Crowd-sourced Funding – Have the Taxation Consequences Been Thought Through?

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Introduction

The *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) was passed on 22 March 17, it received Royal Assent on 28 March 2017 and it commenced operation on 29 September 2017 (so crowd-sourced platforms were able to apply for a licence to allow them to accept CSF investments from small investors from that date). Under it, 'eligible CSF companies' are able to access crowd-sourced equity funding (CSF) provided they meet the threshold eligibility requirements, they pass both the 'assets test' and the 'turnover test', the amount they seek falls within the 'issuer cap', the funds are raised through a CSF intermediary and their 'CSF offer document' and 'CSF offer' both meet the requirements of the Act.

The Act has its origins in a reference to the Corporations and Markets Advisory Committee (CAMAC) in June 2013. That reference required CAMAC to consider CSF and whether it could be facilitated in Australia. CAMAC reported in June 2014, noting that while CSF had potentially significant benefits for both fund-raising companies and investors, there were major regulatory barriers to small businesses being able to use CSF as an effective means of fund-raising. These included the 50 non-employee member 'shareholder caps' that apply to proprietary companies, the *Corporations Act's* s 113(3) prohibition on proprietary companies making public offers of equity and the reporting and corporate governance requirements that public companies have to meet, which would, in many cases, make it uneconomic for small business to adopt that structure purely to fund-raise.

In the end result CAMAC recommended that CSF should be facilitated for small business in Australia but that a modified regulatory regime be introduced to allow it to occur in a cost-effective way.[1]

Treasury issued a Discussion Paper in December 2014 seeking submissions on three identified 'Policy Options' (the CAMAC Model, a 'Regulatory Framework Based on the New Zealand Model' and the Status Quo). In August 2015, following submissions, the government released an outline of its proposed framework. Legislation based on that framework[2] was introduced into parliament in December 2015[3] and passed the House of Representatives. It had not passed the Senate before the 2016 Federal Election was called, however, and it therefore lapsed.

A new Bill, largely replicating the 2015 Bill, though with modifications to the 'assets and turnover' tests and an increase in the cooling-off period from 48 hours to 5 days was introduced in 2016[4] and passed in March 2017. It inserts a new Part 6D.3A into the *Corporations Act 2010* (Cth) the object of which, as detailed in the new s 738A, is 'to provide a disclosure regime that can be used for certain offers of securities for issue in small unlisted companies, instead of complying with the requirements

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[1] Reducing the regulatory impediments to crowdfunding was also a specific recommendation of the Financial System Inquiry Final Report (Murray Inquiry) in November 2014. See Recommendation 18 (p 177). It was also supported by the Productivity Commission in both its Business Set-up, Transfer and Closure draft report (released in May 2015) and its final report (delivered to government in September 2015 and publically released in December 2015). See Recommendation 6.1 (final report p 150). The government's FinTech Statement (released in March 2016) also included CSF as a FinTech priority.
[2] *Corporations Amendment (Crowd-sourced Funding) Bill 2015* (Cth).
[3] It was also included as one of the measures that the government announced in the *National Innovation and Science Agenda* that it released on 7 December 2015 and which were included in the *Mid-year Economic and Fiscal Outlook 2015-16* released on 15 December that year.
[4] *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth).

of Part 6D.2'.[5] That is, those companies will be able to access concessions in relation to holding AGMs, reporting to shareholders and appointing auditors that are not generally available to public companies.

The aim of the new regime, as detailed in the Explanatory Memorandum was to 'provide an additional funding option for small businesses and start-ups in particular, that may otherwise struggle to obtain affordable finance'.[6] The Explanatory Memorandum also noted that '[f]acilitating CSF would also provide additional investment opportunities to retail investors, who are generally unable to gain direct access to early-stage financing activities'.[7]

What is Crowd-sourced funding?

