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Encouraging Innovation – The Tax Laws Amendment (Tax Incentives for Innovation) Act 2016

Introduction

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

Those measures included:

- Providing new tax breaks for early stage investors in innovative start-ups;
- Building on already existing measures to encourage venture capital investment in Australia;
- Permitting companies to attract financing through crowd-funding;[1]
- Relaxing the 'same business test' to ensure that a company is not denied a deduction for carry-forward tax losses just because it changes its business activities. It will be replaced with a 'predominantly similar business test' which will allow start-ups to bring in a new equity partner and secure new business opportunities without the risk of adverse tax consequences for existing accumulated losses;
- Removing the rules that limit depreciation deductions for some intangible assets (notably patents) to a statutory life and allow them, instead, to be depreciated over their economic life – as is presently the case for other assets;
- Reforming Australia's insolvency laws to encourage greater entrepreneurial risk taking; and
- Making the existing employee share scheme rules more user-friendly by allowing companies to offer shares without having to reveal commercially sensitive information which could, thereby, be accessed by competitors.

The measures that were announced in the *National Innovation and Science Agenda* are the latest in a number of tax incentives that have been introduced to assist innovating enterprises, especially in the start-up phase. There have always been some taxation incentives for innovation but the current suite really commenced with the *Venture Capital Act 2002* (Cth) (and the associated amendments to the Commonwealth's taxation legislation and the individual state and territory Partnership Acts) to facilitate non-resident investment in the Australian venture capital industry.[2] They include the R&D

[1] An equivalent provision already exists in New Zealand where new companies can access up to NZ$2 million each year in crowd-sourced equity funding (CSEF): see *Financial Markets Conduct Act 2013* (NZ) and *Financial Markets Conduct Regulations 2014* (NZ). Similar provisions also apply in the US (annual cap US$1 million) and the UK (uncapped) as well as in some provinces in Canada (annual cap C$500,000) and a range of other, mainly European, countries.

[2] Tax incentives are available for making 'early venture capital investments' (ECVIs) through specific forms of investment vehicles (all of which are 'incorporated limited partnerships' – either Venture Capital Limited Partnerships (VCLPs), Early Stage Venture Capital Limited Partnerships (ESVCLPs) or Australian Venture Capital

Tax Offset under Div 355[3] (jointly administered by AusIndustry and the ATO[4]), the amendment of Div 83A of the ITAA97, in line with the government's *Industry Innovation and Competitiveness Agenda,* to provide, *inter alia,* a 'start-up' concession for shares and options that eligible small start-up companies issue to their employees in lieu of the higher salaries that they might otherwise have to pay to attract the best available talent to their enterprises, the introduction of an immediate write off for small businesses for expenses they incur in setting up a proposed small business which either relate to obtaining advice or services relating to the proposed structure or proposed operation of the business or are a payment to an Australian government agency of a fee, tax or charge incurred in relation to setting up the business or establishing its operating structure.[5]

The new tax incentives for early stage investors in innovative start-ups (referred to as 'angel investors') are contained in the new Subdivision 360-A of the ITAA97. They were introduced to augment the other already-existing measures, in particular, the incentives that are available to venture capital funds (ESVCLPs and VCLPs) which 'typically focus on companies that have already developed a concept that is anticipated to attract capital and the company is generally seeking higher amounts of capital to grow'.[6]

This timing problem is addressed by the new provisions, which are designed to allow Early Stage Innovation Companies (ESICs) 'to attract seed and pre-commercialisation equity at an earlier stage of

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Funds of Funds (AFOF)). The available incentives include an exemption from CGT on investments in ECVIs that have been held for at least 12 months and an exemption from income tax on their share of any profits (though losses on both capital and revenue account are also disregarded. In New Zealand the same considerations led to the passage of the *Limited Partnerships Act 2008* (NZ) to encourage venture capital investment into New Zealand.

[3] Div 355 replaced the formerly available 'R&D Tax Concession' with effect 1 July 2011. It allows eligible R&D entities that incur eligible R&D expenditure on defined 'core' or 'supporting' R&D activities to a self-assessed tax offset, the nature and extent of which depends on the size of their turnover and the amount of their eligible expenditure (those with an aggregated turnover of less than $20m on a worldwide basis are entitled 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 $20m or more on that basis are entitled to a *non-refundable* tax offset equal to 38.5% of their total eligible R&D expenditure for that year – in both cases, provided they have notional deductions of at least $20,000 and, since 2014, with those offsets being limited to the first $100m of eligible R&D expenditure for that year; an offset equal to the company tax rate is available for expenditure over $100m). The offset is in lieu of a tax deduction so the net effect of the offset is that entities under the $20m threshold receive a net benefit of 13.5¢ in the dollar and those over the threshold receive a net benefit of 8.5¢ in the dollar – at least up to a notional R&D expenditure of $100m. (The offsets were originally 45% and 40% respectively but they were reduced by the *Budget Savings (Omnibus) Act 2016* under which the new rates were introduced to apply to income years commencing on or after 1 July 2016.

[4] AusIndustry and the ATO have joint administration of the R&D Tax Incentive Program. Under Part III of the *Industry Research and Development Act 1986* (Cth), AusIndustry has responsibility for registration and administration of program activities and, under Div 355, the ATO has responsibility for administration of expenditure on what might be eligible R&D activities.

[5] See s 40-880(2A) ITAA97, applicable since 1 July 2015. There are limitations on the expenses that can be immediately deducted under the section and, in particular, the cost of acquiring assets that may 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 for a business) and expenditure relating to taxes of general application, such as income tax are not included.

[6] Explanatory Memorandum to the *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.4

their development'[7] by offering 'early stage investors' in those companies both a tax offset and a 'modified CGT treatment' for their investments.

The Act also amends the present Early Stage Venture Capital Limited Partnership (ESVCLP) and Venture Capital Limited Partnership (VCLP) rules to improve access to venture capital investment in the next phase of the company's development, by making those regimes more attractive to investors – again, to support innovation, risk-taking and an entrepreneurial culture.[8]

This paper will analyse the new 'tax incentives for early stage investors' (TIFESI)[9] and assess their likely effectiveness – especially given the threshold, equity interest, reporting and other requirements that early stage innovation companies (ESICs) are required to meet to ensure that their 'angel investors' qualify for the concessions.

What is the Problem?

Backing innovative start-ups is inherently risky. It is estimated that more than 98% of all innovation attempts end in failure[10] (about 90% fail before they reach the market and about 90% of those that do reach the market also fail)[11]. Consequently, potential investors are naturally selective, both in the innovations they are prepared to back, particularly in the very early stages of the business's existence, and in the amount of money they are prepared to risk. They also usually demand a significant equity stake to compensate them for the risks they undertake, and an associated level of control over decision-making (though if that means that the start-up then has access to the investor's managerial and marketing expertise, that could be a potential positive for both the start-up and the investor – and it is also an express aim of the new incentives[12]).

In fact, investor reluctance to invest in innovation, and the resulting lack of access by businesses to adequate financing, has been identified as 'a major contributor to poor innovation outcomes in Australia,'[13] a contention supported by the Australian Bureau of Statistics *Business Characteristics Surveys* which have consistently rated 'lack of access to additional funds' as the greatest barrier to

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[7] ibid

[8] Schedule 2 to the *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* (Cth). The amendments provide non-refundable carry-forward tax offsets for limited partners in ESVCLPs, equal to up to 10% of the partner's contributions to the ESVCLP during the income year, increase the maximum fund size for ESVCLPs from $100 million to $200 million, remove the requirement that an ESVCLP divest itself of an investment in an entity once the value of the entity exceeds $250 million (but restricting tax concessions for such investments) and allowing entities in which an ESVCLP or a VCLP or an AFOF has invested to invest in other entities provided that, after the investment, it controls the other entity and the other entity broadly satisfies the requirements to be an eligible venture capital investment.

