Using Taxation to Encourage Innovation: The Australian Experiments

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Introduction

In addition to measures such as development grants and funding for incubator programs Australia has long used tax incentives to encourage and reward innovation. Like many other countries it has traditionally offered standard tax breaks, such as write-offs for expenditure on R&D and accelerated depreciation for capital expenditure but the 21st century has been noteworthy for the range and scope of tax incentives (and other measures) that both state and Federal governments have introduced to assist innovating enterprises, especially in their start-up phase.

Those incentives, at least at Federal level, 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.

Taken collectively, those changes introduced tax incentives for investors making 'early venture capital investments' ('EVCI') through specific forms of investment vehicles — Venture Capital Limited Partnerships ('VCLP'), Early Stage Venture Capital Limited Partnerships ('ESVCLP') or Australian Venture Capital Funds of Funds ('AFOF').

The incentives include both an exemption from Capital Gains Tax ('CGT') on EVCIs that have been held through one of those vehicles — provided the investment has been held for at least 12 months — and an exemption from income tax on any profits made through the vehicle (though losses on both capital and revenue account are also disregarded). A non-refundable 10% carry-forward tax offset was added to those incentives in 2016.

Other currently available incentives include an immediate write off under *Income Tax Assessment Act 1997* (Cth) ('ITAA97') s 40-880(2A) for defined expenses incurred in setting up a proposed small business — including expenditure incurred 'in obtaining advice or services relating to the proposed structure, or proposed operation of the business; or in payment [of government] fees, taxes or charges relating to establishing the business or its operating structure' (though expenses, including the cost of acquiring assets to be used by the business, the direct costs of acquiring start-up 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, and expenditure relating to taxes of general application, such as income tax, cannot be immediately written off).

There is also a R&D Tax Offset under ITAA97 Div 355 which 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. That offset, which is jointly administered by AusIndustry (within the Department of Industry, Innovation and Science which manages the R&D Tax Incentive on behalf of Innovation and Science Australia, an independent statutory board of entrepreneurs, investors, researchers and educators) and the Australian Taxation Office ('ATO'), [1] is in lieu of a tax deduction.

[1] AusIndustry manages the registration of R&D activities; the ATO manages the rules on eligible entities and costs.

ITAA97 Div 83A also provides a 'start-up' concession for shares and options that eligible small start-up companies might issue their employees — in lieu of the higher salaries that they would otherwise have to pay to attract talent. It, inter alia, allows employees participating in option schemes to defer, more easily, their liability to taxation until the options are exercised and, in particular, without the options having to be at risk of forfeiture — though the scheme rules must still genuinely restrict employees from immediately disposing of the rights they receive.

The 2016 'Early Stage Innovation Company' ('ESIC') Investment Concessions

In 2016 those incentives were joined by a new set of tax breaks that were specifically aimed at early stage investors in innovative startups (those commonly referred to as 'angel investors'). Contained in a new ITAA97 Subdiv 360-A, they were specifically introduced to augment other already-existing measures (in particular, those available to ESVCLPs and VCLPs) which 'typically focus on companies that have *already developed* a concept that is anticipated to attract capital and [where] the company is generally seeking higher amounts of capital to grow'.

The 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' address that timing problem by offering 'early stage investors' both a tax offset and a capital gains tax exemption, similar to those applicable to EVCIs.

The same Act also amended the already existing ESVCLP and VCLP rules 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.

The 2017 Crowd-sourced Equity Funding ('CSF') Measures

In 2017 the *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth), was passed to allow 'eligible CSF companies' to access crowd-sourced equity funding. To qualify, those companies must meet the threshold eligibility requirements, they must pass both an 'assets test' and a 'turnover test', the amount they seek must fall within the 'issuer cap', the funds must be raised through a CSF intermediary and their 'CSF offer document' (and, if it is not included in the 'CSF offer document', their 'CSF offer') must meet the requirements of the Act.

Unlike most of its predecessors the new Act was not designed to provide tax incentives but to remove (or at least ameliorate) a number of major regulatory barriers to small businesses using crowd-funding as an effective means of fund-raising.

Those barriers included the 50 non-employee member 'shareholder caps' that apply to proprietary companies, the *Corporations Act 2001* (Cth), s 113(3) prohibition on proprietary companies making public offers of equity and the reporting and corporate governance requirements that public companies have to meet, which would, in many cases, make it uneconomic for small business to adopt a public company structure purely to fund-raise.

The Act addressed those barriers by inserting a new Part 6D.3A into the *Corporations Act 2010* (Cth). Its object was 'to provide a disclosure regime that can be used for certain offers of securities for issue in *small unlisted companies*, instead of complying with the requirements of Part 6D.2'.[2]

If their offers qualified for the modified disclosure regime, small unlisted public companies were able to access a number of regulatory concessions, including not holding annual general meetings, only reporting to shareholders online, and not appointing auditors — concessions that are not generally available to public companies.

[2] *Corporations Act 2001* (Cth) s 738A.

The aim of the regime (since extended to proprietary companies — but with modified concessions) was to 'provide an additional funding option for small businesses and start-ups in particular, that may otherwise struggle to obtain affordable finance'.[3] The Explanatory Memorandum also noted that '[f]acilitating CSF would also provide additional investment opportunities to retail investors, who are generally unable to gain direct access to early-stage financing activities'.[4]

This paper will outline the operation of the major Federally based 'start-up' incentives (particularly in relation to 'angel investors' and crowd-sourced equity funding) and analyse the extent to which they have already proven effective, the barriers to them becoming more effective and the steps that other jurisdictions that are considering similar incentives to assist entrepreneurial start-ups should consider.

Competing Policy Objectives

A major issue affecting how effective many of the measures are has been how Government manages the competing policy objectives of encouraging innovation while, at the same time preserving the integrity of the taxation system and protecting it from abuse through tax avoidance or tax evasion associated with the incentives.

The R&D Tax Offset

The R&D tax offset, which replaced the formerly available 'R&D Tax Concession' from 1 July 2011, 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 the R&D entity's turnover and the amount of its eligible expenditure.

As it was originally structured it entitled R&D entities with an aggregated turnover of less than $20 million, on a worldwide basis, to a *refundable* tax offset equal to 43.5% of their total eligible R&D expenditure for the year of income. Those with an aggregated turnover of $20 million or more on the same worldwide basis were entitled to a *non-refundable* tax offset equal to 38.5% of their total eligible R&D expenditure for that year. In both cases, the entities had to have notional deductions of at least $20,000.[5] Since 2014, however, those offsets have been limited to the first $100 million of the affected R&D entity's eligible R&D expenditure for that year. A separate offset equal to the company tax rate is available for expenditure over $100 million.

Those offsets are in lieu of a tax deduction, so their net effect was that entities under the $20 million threshold receive a minimum net benefit of 13.5¢ in the dollar and those over that threshold receive a minimum net benefit of 8.5¢ in the dollar — at least up to a notional R&D expenditure of $100 million. After that, the net effect of the then-available lesser offset was, effectively, to provide an immediate write-off for the additional expenditure.

A number of changes to that regime, based on recommendations from the government's 2016 review of the R&D tax incentive and the subsequent 'Australia 2030: Prosperity through Innovation Report' that was released by the Board of Innovation and Science Australia in January 2018, were proposed as part of the Commonwealth Government's 2018-19 budget. Those changes, which were to have taken effect from 1 July 2018, were projected to reduce the cost of the R&D tax offset to revenue by $2.4 billion over 4 years. They included a number of changes to the tax offset as it applied across the board, including changes to the refundable tax offset for companies with turnovers under $20 million and to the non-refundable tax offset for companies with higher turnovers.

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[3] Explanatory Memorandum, Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth), para 1.6.

[4] Ibid para 1.8

[5] The offsets were originally 45% and 40% respectively but they were reduced by the *Budget Savings (Omnibus) Act 2016 (Cth).* The new rates apply for income years commencing on or after 1 July 2016.

The changes for companies with an aggregated turnover of less than $20 million included:

a. replacing the blanket 43.5% offset rate with an offset tied to the company's actual tax rate, fixing it at 13.5% above that rate;[6]

b. imposing a $4 million cap on the annual cash refund actually payable to individual claimants, with any remaining offset to be carried forward for use against future taxable income (though clinical trials were to be exempt from the cap).

For companies with aggregated annual turnover of $20 million or more, an 'R&D premium' was to be introduced to tie the rates of the *non-refundable* R&D tax offset to the company's incremental intensity of R&D expenditure as a proportion of its total expenditure for the year. The proposed marginal R&D premium was to be the sum of the company's company tax rate and:

a. Four percentage points if the company's R&D expenditure is between 0% and 2% R&D intensity;
b. Six and a half percentage points if the company's R&D expenditure is between 2% and 5% R&D intensity;
c. Nine percentage points if the company's R&D expenditure is between 5% and 10% R&D intensity; and
d. Twelve and a half percentage points if the company's R&D expenditure is above 10% R&D intensity.

The expenditure threshold was, however, to increase from $100 million to $150 million so companies with R&D expenditure in excess of $100 million but under $150 million could continue to qualify for offsets in excess of their company tax rate.

Those changes were included in the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018. It was introduced into Parliament on 20 September 2018 but was referred by the Senate to the Senate Economics Legislation Committee which reported on 11 February 2019. It recommended that the Senate defer consideration of the Bill until there had been further examination and analysis of the impact of the proposed changes.[7] The Bill lapsed on dissolution of Parliament on 11 April 2019 and, when it was reintroduced into parliament on 4 July 2019, as the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2019, the proposed changes to the R&D Tax Incentive that had been in Schedules 1-3 of the previous Bill were omitted.

It is perhaps not surprising that there was virtually no mention of R&D in the 2019-20 Budget — except that the Budget Papers showed a significant decline in expected government support for R&D. Those changes in the Budget Projections for the 2018-19 and 2019-20 Budgets included a drop from $2.466 billion to $2.237 billion in 2019-20, from $2.566 billion to $2.449 billion in 2020-21 and from $2.689 billion to $2.292 billion in 2021-22, a total projected decline over the three years of $943 million (or $1.349 billion if the $406 million shortfall in 2018-19 was also included). Given that the $2.4 billion of anticipated savings from the 2018-19 Budget will not now be forthcoming (at least in the immediate future), that was somewhat surprising, as it might have been expected that the amounts would increase instead of decrease.