Crowd-sourced funding typically involves raising funds from a (normally) large number of small contributors to provide finance for some specific objective.[8]

One of the earliest modern examples of crowd-sourced funding was its use, in the US, to finance the erection of the Statue of Liberty on Liberty Island in New York harbor. While the French had donated the statue itself, the Americans were required to provide the site and build the pedestal. In 1885 the statue had been delivered and was awaiting assembly in New York but the city had not been able to raise the entire $250,000 that was needed to finance the granite pedestal on which it was to stand. The then Governor, Grover Cleveland, refused to use city funds to meet the shortfall and Congress was unable to agree on an alternative source of funds. Other cities (notably Boston, Philadelphia, Baltimore and San Francisco) were hovering, offering themselves as alternative locations. To counter that threat, Joseph Pulitzer, the publisher of the *New York World,* launched a fundraising campaign through his newspaper, publishing the names of every donor and the amounts they donated as a practical incentive. Within five months he had raised $101,091 from over 160,000 donors, each of whom donated, on average, less than $1, but more than enough, collectively, to cover the shortfall.

Types of Crowd-sourced Funding.

There are four types (or models) for crowd-sourced funding:

- Donation-based (funds are raised from donors who receive nothing in return, apart from, perhaps, some acknowledgement of their donation – as was the case with Pulitzer's fund-raising for the Statue of Liberty);
- Reward-based (funds are raised from contributors who receive some form of reward in the form of goods, services or rights – perhaps rights to a future discount – in exchange for their contribution. Typically, the rewards are graduated - with higher rewards, for greater contributions. The rewards may also be contingent on the fundraising reaching identified minimum levels);
- Equity-based (funds are raised from contributors in exchange for a share - or other equity interest - in the fundraising entity. That gives them the normal rights of share-ownership, including the right to participate in future dividends, the right to vote in company meetings and the right to participate in a distribution of surplus capital on winding-up);

[5] *Corporations Act 2010* (Cth) s 738A – inserted by *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth), s 14.
[6] Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), para 1.6.
[7] ibid, para 1.8.
[8] Ibid, para 1.5.

- Debt-based (funds are raised from contributors who lend money to the promoters in exchange for agreed interest payments for the life of the loan and a promise of repayment on maturity – which can be with or without a premium for the risk).

Background to the Australian CSF provisions.

Crowd-sourced equity funding schemes currently exist in a number of other countries including the US, the UK, Canada and NZ[9]. In general, they seem to be less restrictive in their application than the new Australian model[10] though at least some of the Australian provisions have been modelled on, in particular, the equivalent New Zealand provisions.

Crowd-sourced equity funding is less popular in the EU – though France, Germany and the Netherlands all have country-based regimes, none of which have been used raise large amounts of equity funding.[11] Italy also introduced a new crowd-funding regime in 2013 which was initially restricted to 'innovative start-ups' but which was extended to 'innovative small to medium enterprises' in 2015, a change which seems to have had a very limited (if any) effect. On the evidence to date it has not been particularly successful in allowing its target companies to raise significant sums effectively.

Crowd-sourced Funding Covered by the New Legislation

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

How the New Regime Works

Provided the entity seeking to raise funds qualifies as an 'eligible CSF company' and its offer is a 'CSF offer' (ie one that is 'eligible to be made' under the new provisions and is 'expressed to be made' under them[12]), it can access the regime[13] – and Part 6D.2 (which contains the general rules regarding when disclosure is required for offers of securities) and Part 6D.3 (which deals with the prohibitions, liabilities and remedies that normally apply to offers of securities that require disclosure) do not apply to its 'CSF offers' (unless there is specific provision under which they continue to apply to those offers)[14].

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[9] In the first 12 months of the NZ scheme 20 innovation companies raised over $12 million using CSEF.