[9] See the heading to the new Subdivision 360-A, ITAA97

[10] Darrel Mann, Systematic Innovation '*Occam's Innovation Consultant*' (he also estimates that 90% of innovations are delivered late, over budget or to a lower quality than was originally planned and that 90% of all collaborative innovations fail).

[11] In the Australian context, 'Silicon Beach', a 2012 'study of the Australian Start-up Ecosystem' by Deloitte Touche Tohmatsu, reported that only 4.8% of Australian start-ups reached 'scale stage' – that period in the business's life cycle when its board and management believe that growth can be systematically accelerated with a realistic expectation that the resources that will be required will yield positive, significant and measurable results.

[12] Explanatory Memorandum to the *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.6

[13] Withers G, Gupta N, Curtis L and Larkins N '*Australia's Comparative Advantage: Final Report'* Australian Council of Learned Academies, Melbourne, August 2015, p 120.

innovation in Australian businesses.[14] The *Startup Muster* 2015 report also reported that in 2015 27.6% of startups that attempted to raise capital were unable to raise any at all and a further 22.7% failed to raise as much as they had sought.[15]

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

This intermediate stage where the business need to establish the 'proof-of-concept' and the 'profit-potential' of their innovation in order to become attractive to venture capital investors and other more traditional sources of finance, so it can move to the commercialisation phase, (an intermediate stage commonly referred to as the 'valley of death') is where most start-up innovation businesses 'fail simply because they find themselves vulnerable to cash-flow requirements.'[16]

The Funding Life-cycle for Start-ups

Getting a start-up from initial concepts to functioning maturity typically takes somewhere between 8 and 12 years and involves a number of defined phases, in each of which it will need to raise sufficient capital to complete that phase successfully and to position itself to move on to the next phase. In broad outline the phases can be identified as 'pre-seed', 'seed' and 'commercialisation (including initial commercialization, expansion and preparation for IPO or sale).

Different risks of failure attach at each stage (and reduce as the company matures) so investors at the early stages of a company's development are more likely to demand a significant stake in the company's future (and equity) in exchange for their investments than investors who 'buy-in' later. For this reason it is important for that the founders clearly identify exactly how much capital they need to get to the next inflection point and seek only what they will need to get there (with some additional 'fat' to cover contingencies), leaving funding for the next phase to be raised in a subsequent funding round when it is likely to be easier and cheaper to raise.

Initial 'pre-seed' funding for most start-ups, when all that exists is still just a potentially 'good idea', is mainly derived from the '4 Fs' – founders, friends, family and fools (anyone else who you can convince to invest in what is effectively still 'blue sky). Government grants may also be available[17] as

[14] See, for example, Australian Bureau of Statistics, '*Business Characteristics Survey' 2014-15*' para 8158.0 (released 21 July 2016). It reports that for 2014-15 lack of access to additional funds was identified by both innovative-active businesses and businesses overall as the most common barrier to innovation: 28% of all innovation-active businesses rating it as the greatest barrier to innovation (with an even higher percentage among SMEs). For the purposes of the Surveys 'Barriers to innovation' are defined as 'those barriers that significantly hampered the development or introduction of any new or significantly improved goods, services, processes and/or methods'.

[15] Available at https://www.startupmuster.com/. These figures were an improvement on the 2014 results where 32.7% of startups reported that they had attempted to raise capital but were unable to raise any and a further 26.5% reported that they had failed to raise as much as they had sought

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

[17] All level s of government provide programs to support business development. They range from direct financial grants to the provision of assistance and mentoring through incubator and accelerator programs.

may other incentives, such as the R&D tax offset and the other similar stage tax incentives that were referred to earlier. Crowd-funding may also be an option at this stage.[18]

When the business matures to the stage where the founders realise that 'bootstrapping' (surviving on what is available from the '4 Fs') will not suffice if the business is to develop, the business moves into the 'seed capital' phase. The money raised during this phase is normally used for initial market research and product development and the aim is to raise enough to determine exactly what the product is and who will use it and, once that has occurred, to launch it at its target market. At this stage there is still significant risk and, therefore, significant potential for the venture to fail. The investors who are likely to become involved at this 'seed funding' stage are the so-called 'angel investors',[19] augmented perhaps by some early stage venture capital firms. Some indirect cash funding may also be available at this stage through refundable R&D tax offsets for any R&D expenditure the start-up incurs.

From the 'seed capital' phase, businesses that are still on foot typically then need a further injection of funds to move into the commercialisation phase of their development. Seeking capital for this phase, normally the company's first significant institutional round of venture capital finance raising, is referred to as a 'Series A' funding round. It normally occurs after product development has concluded, when the product is ready to take to market and when the company has established some sort of track record. The money obtained during this phase is used to optimise both the product and the customer base. It may also be used to promote the product across other markets to get the benefits of economies of scale. The investors who are most likely to be involved in this round are the more traditional early stage venture capital and venture capital firms – though angel investors may also continue, and expand, their involvement. Investors here are traditionally looking for about 25-35% of the company in exchange for their investment[20] - though this is normally structured, at least initially, through an issue of convertible notes rather than a direct issue of shares.[21]

Once the business has become fully operational it may require additional capital to expand, or to prepare it for an IPO. It will have already achieved a measure of success but needs to be taken to the next level though additional spending on, for example, staff, business development, marketing, sales and customer support. Therefore, it may need to raise additional capital through a 'Series B' funding round. In many respects a Series B funding round is very similar to a Series A round, both in the way

[18] If the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth) is passed crowd-funding is likely to become more common and a more significant source of funding at this stage of a start-up's business.
[19] These are, often, high net wealth individuals, successful entrepreneurs or a combination of both.
[20] For example, if the business had a value of $2m before the seed capital injection (a state referred to as 'pre-money') the angel investor would be seeking a one third interest in exchange for an investment of $1m. This has implications for the availability of the tax offset under Subdivision 360-A because an investor who holds more than 30% of the equity interests in the ESIC immediately after an issue of shares is not entitled to the offset: s 360-15(1)(f)
[21] This has benefits for both parties: for the company, it does not force a valuation of the enterprise at the time when there may not be a lot on which to base a valuation, they are administratively easier (and quicker) to issue and, because it is debt rather than equity (until converted), the founders retain control and do not need to cede board seats to the investors; for the investor it is debt and therefore, if the venture fails, they have some priority on repayment (if there are any available assets) but they also have the potential to share in the venture's success by converting their debt into equity on a pre-determined (and advantageous) basis if it moves to a commercialization stage.

in which it is conducted and the people who are likely to be involved. Many of the same investors can be asked for additional funds – though it is now likely that more risk-adverse venture capital investors will want to be involved,

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

Where the New Tax Incentives Fit

The new Subdivision 360-A 'tax incentives for early stage investors' (TIFESI), provide incentives for qualifying investors[22] to invest in Early Stage Innovation Companies (ESIC) to allow them to get their innovations from the concept stage ('pre-seed') to the commercialisation stage,[23] providing 'seed' funding for the initial 'proof of concept' and 'proof of profit potential' phases of development before the companies start generating any significant revenue, a normally high risk period during which it is difficult to attract investors or obtain finance - with the result that this phase normally involves a high risk of failure.[24]

The Incentives

The new provisions provide investors with two forms of tax incentives, a tax offset and a modified CGT tax treatment for gains or losses on their investments.[25]

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

The modified CGT treatment allows early stage investors to disregard any capital gains that they realise on shares in eligible Early Stage Innovation Companies (ESIC) where the shares have been held for between one and ten years – a tax treatment which is similar to that which is already accorded Early Stage Venture Capital Limited Partnerships, Venture Capital Limited Partnerships and Australian Venture Capital Funds of Funds under the existing Subdivision 118-F.[26] For investments in

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[22] Those who meet the s 360-15 requirements and who are not excluded under s 360-20

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

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

[25] Section 360-10 ITAA97

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

ESICs that concession is not limited to shares within the $200,000 maximum tax offset cap though, to ensure that investments are not made and then withdrawn before the company can benefit from them, any capital losses that are realised on shares that have been held for less than 10 years are also disregarded.