[6] This reflected the fact that the standard 30% company tax rate has been replaced with a 27.5% rate for 'base rate entities' (companies carrying on business and having an annual turnover of less than $50 million in 2019-20). That rate will reduce progressively to 25% from 2012-22.
[7] The Committee's recommendation (at para 2.111) was 'that the Senate defer consideration of the bill until further examination and analysis of the impact of schedules 1–3 is undertaken. In particular, the committee recommends that: • the approach to the cap on the refundable portion of the Research and Development (R&D) tax incentive is refined, noting investment decisions already taken; and • the formula for R&D intensity is refined, noting inherent differences in R&D intensity across industries and impacts on businesses with large operating costs'.

The reason given for the projected drop was that the reduction reflected a 'one-off adjustment recognising lower than estimated claims for prior years … both for the numbers and size of claims'.

The reality is likely to be a little more sinister with the reduction in claims and claimants being the result of crackdowns by both AusIndustry/ Innovation and Science Australia and the ATO which have seen taxpayers being audited and required to refund the (self-assessed) offsets they have already claimed (together with penalties and interest). In some cases the ATO action has even resulted in the audited businesses being placed into liquidation.[8]

Audits can occur if the Department of Industry, Innovation and Science makes an adverse finding about the claimant's registration or if the ATO conducts a review on the claimant's R&D claim. In such cases, if all or part of the claimant's R&D activities are determined not to be eligible, their tax return will be amended, penalties and interest charges may be applied, and the claimant can merely seek to have the assessment overturned through the objections and appeals process, in which the claimant bears the onus of proof.

The reductions in claims may also be the result of new 'guidance' from those bodies (especially the ATO) which have narrowed the scope of the activities and the types of expenditure which are now taken to qualify as eligible R&D activities and R&D expenditure (including the apparently unwarranted view that 'business as usual' activities and expenditure do not qualify — even for start-ups or other innovative enterprises where their 'business as usual' is essentially their R&D activities).

Employee Share Scheme (ESS) Concessions

Employee Share Ownership Schemes have operated in Australia since at least the 1950s[9] — mainly following the then Prime Minister Robert Menzies' belief in the 'encouragement and introduction of profit sharing schemes wherever possible'.[10]

The original intent was mainly to encourage employee participation rather than to support innovation but, over time, the schemes have been used as a way of rewarding employees, especially in cash-strapped companies (often start-ups) that needed other ways to attract and retain the employees they needed to develop their businesses. Interestingly, the early ESS measures made no specific provision for innovation companies and it was only in 2015 that the first 'small start-up concession' was introduced. Until then, if start-ups benefitted from tax concessions available to participants in ESS it was merely incidental because the concessions were generally available, and also varied over time.

Pre-1974

Until 1974 there was no specific provision covering the tax treatment of employee share schemes. Instead s 26(e) of the ITAA36 simply taxed 'the value to the taxpayer' of any discount in the same way as any other employment 'benefit', other than salary or wages, was taxed.[11] This posed two difficulties. First, s 26(e) did not provide any objective means whereby that 'value' could be calculated and,

[8] See, for example, the ATO actions against Helen Petaia and her company 'Safe Family Cards Australia' which was eventually 'resolved' with the ATO apologising and awarding an inadequate $30,000 in compensation. (Deloittes estimated that the true loss was between $13 million and $40 million).

[9] House of Representatives Standing Committee on Employment, Education and Workplace Relations, *Shared Endeavours – an Inquiry into Employee Share Ownership in Australia (Majority Report)* (2000) 9 [2.1].

[10] McElvaney, J and Waddel, D, *The Employee Share Ownership Plan: what value has it for Australia?* in Kennedy, J and Di Milia, L (eds), *ANZAM 2006: Proceedings of the 20th Annual Conference of the Australian and New Zealand Academy of Management*, pp. 1-14, Australian and New Zealand Academy of Management, Lindfield, NSW.

[11] Now ITAA97 s 15-2.

secondly, it brought the 'value' of that benefit into assessable income even if receipt of the benefit was conditional or did not arise until some point in the future.[12]

1974 to 1995

In 1974 the government sought to address these disincentives by inserting a new s 26AAC into the ITAA36, specifically to deal with employee share schemes. It expressly provided that, for the purpose of s 26(e), the acquisition of shares or rights to acquire shares under an employee share scheme was 'deemed not to be an allowance, gratuity, compensation, benefit, bonus or premium allowed, given or granted to him'.[13] Similarly, when FBT was introduced in 1986, benefits under employee share schemes were specifically excluded from the definition of 'fringe benefit'[14] to ensure that qualifying benefits could only be taxed under s 26AAC.

The new section also provided a mechanism for determining the value of the shares or rights that the employee received[15] and specified with some particularity *when* that value was to be included in the employee's income. It provided that the appropriate taxing point was when the share was actually acquired — whether at a simple discount to market value or pursuant to the exercise of a previously conferred option or right[16] — not when the underlying right was originally conferred.[17]

It also provided that, if the shares were issued subject to conditions or restrictions which limited the employee's right to dispose of them, or if they were liable to be divested, they were deemed to be acquired if and when those conditions or restrictions ceased to apply.

When capital gains tax was introduced in 1985 two additional alternative concessions were introduced — a tax deferral option, which allowed taxpayers to elect to be assessed in the year in which shares that were subject to conditions or restrictions or a risk of divestiture were actually acquired, instead of in the year in which they were deemed to be acquired[18] and a tax exemption option which allowed the first $200[19] of any discount to be excluded from the employee's assessable income each year.[20]

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[12] See *Donaldson v FCT* [1974] 1 NSWLR 627; (1974) 23 FLR 1 where the Court held that although the options granted to the taxpayer were not exercisable until specified times in the future and were conditional on the taxpayer remaining in the company's employ, they were in the nature of a bonus or addition to salary and their 'value to the taxpayer' was immediately assessable under s 26(e).

[13] Section 26AAC(10).

[14] *Fringe Benefits Tax Assessment Act 1986* (Cth) s 136(1). That exclusion was subsequently extended to cover equivalent benefits caught by s 26AAC's replacement, Division 13A of Part III if the *Income Tax Assessment Act 1936* (Cth), as well as those acquired through employee share trusts. The present definition excludes 'a benefit constituted by the acquisition of an ESS interest under an employee share scheme (within the meaning of the *Income Tax Assessment Act 1997*) to which Subdivision 83A-B or 83A-C of that Act applies'.

[15] Its valuation mechanism was not particularly detailed but the Commissioner's view that it meant 'market value' at the time of acquisition[15] was generally accepted — a considerable advance on s 26(e)'s 'value to you'.

[16] As the AAT noted in *Case X43* 90 ATC 354 at 359 'sec 26AAC(5) … deals purely with the acquisition of shares and not with the acquisition of rights to a share'.

[17] Therefore the taxing point for options was when they were exercised and converted to shares. See *Fraunschiel v FCT* (1989) 20 ATR 955; 89 ATC 4616.

[18] ITAA36 s 26AAC(15). The tax deferral option allowed any subsequent increase in the shares' value to be taxed under the more beneficial CGT provisions.

[19] The $200 exemption was determined by applying the maximum discount rate of 10% to the maximum aggregate share value of $2000. If those limits were exceeded the reduction still applied and only the amount of the benefit that exceeded the permitted exemption was assessed.

[20] This also reduced the shares' cost base by an equivalent amount. This concession was further amended in 1988 to only apply where the shares were ordinary shares, the scheme required that any interest acquired could not be disposed of within 3 years of its acquisition unless the employee ceased employment (unless the interest was a right and it was disposed of by exercise) and where the scheme was limited to, but open to all permanent employees with at least 12 months service and applied equally to them all.

1995 to 2009

Section 26AAC continued to apply until it was replaced by Div 13A in March 1995. Like s 26AAC, Div 13A was specifically designed to tax the discount at which shares or other interests were issued under an ESS, but it was mainly aimed at rectifying s 26AAC's perceived deficiencies. In particular it was aimed at preventing the exploitation that was perceived to have occurred under s 26AAC[21] — and at ensuring that the applicable tax concessions were directed at schemes that were broadly available to all permanent employees. It also, incidentally, addressed the problems of determining 'market value' by providing detailed rules for ascertaining it.[22]

How employees were taxed on the discounts they received on their 'ESS interests' depended on whether the scheme operated inside the Division's concessional provisions (as a 'qualifying share scheme) or outside them (as a non-qualifying share scheme) — and, if it operated inside those provisions, whether the employee elected the tax deferral or the tax exemption option. The default position, for both shares and rights, was that the taxing point was the year of acquisition, thereby maintaining the s 26AAC position for shares but reinstating the pre-s 26AAC position for rights.

The tax deferral option allowed employees to defer inclusion of the discount in assessable income for up to 10 years, until the year in which the 'cessation time' occurred.[23] It was most attractive to executives who were able to take significant parts of their remuneration in the form of shares, stapled securities or other ESS interests and defer the payment of tax on those equities for as long as possible.

The tax exemption option was most attractive to general employees whose annual participation in such schemes was usually limited to relatively small parcels of shares with taxable discounts typically not exceeding $1000. If the employee made the required election he or she became liable to pay tax on the benefit (the discount at which the shares or other interests were issued) in the year in which the benefit was received, but, provided the 'exemption conditions' in then s 139CE[24] were satisfied, the first $1,000 of the discount[25] was excluded, thereby, in most cases, eliminating any tax liability. When the shares were ultimately sold any post-acquisition increase in value was taxed under the CGT provisions and, after 21 September 1999, could be subject to the 50% CGT discount.

2009 to 2015

Div 13A continued in operation until 2009 when it was replaced by ITAA97 Div 83A because of concern about escalating executive remuneration. One reason for introducing it was to reduce opportunities for tax evasion and avoidance and to protect Commonwealth revenues in a period of global recession[26]

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[21] As the then Treasurer noted in announcing the change, the effect of s 26AAC had been that share schemes had become 'no more than executive remuneration packages designed to convert salary into shares in order to take advantage of open ended tax deferral opportunities'.

[22] ITAA36 ss 139FA-139FN.

[23] The 'cessation time' depended on whether the 'ESS interest' was shares, rights or stapled securities. For shares, where there were no restrictions on disposal and the scheme did not have conditions that could lead to the share being forfeited, the cessation time was the time of acquisition (so there was no deferral of the taxing point). In all other cases the cessation time was when the share was disposed of or the later of the time when any disposal restrictions or forfeiture conditions expired, when the employee's employment ceased or 10 years after the share was acquired. Similar provisions applied to rights to acquire shares.

