that a particular investor is not entitled to those incentives (for example, because the investor is an affiliate or because their interest in the company then exceeds 30% or because the shares were acquired through an employee share scheme) that issue of shares need not be reported.

[124] https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=4#For_investors accessed 7 March 2018

[125] https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=2#Qualifying_as_an_early_stage_innovation_company accessed 7 March 2018

[126] Section 360-25

[127] It says merely that it 'has the meaning given by section 4-10' which merely provides that 'a tax offset reduces the amount that you have to pay'

that the 'paid' requirement in s 360-25(1) could be satisfied by an in-kind 'payment' – and that, if it did, the normal valuation rules would apply.[128] In such cases the taxpayer would bear the onus of justifying the valuation that was adopted if it were subsequently challenged.[129] Further, because Part IVA has also been amended to ensure that any wrongfully obtained scheme benefit involving an innovation tax offset can be cancelled, it, too, could provide the Commissioner with grounds to reverse any tax offset that was claimed on the basis of a spurious valuation.[130]

There is some further support for the contention that the term 'paid' would encompass in-kind payments in the CGT rules. Under ITAA97 s 110-25(2) the first element of the shares' cost base is the total of 'the money you paid' and 'the market value of any other property you gave, or are required to give' for them. Under s 360-50 if a capital gain is made on any disposal by an investor of shares issued by an ESIC within 12 months of their issue that capital gain is calculated under 'normal' Pt 3-1 rules – including the cost base rules in s 110-25. Similarly, any disposal on or after the tenth anniversary of their issue will also be dealt with under 'normal' Pt 3-1 rules – though modified slightly so that the first element of the cost base, or reduced cost base, will be their 'market value on that anniversary', instead of the 'normal' s 110-25(2) amount.[131] Shares issued by ESICs are therefore affected by the s 110-25(2) valuation rules – including that their cost base can include 'the market value' of in-kind 'payments'.

It would however be preferable if the matter was put beyond doubt by amending s 360-25(1) to include an express form of words similar to those in s 110-25(2).

Further problems arise in determining the amount of the tax offset in relation to:

a. the $200,000 tax offset cap that applies to 'sophisticated' investors;
b. the way in which investments over $50,000 by 'other investors' are treated;
c. investments through trusts or partnerships; and
d. investments through companies.

8.3.1 Problems with the $200,000 Tax Offset Cap

'Sophisticated' investors are subject to an annual affiliate-inclusive cap to the tax offset they can claim. As discussed above, that cap includes not only the 'the sum of the tax offsets under this Subdivision for the income year for which you or your affiliates (if any) are entitled'[132] but also 'the sum of the tax offsets under this Subdivision that you and your affiliates (if any) carry forward to the income year'.[133] Therefore, total investments over $1m in any year will not attract an offset greater

[128] Together with the specific provisions in Subdivision 960-S of the ITAA97 relating to the calculation of 'market value'
[129] *Taxation Administration Act 1953* (Cth) ss 14ZZK(b) and 14ZZO(b) – though the ATO does provide some guidance and advice on market valuation for tax purposes: see https://www.ato.gov.au/General/Capital-gains-tax/In-detail/Market-valuations/Market-valuation-for-tax-purposes/ accessed 7 March 2018
[130] See, in particular, ITAA36 s 177F(1)(da) – though the Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 states that, 'These rules will apply to prevent taxpayers from being able to obtain tax benefits by entering into artificial or contrived schemes to access the TIFESI tax offset … or the ESVCLP tax offset'. Therefore, unless the in-kind payment was clearly part of a 'scheme' it is unlikely that Pt IVA would have any application.
[131] Section 360-50(5)
[132] Section 360-25(2)(a)
[133] Section 360-25(2)(b)

than the $200,000 cap, either in that year or (because they cannot be carried forward) in any subsequent year.[134]

The $200,000 tax offset cap is, arguably, too limiting: (a) because it applies to the totality of all investments in ESICs by the entity and all affiliates of the entity in that income year; (b) because the amount that can be invested tax-effectively in ESICs in any income year is also further limited if the investor has any unapplied tax offset carried forward from a previous period; and (c) the 'affiliate-inclusive' aspect may also limit the amount that can be invested in any income year if the affiliate has also made investments to which the tax offset can apply – or has prior year unapplied tax offsets which it has carried forward (though the definition of 'affiliate' in ITAA97 s 328-130 could limit the instances in which such investments would be taken to have been made by an 'affiliate').