Pre-conditions that must be Met to Qualify for the Incentives

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

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

Qualifying as an Early Stage Innovation Company

In general terms a company will qualify as an ESIC if it is incorporated in Australia, '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)'.[27]

Therefore, a company will only qualify as an Early Stage Innovation Company (ESIC) if it satisfies those two 'limb' conditions:

a. it must be '*early stage*' – a requirement that is determined against a set of criteria involving, incorporation or registration, expenditure, assessable income and stock exchange listing.[28] If the company passes all four of those 'tests' it will qualify as 'early stage'; if it does not it will not be 'early stage';[29] and
b. it must be genuinely involved in innovation, something which is self-assesses against either a principles-based test[30] (which the Explanatory Memorandum describes as 'designed to provide enough legislative flexibility to accommodate both existing and future forms of innovations while specifically targeting high growth potential companies based on the

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[27] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.61
[28] Section 360-40(1)(a)-(d). It must either have been incorporated in Australia or registered in the Australian Business Register within the last three income years (the latest being the current year) or, if not, it must have been incorporated in Australia within the last 6 years – *and* it and its subsidiaries must have incurred total expenses of $1 million of less across the last three years; it and its 100% subsidiaries must have incurred total expenses of $1 million or less in the income year before the current year; it and its 100% subsidiaries must have had a total income of $200,000 or less – excluding any amount of Accelerating Commercialisation Grant it may have received - in the income year before the current year; and none of the company's equity interests must be listed for quotation in the official list of any stock exchange, in Australia or overseas.
[29] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.62
[30] Section 360-40(1)(e). The requirements are that the company is genuinely focused on developing for commercialization one or more new, or significantly improved, products, processes, services or marketing or organizational methods (so merely customizing an existing product, updating existing products, changing pricing strategy, changing goods because of cyclical or seasonal change etc are unlikely to qualify), the business relating to those products etc must have a high growth potential, the company must be able to demonstrate that it has the potential to be able to successfully scale the business, as well as the potential to be able to address a broader than local market, including global markets, through the business and that it also has the potential to be able to have competitive advantages for that business.

innovation company's focus and potential business capability[31]) or the statutory '100 point innovation test' that is set out in s 360-45[32] (both of which can be modified by regulation if the government determines that the tax incentives should be more tightly targeted or if they are being used for inappropriate purposes[33]). Companies can also seek a ruling from the ATO on whether they qualify as an ESIC under the tests[34] - though the ATO's stated position is that the ruling cannot be 'used in promotional materials to imply that we guarantee or endorse investment in your company'[35] and warns that 'the promoter penalty laws may apply if you use a ruling to encourage investors to invest in your company, when the company's circumstances at that time are materially different to those covered by the ruling'.[36]

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

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 relevant time[37] - though the Explanatory Memorandum does note that the reason that ESICs are required to report information about their share issues and their investors to the ATO is 'so that the ATO can assess whether those investors may qualify for the tax offset and the modified CGT treatment'.[38] It might also be expected that the company would make information (including any ruling) available to them for that purpose.

The Shares Must Be Eligible for the Tax Incentives

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

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

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

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

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

[35] See https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=3#For_early_stage_innovation_companies__ESICs_, accessed 11 January 2017

[36] ibid

[37] See https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=2, accessed 11 January 2017

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

a. the investment must be via 'equity interests[39] that are shares in the company';[40]
b. those shares must be new shares[41] that are issued by the ESIC on or after 1 July 2016;[42]
c. the company must be an early stage innovation company as defined in s 360-40 'immediately after' the issue;[43]
d. the investor and company may not be affiliates[44] of one another at that time;[45]
e. the issue of the shares must not be 'an acquisition of ESS interests[46] under an employee share scheme';[47] and
f. immediately after the issue the investor must not hold more than 30% of the equity interests in the company of in an entity connected with[48] the company.[49]

To allow the ATO to assess whether investors are entitled to the tax incentives the issuing company is required to report any issues of new shares that could give rise to an entitlement to the ESIC tax incentives to the ATO 31 days after the end of the financial year in which the shares were issued (ie normally by 31 July of that income year).[50] Presumably, the company would also be expected (though

[39] Equity interests' are defined in ss 974-70 and 974-75. Those sections distinguish them from 'debt interests' on the basis of their economic substance rather than their legal form as was previously the case. In very broad terms an interest that gives rise to 'contingent returns' will be an equity interest; one that gives rise to 'non-contingent returns' will be a 'debt interest'. If an interest satisfies both the debt and equity tests it is treated as a 'debt interest': s 974-5(4). From a practical standpoint this requirement would seem to preclude an issue of preference shares qualifying under the section because of their debt character: see Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.27

[40] Section 360-15(1)(b). In addition to being 'equity interests' the interest must also be constitute a 'share' under the s 995-1 definition of 'share: 'a share in the company and includes stock' (though s 245F of the *Corporations Act 2010* (Cth) now prohibits Australian companies from issuing or converting shares into stock).

[41] The requirement for new shares ensures that the ESIC acquires new funding through the issue. The tax offset is not available for investments that do not raise additional funds for the ESIC: see Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.28. However, as the Explanatory Memorandum notes in para 1.29, this does not preclude equity interests arising from the conversion of convertible notes from qualifying for the tax offset.

[42] The date of commencement of the Act. See s 19 in Schedule 1 to the *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* (Cth) and Item 2 in the Table in s 2 of that Act.

[43] Section 360-15(1)(c).

[44] ITAA97 s 328-130 defines 'affiliate' as: 'An individual or a company [which] acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the business of the individual or company'.

[45] Section 360-15(1)(d) The Explanatory Memorandum notes, at para 1.34, that the affiliate test is used to target the tax incentives to new investors 'rather than merely subsidise the existing investment'. It also notes (at para 1.36) that the test is an 'integrity rule to prevent entities acting in concert to obtain the benefit of the tax offset, where the investment is not for an innovation purpose or does not attract new capital for the ESIC'.

[46] Defined in ITAA97 s 83A-10.

[47] Section 360-15(1)(e)

[48] The term 'connected with' is defined in s 328-15 ITAA97 to cover situations where either entity controls the other or both are controlled by the same third entity.

[49] Section 360-15(1)(f). The Explanatory Memorandum notes, at para 1.38, that this limitation is to encourage investors to spread their investments across more than one ESIC.

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

the legislation does not expressly require it) to provide investors with advice relating to whether it did qualify as an ESIC at the relevant 'test time'.[51]

The Investor Must Qualify for the Incentives

The incentives under Div 360, unlike the incentives available through ESVCLPs, VCLPs and AFOFs 'are available to all types of investors,[52] regardless of their preferred method of investment … other than "widely held companies" … and 100 per cent subsidiaries of these companies'. [53] Consequently, investments can be made by, inter alia, individuals, trusts, partnerships, superannuation funds and non-widely held companies.[54]

There is also no residence restriction[55] so the incentives are available to both residents and non-residents (though, given that the offset is non-refundable, they are likely to be less attractive to non-residents who do not have Australian source income, and an associated tax liability against which the offset can be applied).