[10] In the US the *Jumpstart Our Business Startups Act 2012* (US) provides two exceptions to the standard prohibition preventing the issuers of private securities from 'advertising their offerings or generally solicit investors' – Rule 506(b) allows and unlimited number of 'accredited investors' and up to 35 'non-accredited investors' to invest via an CSEF, though the prohibition on general solicitation still applies. Rule 506(c) removes the prohibition on general solicitation but, importantly, does so in relation to 'accredited investors' only

[11] Crowdfunding in Europe – Introduction and State of Play. EU Parliament Briefing January 2017.

[12] *Corporations Act 2010* (Cth), s 738B.

[13] ibid, s 738G.

[14] ibid, ss 703B, 704 and 706 (in relation to Part 6D.2) and s 725A (in relation to Part 6D.3). The new s 738E does, however, also provide that the fact that a company makes a CSF offer of securities does not prevent it from also making an offer of securities of the same class in reliance on a provision of s 708. Consequently, a company could make a CSF offer to crowd investors and, at the same time, also make an offer to investors for

To qualify as an 'eligible CSF company' the entity must:[15]

- be a public company limited by shares;[16]
- have its principal place of business in Australia;
- have a majority of its directors resident in Australia;
- comply with the assets and turnover test;
- not be a listed corporation (neither the company nor any related party of the company);[17]
- not have a substantial purpose of investing in securities or interests in other entities or managed investment schemes (neither the company nor any related company).

The 'asset and turnover test' is satisfied if, at the 'test time', the value of the consolidated gross assets of the company and all of its related entities is less than $25 million (or, if the regulations specify a different amount, that amount) - and the consolidated annual revenue of the company and all of its related parties for the 12 month period immediately prior to the company determining its eligibility to crowd-fund,[18] is less than $25 million (or, if the regulations specify a different amount, that amount).[19]

Offers can also only be made by existing companies. Offers cannot be made to companies that have not yet been formed or which do not exist.[20]An offer will be 'eligible to be made under this Part' if and only if:

- it is an offer by the company for the issue of securities of the company;[21]
- the company is an 'eligible CSF company' when the offer is made;
- the securities are of a class specified in the regulations (under the current provisions they must be fully paid ordinary shares[22] - but the fact that that requirement is merely provided for in the current regulations, it could readily be changed if it were found to be unnecessarily restrictive[23]);

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whom disclosure is not required – such as venture capital funds and angel investors: see Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), para 2.7.

[15] *Corporations Act 2010* (Cth), s 738H(1).

[16] To be eligible for the regimes limited governance requirements the company must be either a registered as a public company limited by shares or be converted from a proprietary company to a public company limited by shares: s 738ZI. While already existing public companies (who are therefore already covered by the more stringent governance requirements) may be able to make a CSF offer cannot escape their existing corporate governance and reporting requirements by fund-raising under the new provisions. They will therefore not be eligible for the concession new or converted public companies can: Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), para 7.20.

[17] Listed companies are excluded because they have already 'demonstrated an ability to bear the costs of compliance requirements associated with listing on a public market' and because they 'generally have access to other forms of equity raisings because of their listing and continuously disclosing status, such as rights issues and share purchase plans': Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), para 2.27 .

[18] Companies that have been in existence for less than 12 months will still be able to crowd-fund so long as their consolidated annual revenue for the period that they have been on foot is under $25 million: Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), para 2.25.

[19] *Corporations Act 2010* (Cth), s 738H(2).

[20] ibid, s 738ZF.

[21] The offer can only be for an initial issue of securities, not for a subsequent sale: see Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), para 2.12.

[22] *Corporations Amendment (Crowd-sourced Funding) Regulations 2017* (Cth), Reg 6D.3A.01(1).

[23] Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), paras 2.31-2.34.

- the offer complies with the 'issuer cap'; and
- the company does not intend that the funds raised will be used either by itself or by a related party, to invest in securities or interests in other entities or schemes.[24]

The 'issuer cap' is $5 million or, if the regulations specify a different amount, that amount. That $5 million is the maximum that the company can raise in a single year and includes not only the maximum amount that it intends to raise in the current offer but also any amounts that it, or a related party, raised through both other CSF offers, and all other amounts that were raised in circumstances where ss 708(1) or (10) did not require disclosure, within the immediately preceding 12 months.

