



THE TAX INSTITUTE

10 November 2017

Ms Tina Smith
Manager
Small Business Entities and Individual Concessions Unit
Individuals and Indirect Tax Division
Treasury,
Langton Crescent
PARKES ACT 2600

By email: innovationamendments@treasury.gov.au

Dear Ms Smith,

Innovation Technical Amendments

The Tax Institute welcomes the opportunity to make a submission to Treasury in relation to the *Treasury Laws Amendment (Measures for a later sitting) Bill 2017: Fintech and venture capital amendments* Exposure Draft (**Exposure Draft**).

Summary

The Tax Institute considers that the Exposure Draft could have had a wider scope to cover more matters than are currently included in the Exposure Draft. Our submission below covers:

- our specific comments on the Exposure Draft; and
- other matters we consider that Treasury should include in the scope of the Exposure Draft.

Discussion

Specific comments on the Exposure Draft

1. Draft section 118-426

The venture capital investments changes in the Exposure Draft are predominantly aimed at allowing these vehicles to invest in companies that have finance or insurance ('fintech') activities as their predominant activities provided that they are early stage companies. The new 'early stage' test in draft section 118-426 (within Subdiv 118-F *Venture Capital Investment*) mirrors the test for Early Stage Innovation Companies (**ESIC**) in section 360-40 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**).

It is unclear whether the addition of the early stage test as an exception to the ineligible activities definition in section 118-425(13) is intended to apply at the time the investment is made, or is to be applied on an ongoing basis over the life of the investment. The answer to this question could be problematic particularly when dealing with the three-year requirement in the new section 118-426(a). We anticipate that it is intended that the test be a 'point-in-time' test and that the investment holder would not be required to retest the investment for eligibility annually. If that is the case, this should be clarified in the legislation as well as the Explanatory Memorandum (**EM**). The EM should also make it clear what the consequences are if the investment is ineligible.

Alternatively, a simpler solution would be to remove fintech activities from the list of ineligible activities rather than impose a second set of requirements on top of those activities.

2. Start date for ESIC changes

The ESIC changes are proposed to start from the 2018-19 income year. For taxpayers that are early balancers, this would mean the rules could apply from 1 January 2018. It would be preferable for the amendments to start for investments made on or after 1 July 2018 (in line with other amendments proposed by the draft Bill). The law changes should commence after the Bill has passed Parliament, to give taxpayers sufficient certainty as to how the law will operate and which investments can qualify as ESICs.

3. Note to section 360-40(1)

Item 15 of the Exposure Draft inserts a note into the legislation concerning the circumstances when a company can satisfy section 360-40(1) and demonstrate whether it is engaging in certain activities by engaging the services of another entity for that purpose of subsection 360-40(1)(e) (as explained in paragraph 1.72 of the EM).

We note that the Australian Taxation Office has a consultation on foot in relation to this matter¹. It appears the note has been included to address the concerns in the ATO's consultation, namely that the test entity in 360-40(1)(f) is 'the Company' that equity is being issued in.

Other issues arising from the inclusion of the draft note are:

- a) This change ostensibly expands the test to cover entities that do things on behalf of the test company – the focus being on “*services*”;
- b) It is not exactly clear from the legislative note itself (and the EM provides minimal assistance) whether this expansion includes entities that hold rights on behalf of the other entity; and

¹ Refer to the *ESIC Company level tests* document on the ATO Let's Talk Page: <https://lets-talk.ato.gov.au/ESIC>

- c) A 100% subsidiary is not necessarily ‘engaged’ to provide services and it would not, in equity or agency, necessarily be treated as holding assets on *behalf* of its parent.

In our view, the policy setting should capture activities and services performed by 100% subsidiaries, and rights held by these subsidiaries, as it is common to establish a structure whereby a holding company owns 100% of the shares in both a company that holds the intellectual property (**IP**) and an operating company. There are basic and genuine commercial reasons why one might seek to split the valuable IP from operating activities (rather than combine both in a single company). Accordingly, we suggest the note could be drafted as follows:

Note: For the purposes of paragraph (e), two ways the company can demonstrate something include:

- (a) *where it has engaged (or is engaging) another entity to:*

- i) *perform the relevant activities; or*
- ii) *hold the relevant rights/assets,*

for or on behalf of the company; or

- (b) *where a 100% subsidiary of the Company performs the relevant activities or holds the relevant rights or assets.*

However, we consider that it would be far better to include a legislative amendment in the Exposure Draft by way of a new sub-item (vi) to subsection 360-40(1)(e) rather than by way of a note.

Other matters to include in the Exposure Draft

1. Subsidiaries of ESICs and Venture Capital Limited Partnerships

As noted above, we consider that the policy setting should capture activities and services performed by 100% subsidiaries, and rights held by these subsidiaries for both venture capital investment structures and ESICs. The relevant rules for ESICs and venture capital investment structures should take into account 100% subsidiaries to determine eligibility for the relevant tax offset. For example, in the existing legislation, section 118-425(2) requires that “the company” which is being invested in must have at least 50% of its employees and 50% of its assets in Australia. Section 118-425(12) enables the activities of consolidated group members to be attributed to the head company. However, it does not take into account the employees and assets of non-consolidated group companies (for example as offshore subsidiaries or indirectly owned subsidiaries). It seems this is an unintended consequence of the existing drafting of section 118-425.

It is common to have a number of entities within a structure for commercial or historical reasons and we would consider it appropriate that the tests operate on a “whole of group” basis rather than focusing on the company in which the investment is being made. These changes could be included in the Exposure Draft.

2. Investments through special purpose vehicles

Section 118-425(4) of the existing legislation requires that the entity being invested in must not invest in another entity unless the other entity is controlled (and meets the other tests). Where a venture capital limited partnership (**VCLP**) chooses to invest in a target through a special purpose vehicle (**SPV**), the current rules prevent the investment in the SPV from being an eligible investment unless the target entity is connected with or controlled by the SPV. This prevents VCLPs investing through a SPV into a minority interest in a target company. The former section 118-425(11) allowed a VCLP to invest in an SPV which was formed solely for the purpose of investing in a target company. Those provisions would have allowed the SPV to take a minority interest in the target company.

However, when the law was amended in 2016, the changes to the law resulted in the ability to invest in a SPV or holding company being limited to circumstances where the SPV controlled the target. It is unclear what the policy reason is to require the SPV to control the target entity. The rules should be amended to reinstate the ability for VCLPs to invest in a target through an SPV and not be required to take a controlling interest in the target.

If you would like to discuss any of the above, please contact either myself or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Matthew Pawson', with a stylized, flowing script.

Matthew Pawson
President