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

First, recognising that investing in start-ups is 'inherently risky' the new Subdivision contains express provisions to ensure that 'more vulnerable investors are not over-exposed to this risk'.[56] These protections centre around classifying investors as either 'sophisticated investors', using the tests in s 708(8), (10) or (11) of the *Corporations Act 2001* (Cth),[57] or 'other'.

There is no limit on the amount that 'sophisticated investors' can invest (provided they meet the requirements of the 'sophisticated investor' test in relation to at least one offering of relevant equity interests in the income year – so they need not have that status for all investments made during the year). However, because there is 'affiliate-inclusive' annual offset cap of $200,000, tax effective investments under the new provisions are, in a practical sense, limited to a maximum of $1 million

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[51] Although the term is used throughout the new Subdivision it is not expressly defined. From the context it appears to be immediately after the company issues an investor with the relevant 'equity interests that are shares': see s 360-15(1)(b), (c) and (f). The Explanatory Memorandum also indicates that it is 'immediately after' the time of the issue; see para 1.29.
[52] See the definition of 'entity' in ITAA97 s 960-100
[53] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.16. A 'widely held company' is one that is either listed for quotation in the official list of an approved stock exchange or has more than 50 members, other than companies that met the 20/75 rule during the income year: s 995-1. A '100% subsidiary' is, generally speaking, a company that is wholly owned by a holding company and/or other 100% subsidiaries of the holding company: s 975-505.
[54] Trusts and partnerships do not have a direct entitlement to the tax offset. Instead it flows-through to the individual partners, beneficiaries or, where relevant, the trustee; s 360-30 and 360-35.
[55] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.17
[56] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.18
[57] Section 360-20. Section 708 of the *Corporations Act 2010* (Cth) exempts certain categories of investor from the disclosure document requirements of that Act, in recognition that certain categories of investors who fit within its criteria 'are more likely to be able to evaluate offers of securities and other financial products without needing the protection of a disclosure document': see Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.19. The investors affected are 'sophisticated investors' (s 708(8)), certain experienced investors acquiring securities through a financial services licensee (s 708(10)) and 'professional investors' (s 708(11).

or less in each year[58] - so the total that any investor would be prepared to invest, in total, in all ESICs in which that investor invests in that year, could be limited to $1 million (and less if the investor has carried forward part of the available offset from a previous year).[59]

'Other investors' are limited to investing $50,000 or less, in total, in all ESICs in which they invest in any income year.[60] If they exceed that limit they lose all entitlement to the tax offset – including their entitlement to any part of it that might have applied to the amount up to $50,000. This occurs because, by investing more than $50,000 in any income year, they are deemed not to satisfy the s 360-15(1)(b) requirement that they have been issued with 'equity interests that are shares in the company'.[61] Because they lose their entitlement to the tax offset they also lose their entitlement to the 'modified CGT treatment'.[62]

Second, s 360-15(1)(d) specifically denies the tax offset if the investor and the company are affiliates of one another. Again, this does not preclude the investment but it does make it significantly less attractive for an investor who falls within the definition of 'affiliate' – especially as they are also then denied the 'modified CGT treatment'.[63]

Third, s 360-15(1)(f) denies the tax offset (and, as a consequence, the 'modified CGT treatment' under s 360-50 as well) to those who would 'hold more than 30% of the equity interests in the company or in an entity connected with[64] the company' following the investment. Again, this does not preclude the investment but it does make it less attractive for an investor – especially where the risk is to be compensated for by requiring (and obtaining) a significant interest in the company in return for the investment. [65]

The Tax Offset

If the three pre-requisites are met investors will be entitled to a non-refundable tax offset of 20% of the 'total amount paid' for the shares.[66] There is no requirement that the ESIC have actually applied the funds in its business in that income year; the investor must merely have paid for the shares.[67]

Similarly, because the 'test time' for determining whether a company is an ESIC under the Act, and therefore whether the offset is available, is immediately after the shares are issued,[68] if the company

[58] That offset cap also applies to the investor's total affiliate-inclusive investment in all ESICs in a single year not 'per investment'
[59] The $200,000 offset cap is reduced by any tax offsets that the taxpayer carries forward from a prior year: see s 360-25(2)(b)
[60] Section 360-20(1)(b).
[61] ibid
[62] It only applies if the issuing of the share 'gives rise to an entitlement to a tax offset under this Subdivision': see s 360-50(1)
[63] ibid
[64] n 47 above
[65] Though the problem could presumably be removed by taking convertible notes rather than shares for any interest that would otherwise exceed 30% - but the tax osffset would not be available for that part of the investment
[66] Section 360-25(1).
[67] The 'paid' requirement derives simply from the reference in s 360-25(1) to the amount of the offset being '20% of the total amount *paid* for the shares to which paragraph 360-15(1)(b) applies' (emphasis added)
[68] Section 360-15(1)(f) – but see n 50 above

subsequently ceases to be a qualifying ESIC the investor will not lose the tax offset (or the modified CGT treatment).[69]

If the investor cannot use the tax offset, in whole or in part, to reduce his or her tax liability in that income year[70] any excess can be carried forward and applied in a later income year.[71]

Where the investment is made through a trust or partnership the offset is not available at the entity level but, instead, 'flows through' the trust or partnership to the individual partners or beneficiaries[72] who therefore gain the benefit of the offset, 'if the trust or partnership would be entitled to a tax offset, under [s 360-15(1)] for the income year if the trust or partnership were an individual'.[73] If a particular beneficiary, unit holder or partner is another trust or partnership the offset continues to flow through until it reaches an entity that is not a trust or partnership.[74]

The amount of the offset to which each ultimate beneficiary or partner is entitled is determined by multiplying the 'notional tax offset amount' (the amount of the tax offset under s 360-25 to which the trust or partnership would have been entitled if it had been an individual) by the 'determined share of national tax offset' – a percentage determined by the trustee or partnership.[75] Unless the beneficiary or partner is entitled to 'a fixed proportion of any capital gain from a disposal' of the share were one to occur at the end of the income year (when the percentage must be equivalent to that fixed proportion) the trustee or partnership is free to set the percentage on any basis it sees fit[76] - potentially leaving open scope to stream the offset.

In instances where the trustee of a trust is liable to be assessed, or has been assessed and is liable to pay tax under ss 98, 99 or 99A of the ITAA36, on either a share of, or all of, the net income of the trust, the trustee is entitled to a tax offset.[77] The amount of the tax offset to which the trustee is entitled is the difference between the total amount of the tax offset and the amount to which the beneficiaries are entitled under s 360-30.[78]

The only real limitation is that under s 360-25(2) there is a $200,000, affiliate-inclusive annual cap on the amount of the offset that each (sophisticated) investor can claim.[79] That cap includes not only 'the sum of the offsets under this Subdivision for the income year for which you or your affiliates (if