[24] ITAA36 s 139CE required that the scheme not have conditions that could result in forfeiture, that recipients not be permitted to dispose of a share or right acquired under the scheme for three years (or on cessation of employment) and that the scheme operate on a 'non-discriminatory basis' (as defined in s 139GF).

[25] The original $500 exemption was increased to $1000 in 1997 to 'broaden access to and increase the benefits of participation in employee share schemes': *Taxation Laws Amendment Act (No 1) 1997* (Cth), Sch 3.

[26] Explanatory Memorandum to the *Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009* at paras 1.14 and 1.15. Concerns included executives and directors failing to pay tax associated with ESS by (a) attempting to

(though it was also expected to generate $135 million in additional revenue over the 2010-13 forward estimates[27] — mainly through a new 'ESS Reporting Regime' the effect of which was to better identify employees who received benefits, and the nature and amount of those benefits).

Despite this, Div 83A effectively replicated many of the concessions in the former Div 13A but it also provided that, generally, any discount to the market value of 'ESS interests' would be included in the employee's assessable income in that year. Its default effect, therefore, was to tax the discount upfront, at the point of acquisition.[28] The $1000 tax exemption was retained but only for taxpayers with an adjusted taxable income[29] of $180,000 or less.[30]

There was also a deferral option though, unlike the former Div 13A, whether it applied depended on the structure of the scheme rather than on an election by the employee. For the deferral to apply, the ESS interests either had to be acquired under an employee share scheme, had to relate to ordinary shares and had to be subject to a real risk of forfeiture[31] or, alternatively, they had to have been acquired at a 100% discount under a salary sacrifice arrangement where the employee was limited to acquiring no more than $5000 worth of shares (it did not apply to rights) in an income year.[32]

There were a number of problems with Div 83A. While it reduced the opportunities for tax evasion and avoidance, it did so by reducing the attractiveness and, therefore, the extent to which employee share schemes were used,[33] thereby depriving the economy of the benefits that such schemes can confer.[34] It also did it in a way that increased both administrative complexity and compliance costs,[35] the complexity of the required valuation methodology for options being a particular problem.[36]

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retrospectively elect to be taxed upfront; (b) failing to include the value of the discount at the cessation time; or (c) incorrectly applying the capital gains tax rules to the discount instead of including it in their assessable income: see *'Employee Share Scheme Arrangements*', Treasury Submission to the Economics References Committee, July 2009. There was also concern that the 10 year maximum deferral period gave directors and senior executives, who were usually able to ensure that the deferred taxing point did not occur before the 10 year maximum expired, an incentive to defer their tax liability for the full 10 years.

[27] Explanatory Memorandum to the *Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009* at p 7

[28] ITAA97 s 83A-25

[29] The sum of the taxpayer's taxable income (including the full amount of the discount and ignoring the possible exemption), reportable fringe benefits total, reportable superannuation contributions and total investment loss – see s 83A-35(2)

[30] ITAA97 s 83A-35.

[31] Defined in s 83A-105(3) as a real risk that under the conditions of the scheme the employee would forfeit or lose the ESS interest (other than by disposing of it or in the case of rights to acquire shares, by exercising the right or allowing it to lapse).

[32] ITAA97 s 83A-105(4).

[33] The Employee Ownership Australia and New Zealand April 2013 Report (n 35 below) noted (at p 6) that 'over 90% of plans were suspended during the first year and 30% of plans were suspended for up to two years. Of the 30% of plans suspended for two years many have not been reinstated'. It also noted that: 'The $5000 salary sacrifice limit [had caused] a noticeable decline in the amounts that are contributed to salary sacrifice employee share ownership plans' and that 'Overall, the number of employees participating in, and the amount invested by employees in, employee share ownership plans has substantially reduced'. See also Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* at p 33.

[34] See '*Employee Share Schemes – Their Importance to the Economy',* Employee Ownership Australia and New Zealand Expert Panel Report, July 2014, pp 9-11.

[35] Nearly all companies had to review and revise existing ESS arrangements and many introduced new plans and/or amended existing plans: see *'The Changing ESS Landscape since 1 July 2009'*, Employee Ownership Australia and New Zealand (EOA) Report, April 2013 pp 11-12.

[36] Valuations were required whenever shares or options were issued. The Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* (at p 32) noted that

A major problem was that Div 83A moved the taxing point for options (when there was no risk that they would be forfeited) to when they were provided rather than when they were exercised (when employees could generally realise them to pay the tax)[37]. This effectively killed off the provision of options under employee share schemes, especially for start-ups.[38]

That problem was exacerbated by the effective elimination of tax refunds for options that had vested (and therefore had been subject to tax) but which were 'out of the money' at exercise time.[39]

One obvious consequence was that start-ups that had used ESS in lieu of higher salaries found it increasingly difficult to attract employees and, in some cases, that contributed to them relocating overseas.[40]

Even where companies retained their presence in Australia the change in the taxing point effectively forced them to 'expend considerable time and financial cost in restructuring employee equity plans'.[41]

The same applied to international companies that had previously offered their Australian employees options to acquire shares in an overseas listed parent. The result was a decline in the number of international plans that were offered to Australian employees which adversely affected both the employees (by denying them an opportunity to participate in the schemes) and the companies (by compromising their ability to offer their Australian employees competitive remuneration packages).[42]

Finally, changes to the disposal restriction that had to be included in ESS rules made salary sacrifice plans less attractive. Under Div 13A the restriction had applied for the maximum 10 year tax deferral period but, even though 85% of employees did not try to access their shares during that period, there was a degree of flexibility and access was possible. Under Div 83A the disposal restriction had to apply from the date of the offer and could only be removed in extreme cases such as financial hardship or special circumstances. This made participating in ESS less attractive and resulted in companies limiting their restriction period to the minimum 3 years required (the maximum was 7 years). It also led to a majority of participants selling their shares at the end of that period in order to fund their tax liability.[43]

2015 to the Present

The problems with the 2009 amendments led the incoming government to announce that, as part of its focus on measures with the potential to encourage innovation it would reform the taxation and regulation of employee share schemes.

'Stakeholders have advised that this can cost as much as $50,000 per valuation in Australia, compared, for example, with the United States where the cost is US$2000 to US$5000'.

[37] For plans that did continue this also defeated one of the major objectives behind encouraging ESS – to give employees 'skin in the game'. By advancing the taxing point employees often found that they had to dispose of their shares to meet their tax liability instead of retaining them as long-term investments.

[38] In its July 2014 Report, '*Employee Share Schemes – Their Importance to the Economy*' the Employee Ownership Australia and New Zealand Expert panel noted (at p 3) that 'Pre 2009 85% of start-up/growth sector companies used option plans. Post 2009 this number dropped to 6%'.

[39] ibid. Under ITAA97 s 83A-310 a refund of tax paid was available but only where the interest was forfeited otherwise than as the result of a choice by the employee or of a condition of the scheme that had the direct effect of protecting (wholly or partly) the taxpayer against a fall in the market value of the interest.

[40] Industry and Innovation Agenda - An Action Plan for a Stronger Australia, Department of Prime Minister and Cabinet 14 October 2014, p 77.

[41] *'The Changing ESS Landscape since 1 July 2009'*, Employee Ownership Australia and New Zealand (EOA) Report, April 2013 p 6.

[42] Ibid p 7.

[43] '*Employee Share Schemes – Their Importance to the Economy',* Employee Ownership Australia and New Zealand Expert Panel Report, July 2014, p 5.

The reforms it proposed were designed 'to bolster entrepreneurship in Australia and support innovative start-up companies',[44] 'to make Australia's taxation of ESS interests more competitive by international standards and to facilitate the commercialisation of innovative ideas in Australia … to assist innovative Australian firms to attract and retain high quality employees in the international labour market'[45] and to reduce 'the compliance burden faced by small businesses and … make it easier and cheaper for businesses to set up and maintain an ESS'.[46]

In particular the stated aims of the proposed reforms were:

- 'For all companies … to ensure that they remain internationally competitive and reduce disincentives for employers and employees to participate in ESSs.
- For start-ups … to minimise complexity and compliance costs associated with the tax law, and increase the incentives for the start-up sector to use ESSs'.[47]

For small start-up companies the incentives included a new 'start-up concession' for shares and rights issued to employees, provided the issue was at no more than a small discount to market value.

To be eligible the company:

- had to be an Australian resident company;[48]
- had to have been incorporated for less than 10 years (a restriction applying not only to the start-up but also to any associated holding or subsidiary companies);[49]
- could not be listed on a stock exchange;[50] and
- must have had an aggregated annual turnover not exceeding $50 million.[51]

If the company qualified, the concession could apply to both shares and rights (including options), though, as a stand-alone concession, employees who took advantage of it could not also access the $1,000 up-front concession or the deferred taxation concession for the same 'ESS interests'.[52]

For shares to qualify, they had to be issued at a discount of no more than 15% to market price on the date of acquisition. For rights to qualify, they had to be issued with an exercise price that was greater than the market price of the company's ordinary shares on the date the rights are issued (ie to qualify the rights had to be 'out of the money' at the point of issue).

If the start-up concession applies, the discount is not included in the employee's assessable income,[53] so it is not subject to up-front taxation. Instead, it is treated as capital and tax is deferred until the shares, either those issued originally or those acquired subsequently (on exercise of rights), are sold. For shares acquired pursuant to a right, the time of acquisition for CGT discount purposes is the time the right was acquired not when it was exercised to allow the share to be acquired.

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44 Explanatory Memorandum to the Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015 para 1.4
45 ibid at 1.5
46 ibid at 1.6
47 Ibid at pp 33-34
48 ITAA97 s 83A-33(6).
49 ITAA97 s 83A-33(3).
50 ITAA97 s 83A-33(2).
51 ITAA97 s 83A-33(4).
52 ITAA97 ss 83A-(2)(c) and 83A-105(1)(ab).
53 ITAA97 s 83A-33(1).