A company (and its related parties) can also only have one CSF offer open at a time.[25]

The Offer

The offer must be contained in a 'CSF offer document' which *must* contain the information required by the regulations and which *may* set out the CSF offer.[26] In both cases it 'must be worded and presented in a clear, concise and effective manner'.[27]

Amongst other things, the CSF offer must set out both the 'maximum subscription amount' and the 'minimum subscription amount' being sought through the offer.[28]

The CSF offer document must then be published and it is here that the role of the 'CSF intermediary' comes into play. The CSF offer can only be made[29] by publishing it 'on a platform of a single CSF intermediary'[30] – defined as 'a financial services licensee whose licence expressly authorises the licensee to provide a crowdfunding service'.[31]

Role of the CSF Intermediary

The CSF intermediary has a number of defined roles in the CSF process, all of which are aimed at protecting investors. First, the CSF intermediary has a defined statutory 'gatekeeper' role[32] and must not publish a CSF offer document unless it has first conducted the checks required by the regulations[33] and is satisfied as to the identity and bona fides of the company making the offer and

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[24] *Corporations Act 2010* (Cth), s 738G(1).
[25] ibid, s 738R.
[26] ibid, s 738J(1). If the CSF offer document does not contain the CSF offer, that offer must be published together with the CSF offer document – see s 738L(1).
[27] ibid, s 738K.
[28] Defined in *Corporations Act 2010* (Cth), s 738L(7) and (8) respectively.
[29] ibid, s 738L(3) provides that companies 'must not make the CSL offer otherwise than in accordance with [the requirement to make it through a CSF intermediary]'.
[30] ibid, s 738L(1). While advertising a CSF offer or intended CSF offer is generally prohibited – see s 738ZG(1) – that prohibition does not apply to publishing a CSF offer or a CSF offer document on a responsible intermediary's platform: see s 738ZG(2).
[31] ibid, s 738C. Depending on the nature of the activities in which the CSF intermediary engages it 'could also be considered to be operating a financial market and therefore be required to hold an Australian Market Licence (AML)': Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), para 3.8. The Minister has power under s 791C to exempt operators from the requirement to hold an AML.
[32] ibid, s 738Q.
[33] ibid, s 738Q(1).

its directors and officers and that the offer is eligible to be made under Part 6D.3A and is not misleading or deceptive.[34]

Secondly, the responsible intermediary must ensure that 'the general CSF risk warning' appears prominently on the offer platform at all times while the offer is open or suspended.[35] The risk warning is a statement in terms prescribed by the regulations.[36]

The responsible entity must also ensure that an 'application facility' (a facility for investors to make an application under the offer) is available at all times when the offer is open,[37] that any application made otherwise than through that facility is rejected[38] and that a 'communication facility' be provided through which potential investors can make posts related to the offer, see posts made by others and ask questions about the offer – and through which it or the company can make posts or respond to questions or posts.[39]

It must also ensure that statements drawing investors' attention to their rights to withdraw applications during the cooling off period[40] and the process by which that can be done, appear prominently on the platform.[41] The fees the intermediary charges the company and details of any pecuniary interest that the intermediary has or expects to acquire in either the company or a related party must also appear prominently on the platform.[42]

Finally, the arrangement between the company and the CSF intermediary (the 'hosting arrangement') must require that all applications that are made in response to the offer, and all application money in respect of those applications, be sent or paid to the intermediary and be then dealt with by the intermediary in accordance with the provisions of the Part.[43]