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[69] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.30
[70] Either because there is no tax liability or because it has already been extinguished by other offsets with a higher application priority under s 63-10 ITAA97
[71] The Act has amended s 63-10(1) ITAA97 (dealing with the 'Priority rules' for tax offsets) by inserting a new item, Item 33, into the Table. It provides that any unused tax offset under Subdivision 360-A may be carried forward to a later income year.
[72] Or, if there are no presently entitled beneficiaries, the trustee: see s 360-35
[73] Section 360-15(2)
[74] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.50
[75] Section 360-30(1)
[76] Section 360-30(2) and (3). In particular there is no requirement to set it the level of income shares under the relevant trust instrument or partnership agreement or in accordance with the default profit-sharing rule in the respective state and territory Partnership Acts
[77] Section 360-15(3)
[78] Section 360-35
[79] Other investors are limited to a total investment of $50,000 across all ESICs in any year. Any investment above that limit will result in a loss of entitlement to both the tax offset and the modified CGT treatment, in total. See n 59 above

any) are entitled'[80] but also 'the sum of any tax offsets under this subdivision that you and your affiliates (if any) carry forward to the income year'.[81] Any potential offset exceeding the $200,000 cap cannot be applied in the income year in which the underlying investment was made and nor can it be carried forward into a later income year and applied then; it is simply lost.[82]

The cap seems to be somewhat at odds with the Subdivision's express object 'to encourage new investment in small Australian innovation companies with high growth potential' in that, by denying the tax offset to that part of the investor's (and the investor's affiliates) investment (across all ESICs) in any particular year that exceeds $1 million (and less if the investor has prior year offsets which have been carried forward), it effectively limits potential tax-advantaged investment to the amount from which the investor can expect the offset (though the modified CGT treatment is not so limited[83] and, in appropriate cases, it may provide the necessary investment incentive, even in the absence of the tax offset).

Modified CGT Treatment

The 'modified CGT treatment' only applies to shares issued to an investor 'if the issuing of a share to an entity gives rise to an entitlement to a tax offset under this Subdivision' (ie under s 360-15).[84]

Interestingly, this does not preclude sophisticated investors[85] from claiming the 'modified CGT treatment' for all shares they are issued, not just those that fall within the $200,000 tax offset cap (ie the $200,000 tax offset cap does not limit the shares that qualify for the modified CGT treatment, so long as the shares would otherwise have qualified for the tax offset[86]).

If the shares did qualify for the tax offset under s 360-15 then, irrespective of how they were in fact acquired, they are taken to have been acquired on capital account,[87] so any subsequent disposal will result in either a capital gain or capital loss instead of a gain or loss of a revenue nature.

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

- If the shares are 'continuously held' for less than 12 months from the date of issue, any capital gain is assessed under normal principles[88] but any capital loss must be disregarded.[89]

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[80] Section 360-25(2)(a)
[81] Section 360-25(2)(b)
[82] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.47
[83] See the Note to s 360-50(1)
[84] Section 360-50(1)
[85] Because 'other' investors do not qualify for the tax offset if their investment exceeds $50,000 (s 360-20(1)(b) and 360-15(1)(b)) nor will they then qualify for the modified CGT treatment: see s 360-50(1)
[86] See the Note to s 360-50(1)
[87] Section 360-15(2)
[88] This is because the investor is taken to hold the share on capital account under s 360-50(2) but the modified tax treatment of any capital gain does not come into effect under s 360-50(4) unless the relevant CGT event occurs 'on or after the first anniversary … of the issue': s 360-50(4)(b)
[89] Section 360-50(3)

- If the shares are 'continuously held' for at least 12 months and less than 10 years from the date of issue, any capital gain arising on the occurrence of the relevant CGT event is disregarded[90] – as is any capital loss.[91]
- If the shares are 'continuously held' for 10 years of more from the date of issue, the normal CGT rules apply, so any gains or losses that are realised on any after-occurring CGT event will be determined, and dealt with, under s 102-5 (for gains) or s 102-10 (for losses) – but with the modification that the first element of the shares' cost base, or reduced cost, becomes the market value of the shares on the tenth anniversary of their issue instead of their actual cost at issue.[92]

While the term 'entity' in the section is widely defined to include individuals, companies, partnerships and trusts (among others – including superannuation funds),[93] if the investment is made by a partnership there is a problem because, under ITAA97 s 106-5, each partner's interest in each CGT asset of the partnership is deemed to be separately held with a separate cost base or reduced cost base.[94]

Consequently, where the shares were issued to a partnership it is not the 'entity' that makes the gain or loss on disposal but the individual partners within that 'entity'. Therefore, the modified CGT treatment must be directed to the partners individually instead of to the partnership as a whole. This occurs through s 360-55 which provides for an alternative modified CGT treatment for partnerships 'to ensure that the modifications made by s 360-50 apply to each partner in the partnership in a case where the partnership is the entity that is issued with the share'.[95] It does this by providing that the same tax treatment rules (dictated by when the disposal occurs), including deeming that each partner's interest in the shares is held on capital account, apply at individual partner level to any gain or loss derived from an CGT event in respect of their individual interests in the shares held by the partnership.[96]

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

There is a further, alternative modification to the 'normal' CGT rules if the originally issued shares are subject to either a 'same-asset roll-over'[97] or a 'replacement-asset roll-over'.[98] This alternative modification applies specifically 'to ensure that the modifications made by s 360-50 are not affected merely because of one or more … [of those roll-overs] … (other than roll-overs under Div 122 or

[90] Section 360-50(4)
[91] Section 360-50(3)
[92] Section 360-50(5)
[93] ITAA97 s 960-100
[94] Section 106-5(2)
[95] Section 360-55(1)
[96] Section 360-55(1)-(3)
[97] Subdivision 112-D ITAA97. See, in particular, the 'Table of same-asset rollovers' in s 112-150
[98] Subdivision 112-C ITAA97. See, in particular, the 'Table of replacement-asset rollovers' in s 112-115

Subdivision 124-M)'.[99] Its effect is to treat the rolled-over asset as having been issued when the original share was issued,[100] to deem the entity that now holds the assets to have 'continuously held that asset since the original share was issued'[101] and to be, itself, the original entity[102] with the effect that the modifications in either s 360-50 (for non-partnerships)[103] or s 360-55 (for partnerships)[104] will continue to apply to the rolled-over assets.

Where the roll-over is covered by Div 122 (wholly-owned company roll-overs) or Subdivision 124-M (scrip-for-scrip roll-overs) (so they are therefore not covered by the s 360-60 provisions), s 360-65 provides for a completely separate modified tax treatment. Instead of any capital gain or loss on any subsequent disposal (ie after the roll-over) being disregarded the gain or loss is recognised for tax purposes, but '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'.[105]

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'.[106] The rule does achieve that objective but it also has a number of other potentially adverse practical consequences which have the potential to limit the investor's – and the ESIC's - future organizational flexibility.[107]

Problems with the new Provisions

As they are written, there are a number of issues with the new provisions that are likely to affect their operation in a practical sense. In most cases the issues arise because of the standard tension that arises when the tax system is used to promote particular behaviours within an affected community and the desire to ensure that those affected people do not obtain some sort of unintended tax advantage by engaging in those behaviours.

The Issues arise across all of the new provisions but, in particular, they relate to matters involving:

1. The Threshold Tax Offset Entitlement requirements in s 360-15(1);
2. Determining whether a company qualifies as an ESIC (so an investment in it does qualify for the incentives);
3. Determining the Amount of the Tax Offset; and
4. The operation of the 'modified CGT treatment'.