To qualify for the concessions the scheme must be 'broadly available',[54] it must relate to an ESS interest that relates to ordinary shares only,[55] the predominant business of the company must not be 'the acquisition, sale or holding of shares, securities or other investments,[56] the issue must not result in the employee holding a beneficial interest in more than 10% of the shares in the company or being able to control the casting of more than 10% of the maximum number of votes that might be cast at a general meeting[57] and, generally, the shares/rights must be held for at least three years.[58]

In summary the effect of the 2015 changes was that:

a. the default position was that benefits from the receipt of shares or options under an ESS are taxed upfront when the shares or options are provided;
b. employees participating in option schemes can more easily defer their tax liability until the options are exercised and the options do not have to be at risk of forfeiture — though the scheme rules still had to state that the tax deferred treatment applies to the scheme and the scheme had to genuinely restrict employees from immediately disposing of the rights;
c. the deferral period was extended from a maximum of 7 years to a maximum of 15 years — mainly to allow start-ups more time to succeed and, therefore, for the value of the ESS interests to increase before employees had to dispose of them to pay the tax liability. The 'ESS deferred taxing point' did however continue to include the *earliest* of when there was no real risk of forfeiture of the interest, when any restrictions on sale were lifted or when the employment ceases;
d. the exemption from taxation of the first $1000 of ESS interests provided to employees who earn less than $180,000 was retained;
e. the 2009 integrity measures were also largely retained — though the refund provisions were relaxed a little so that if an employee chooses not to exercise a right, or lets a right be cancelled, a refund was possible (provided the scheme has not been structured to directly protect the employee from downside market risk);
f. safe harbour valuation methods were developed to improve certainty and reduce compliance costs.[59] Approved methodologies are binding on the Commissioner but taxpayers may choose another methodology if it is more appropriate to their circumstances;
g. standard documentation has been developed and approved to streamline the process of establishing and maintaining an ESS;[60]
h. a new 'start-up concession' is available for shares and rights (including options) that eligible small start-up companies issue to their employees, provided the issue conditions are met;
i. the ownership and voting rights limitations that were introduced in 2009 to prevent employees using the concession to buy a business or indirectly access company profits were relaxed by doubling the 5% ownership and voting rights limitation to 10%, allowing employees

[54] ITAA97 s 83A-33(1)(c) and 83A-105(2)
[55] ITAA97 s 83A-33(1)(b) and 83A-45(2).
[56] ITAA97 s 83A-33(1)(b) and 83A-45(3).
[57] ITAA97 s 83A-33(1)(b) and 83A-45(6) and (7).
[58] ITAA97 s 83A-33(4) and (5).
[59] See https://www.ato.gov.au/General/Employee-share-schemes/In-detail/ESS---Safe-harbour-valuation-methods/ and Legislative Instrument – Income Tax Assessment (ESS 2015/1) and ESS 2015/1 Explanatory statement.
[60] See https://www.ato.gov.au/General/Employee-share-schemes/In-detail/ESS---Standard-documents-for-the-start-up-concession/.

to have a greater ownership share in their employer without breaching the restriction (though not to such an extent that the benefits of the ESS cannot be spread widely among employees or that the fairness or integrity of the tax system is put at risk by facilitating misuse of ESS arrangements). This can be especially important for small start-ups in the early stages of their development when they have limited numbers of employees and a 10% interest in the company may be worth comparatively little.

Residual Problems

Despite the positive changes introduced in 2015, there are still some residual problems with the rules:

a. First, cessation of employment remains an ESS deferred taxing point[61] — even if the vesting conditions have not then been satisfied or the ESS interests are 'out of the money'. That is a problem especially when combined with the relaxed but still restrictive refund rules.
b. The $1,000 tax reduction limit (originally introduced in 1997) was not increased, so the real value of the concession has decreased significantly. If advancing the time when tax is paid on ESS discounts is still an aim of the legislation, electing up-front taxation would be far more attractive if the real value of the concession was at least restored, with provision for regular future increases, through indexation to AWOTE, CPI, or otherwise.
c. The concession could also have been made available to all employees, as it was until 2009, and not simply to those with an adjusted taxable income of less than $180,000.
d. The $180,000 cap could have been made subject to some form of automatic escalation — whether by alignment with changes to the top marginal tax rate threshold, by indexation to AWOTE or CPI, or otherwise, to preserve its true value and to prevent bracket creep excluding otherwise qualified employees from participation in ESS.
e. While the introduction of the small start-up concession was a significant development, the limitations on companies eligible to access it — while explicable for the reasons set out in the Explanatory Memorandum (essentially to 'ensure that the concession is appropriately targeted to genuine Australian start-up companies)[62] — do unnecessarily constrain the achievement of the government's stated aims of bolstering entrepreneurship in Australia and supporting innovative start-up companies.[63] For example, it does not extend to listed companies — so start-ups that choose to list to obtain capital through a public offer cannot qualify for the concession.[64] Nor can companies that increase turnover — but not necessarily available profit — to more than $50 million.[65] The necessity to reinvest could still constraint the ability of such companies to pay the salaries that concessionally taxed ESS were designed to replace, while the turnover limitation could restrict them from offering such schemes at precisely the point in their development where they are most needed.

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[61] Cessation of employment was originally introduced as a taxing point before the introduction of Div 83A's reporting regime because of concerns about employees leaving the jurisdiction post-employment but before vesting – thereby creating potential collection problems. Its application was not however restricted to such employees: '*Employee Share Schemes – Their Importance to the Economy',* Employee Ownership Australia and New Zealand Expert Panel Report, July 2014, pp 6-7.
[62] Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015* paras 1.72-1.79
[63] ibid at para 1.4
[64] ITAA97 s 83A-33(2).
[65] ITAA97 s 83A-33(4).

f. Similarly, the requirement that the scheme be 'broadly available' to qualify for the start-up concession should be clarified to ensure that it does not preclude participation by 'true' start-ups (those that have only recently been formed). That requirement is defined in s 83A-105(2) to mean that the scheme must be available to at least 75% of the company's Australian resident, permanent employees who have completed at least three years of service. But 'true' start-ups will have no employees of three years standing at that time. *Interpretive Decision* ID 2003/24, which applied to the equivalent provision under Div 13A, seems to indicate that this would not prevent the concession applying (because 75% of zero is zero so the requirement would always be satisfied) — though legislative clarification would be preferable.

g. The taxation treatment of shares and rights under the start-up concession are misaligned. While the concession applies to shares issued at a discount of up to 15% to market value, it only applies to rights if the exercise price is greater than or equal to the market value of the company's ordinary shares when the rights were acquired.[66] Given the possibility of start-up failure, that is not particularly attractive.

h. Similarly, in a globalised economy with an increasing use of remote workforces it is difficult to understand why the concession should only apply to Australian resident employees.[67] If the aim is to permit start-ups to attract the best possible talent this limitation would seem to be an unnecessary constraint on their ability to do so.

i. There are still considerable administrative compliance and cost burdens associated with ESS which could have been further reduced (though the ATO's development of safe-harbour valuation methodologies and standard documentation for ESS has gone some way to reducing those burdens).

Since 2015

While the rules for taxing ESS have not changed since 2015, the Australian Government announced in November 2018 that it intended to introduce a number of new measures to improve 'the ability of small businesses to offer employee share schemes to help employers attract, retain and motivate employees and grow their businesses'. [68]

The proposed changes are however mainly to do with simplifying the regulatory framework governing ESS (which the Press Release describes as 'too complex and fragmented and ultimately discourages business — particularly, small businesses — from offering employee share schemes'[69]) rather than the tax measures associated with them.

In broad outline, what is proposed is:

- consolidating and simplifying the exemptions from disclosure, licensing, hawking, advertising and on-sale obligations under the *Corporations Act 2001* (Cth);
- increasing the value limit of financial products that an unlisted company can offer in a 12 month period from $5,000 per employee to $10,000 per employee;
- expanding relief for unlisted companies offering an ESS to cover contribution plans, where an employee can make a monetary contribution to acquire financial products; and

[66] ITAA97 s 83A-33(5).
[67] ITAA97 s 83A-33(6).
[68] The Hon Josh Frydenberg MP, 'Government proposes to double the value limit available under employee share schemes' (Press Release, 12 November 2018).
[69] Ibid.

- allowing small companies that cannot come within these exemptions to offer an ESS under a disclosure document lodged with the Australian Securities and Investments Commission ('ASIC') without publicly disclosing commercially sensitive financial information, unless they are otherwise obligated to do so.[70]

Of these, the only proposal with any possible direct relevance to taxation is the proposal to increase the value limit of financial products that an unlisted company can offer in a 12 month period from $5,000 per employee to $10,000 per employee.

Under s 83A-105(4) there is a tax deferral option for ESS interests that were acquired at a 100% discount under a salary sacrifice arrangement where the employee was limited to acquiring no more than $5000 worth of shares in an income year — but that is not what the proposal relates to.

It relates, instead, to conditional relief that ASIC) provides companies that offer eligible financial products to their employees under 'an employee incentive scheme' to reduce the otherwise applicable compliance burden under disclosure, licensing, advertising, hawking and on-sale provisions in the *Corporations Act 2001* (Cth).

For unlisted companies (the only companies to which the small start-up concessions apply) the concessions, and the conditions that must be met, are set out in ASIC Class Order 14/1001. One condition is that the company can only make ESS offers without a disclosure document if they do not exceed $5,000 in value per eligible employee over a 12 month period.[71]

That cap was intended to reduce the employee's risk (which arises because of the difficulty of establishing a reliable market price for an unlisted company's shares and the lack of a regulated disclosure document), but the option of increasing it to $10,000 is considered manageable because there is an existing minimum level of disclosure[72] which would be retained and, if required, which could be modified.[73] The $10,000 figure is also consistent with the retail investor limits that apply under the recently introduced crowd-sourced equity funding regime which has similar disclosure requirements and also applies to start-ups and small to medium sized companies.[74]

It is not at all clear from either the Treasurer's Press Release or the Consultation Paper whether the proposed changes to the $5000 upper limit for Class Order disclosure relief will also flow on to the tax deferral limits for salary sacrifice based employee share acquisitions. There is certainly no mention of that in either document and the Consultation Paper devotes only three and a half lines to 'tax concessions', merely mentioning the 2015 changes without comment.

Tax Concessions for Investments in Early Stage Innovation Companies (ESICs)

The *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* (Cth) inserted Subdiv 360-A into the ITAA97 as part of the Australian Government's *National Innovation and Science Agenda.* Its aim, to 'foster a shift towards a culture of innovation, whereby entrepreneurial risk-taking is encouraged and rewarded',[75] was to be achieved by providing two new tax breaks for early stage investors (known

[70] Australian Government, The Treasury, *Employee Share Schemes* (Consultation Paper April 2019), p 2.
[71] ASIC Class Order [CO14/1001] para 18(a).
[72] ibid para 17.
[73] Australian Government, The Treasury, *Employee Share Schemes* (Consultation Paper April 2019), p 12.
[74] *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) and *Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Act 2018* (Cth). See also ibid at p 13.
[75] Commonwealth of Australia, *Parliamentary Debates* House of Representatives, 16 March 2016, 3251 (Scott Morrison MP, Treasurer).

as 'angel investors') in innovative startups. They were designed to help Early Stage Innovation Companies (ESICs) 'attract seed and pre-commercialisation equity at an [early] stage of their development'[76] when they are still establishing 'proof of concept' and 'profit potential' — a stage popularly known as 'the valley of death'. The tax incentives, an immediate tax offset and a 'modified CGT treatment' for later disposals, are similar to those available under ITAA97 Subdiv 118-F[77] to 'early venture capital investments' ('EVCIs') by ESVCLPs, VCLPs and AFOFs.