The practical effect of the tax offset cap is therefore likely to be to limit the amount that any 'sophisticated' angel investor will be prepared to invest in any income year (spread across all ESICs in which they invest) to a maximum of $1 million.

8.3.2 Problems with 'Other' Investors

'Other' (non-sophisticated) investors do not qualify for an offset at all (and are therefore also denied the 'modified CGT treatment') if their investments in any income year, across all ESICs, exceed $50,000. While the aim of that limit is laudable – to protect retail investors from themselves[135] – the $50,000 cap as an 'omnibus' limit is arguably too low (or the threshold for 'sophisticated' investor status is too high), given the wide variety of investors (with widely differing financial and other circumstances) to whom it will apply (all those not qualifying as 'sophisticated' investors).

That penalty for exceeding the limit, losing the entire benefit of the tax incentives, also appears to be disproportionately draconian. Limiting the available tax offset to $10,000 (20% of the permitted $50,000 investment amount) and not restricting the availability of the modified CGT treatment (ie effectively mimicking the treatment accorded 'sophisticated' investors – but at a lower monetary level) would seem to be a preferable solution. That is especially so given that the current restriction will also effectively require ESICs (which will generally not be aware of any other investments that their investors may have made) to be very careful in what they say in their promotional material and what they include in their disclosures to those investors.

8.3.3 Problems where the Investment is through a Trust or Partnership

There are a number of possible problems where the investment in an ESIC is made through a trust or partnership and the tax offset then flows through either to the 'members' of that entity[136] or, in the case of trusts, to the trustee.[137]

First, except in those cases where the 'members' of the entity are 'entitled to a fixed proportion of any capital gain from a disposal were the disposal to happen in relation to the trust or partnership at

[134] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.47
[135] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.9
[136] Section 360-15(2)
[137] Section 360-15(2)

the end of the income year' (when each member's share of the offset must equal 'that fixed proportion'),[138] each member's share is determined by the trustee or partnership.[139]

This seems to allow trusts and partnerships to 'stream' the available offset to those 'members' who would derive most benefit from it. Given the offset's non-refundable nature, they are likely to be residents with significant taxable income (instead of non-residents with no, or limited, Australian source income and other 'members' with no, or a limited, taxable income). In other parts of the Income Tax legislation there are express anti-streaming provisions and it is unclear whether this omission in Subdivision 360-A was intended or an oversight.

Secondly, the Explanatory Memorandum notes that if the trustee or partnership does not make a determination or does not allocate a part of the tax offset to a member then no-one is entitled to that amount of the tax offset.[140] It is doubtful whether this is an accurate statement of the true effect of s 360-30(2) – for four reasons:

a. that consequence is not expressly provided for in the legislation;
b. the subsection is permissory, not mandatory, in nature;[141]
c. section 360-15(2) gives members of those entities an express entitlement to a tax offset 'if the trust or partnership would be entitled to a tax offset, under subsection (1), for the income year if the trust or partnership were an individual' – so the statement in the Explanatory Memorandum appears, directly, to contradict that express entitlement; and
d. at least in the case of trusts, where the trustee is liable to be assessed and pay tax and, so, is entitled to a tax offset[142] equal to the difference between the total amount of the available offset and the amounts which are allocated to the members under s 360-30,[143] the offset will be available to the trustee and will not be lost, even if no determination is made.

If the legislation was in fact intended to deny an offset if no determination is made (and notified to 'members' under s 360-30(4)) that would seem to impose an unnecessary (and unnecessarily punitive and potentially counter-productive) compliance burden on investors.[144] For that reason, if that consequence was intended, it might be expected that that would have been clearly stated in the legislation. The current simple, unsupported reference in the Explanatory Memorandum is neither adequate nor effective.