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[99] Section 360-60(1)
[100] Section 360-60(2)(b)
[101] Section 360-60(2)(c)
[102] Section 360-60(2)(d)
[103] Section 360-60(2)(f)
[104] Section 360-60(2)(e)
[105] Section 360-65(1) (for 'normally' issued shares) and (2) (for shares that were previously subject to a same-asset rollover or a replacement-asset roll-over)
[106] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* Example 1.124
[107] See 'Problems with the New Provisions' (below)

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

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

Firstly, the section excludes widely-held companies or their 100% subsidiaries (as defined in s 995-1 and s 975-505 respectively) from entitlement to the offset. If the aim of the legislation is, in fact, 'to encourage new investment in small Australian innovation companies' by providing the incentives (as s 360-10 expressly provides) it is difficult to see why 'qualifying investors' should not include such entities, especially as they are more likely to have 'both the requisite funds and business experience to assist entrepreneurs in developing successful innovative companies' to which the Explanatory Memorandum refers[108] (and the financial wherewithal to accept the risks that those investments will entail). Certainly, there is nothing in the legislation, the Explanatory Memorandum or the Treasurer's Second Reading speech which indicates why they have been excluded – though it is, possibly, because the government believes that those entities do not need additional tax incentives to be involved or, perhaps, because of some other 'control' related reason. Worse, irrespective of the reason, the limitation is in many respects pointless because it is so easy to circumvent. So long as the widely held company invests through a non-100% subsidiary the tax incentives will be available (in the absence of some a trigger for the operation of Pt IVA).

Second, 'affiliates' are excluded from entitlement to the incentives. The Explanatory Memorandum notes, at para 1.34 that this is 'to target the tax incentives to new investors in an ESIC … to encourage new investment in ESICs rather than merely subsidise the existing investment'. It goes on to note that 'If an investor exerts a degree of influence over an ESIC or vice versa, as per an affiliate relationship, it might be expected that the offset is not attracting this type of new investment'. There are two issues with this exclusion:

a. on its face it would appear to exclude the founders (and, potentially, their family and friends – who may have already invested in the 'pre-seed' stage and may be willing to advance further seed funding) from entitlement to the incentives. That will certainly be the case if the founders invest directly but it is less clear that it will necessarily exclude other 'associates' because the term 'affiliate' is much more restricted and applies only to those who act, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the business of the individual or company'. This will not apply, in most cases, to family, friends and other early investors. In fact the Explanatory Memorandum expressly even notes (at para 1.33) that 'entities will not be considered affiliates merely because of the nature of the business relationship shared between them'. Consequently employees and even directors would not, for that reason alone be considered 'affiliates' of the ESIC (though para 1.35 does note that 'a director-owner of an ESIC would be precluded from qualifying for a tax offset as the ESIC would be an affiliate of the director-owner' - presumably because the status of 'owner' rather than just the status of director, would confer the required expectation that the ESIC would act in accordance with his or her directions or wishes; and

[108] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.6

b. this restriction, too, can be easily circumvented, even by founders. The term 'affiliate' is defined in s 995-1 as having 'the meaning given by s 328-130' Section 328-130 notes that 'An *individual or company* is an affiliate of yours if …' (emphasis added). There is no provision for any other entity (as defined in s 960-100) to be an 'affiliate'. Consequently, provided a founder invests in the ESIC not directly but through a partnership or (with an even greater degree to separation and therefore greater protection) a trust or superannuation fund, he or she should be able to access an indirect entitlement to the incentives,[109] unless, again, Pt IVA is triggered.

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

Worse, however, it too can be readily circumvented because the 30% limit is not an 'associate-inclusive' restriction. The section refers only to 'you' holding more than a 30% equity interest and the term 'you' applies only individual entities not to them and their associates or affiliates.[110] A single investor who structures the investment through two or more vehicles, even if they are affiliates (provided they are not also affiliates of the ESIC) would therefore seem not to breach the limit provided none of those investing 'entities' individually breach it – again, unless Pt IVA is triggered.

Fourth, the s 360-15(1)(b) requirement that the investment be through 'equity interests that are shares' prevents ESICs from issuing preference shares (because of their 'debt interest' characteristics[111]) even though experienced investors are known to prefer preference shares.

Finally, there is also a possible issue if capital is raised using convertible notes, another favoured means of capital raising at this stage of an ESIC's lifecycle, because, until the notes are converted into shares the Subdivision cannot apply, and the tax offset will not be available. In most cases this will only affect the timing of the offset, not its availability once the notes are converted into shares - because the conversion gives rise to a new interest and is not just a continuation of the existing debt interest.[112] However, if the trigger event for the conversion occurs after the ESIC ceases to be an ESIC, any right to the tax offset that may otherwise have arisen will be lost.[113]

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

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

[111] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.27

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

[113] Para 1.29 of the Explanatory Memorandum notes that the 'point in time' test (for determining whether the issuing company is an ESIC) means that 'investors that acquire equity interests from the conversion of

Problems with Determining whether the Company Qualifies as an ESIC

Under s 360-15(1)(c), an entitlement to the tax offset (and therefore to the modified CGT treatment) only arises if 'subsection 360-40(1) (about early stage innovation companies) applied to the company immediately after [the share issue]' – and the onus of ensuring that the company is in fact an ESIC immediately after the issue therefore rests squarely on the investor. There are a number of issues with this requirement.

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

Self-assessment, per se, does not create a problem but the overt subjectivity of the five 'principles' of the principles-based test – all of which must be satisfied to pass the test - is such that it could well be very difficult for a company, on a subsequent audit, to justify any determination it may have made that it qualifies as an ESIC on the basis of that test (a problem exacerbated by the fact that the requirement must be met not once but on each occasion on which it issues shares that might carry an entitlement to the incentives). This is especially so because four of the five tests require the company to demonstrate that it has 'potential' at that time - for high growth, scalability, ability to address a broader than local market and ability to have competitive advantages for its business.

The potential cost of 'getting it wrong' (a complete loss of the tax incentives for its investors – coupled with a possible class action by them), is such that any company choosing to use the principle-based test would be poorly advised if it did not seek confirmation of the accuracy of its self-assessment by also applying for a ruling, despite the delay that that will involve.

Even where a company does seek certainty through a ruling though it will come with the standard ATO caveat that 'the ruling is only about how the tax law applies on the facts that you have provided – if the facts change, this may lead to a different outcome under the tests.'[114] The ATO also warns that 'the ruling should not be used in promotional materials to imply that we guarantee or endorse investment in your company' and that 'the promoter penalty laws … may apply if you use a ruling to encourage investors to invest in your company, when the company's circumstances at that time are materially different to those covered by the ruling.'[115] The ruling will therefore provide less than complete protection.

Consequently, it is perhaps unsurprising that even the ATO acknowledges that 'In practice, if a company undertakes activities that meet the 100-point innovation test, this is likely to be the simplest way to determine its eligibility, when compared to the principle-based innovation test.'[116]

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convertible notes are not precluded from qualifying for the tax offset, where the company issuing those equity interests is a qualifying ESOIC at the time of the conversion into shares'.

[114] https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=3#For_early_stage_innovation_companies__ESICs_ accessed 11 January 2017

[115] ibid

[116] https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=2#Qualifying_as_an_early_stage_innovation_company accessed 11 January 2017

Second, the investor bears the onus of determining whether a company is an ESIC[117] (and, therefore, that there may be an entitlement to the tax incentives). There is a requirement that the issuing company report information to the ATO about their investors when they issue new shares that could give rise to an entitlement[118] but there is no commensurate obligation on either the company or the ATO to make that information available to investors. In any case, given that it occurs after the issue, it would be too late for investors anyway. In reality then, if investors are to have confidence in the company's determination of its status as an ESIC there should be some binding mechanism, such as a Class Ruling, which would provide the necessary degree of certainty. Certainly, it would not seem to be good enough for the ATO simply to warn potential investors, as it has, that: 'The ruling provided to the company does not amount to financial advice or imply that we endorse or guarantee investment in the company. Investors should form their own views about whether to invest in a company and should seek independent financial advice if needed'[119] and that they 'should keep records to support their entitlement to the early stage investor tax incentives.'[120]

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

Problems with Determining the Amount of the Tax Offset

Determining the amount of the tax offset involves, in the 'general case'[121] a relatively simple calculation under s 360-25 or, where the shares are held by a trust of partnership, a similarly simple modified calculation under either s 360-30 (where the offset flows to 'members' of those entities) or s 360-35 (where it flows to a trustee).