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 gain on shares in eligible ESICs provided they held them for between one and ten years. That concession is not limited to shares within the $200,000 maximum tax offset cap but, to ensure that investments are not withdrawn before the company can benefit from them, capital losses on shares held for less than 10 years are also disregarded.

The tax incentives are only available 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 must be eligible for the tax incentives; and
c. the investor must be eligible to receive the incentives.

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)'.[78]

Therefore, a company will only qualify as an ESIC if it satisfies two conditions:[79]

a. it must be '*early stage*' – a requirement assessed against criteria involving, incorporation or registration, expenditure, assessable income and stock exchange listing.[80] If the company passes all four 'tests' it qualifies as 'early stage'; if it does not, it will not[81]; and
b. it must be genuinely involved in innovation, something which it self-assesses against either a principles-based test[82] or the statutory '100 point innovation test' in s 360-45[83].

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[76] Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.4.
[77] See ITAA97 ss 118-405, 118-407 and 118-410 (CGT exemption), ITAA97 ss 51-54 and 51-55 (income tax exemption), ITAA97 ss 26-68 and 26-69 (loss deduction denial). A non-refundable carry-forward tax offset equal to 10% of the EVCI was introduced by the 2016 Act.
[78] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.61.
[79] A new s 360-40(1)(f) will also preclude foreign companies from being ESICs for the purposes of the tax incentives: Explanatory Memorandum, Treasury Laws Amendment (2018 Measures No 2) Bill 2019, para 2.53.
[80] ITAA97 s 360-40(1)(a)-(d).
[81] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.62.
[82] ITAA97 s 360-40(1)(e).
[83] ITAA97 ss 360-40(1)(e) and 360-45. The tests allocate points for particular objective activity-based criteria. Amendments proposed by the Treasury Laws Amendment (2018 Measures No 2) Bill 2019 will specifically note that a company can meet the requirements by engaging others to do those things for it or on its behalf: Explanatory Memorandum para 2.54.

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 the tax concessions. However, if it does meet the conditions it will qualify and its investors will be entitled to both concessions — whether they want them or not.

The Shares Must Be Eligible for the Tax Incentives

Technically, it is not the shares but the investor who must qualify. However, unless the relevant issue of shares meets each of the criteria in s 360-15(1)(b)-(f) the investor will not be entitled to the offset (and will also then be denied the modified CGT treatment). Those criteria are:

a. the investment must be via 'equity interests[84] that are shares in the company';[85]
b. those shares must be new shares[86] that are issued by the ESIC on or after 1 July 2016;[87]
c. the company must be an early stage innovation company 'immediately after' the issue;[88]
d. the investor and company may not be affiliates[89] of one another at that time;[90]
e. the issue cannot be 'an acquisition of ESS interests[91] under an employee share scheme';[92] 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[93] the company.[94]

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'.[95] Companies must report issues of new shares that could give rise to an entitlement to the tax incentives within 31 days of the end of the financial year in which the issue occurred[96] but that is 'so that the ATO can assess whether those investors may qualify for the tax offset and the modified CGT treatment.'[97] It is not to assist investors.

The Investor Must Qualify for the Incentives

The incentives 'are available to all types of investors,[98] regardless of their preferred method of investment … other than "widely held companies" … and 100 per cent subsidiaries of these

[84] 'Equity interests' are distinguished from 'debt interests'. Generally, an interest with 'contingent returns' is an equity interest; one with 'non-contingent returns' is a 'debt interest': ITAA97 ss 974-70 and 974-75. An interest with both is treated as a 'debt interest': ITAA97 s 974-5(4).
[85] ITAA97 s 360-15(1)(b).
[86] This ensures that the ESIC acquires new funding by the issue. Equity interests acquired by converting convertible notes also qualify for the tax offset: Explanatory Memorandum para 1.29.
[87] The date of commencement of the Act.
[88] ITAA97 s 360-15(1)(c).
[89] An 'affiliate' is: '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': ITAA97 s 328-130.
[90] ITAA97 s 360-15(1)(d).
[91] Defined in ITAA97 s 83A-10.
[92] ITAA97 s 360-15(1)(e).
[93] 'Connected with' is defined in ITAA97 s 328-15 to involve 'control' by either entity over the other or of both by the same third entity.
[94] ITAA97 s 360-15(1)(f).
[95] Immediately after the issue: see Treasury Laws Amendment (2018 Measures No 2) Bill 2019.
[96] *Taxation Administration Act 1953* (Cth) Schedule 1 s 396-55 and Schedule 1, s 396-60(1)(a).
[97] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.15.
[98] See the definition of 'entity' in ITAA97 s 960-100.

companies.'[99] Consequently, individuals, trusts, partnerships,[100] superannuation funds and non-widely held companies all qualify — though ESVCLPs are to be excluded from entitlement to the concessions to prevent 'double-dipping' of the available offsets.[101]

There is also no residence restriction,[102] so both resident and non-resident investors can qualify (though, because the offset is non-refundable, ESIC investments are likely to be less attractive to non-residents with no Australian tax liability). There are, however, a number of other restrictions on who can receive the incentives which may restrict those who will be willing to invest.

1. Disqualifying 'Other' Investors

Because investing in startups is 'inherently risky' Subdiv 360-A divides all investors into 'sophisticated' and 'other'[103] and limits how much 'others' can invest to protect them from over-exposure to risk'.[104]

There is no limit on how much 'sophisticated investors' can invest but, because they are subject to an 'affiliate-inclusive' annual offset cap of $200,000, their tax-effective investments may, in a practical sense, be limited to $1m or less in any tax year[105] (and less if the investor has carried forward part of the available offset from a previous year).[106]

'Other investors' are limited to investing $50,000 or less, in total, in any income year.[107] If they exceed that limit they lose all entitlement to the tax offset — including their entitlement to any part that might have applied up to $50,000 — and they also lose the 'modified CGT treatment'.[108]

2. Disqualifying 'Affiliates'

Section 360-15(1)(d) also 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 if the investor is an 'affiliate'.[109]

3. **Disqualifying Major Shareholders**

Those who would 'hold more than 30% of the equity interests[110] in the company or in an entity connected with the company' following the investment are also denied the concessions.[111] While this

[99] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.16. A 'widely held company' is either listed on an approved stock exchange or has more than 50 members, with some other restrictions. 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.
[100] Trusts and partnerships do not have a direct entitlement to the tax offset but it flows-through to the individual partners, beneficiaries or, where relevant, the trustee: ss 360-30 and 360-35.
[101] Treasury Laws Amendment (2018 Measures No 2) Bill 2019: proposed ss 360-15(1)(a)(ia) and 360-15(2).
[102] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.17.
[103] Using the tests in s 708(8), (10) or (11) of the *Corporations Act 2001* (Cth): see ITAA97 s 360-20.
[104] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.18.
[105] The offset cap applies to the total of all affiliate-inclusive investments in ESICs in any year.
[106] The $200,000 offset cap is reduced by tax offsets carried forward from a prior year: s 360-20(2)(b).
[107] ITAA97 s 360-20(1)(b).
[108] The 'modified CGT treatment' only applies if the shares qualify for a tax offset: ITAA97 s 360-50(1).
[109] ITAA97 s 328-130.
[110] Treasury Laws Amendment (2018 Measures No 2) Bill 2019 will amend s 360-15(1)(f) to clarify that 'equity interests' are those that carry rights to receive more than 30% of any income or capital distributions, or to exercise, or control the exercise of, more than 30% of voting power in the company or a 'connected' entity.
[111] ITAA97 s 360-15(1)(f)

does not preclude the investment, it does make it less attractive for a major investor – especially those who compensate for the investment risk by taking a significant interest in the company.

Problems with the Subdivision

There are a number of problems with Subdiv 360-A, most of which result from the standard tension that arises whenever the tax system is used to promote particular behaviours and the revenue authorities act to limit the possibility of tax avoidance.

The issues relate, especially, to:

1. The threshold tax offset entitlement requirements in s 360-15(1);
2. Determining whether 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'.

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

1. Excluding Widely held Companies and their 100% Subsidiaries

If the aim of the legislation is, 'to encourage new investment in small Australian innovation companies with high-growth potential' (s 360-10), 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'[112] and the financial wherewithal to accept the risks that those investments might entail.

However, irrespective of why they are excluded, their exclusion is effectively pointless because it is easy to circumvent. As long as the widely held company invests through a non-100% subsidiary the tax incentives will be available through the subsidiary — absent a trigger for the operation of the general anti-avoidance provision in the *Income Tax Assessment Act 1936* (Cth) ('Pt IVA').

A similar loophole, allowing a widely held company (or its wholly owned subsidiary) to claim the tax incentives by investing indirectly, through a trust or partnership, is being addressed by the Treasury Laws Amendment (2018 Measures No 2) Bill 2019. Its proposed amendment of s 360-15(2) will extend the exclusion to indirect investments through a trust or partnership — though it contains no provision dealing with non-100% subsidiaries.[113]

2. Excluding 'Affiliates'

The Explanatory Memorandum to the original Bill notes, at para 1.34, that the exclusion of affiliates is 'to target the tax incentives to new investors in an ESIC … to 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 the exclusion of 'affiliates':

a. On its face it would appear to exclude founders from entitlement to the incentives (as well as, potentially, family and friends who may have already invested in the ESIC in its 'pre-seed' stage and may be willing to contribute further funding). That will certainly be so if the founders invest directly but it is less clear that it will exclude others because the term 'affiliate' applies

[112] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.6.
[113] Explanatory Memorandum, Treasury Laws Amendment (2018 Measures No 2) Bill 2018 paras 2.38-2.39.

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'.[114]

b. As with the exclusion of 'widely held companies or their 100% subsidiaries', the exclusion of 'affiliates' can be easily circumvented, even by founders. As the term is defined in s 328-130 it applies only to: 'An *individual*[115] *or company*'; there is no provision for any other 'tax entity' to be caught. Consequently, if a founder invests indirectly through a partnership or (with an even greater degree to separation) a trust or superannuation fund, he or she should be able to access an indirect entitlement to the incentives[116] — unless, again, Pt IVA is triggered.