On the other hand, if, as is likely, the section is aimed only at ensuring that a determination is made, and that it is made in a timely fashion (as is indicated by the 'timing of notice' provisions in s 360-30(4), which include power for the Commissioner to extend the normal three month period, after the end of the income year, within which notification is to occur – so members can 'work out the

[138] Section 360-30(3)
[139] Section 360-30(2). The provision will therefore apply to all discretionary trusts.
[140] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.53
[141] The exact wording of s 360-30(2) is: 'The trustee of partnership *may determine*' the percentage of the notional tax offset that is the member's share of the notional tax offset'.
[142] Section 360-15(3)
[143] Section 360-35
[144] A burden which seems to be at odds with the Explanatory Memorandum's emphasis, elsewhere, of minimising compliance costs: see, for example para 1.15

amount of [their] share of the notional tax offset'[145]), that should be clarified (and the statement in the Explanatory Memorandum should be expressly retracted).

Thirdly, where the trustee is entitled to a tax offset (because the trustee is liable to be assessed and to pay tax under ITAA36 s 98[146] – either because there are presently entitled beneficiaries who are under a legal disability[147] or non-residents[148]), there is a danger that the benefit of the tax offset might be inadvertently lost if a s 360-30 determination is not made to allocate the offset to the relevant members and, instead, by default, the offset flows to the trustee under s 360-35.

This danger arises because, where the trustee pays tax under ITAA36 s 98 for a non-resident beneficiary, that beneficiary is also liable to pay tax on that amount under ITAA36 s 98A(1). However, that beneficiary is also then entitled to a '[deduction] from the income tax assessed' equal to 'the tax paid by the trustee in respect of the beneficiary's interest in the net income of the trust estate' or, if the tax paid by the trustee exceeds the beneficiary's tax liability, a refund of the difference.[149] The same tax treatment applies where the trustee pays tax in respect of the income share of a beneficiary who is under a legal disability – if that beneficiary is 'a beneficiary under more than one trust estate or derives income from any other source'.[150]

Consequently, if a trustee receives a tax offset under s 360-35, it will decrease the tax the trustee is required to pay under ITAA36 s 98. It will therefore also decrease the '[deduction] from the income tax assessed' that is available to the beneficiary (and will effectively increase the tax actually payable by that beneficiary) while, at the same time, denying the beneficiary the otherwise available tax offset for the trust's investment in the ESIC.

There is no similar problem where the trustee is liable to be assessed and to pay tax under ITAA36 ss 99 or 99A (because there are no affected beneficiaries). However, where the entitlement to an offset arises because of ITAA36 s 98 the trustee will need to be very careful to make the s 360-30 determination to allocate the entire tax offset to the beneficiaries use to ensure that it is not effectively lost. It would, however, be preferable to repeal the current reference to ITAA36 s 98 in s 360-15(3)(b) to remove the risk entirely.

8.3.4 Investments through Companies

Where the investment is made through a company, there is no flow-through treatment: the company is entitled to the tax offset and can apply it to reduce its tax liability on its taxable income in that income year or carry it forward. If it applies it to reduce its own tax liability that means that it will pay less tax (so will have more available cash which it can pay as dividends) but that also means that it will have fewer franking credits with which to frank those dividends.

Its shareholders will therefore, potentially, have a greater tax liability – and be worse off than they would have been if the company had paid tax on its income without the benefit of the tax offset, had paid a smaller, but more highly franked, dividend to its shareholders – and had been able to

[145] Section 360-30(4)(a)
[146] ITAA97 s 360-15(3)
[147] ITAA36 s 98(1)
[148] ITAA36 s 98(2A) and (3)
[149] ITAA36 s 98A(2)
[150] ITAA36 s 100(1) and (2)

flow-through the tax offset to those shareholders (in a manner similar to that applicable to trusts and partnerships). Realistically, the rules are unlikely to be modified to permit that to happen but that means that investors will need to consider this consequence when selecting the vehicle through which they make their investment.

8.4 Problems with the 'Modified CGT treatment'.

There are a number of issues with the 'modified CGT treatment' provisions as they stand.

8.4.1 The 'Modified CGT Treatment' generally only applies to the original investor

Unless one of the roll-over provisions is triggered, the modified CGT treatment only applies to the entity to which the shares were originally issued. In most cases this will not be an issue but, where a disposal of shares within the first 10 years is involuntary, especially in the case of death, there is an argument for extending the benefit of the modified CGT treatment to the beneficiaries of the investor's estate in a manner equivalent to the present extension of those modifications in cases involving a same-asset or replacement-asset roll-over.