The CSF offer remains 'open' until it is 'closed'.[44] It opens when it is first published on the responsible intermediary's platform and it closes when the responsible intermediary closes it – which must be as soon as practicable after the first of: a period of three months after the offer opens, the specified end date for the offer, when the intermediary considers that the offer is fully subscribed, the company notified the responsible intermediary that it wants the offer withdrawn or the Act prohibits the continued publication of the CSF offer document.[45]

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[34] ibid, s 738Q(5).
[35] ibid, s 738ZA(1). The detailed wording of the risk warning is set out in Regulation 6D.3A.03.
[36] ibid, s 738ZA(2).
[37] ibid, s 738ZA(3).
[38] ibid, s 738ZA(4).
[39] ibid, s 738ZA(5). The intent is that investors will be able to 'rely on the collective wisdom of the "crowd" in making their investment decision': Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), para 3.64.
[40] Investors may withdraw their application within 5 business days of making it: *Corporations Act 2010* (Cth), s 738ZD.
[41] *Corporations Act 2010* (Cth), s 738ZA(8).
[42] ibid, s 738ZA(9).
[43] ibid, s 738L(2). The responsible entities' obligations in relation to application money are set out in s 738ZB. It provides that the general obligation in Subdiv A of Div 2 of Part 7.8 of the *Corporations Act 2010* (Cth) continue to apply – with some modifications provided for in that section.
[44] ibid, s 738N(1), (2) and (3).
[45] ibid, s 738N(4).

Accepting the Offer

In addition to requiring that all applications be made through the responsible intermediary the new provisions also provide a number of additional protections for investors.

First, individual 'retail clients'[46] are limited to investing a maximum of $10,000 in CSF offers by the same company in any period of 12 months. Applications exceeding that amount must be rejected by the responsible intermediary.[47] Further, neither the company, nor any related party nor the responsible intermediary may provide financial assistance to allow that investor to make the investment.[48]

Availability of the new Regime

The new CSF regime is currently only available to unlisted public companies limited by shares with less than $25 million in both gross assets and annual revenue – so all proprietary and many public companies are automatically excluded (ie about 99.7% of all Australian companies are excluded[49]). There is however currently proposed legislation which would extend the regime to proprietary companies.

The Regulatory Concessions

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

- modified disclosure obligations in the CSEF offer document; and
- an exemption from the requirement to hold an AGM;
- an option to provide reports to shareholders by merely making them available online; and
- an exemption from the requirement to appoint an auditor until the company has raised at least $1 million[50] from CSF offers;

for a concession period of up to a maximum of five years.

Problems with Current 'Public Company' Requirement: The initial requirement that only unlisted public companies could access CSF is a problem because, even though the new legislation exempts them from some of the standard public company regulatory obligations (reduced disclosure obligations for their offers, an exemption from the requirement to hold an AGM, an option to provide reports to shareholders simply by making them available online, and an exemption from the requirement to appoint an auditor until the company had raised at least $1 million from its CSF

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[46] Defined in ibid s 738D as 'a person who is a retail client for the purposes of Chapter 7 in relation to a crowd-funding service that relates to a particular CSF offer'. Chapter 7 provides that financial service or products with be provided to a person as a retail client unless the exclusions in ss 761G(5)-(7) ('wholesale clients') or 761GA ('sophisticated investors') apply to them.

[47] ibid, s 738ZC(1).

[48] ibid, s 738ZE.

[49] Marina Nehme,' Australia finally has crowd-sourced equity funding, but there's more to do'. The Conversation 22 March 2017.