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

The definition of 'tax offset' in s 995-1 does not help[122] and nor does the definition of 'paid' in s 6(1) of the ITAA36 (which only applies to the payment of 'dividends'). The provision in s 21 of that Act that 'Where, upon any transaction, any consideration is given otherwise than in cash, the money

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[117] ibid

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

[119] https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=4#For_investors accessed 11 January 2017

[120] https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/?page=2#Qualifying_as_an_early_stage_innovation_company accessed 11 January 2017

[121] Section 360-25

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

value of that consideration shall, for the purposes of this Act, be deemed to have been paid or given' would seem to indicate that the 'paid' requirement in s 360-25(1) could be satisfied by an in-kind 'payment' - and that, if it did, the normal valuation rules would apply,[123] and the taxpayer would bear the onus of justifying any valuation that was adopted.[124] Further, because Part IVA has also been amended to ensure that any wrongfully obtained scheme benefit involving an innovation tax offset can be cancelled, it, too, could provide the Commissioner with grounds to reverse any tax offset claimed on the basis of a spurious valuation.[125]

There is some further support for the contention that the term 'paid' would encompass in-kind payments in the CGT rules. Under s 110-25(2) ITAA97 the first element of the shares' cost base is the total of 'the money you paid' and 'the market value of any other property you gave, or are required to give' for them. Under s 360-50 if a capital gain is made on any disposal by an investor of shares issued by an ESIC within 12 months of their issue that capital gain is calculated under 'normal' Pt 3-1 rules – including the cost base rules in s 110-25; any disposal of them on or after the tenth anniversary of their issue will also be dealt with under 'normal' Pt 3-1 rules – modified, however, so that the first element of the shares' cost base, or reduced cost base, becomes their 'market value on that anniversary', instead of the figure that would normally be calculated under s 110-25(2).[126] Shares issued by ESICs are therefore affected by the s 110-25(2) valuation rules – including the stipulation that their cost base can include 'the market value' of in-kind 'payments'.

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

Two further problem areas arise in relation to:

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

'Sophisticated' investors are subject to an annual affiliate-inclusive tax offset cap. As already discussed, that cap includes not only the 'the sum of the offsets under this Subdivision for the income year for which you or your affiliates (if any) are entitled'[127] but also 'the sum of any tax offsets under this subdivision that you and your affiliates (if any) carry forward to the income year'.[128] Any potential offset exceeding the $200,000 cap cannot be applied in the income year in which the underlying investment was made. Nor can it be carried forward into a later income year and applied then; it is simply lost.[129]

The $200,000 tax offset cap is, arguably, too limiting because:

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[123] Together with the specific provisions in Subdivision 960-S of the ITAA97 relating to the calculation of 'market value'
[124] *Taxation Administration Act 1953* (Cth) ss 14ZZK(b) and 14ZZO(b)
[125] See, in particular, the new s 177F(1)(da) ITAA36 – though the Explanatory Memorandum says that 'These rules will apply to prevent taxpayers from being able to obtain tax benefits by entering into artificial or contrived schemes to access the TIFESI tax offset … or the ESVCLP tax offset' so, unless the in-kind payment was clearly part of a 'scheme' it is unlikely that Pt IVA would have any application.
[126] Section 360-50(5)
[127] Section 360-25(2)(a)
[128] Section 360-25(2)(b)
[129] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.47

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

The practical effect of the cap is therefore likely to be to limit the amount that any angel investor is prepared to invest in any income year (spread across all ESICs in which investments are made) to a maximum of $1 million – a consequence which seems to be inconsistent with the Subdivision's express object of encouraging new investment in small innovation companies (though, because the modified CGT treatment is not so restricted,[130] it is possible that the cap was inserted in the belief that, in appropriate cases, the modified CGT treatment could provide the necessary investment incentive, even in the absence of the tax offset,[131]something which only time will show).

'Other' (non-sophisticated) investors' do not qualify for the offset at all (and are therefore also denied the 'modified CGT treatment') if their investments in any income year, again across all ESICs in which they invest, exceeds $50,000. While the aim of the limit is laudable – to protect retail investors from themselves[132] - the $50,000 cap as an 'omnibus' limit is arguably too low (or the threshold for 'sophisticated investor' status is too high) given the wide variety of investors (with widely differing financial and other circumstances) to whom it will apply (all those not qualifying as 'sophisticated' investors under the Act).

The penalty for exceeding the limit, losing the entire benefit of the incentives, also appears to be disproportionately draconian. Limiting the available tax offset to $10,000 (20% of the permitted $50,000 investment amount) and not restricting the availability of the modified CGT treatment (ie effectively mimicking the treatment accorded 'sophisticated' investors) would seem to be a preferable solution – especially as the current restriction will also effectively put an onus on ESICs to exercise extreme care in what they include both in their promotional material and in their formal disclosures to potential investors.

Where the investment is made through a trust of partnership the tax offset does not apply at entity level but, instead, flows through to the 'members' of that entity[133] or, in the case of trusts, to the trustee – at least in cases where 'the trustee is liable to be assessed or has been assessed, and is liable to pay tax, on a share of, or all or a part of the trust's net income under s 98, 99 or 99A … '.[134] There are a number of possible problems with this treatment.

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[130] See the Note to s 360-50(1)
[131] A possibility hinted at in para 1.43 of the Explanatory Memorandum
[132] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* para 1.9
[133] Section 360-15(2)
[134] Section 360-15(2)

Firstly, except in those cases where the 'members' of the entity are 'entitled to a fixed proportion of any capital gain from a disposal were the disposal to happen in relation to the trust of partnership at the end of the income year'[135] (when each member's share of the offset must equal 'that fixed proportion'), each member's share is determined by the trustee or partnership.[136] This provision seems to allow trusts and partnerships to 'stream' the available offset to those 'members' of the entity who would derive most benefit from it. Given the offset's non-refundable nature, they are likely to be residents with significant taxable income (instead of non-residents with no, or limited, Australian source income and others with no, or a limited, taxable income). In other parts of the Act there are express anti-streaming provisions and it is unclear whether this was intentional or an unintended consequence. The consequences of that provision need to be further considered.

Second, the Explanatory Memorandum notes that if the trustee or partnership does not make a determination or does not allocate a part of the tax offset to a member then no-one is entitled to that amount of the tax offset.[137] It is doubtful whether this is an accurate statement of s 360-30(2)'s true effect - for four reasons:

a. that consequence is not expressly stated in the legislation;
b. the subsection is permissory, not mandatory, in nature;[138]
c. section 360-15(2) gives members of those entities an express entitlement to a tax offset 'if the trust or partnership would be entitled to a tax offset, under subsection (1), for the income year if the trust or partnership were an individual', and the statement in the Explanatory Memorandum appears, directly, to contradict that express entitlement; and
d. at least in the case of trusts where the trustee is liable to be assessed and pay tax and, so, is entitled to a tax offset[139] (equivalent to the difference between the total amount of the available offset and the amounts allocated to members under s 360-30[140]), the offset will be available to the trustee and, therefore, will not be lost, even if no allocation determination is made.

If the legislation was in fact intended to deny an offset if no determination is made (and notified to the affected members under s 360-40(4)), it would seems to impose an unnecessary (and unnecessarily punitive and potentially counter-productive) compliance burden on investors.[141] For that reason, if that consequence was intended it should be clearly stated in the legislation.