3. Excluding Major Shareholders

The Explanatory Memorandum explains that the exclusion of investors who, after their investment, hold 'more that 30% of the equity interests in the company or in an entity connected with the company' is to 'encourage investors to spread their investments across more than one ESIC'.[117] However, depending on the capital needs of the company and the availability of other investors (or sources of finance), this restriction could prevent the ESIC obtaining the required capital and could, therefore, preclude the achievement of the Subdivision's expressly-stated object.

Worse, 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' only applies to individual entities, not to them and their associates or affiliates.[118] A single investor who structures an 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. For some reason, perhaps inadvertence, this apparently unintended loophole has not been addressed by the Treasury Laws Amendment (2018 Measures No 2) Bill 2019's proposal to amend s 360-15(1)(f).

4. Only 'Equity Interests that are Shares' Qualify

On its face the requirement that the investment be through 'equity interests that are shares' could prevent ESICs from issuing preference shares (because of their 'debt interest' characteristics[119]). This is despite the fact that experienced investors are known to prefer preference shares because of the 'liquidation preference' rights they standardly confer.

There is also a possible issue if capital is raised using convertible notes, another favoured means at this stage of an ESIC's lifecycle. Until the notes are converted into shares the Subdivision cannot apply and the tax concessions 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 (the conversion gives rise to a new interest and is not just a continuation of the existing debt interest[120]). However, timing

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[114] ITAA97 s 328-130(1).
[115] ITAA97 s 995-1 defines an 'individual' as 'a natural person'.
[116] A possibility confirmed by the ATO's view of the term.See, for example, *ATO Private Ruling Number* 1011364504879.
[117] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.38.
[118] ITAA97 s 995-1 (through ITAA97 s 4-5).
[119] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.27. While that statement 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 Subdiv 974-C – and are not caught by the tie-breaker provision in ITAA97 s 974-5(4).
[120] See ITAA97 s 974-100(1).

is critical. If the trigger event for the conversion occurs after the ESIC ceases to be an ESIC the right to the tax concessions will be lost.[121]

Problems Determining whether the Company Qualifies as an ESIC

1. The Self-assessment Tests

Companies are required to self-assess whether they are an ESIC at the 'test time' and must do so by applying either the 'principles-based test' or the '100 point innovation 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 be very difficult for a company, on a subsequent audit, to show that it qualified as an ESIC at that time, especially as four of the five tests require it to demonstrate that it has particular 'potential' at that time.[122]

This problem is exacerbated because companies (and investors) must make (and be able to justify) the determination not once but each time shares are issued and the cost of 'getting it wrong' (a complete loss of the tax incentives for its investors) is a critical problem.

2. Onus of Proof

The onus of determining whether a company is an ESIC rests squarely with the investor who, in many cases, is not in a position to know whether it qualifies. The issuing company must report information to the ATO after they issue new shares[123] but, because that occurs after the issue, it would be too late to protect investors — even if the company and/or the ATO had to make it available to them.

3. Holding Companies

If the governance structure used to develop and exploit an 'innovation' involves a holding company with 100% ownership of a subsidiary which will actually develop and exploit the 'innovation', investors in the holding company will not be entitled to the incentive, even if the subsidiary meets all of the requirements to be an ESIC. The absence of some flow-through mechanism is likely to constrain investor willingness — and restrict the extent to which the legislation can achieve its aims.

Problems Determining the Amount of the Tax Offset

Determining the amount of the tax offset involves, in the 'general case'[124] 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).

However, there are a number of problems determining the amount of the tax offset. They relate 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

[121] Para 1.29 of the Explanatory Memorandum notes 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' (emphasis added).
[122] For high growth, scalability, ability to address a broader than local market and ability to have competitive advantages for its business.
[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 to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 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'.
[124] ITAA97 s 360-25.

d. investments through companies.

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. It includes not only the tax offsets applicable to investments in the current year but also any unused tax offsets that have been carried forward from a previous year.[125] Therefore, taking s 360-25(1) at face value, total investments over $1m in any year will not attract an offset greater than the $200,000 cap, either in that year or (because they cannot be carried forward) in any subsequent year.[126]

As originally enacted, that cap could be very easily circumvented. It applied only to *direct* investments by the investing entity and its 'affiliates'; not to *indirect* investments. Consequently, 'sophisticated investors' could claim unlimited offsets, provided they invested *indirectly* through trusts and partnerships (if they did not thereby breach the '30% equity interest'). The Treasury Laws Amendment (2018 Measures No 2) Bill 2019 will close that loophole by providing that the maximum rebate that can be claimed is a single combined $200,000 limit — for all investments, whether direct or indirect.[127]

There is still the problem though that the $200,000 tax offset cap is, arguably, too limiting and should be reconsidered: (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) because the 'affiliate-inclusive' wording also limits the amount that can be effectively invested in any income year if the affiliate has also made investments to which the tax offset can apply — or has unapplied prior year tax offsets which it has carried forward.

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, at least through direct investments, in any income year to a maximum of $1m (spread across all ESICs in which they invest).

2. Problems with the Tax Treatment of 'Other' Investors

'Other' (non-sophisticated) investors do not qualify for the incentives at all if their total 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[128] — 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 applies.

The penalty for exceeding the limit, losing all the tax incentives, is also disproportionately draconian. Limiting the available tax offset to $10,000 (20% of the permitted $50,000 investment) and not restricting the availability of the modified CGT treatment (effectively mimicking the treatment accorded 'sophisticated' investors — but at a lower monetary level) would seem to be more equitable.

3. Problems Where the Investment is through a Trust or Partnership

Except in cases where 'members' of the entity are 'entitled to a fixed proportion of any capital gain from a disposal'[129] (when each member's share of the available tax offset must equal 'that fixed

[125] ITAA97 s 360-25(2).
[126] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.47.
[127] See the proposed new s 360-30(1A) and the Explanatory Memorandum to the Treasury Laws Amendment (2018 Measures No 2) Bill 2019 paras 2.46-2.47.
[128] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.9.
[129] Under amendments proposed by Treasury Laws Amendment (2018 Measures No 2) Bill 2019 the wording will change to 'If, under the terms and conditions under which the trust or partnership operates, the member would be entitled to a fixed proportion of any capital gain from a disposal …'. The amendment makes no

proportion'),[130] each member's share is determined by the trustee or partnership.[131] That seems to allow trusts and partnerships to 'stream' the offset to 'members' who would derive most benefit from it, residents with significant taxable income instead of non-residents and residents with no, or limited, Australian taxable income. There are express anti-streaming provisions elsewhere in the Income Tax legislation and it is unclear whether this apparent inconsistency was intended or an oversight.

The Explanatory Memorandum also 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.[132] While that is doubtful (because that limitation does not appear in the legislation and s 360-15(2) appears, expressly, to confer an unconditional entitlement to the tax offset), if that is what was in fact intended, it would seem to impose an unnecessary (and unnecessarily punitive and potentially counter-productive) compliance burden on investors.[133]

There is also a problem when the trustee could be entitled to a tax offset (because of a liability to pay tax under ITAA36 s 98[134] whenever there are presently entitled beneficiaries under a legal disability[135] or non-resident beneficiaries[136]). In such cases there is a danger that the benefit of the tax offset might be lost if a s 360-30 determination is not made allocating the offset to the members and, instead, it flows to the trustee under s 360-35. This is because, if the trustee pays tax under s 98 the beneficiary is also liable to pay tax on the same amount under ITAA36 s 98A(1) but is 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, to a refund of the difference.[137]

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, also, denying the beneficiary the otherwise available tax offset for the trust's investment in the ESIC.

Finally, there is an even more fundamental problem if the investment is made by a partnership (or, potentially, a trust), where the membership changes between when the investment is made and the end of the income year (when the individual partners' entitlement to a share of the tax offset is calculated). In such cases it is also arguable that the entire tax offset may be lost.

Partnerships are contractual in nature so any change in their membership automatically dissolves them.[138] Even if the firm's business continues, with some or all of the previously existing partners (with or without any new partners), it does so as a new partnership; the old one ceased to exist immediately the change occurred — and there is nothing the partners can do to avoid that happening.

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substantive change to the effect of the existing provision; it merely clarifies what 'the relevant disposal' is: Explanatory Memorandum para 2.49.

[130] ITAA97 s 360-30(3).

[131] ITAA97 s 360-30(2). The provision will therefore apply to all discretionary trusts.

[132] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 para 1.53.

[133] A burden which seems to be at odds with the emphasis on minimising compliance costs.

[134] ITAA97 s 360-15(3).

[135] ITAA36 s 98(1).

[136] ITAA36 s 98(2A) and (3).

[137] ITAA36 s 98A(2).

[138] *Commissioner of State Taxation (SA) v Cyril Henschke Pty Ltd* (2010) 242 CLR 508 at [11]-[12]. See also *Hadlee v Commissioner of Inland Revenue* [1989] NZLR 447 at 455 and *Income Tax Commissioners (City of London) v Gibbs* [1942] AC 402 at 414, 429, 430 and 432.

Therefore, if a partnership invests in an ESIC and then changes its composition before the end of the income year, one partnership (the 'original') will have made the investment and another (the 'new' partnership) will own that investment at the end of the income year (in most cases having inherited it under the terms of the 'technical' dissolution).

Because entitlement to the tax offset accrues to 'a member of a trust or partnership … at the end of an income year if the trust or partnership would be entitled to a tax offset', the partners in the 'new' partnership will not be entitled to an offset (even if they were partners in the 'old' partnership) — because the 'new' partnership was not issued with the shares. But nor will the partners in the 'old' partnership — even though it was in fact issued with the shares — because it has been dissolved and does not exist when the entitlement of its (now former) partners must be determined.

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 use it to reduce its tax liability. That means that it will pay less tax, so will have more cash which it can pay as dividends; but it 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 flow-through the tax offset to those shareholders (as is the case with trusts and partnerships).

Problems with the 'Modified CGT treatment'.

1. The Potential Disincentive — and Lack of an 'Opt-out' Provision

The 'modified CGT treatment' automatically applies 'if the issuing of a share to an entity gives rise to an entitlement to a tax offset under this Subdivision'.[139] That section does not require that the tax offset be actually claimed before the modified tax treatment applies, only that there be an 'entitlement' to it. That 'entitlement' arises if the conditions in s 360-15 are met. If they are, there is no 'opt-out' mechanism to allow an investor to choose not to claim the offset — and, thereby, to preserve the 'normal' CGT treatment that would otherwise apply.