[50] Under the *Corporations Amendment (Crowd-source Funding for Proprietary Companies) Bill 2017* (Cth) the audit threshold is to be raised from $1 million to $3million to align it with the audit threshold being proposed for proprietary companies that raise funds through CSEF.

offers) these exemptions only applied for a maximum five year concession period starting after they had completed 'a successful CSF round[51]. This had a number of negative effects:

a. if a small business (including a start-up) wants to raise capital through CSF it has either to register as or, (if it was already registered as a proprietary company) convert to a public company to be eligible to do so;
b. as the concessions only last for a maximum of 5 years the small business (especially if it is a start-up) will need to consider where it will be at the end of the concession period. The risk is that, having registered as a public company to attract initial capital, it could be left with a structure that is not really appropriate for its business (especially if it does not achieve the sort of scale that would justify such a structure) – and the compliance burdens that are associated with that structure;
c. it limits the type (and therefore the number) of companies that can use the new rules to raise capital (and therefore the number of crowd-sourced platforms that can expect to operate profitably as commercially-successful businesses – leading to the probability of reduced competition[52] and, probably, increased costs for the capital raising company);
d. the effect of the concessions is to deny investors the ability to control their risk. In particular, the absence of audit and AGM requirements means that investors may find it difficult to identify and react to problems (by, for example, changing the board, changing the company's direction or even, in extreme case, winding it up);
e. the fact that the company is unlisted raises an additional problem in that 'bailing out' is difficult and shareholders wanting or needing to extract their investment may find it difficult (or even impossible) to sell their shares.

Solving Some of the Problems – Extending the Regime to Proprietary Companies

Even in his Second reading Speech for the 2016 Bill (introducing the present CSF regime) the Treasurer referred to the possibility of extending it to proprietary companies – noting that a consultation paper on that possibility had been released in 2015 and that the government was continuing to consult on how it might work. The problem is, of course, that proprietary companies are generally prohibited from offering shares to the general public.

In the 2017 Budget the Treasurer announced that the crowd-sourced equity funding regime would be extended to proprietary companies to allow a greater number of innovative companies and start-ups to access crowd-sourced funding. Draft legislation was released in May 2017 and legislation to give effect to that announcement was introduced into parliament on 14 September 2017.[53]

Under the proposed legislation proprietary companies that meet the requirements of the proposed Act[54] will be allowed to have an unlimited number of crowd-sourced funding shareholders but, in exchange, will have to meet higher governance reporting obligations. In particular, they will have to prepare financial reports in accordance with accounting standards (whether or not they are 'large proprietary companies' – the only proprietary

[51] See Explanatory Memorandum to the *Corporations Amendment (Crowd-source Funding) Bill 2016* [paras [7.8], 7.25] and [7.31].
[52] In Italy where the availability CSEF is restricted only one CSF intermediary currently exists. Similarly, in NZ a number of intermediaries were established initially some have already withdrawn from the field – see Marina Nehme n 1 above.
[53] *Corporations Amendment (Crowd-source Funding for Proprietary Companies) Bill 2017* (Cth).
[54] To qualify, a proprietary company will be required to have a minimum of two directors, will be subject to the restrictions on related party transactions that are provided for in Part 2 of the *Corporations Act 2010* (Cth).

companies that are currently subject to that requirement), will be required to have those statements audited (at least after it raises more than $3 million from CSF offers), will be required to record details of CSF offers and CSF shareholders and will also be required to report any changes to ASIC.

If they qualify, the process for them is very similar to that which presently applies to public companies. In particular, the location, assets and turnover tests, issuer cap, investor cap, offer requirements, CSF intermediary requirements (and obligations), communication facility requirements, cooling off rights, prohibitions on financial assistance and advertising restrictions are all the same for both types of company.

One change that will be made is that, once the new legislation is passed, the temporary concessions (those presently applicable to AGMs, reporting and audit that can extend for up to 5 years from the completion of a successful CSF raising) that are available to public companies that are registered and proprietary companies that convert to public companies under the current legislation will be removed – subject to a grandfathering of those arrangements for companies that registered or converted to public companies prior to the commencement of the extension of the regime to proprietary companies.

Taxation Considerations

The new crowd-sourced funding regime is merely the last in a long line of measures which have been introduced to assist innovation-based enterprises, especially in their start-up phase.