Absent that, the beneficiaries will take the shares at the cost-base that would have applied to the testator at death[151] and will be subject to CGT on any capital gain that accrues thereafter. They will also lose both the CGT exemption that would otherwise apply if the shares are disposed of before the tenth anniversary of the original acquisition – and the modified cost base that would apply if the shares are disposed of after that anniversary. (On the positive side, though, if the inherited shares are subsequently disposed of at a loss before the tenth anniversary of their original acquisition, the beneficiaries, unlike the original investors, will not be required to disregard the capital loss).

Therefore, unless and until a roll-over provision triggered by death (or other involuntary disposal) is inserted into the legislation, investors, especially those who invest because of the potential capital gain, and the associated CGT exemption, would be well advised to invest through an entity such as a trust, superannuation fund, or company, which is not affected by the issues of mortality.

8.4.2 Problems where the Shares are Held by a Company or Trust

There are also possible problems if the investment is made through (and the shares are held by) a company or trust. For example, any capital gain made by a company on a disposal of the shares before the tenth anniversary of their issue would be disregarded under the legislation but, when the company then seeks to pass the benefits of that 'CGT-free' gain on to its shareholders, that payment would be taxable in full in their hands as a dividend – and the benefit may, therefore, effectively 'disappear'.

Similarly, while a capital gain made by a trust would be disregarded, at least as the legislation was originally written, any subsequent distribution of the proceeds of disposal to the beneficiaries would potentially have triggered ITAA97 s 104-70 (CGT event E4: Capital payment for trust interest'). The result, at least for fixed trusts,[152] was that the disregarded capital gains (in the hands of the trust) would have been clawed back when those gains were distributed – because the beneficiaries' cost

[151] ITAA97 s 128-15
[152] The fact that the payment by the trustee must be 'in respect of your *interest in the trust*' would indicate that this would not apply to a discretionary trust: see *Taxation Determination* TD 2003/28.

base for their interests in the trust would have been reduced by the amount of the distribution. Worse, if the distribution exceeded their cost base it triggered an immediate capital gain.

That 'unintended consequence' was rectified by the *Treasury Laws Amendment (2017 Measures No 1) Act 2017* (Cth), which amended ITAA97 s 104-71(3) by adding in a new paragraph (e). The new paragraph excludes from the calculation of the 'non-assessable part' of the distribution, for s 104-70 purposes, any amounts that are disregarded under s 360-50(4) (ie any capital gains realized by the trust on a disposal between the first and the tenth anniversaries of its acquisition of the shares). In other words the beneficiaries' cost base is now not reduced, and nor are they at risk of making a capital gain, because of the distribution. Instead, the 'modified CGT treatment' effectively 'flows through' to the beneficiaries.

The amendment does not, however, entirely dispose of the CGT event E4 problem. As the Explanatory Memorandum to the 2017 Act makes clear, it only applies if the distribution is made *directly* from the trust that holds the shares in the ESIC. It does not apply 'to payments made to an investor from a trust where that trust is the beneficiary of the underlying trust which holds the interest in the early stage innovation company'.[153] The government has indicated that it may consider extending the exemption to such indirect investments 'at a later date'[154] but that has not yet been occurred. Consequently, as with distributions of realized capital gains by companies, the benefits of the 'modified tax treatment' can be lost if investors hold their interests in the affected shares indirectly through a chain of trusts.

As a result, absent changes to provide for a general flow-through of the benefits of the 'modified tax treatment'[155] to shareholders of companies and indirect beneficiaries of trusts investors will need to consider those consequences when they are choosing the vehicle through which to make their investments.[156]

8.4.3 Wholly-Owned Company and Scrip-for-scrip Roll-overs

As has already been seen,[157] where there is a roll-over of the shares under either Division 122 (wholly-owned company roll-overs) or Subdivision 124-M (scrip-for-scrip roll-overs), the modified CGT treatment in s 360-50 does not apply.[158] Instead, any capital gain or loss on a subsequent disposal (ie after the roll-over) is recognised for tax purposes, and the sole benefit is that 'the first element of the cost base or reduced cost base of the share just before the roll-over is taken to be its market value at that time'.[159]