Given the very real risks that ESIC's might fail, and the concomitant risk of capital losses, it might have been thought that the legislation may have preserved the availability of capital losses, either in whole or in part, even if only after a qualifying period (perhaps equivalent to the 12 months after which any capital gain becomes tax free). Alternatively, the legislation might have provided some form of 'opt-out' mechanism so that investors, especially non-sophisticated investors, could elect to treat their ESIC investment in the same way they would treat any other share investment.

2. 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 that will not be an issue but it could create a problem if the membership of a partnership (and, possibly, of a trust) changes after the investment and before the end of that income year. The result would be that the members of the 'new' partnership (whether 'original' or 'additional') would not be entitled to the tax offset and, therefore, not to the modified CGT treatment either.

[139] ITAA97 s 360-50(1).

It can also create a problem whenever a disposal of shares within the first 10 years is involuntary, especially in the case of death. In such cases, there is an argument for extending the benefit of the modified CGT treatment to the beneficiaries of the investor's estate. Absent that, the beneficiaries will take the shares at the cost-base that would have applied to the testator at death[140] 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 have to disregard the capital loss).

3. Problems where the Shares are Held by a Company or Trust

If the investment is made through a company any capital gain the company made on a disposal before the tenth anniversary of the shares' issue would be disregarded but, when it then seeks to pass the benefits of that 'CGT-free' gain on to its shareholders, that payment would be taxable in full in their hand as a dividend — so the benefit may effectively 'disappear'.

Similarly, while a capital gain on an investment 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,[141] 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 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 amendment does not, however, entirely dispose of the problem. As the Explanatory Memorandum 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'.[142] The government has indicated that it may consider extending the exemption to such indirect investments 'at a later date'[143] but that has not yet been occurred.

4. Wholly-Owned Company and Scrip-for-scrip Roll-overs

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 does not apply.[144] 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'.[145]

[140] ITAA97 s 128-15.
[141] This may not have been the case for a discretionary trust: *Taxation Determination* TD 2003/28.
[142] Explanatory Memorandum to the Treasury Laws Amendment (2017 Measures No 1) Bill 2017 (Cth), para 1.13.
[143] ibid, para 1.14.
[144] ITAA97 s 360-60(1).
[145] ITAA97 s 360-65(1) (for 'normally' issued shares) and s 360-65(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'.[146] The rule does achieve that objective, but it has a number of other potentially adverse practical consequences:

a. if an investor subsequently disposes of shares he acquired 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; and
b. the same problem applies to scrip-for-scrip roll-overs: the modified CGT treatment terminates. This could make mergers by, or takeovers of, the ESIC (perhaps for legitimate commercial reasons, including scaling[147]) significantly less attractive.

5. The Ten-Year Time Limit

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 (in a practical sense) may also be an issue and may place an additional administrative/compliance burden on the ESIC.

Crowd-sourced Funding (CSF)

The *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) commenced operation on 29 September 2017, allowing crowd-sourced platforms to apply for a licence to operate.[148]

It allows 'eligible CSF companies' to access crowd-sourced equity funding ('CSF') provided they meet the threshold eligibility requirements, they pass both the 'assets test' and the 'turnover test', the amount they seek falls within the 'issuer cap', the funds are raised through a CSF intermediary and their 'CSF offer document' (and, if it is not included in the 'CSF offer document', their 'CSF offer') meets the requirements of the Act.

The Act only covers online equity-based crowd-sourced funding (though the Treasurer did note in his Second Reading Speech that it was simply 'a new funding option for small businesses' and that it was not intended to displace 'other forms of crowdfunding already available, such as rewards-based crowdfunding and peer-to-peer lending' which start-ups could already use to fund and finance their operations. It was also intended to 'serve as both a complement and a source of competition to more traditional funding options for small businesses, including bank debt products.'[149] Even then, though, the entities that can access funding by using the new regime are restricted.

How the CSF Regime Works

If the entity wanting to raise funds is an 'eligible CSF company' and its offer is a 'CSF offer' (ie 'eligible to be made' and 'expressed to be made' under the Act[150]), it can access the regime.[151] The effect is

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[146] Explanatory Memorandum, Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016, Example 1.124.
[147] Which Subdiv 360-A specifically seeks to encourage: see, for example ss 360-10 and 360-40(1)(e)(iii).
[148] Persons operating a crowd-sourced funding platform must hold an Australian Financial Services Licence (AFSL) and may be required to hold an Australian Markets Licence (AML): Explanatory Memorandum para 3.4.
[149] Commonwealth of Australia, Parliamentary Debates, House of Representatives, 24 November 2016, 4306 (Scott Morrison, Treasurer).
[150] *Corporations Act 2010* (Cth), s 738B.
[151] ibid s 738G.

that the *Corporations Act 2001* (Cth) Part 6D.2 (which contains the general rules governing disclosure for offers of securities) and Part 6D.3 (which deals with the prohibitions, liabilities and remedies that normally apply to offers of securities that require disclosure) do not apply to its 'CSF offers' (unless there is a specific provision under which they do).[152]

Qualifying as an 'Eligible CSF Company'

To qualify as an 'eligible CSF company' the entity must:[153]

- be a public company limited by shares or a proprietary company with at least two directors and meet all of the other prescribed requirements;[154]
- have its principal place of business in Australia;
- have a majority of its directors resident in Australia;
- comply with the assets and turnover test;[155]
- not be a listed corporation[156] (a restriction that applies to both the company and any related party of the company[157]); and
- not have a substantial purpose of investing in securities or interests in other entities or managed investment schemes (a restriction that applies not only to the company itself but also to any related party).

The company must also exist at the time of making an offer; offers cannot be made if they relate to 'a company that has not been formed or does not exist'.[158]

Eligible Offers

An offer will be an 'eligible offer' if and only if:

- it is an offer by the company for the issue of securities of the company;[159]
- the company is an 'eligible CSF company' when the offer is made;
- the securities are of a class specified in the regulations (under the current provisions they must be fully paid ordinary shares[160] — but that requirement only appears in the regulations so it can readily be changed if it is found to be unnecessarily restrictive[161]);
- the offer complies with the 'issuer cap'; and

[152] ibid ss 703B, 704 and 706 (in relation to Part 6D.2) and s 725A (in relation to Part 6D.3). Section 738E also provides that making a CSF offer does not prevent a company from also making an offer of securities of the same class in reliance on a provision of s 708. Consequently, a company could make a CSF offer to crowd investors and, at the same time, make an offer to investors for whom disclosure is not required anyway – such as venture capital funds and angel investors: Explanatory Memorandum para 2.7.
[153] ibid s 738H(1).
[154] ibid s 738H(1)(a).
[155] ibid s 738H(2). A company satisfies the 'assets and turnover test' if, at the 'test time,' the value of the consolidated gross assets, and the consolidated annual revenue, of it and all of its related entities is less than $25 million (or, if the regulations specify a different amount, that amount).
[156] Listed companies are excluded because they have already 'demonstrated an ability to bear the costs of compliance requirements associated with listing on a public market' and they 'generally have access to other forms of equity raisings because of their listing and continuously disclosing status, such as rights issues and share purchase plans': Explanatory Memorandum para 2.27.
[157] 'Related party' is defined in *Corporations Act 2010* (Cth), s 738G(3) as 'a related body corporate of the company' or 'a person who controls the company or an associate of that person'.
[158] ibid s 738ZF.
[159] A CSF offer can only be for an initial issue of securities, not for a subsequent sale: see Explanatory Memorandum, para 2.12.
[160] *Corporations Regulations 2001* (Cth), reg 6D.3A.01(1).
[161] Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth), paras 2.31-2.34.

- the company does not intend that the funds raised will be used, either by itself or by a related party, to invest in securities or interests in other entities or schemes.[162]

The 'issuer cap' is $5 million or, if the regulations specify a different amount, that amount.[163] It is the maximum that the company can raise in a single year and includes not only the maximum amount that it intends to raise through its current offer but also any amounts that it, or a related party, raised through other CSF offers — together with all other amounts they raised within the immediately preceding 12 months in circumstances where *Corporations Act 2001* (Cth) ss 708(1) or (10) did not require disclosure.

If an offer does not qualify as a CSF offer, it then generally defaults to being an offer that does require disclosure under *Corporations Act 2001* (Cth) Part 6D.2 — so failing to lodge the required disclosure documents with ASIC becomes an offence.[164]

The Regulatory Concessions

For companies whose offers qualify under the CSF rules there are a number of regulatory concessions that are intended to remove what the Treasurer referred to in his Second Reading Speech as 'unnecessary regulatory barriers … [to] … Australia's innovative early-stage businesses to obtain the capital they need to turn good ideas into commercial successes'. These include, for a concession period of up to a maximum of five years:

- modified disclosure obligations in the CSF offer document;
- an exemption from the requirement to hold an AGM;[165]
- an option to provide reports to shareholders merely by making them available online;[166] and
- an exemption from the requirement to appoint an auditor until the company has raised at least $3 million from CSF offers.[167]

Taxation Considerations

Significantly, there are no tax concessions associated with CSF offers and CSF transactions are taxed exactly as if the funds were raised by a normal issue of shares.[168] In this respect, the legislation is almost unique in the context of government support for innovation-based enterprises, especially in their start-up phase. In just about every other area government has provided tax incentives to compensate for risk.

That has a number of consequences for investors. Their investments will clearly not be deductible but, if the shares they receive are subsequently disposed of, any profit will be taxable (as either a capital gain, as a gain on disposal of a revenue asset or as ordinary income, depending on how the shares were acquired and held). Any loss will also be treated as either a capital loss to be dealt with under ITAA97 s 102-10 or as a loss on revenue account to be deducted under ITAA97 s 8-1 (again depending on how the shares were acquired and held). Any return that they get on their investment in the way of dividends will, of course, be taxable as ordinary income under ITAA36 s 44.

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[162] *Corporations Act 2010* (Cth) s 738G(1).
[163] ibid s 738G(2).
[164] ibid s 727(1). See also Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth), paras 2.53-2.54.
[165] ibid ss 738ZI and 250N.
[166] *Corporations Act 2010* (Cth) ss 314(1AF) and 314(2A).
[167] ibid ss 301(2), 301(5)(b) and s 9 (for the definition of 'CSF audit threshold').
[168] For the ATO view see https://www.ato.gov.au/individuals/income-and-deductions/income-you-must-declare/crowdfunding/.