On the other hand, if, as is likely, the section is aimed simply at ensuring that a determination is not only made but made in a timely fashion (as seems to be indicated by the 'timing of notice' provisions in s 360-30(4), which include power for the Commissioner to extend the normal period of three months after the end of the income year within which notification is to occur - so members can

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

‘work out the amount of [their] tax offset’), that should be clarified (and the statement in the Explanatory Memorandum expressly retracted).

Third, where the trustee is entitled to a tax offset (because the trustee is liable to be assessed and to pay tax under s 98,[142] because there are presently entitled beneficiaries who are either under a legal disability[143] or non-residents[144]), there is a danger that the benefit of the tax offset might be inadvertently lost if a determination is not made under s 360-30 to allocate the offset to the relevant members and if, instead of the offset flowing to the members, it flows to the trustee under s 360-35.

This danger arises because, where the trustee pays tax under s 98 for a non-resident beneficiary that beneficiary is also liable to pay tax on that amount under 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, a refund of the difference.[145] The same tax treatment applies where the trustee pays tax in respect of the income share of a beneficiary who is under a legal disability – in cases where that beneficiary is ‘a beneficiary under more than one trust estate or derives income from any other source’.[146]

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

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

Where the investment is made through a company, there is no flow-through treatment: the company is entitled to the offset and can apply it to reduce its tax liability on its taxable income in that income year, or carry it forward. If it applies it to reduce its own tax liability that means that it will pay less tax (so will have more available cash to pay as dividends), but that also means that it will have fewer franking credits with which to frank those dividends. Its shareholders will therefore, potentially, have a greater tax liability on their dividends – and, overall, will 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 – and had been able to flow-through the tax offset to those shareholders (in a manner similar to that already applicable to trusts and partnerships). Realistically, the Subdivision is unlikely to be modified to permit that to happen but

[142] ITAA97 s 360-15(3)
[143] ITAA36 s 98(1)
[144] ITAA36 s 98(2A) and (3)
[145] ITAA36 s 98A(2)
[146] ITAA36 s 100(1) and (2)

the consequence of that not happening is that investors will need to consider, very carefully, whether they use a company as the vehicle through which to make their investment.

Problems with the Operation of the 'Modified CGT Treatment'.

Perhaps the greatest problem with the modified CGT treatment is that it requires the investor to 'disregard any capital loss it makes from any CGT event happening in relation to the share ... before the tenth anniversary of [its] issue'.[147] Given the known figures for failures by start-ups (and the associated probability that any start-up will fail), that requirement is likely to act as a very significant disincentive for investors. This is especially so given that there is no 'opt-out' provision. The modified CGT treatment applies 'if the issuing of a share gives rise to an entitlement to a tax offset under this Subdivision'[148] – it is not even restricted to instances where the entitlement is claimed. If the issue of shares 'gives rise to an entitlement' the modified tax offset applies.

If that is not bad enough, there are a number of other possible issues with the 'modified CGT treatment' provisions as they currently stand which potential investors will need to consider.

Firstly, unless one of the rollover provisions is triggered, the modified CGT treatment only applies to the entity to which the shares were originally issued. In most cases this will not be an issue but, where a disposal of shares within the first 10 years is involuntary, especially in the case of death, there is an argument for extending the modified CGT treatment to the beneficiaries of the investor's estate in a manner equivalent to the present extension of those modifications in cases involving a same-asset or replacement-asset rollover. Absent that, the beneficiaries will inherit the shares at the cost-base that would have applied to the testator at death,[149] will be subject to CGT on any capital gain that accrues thereafter and will lose both the exemption that would otherwise apply if they were to dispose of the shares before the tenth anniversary of the original acquisition and the modified cost base that would apply if that disposal occurred after that anniversary (though, on the positive side, they would also be entitled to any after-occurring capital loss).

Unless a rollover provision of that nature is inserted into the legislation investors, especially those who invest because of the potential for capital gain, and the availability of the associated CGT exemption, would be well advised to invest through an entity such as a trust, superannuation fund, or company, which is not affected by the problem of mortality.

Second, if the investment is made through a company or trust there are other possible problems with modified CGT treatment. For example, any capital gain made by the company on a disposal of the shares before the tenth anniversary of their issue would be disregarded but, when the company then sought to pass the benefits of that gain on to its shareholders, that payment would be taxable in their hands as a dividend.[150] Similarly, while a capital gain made by a trust would be disregarded, any distribution of the proceeds of disposal would potentially trigger ITAA97 s 104-70 (CGT event E4: Capital payment for trust interest') and result, ultimately, in a tax liability for the beneficiary (although the fact that the payment by the trustee must be 'in respect of your *interest in the trust*'

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[147] Section 360-50(3)
[148] Section 360-50(1)
[149] ITAA97 s 128-15
[150] ITAA36 s 44

would indicate that this might not apply to a discretionary trust).[151] Again, absent changes to provide for flow-through of the 'modified tax treatment' to shareholders and beneficiaries, investors will need to consider these consequences when they are choosing the vehicle through which to make their investments.[152]

Third, where there is a rollover of the shares under either Div 122 (wholly-owned company roll-overs) or Subdivision 124-M (scrip-for-scrip roll-overs), s 360-60 expressly does not apply. Instead, s 360-65 provides a completely separate modified tax treatment. Rather than any capital gain or loss on any subsequent disposal (ie after the rollover) being disregarded, the gain or loss is recognised for tax purposes, but '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'.[153]

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'.[154] The rule does achieve that objective but it also has a number of other potentially adverse practical consequences:

a. for an investor disposing of shares in a start-up to a wholly-owned company it means that the modified tax treatment that would otherwise have applied under s 360-50 terminates and any increase in the value of the shares thereafter will be dealt with on 'normal' tax principles (which, presumably) could also mean that any subsequent gain by the company could be on revenue account rather than on capital account (depending on the basis on which the company acquired the shares). The provision may have been inserted, for example, to remove the attractiveness of an investor investing initially to obtain the tax offset and, thereafter, transferring the shares to a wholly-owned company to give it the benefit of the CGT exemption. Whatever the reason, this practical limitation on tax-effective disposal of the shares to a wholly owned company means that an investor will need to consider very carefully which entity it chooses to acquire (and, subsequently, to hold) the shares in the first place;
b. the same problem also applies to scrip-for-scrip rollovers: the modified CGT treatment terminates. As a result, the rule is likely to make mergers by, or takeovers of, the ESIC (perhaps for legitimate commercial reasons, including scaling[155]) significantly less attractive. It also seems to be entirely inconsistent with the thinking underlying the treatment of the tax offset incentive, where the mere fact that an ESIC ceases to be an ESIC after the issue of shares does not affect the investor's continuing right to the offset and, therefore, to the modified tax treatment. Again, this is likely to be a practical disincentive to investors engaging in activity which, in the end result, is intended to promote attainment of the legislation's object.

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[151] See *Taxation Determination* TD 2003/28
[152] There are similar problems where the investment is made through a superannuation fund but, as distributions from superannuation funds can be timed to be tax-free the same issue do not arise.
[153] Section 360-65(1) (for 'normally' issued shares) and (2) (for shares that were previously subject to a same-asset rollover or a replacement-asset roll-over)
[154] Explanatory Memorandum, *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* Example 1.124
[155] Which the new Division specifically seeks to encourage: see, for example ss 360-10 and 360-40(1)(e)(iii)

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

Conclusion

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

How well it succeeds in its aim is yet to be seen however and it will be interesting to see what amendments, if any may be made as problems are identified, to enhance its attractiveness to investors and its potential for success.