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[153] Explanatory Memorandum to the Treasury Laws Amendment (2017 Measures No 1) Bill 2017 (Cth), para 1.13
[154] Ibid, para 1.14
[155] A result which seems to be in line with the comment in ibid para 1.8 that, 'This concessional treatment is intended to be available to all types of investors, regardless of their preferred method of investment (whether an investment is made directly by a corporation or individual or indirectly through a partnership of trust)'
[156] There are similar problems where the investment is made through a superannuation fund but, as distributions from superannuation funds can be timed to be tax-free the same issue do not arise.
[157] See n 103 above
[158] Section 360-60(1)
[159] Section 360-65(1) (for 'normally' issued shares) and (2) (for shares that were previously subject to a same-asset roll-over or a replacement-asset roll-over)

The Explanatory Memorandum says that, 'This rule ensures that any accrued capital gains or losses in the share are not subsequently subject to CGT when the replacement asset is realised'.[160] The rule does achieve that objective but it also has a number of other potentially adverse practical consequences:

a. if an investor subsequently disposes of shares he or she acquires in a startup to a wholly-owned company, the modified tax treatment to which he or she would have been entitled under s 360-50 terminates and any increase in the value of the shares thereafter will be dealt with in the wholly-owned company's hands on 'normal' tax principles (which, presumably) could also mean that any subsequent gain by the company could be on revenue account rather than on capital account – depending on the basis on which the company acquired the shares). The provision may have been inserted, for example, to remove the attractiveness of an investor investing initially to obtain the tax offset and, thereafter, transferring the shares to a wholly-owned company to give it the benefit of the CGT exemption. Whatever the reason, this practical limitation on tax-effective disposal of the shares to a wholly-owned company means that an investor will need to consider very carefully which entity acquires (and, subsequently, holds) the shares in the first place;
b. the same problem applies to scrip-for-scrip roll-overs: the modified CGT treatment terminates. As a result, s 360-65 is likely to make mergers by, or takeovers of, the ESIC (perhaps for legitimate commercial reasons, including scaling[161]) significantly less attractive. It also seems to be entirely inconsistent with the thinking underlying the treatment of the tax offset incentive, where the fact that an ESIC ceases to be an ESIC after the issue of shares does not affect the investor's continuing right to the offset. Again, this is likely to be a practical disincentive to investors engaging in activity which, in the end result, is intended to promote the attainment of the legislation's objectives.

8.4.4 The Ten-Year Time Limit

A final potential issue arises because the full benefit of the modified CGT treatment ceases after 10 years. Given that companies may change direction and take time to succeed (the standard funding cycle is between 8 and 12 years) this may make such investments a little less attractive than they could be. How shares still held at that time are to be valued may also be an issue and may place an additional administrative/ compliance burden on the ESIC.

9. Conclusion

Insofar as Subdivision 360-A provides additional incentives for early stage investment in innovation companies in Australia they are welcome. It is difficult though to escape the impression that, in making the trade-off between providing incentives and protecting the revenue, the legislation has erred, too far, on the side of protecting the revenue.

How well it will succeed in its aim of 'encouraging new investment in small Australian innovation companies with high-growth potential'[162]is yet to be seen. However early indications are that, so far, it is only having a limited impact on investment in the sector. Data from tax returns for the 2016-17

[160] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016, Example 1.124
[161] Which Subdivision 360-A specifically seeks to encourage: see, for example ss 360-10 and 360-40(1)(e)(iii)
[162] Section 360-10.

tax year indicate that a total of only about $300 million was invested in some 340 early stage investment companies by about 3,400 angel investors in that year. It is not clear from the data whether these results are in line with the Government's expectations nor whether those who invested did so because of the incentives or whether they would have invested anyway.[163] It will be interesting to see whether the Government commissions further research into the actual effectiveness of the measures and what further amendments, if any, will be necessary to enhance their attractiveness to investors and, therefore, their potential for success.

[163] Denham Sadler, *Angel tax data revealed by ATO* InnovationAus.com 5 March 2018 available at http://www.innovationaus.com/2018/03/Angel-tax-data-revealed-by-ATO accessed 8 March 2018.