There may also be GST consequences.[169] The supply of shares itself is an input taxed financial supply and is therefore not subject to GST (so the investor receives no input credits). The services that the CSF intermediary supplies to the company are, however, a taxable supply and, provided the intermediary is carrying on an enterprise, is registered or required to be registered for GST, provides the services for consideration and the services are connected to Australia (as they will be because of the eligibility requirements for CSF offers), they will be subject to GST.

Input tax credits are not normally available for acquisitions that relate to the making of input taxed supplies unless certain prescribed circumstances exist, so whether the company will be entitled to input credits for the GST on the fees that it pays the CSF intermediary will therefore depend on whether the provision of the intermediary's services fall within those circumstances (mainly the *de minimis* exception under *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 11-15(4) or the 'reduced credit acquisitions' detailed in the *A New Tax System (Goods and Services Tax) Regulations 1999* (Cth), reg 70-5.02).

So why the difference?

Clearly, providing tax incentives for early stage investing has been an integral part of how governments have approached the issue in the past so what is different this time?

The most obvious difference is in relation to the types of investors and the amounts that they are likely to invest. There is no legislated minimum investment for CSF offers but there is an 'issuer cap' that limits the total amount that individual companies (and any related parties) can raise in any 12 month period to a maximum of $5 million.[170] There is also a $10,000 'investor cap' on the amount that an individual retail client can invest in all CSF offers made by the same company in any 12 month period (and, under *Corporations Act 2001* (Cth) s 738ZC(1), a responsible intermediary *must reject* an application made by a retail client if it would breach that cap).

The $10,000 'investor cap' does not apply to sophisticated and/or professional investors — though offers to them are already exempt from disclosure under *Corporations Act 2001* (Cth) ss 708(8) and 708(11) and it is more likely that companies would seek investments from them under the general fund-raising provisions rather than the CSF regime, especially as those investments do not fall under the $5 million issuer cap[171] which can be preserved for bona fide small 'mum and dad' investors.[172]

Individual investments are therefore likely to be small and the people who make them are less likely to be greatly concerned about possible tax incentives than with the potential for significant possible gains on the occurrence of an expected an exit event (such as a trade sale, IPO or other disposal of their shares).[173] Alternatively, they may be mainly motivated by a desire to assist family or friends who are behind the company seeking the funds — albeit also wanting to protect their investment, to some extent, by acquiring equity (with a voting entitlement) rather than simply providing 'loan' funds.

Because of the probably small scale (and, concomitantly large number) of individual CSF investments that are likely to result from the $5 million 'issuer cap', providing (and administering) tax incentives

[169] For the ATO view see https://www.ato.gov.au/Business/GST/In-detail/Rules-for-specific-transactions/GST-and-crowdfunding/.
[170] *Corporations Act 2010* (Cth), s 738G(2).
[171] Offers that are exempt from disclosure under *Corporations Act 2001* (Cth) s 708 do not count towards the $5 million issuer cap. They are 'small scale personal offers' under s 708(1) and offers under s 708(10) where the offeree has previous experience in investing that allows them to assess the merits and risks of the offer.
[172] A small number of small 'mum and dad' investors can also be catered for under the 'small scale offering' provisions in *Corporations Act 2001* (Cth) s 708(1) which dispenses with normal disclosure if securities worth no more than $2 million are offered to no more than 20 people in a 12 month period. This could be used to preserve the $5 million cap for other investors.
[173] Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth), para 1.61.

for CSF investors (which could be similar to the incentives that are available for investments in ESICs) is likely to involve a disproportionate administrative burden for the fund-raising company and, possibly, the ATO.

However, whatever the reason, the absence of tax incentives may, in fact, operate in the CSF investors' favour — especially as regards the modified CGT treatment that applies to ESIC investments.

A major problem with the 'concessional' modified CGT treatment, especially given the statistics on the likelihood of start-ups failing, is that investors lose the potential benefit of any capital loss if the company fails, or if they sell out to limit their possible losses, within the first 10 years of the company's life. This can have potentially draconian consequences, especially where the disposal is involuntary — as would be the case on death.

Crowd-sourced funding investors do, therefore, have some advantages over investors in ESICs in that, while they may be subject to CGT on their gains, their capital losses are not mandatorily disregarded.

Can a single investment be made concurrently under the ESIC and CSF regimes?

From the legislation, it appears that there is nothing to stop investors investing in the same company under both the ESIC rules (to get the tax concessions) and the CSF rules.[174] It also seems that they could do so in respect of the same investment, provided the company meets the requirements to qualify both as an ESIC,[175] and as an 'eligible CSF company'. The offer would also have to be both 'eligible to be made' and 'expressed to be made' under the CSF rules,[176] and the shares issued would have to be eligible for the tax incentives under the ESIC rules.

None of that would seem to involve insurmountable hurdles. The requirements to qualify as 'early stage' all align neatly with the requirements that 'eligible CSF companies' not be foreign companies and must satisfy their own, somewhat more liberal, gross assets and revenue tests.

The major differences between the two entities are that ESICs do not have a principal place of business or resident director requirement to satisfy, they have a less liberal 'assets and turnover' test to meet and, unlike 'eligible CSF companies', they are not prohibited from having a substantial purpose of investing in securities and interests in other entities (though the same practical effect is likely to be achieved through the requirement that ESICs be 'genuinely involved in innovation').

There would also appear to be no insurmountable hurdles to a single offer being able to meet both sets of requirements. In both cases the offer must be for 'shares in the company' (though the ESIC requirements do allow for the concessions to apply if convertible notes are later converted to shares) — and, with ESICs, there is no express requirement that they be fully paid on issue (as is the case with CSF offers).

One major difference is that ESIC offers are not subject to an 'issuer cap' as CSF offers are (limiting them to raising a maximum of $5 million in a single year). The 'investor' cap that applies in each case[177] is different — as are the consequences of breaching those caps. Companies that want their offers to meet both CSF and ESIC requirements would have to structure them so that they met both sets of requirements (including limiting maximum acceptance to $10,000 for each 'retail client'/non-sophisticated investor) — but that would not seem to be too onerous (depending on the level of funds the company wanted to raise).

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[174] That possibility also seems to be indirectly suggested by the Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth), para 2.42.
[175] Which it would be so long as it was 'early stage' (ie if it satisfied the requirements in ITAA97 sub-ss 360-40(1)(a)-(d)) and was genuinely involved in innovation (something which it self-assesses under either a principles-based test under s 360-40(1)(e) or the '100 point innovation test in s 360-45).
[176] ibid s 738B.
[177] A maximum $50,000 for 'non-sophisticated' investors in ESICs (in total in any one year) as opposed to a $10,000 cap for retail clients applying for shares under a CSF offer in any one company in any year.

The problem though is that neither the CSF nor the ESIC legislation appears to have identified the potential for the two regimes to operate in tandem — or to make provision for that to occur. In theory, there is no reason why the two regimes should not co-exist, except perhaps because of the CSF legislation's prohibition on CSF companies having more than one CSF offer open at a time.[178] It could therefore be argued that allowing them to raise funds through a concurrent capital raising under the ESIC rules could be both inappropriate and at odds with, at least, the spirit of the CSF rules.

If concurrent offers are possible there are some interesting practical tax problems which arise because it is not clear whether an issue of shares under the ESIC rules creates an immediate entitlement to the two tax concessions and, if it does, whether that means that investors are then, immediately, and simply by virtue of the issue of shares to them, automatically covered by the ESIC rules — or does it mean that the issue of shares to them simply raises a possible entitlement which the shareholder must choose to activate (by claiming the tax offset) before the ESIC rules can apply.

This uncertainty gives rise to at least two problems.

First, if accepting a 'CSF offer' does also qualify as an ESIC investment (because the company has aligned the terms of its offer to achieve that effect), 'retail clients' who accept the CSF offer could inadvertently lose their entitlement to claim a capital loss if their investment later fails (or if they dispose of those shares at a loss for any other reason — including through an involuntary disposal, such as might occur on death) within the first 10 years of their investment. This is because, under the ESIC rules, capital losses within that period must be disregarded.[179] That outcome is technically possible, even though those investors may not have invested with the ESIC incentives in mind — and may not even have been aware of them, or of the potential problem.

Secondly (and perhaps more worrying from the ATO's point of view), the uncertainty could give rise to a situation where knowledgeable investors (including 'sophisticated investors' who can invest significant sums under both regimes) might not immediately claim the tax offset to which the ESIC rules would entitle them (thereby preserving the option of claiming a capital loss if the company fails or they otherwise dispose of their shares at a loss shortly after investment), but then seek to amend their returns subsequently (after it appears that the company might succeed) to gain both a (backdated) tax offset and, consequently, the benefits of the modified CGT treatment as well.

Conclusion

Despite the government's overt commitment to encouraging and supporting innovation, especially by start-ups, the reality is that the various programs has been hampered by qualifications within the legislation itself which constrain the availability of the tax and other concessions, and by the way in which the concessions have been administered by, in particular, the ATO.

The extent to that has occurred was demonstrated by the 2019-20 Budget projections for the expected take-up of the R&D tax offset in the next three financial years. It is also well illustrated by the statistics on the use of the new ESIC and CSF provisions. Data from 2016-17 show that only about $300m was invested in 340 early stage innovation companies by around 3,400 angel investors.[180] For CSF the figures are worse. There were only seven complete offers in 2017-18. They raised $7.04m, $5.46 m from retail investors (17,353 individuals) and $1.59m from wholesale investors (104 investors), with amounts ranging from approximately $253,000 to $2.34 million.[181]

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[178] *Corporations Act 2010* (Cth), s 738R.
[179] ITAA97, s 360-50(3).
[180] Denham Sadler, *Angel tax data revealed by ATO* InnovationAus.com 5 March 2018 http://www.innovationaus.com/2018/03/Angel-tax-data-revealed-by-ATO accessed 1 March 2019. Data for 2017-18 is not yet available.
[181] ASIC Report 616 *Survey of crowd-sourced funding intermediaries,* April 2019, para 50. The figures are a little distorted in that the period was only from 11 January 2018 (when the first CSF intermediaries were licensed) to 30 June 2018. They also relate to a period before CSF was extended to proprietary companies.

If the Government's *National Innovation and Science Agenda* is to achieve its potential and to provide meaningful assistance to promote the activities at which it was directed the present apparent disjunct between intent and implementation needs to be addressed.