The first of the more modern measures can be seen in the provisions of the *Venture Capital Act 2002* (Cth) (and the associated amendments to the Commonwealth's taxation legislation and the individual state and territory Partnership Acts) which were introduced to facilitate non-resident investment in the Australian venture capital industry.[55] Tax incentives were provided for 'early venture capital investments' (ECVIs) that were made through Venture Capital Limited Partnerships (VCLPs), Early Stage Venture Capital Limited Partnerships (ESVCLPs) or Australian Venture Capital Funds of Funds (AFOF).

The available incentives, which are all still available, 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.[56]

An R&D Tax Offset is also available under Div 355 (jointly administered by AusIndustry and the ATO[57]) which replaced the formerly available 'R&D Tax Concession' with effect 1 July 2011. Div 355 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.

[55] 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.
[56] Though losses on both capital and revenue account are also disregarded.
[57] 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.

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 the same worldwide 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.[58] Since 2014, however, those offsets have been limited to the first $100m of the R&D entity's eligible R&D expenditure for that year. A separate offset equal to the company tax rate is available for expenditure over $100m.

The offsets are 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, after which the net effect of the lesser offset is, effectively, to provide an immediate write-off for that additional expenditure.

To assist start-ups to attract staff, Div 83A of the ITAA97 was amended in 2015, 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 assist them to attract the best available talent to their enterprises.

Since 1 July 2015 start-up companies, partnerships and trusts can also take advantage of an immediate write-off, under s 40-880(2A) of the ITAA97, for the capital expenditure that they, as 'small business entities' (defined in ITAA97 s 328-110), incur either in obtaining advice or services relating to the proposed structure or proposed operation of the business or in paying an Australian government agency fees, taxes or charges relating to establishing either the business itself or its operating structure. This does not allow them to immediately write-off all set-up expenditure[59] but many of those other expenses may be deductible over 5 years under other provisions in s 40-880.

The most recent set of concessions for start-ups are the 'tax incentives for early stage investors ('TIFESI') which were introduced by the *Tax Laws (Tax Incentives for Innovation) Act 2016* (Cth). That Act inserted a new Subdivision 360-A into the ITAA97 to augment the other already existing measures, especially those applicable to the venture capital industry.

The intent was to provide tax incentives which would encourage 'angel investors' to invest capital at an earlier stage than that at which venture capital funds are typically willing to provide funding.[60] The new measures were therefore specifically aimed at providing tax incentives which would make it easier for 'Early Stage Innovation Companies' (ESICs) 'to

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

[59] 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 to assess locations for a business) and expenditure relating to taxes of general application (such as income tax) are not included.

[60] Paragraph 1.4 of the Explanatory Memorandum to the *Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016* noted, in particular, that '[venture capital funds] 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.

attract seed and pre-commercialisation equity at an earlier stage of their development'[61] – specifically to get their innovations from the concept to the commercialisation stage.[62]

They did that by offering 'early stage investors' in those companies both a tax offset and a 'modified CGT treatment' for their investments. They also sought to make it easier for ESICs to access venture capital investment for the next phase of the company's development by enhancing the attractiveness of those regimes.[63] The avowed intent, in both cases, was to support innovation, risk-taking and an entrepreneurial culture.

The tax offset that 'angel investors' can access 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 'non-sophisticated' investors, 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 ESICs 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.[64] For investments in ESICs that concession is not limited to shares within the $200,000 maximum tax offset cap though, to ensure that investments are not made and then withdrawn before the company can benefit from them, any capital losses that are realised on shares that have been held for less than 10 years are also disregarded.

Those incentives are available provided three conditions 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.

There are a number of problems with the application of Subdivision 360-A in a practical sense[65] but some of those have already been addressed[66] and, in general, the Subdivision's provisions do seem

[61] Ibid.

[62] The TIFESI do not apply at the concept stage because, before a company can be classified as an ESIC under s 360-40 it must, inter alia, 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).

[63] 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, they increase the maximum fund size for ESVCLPs from $100 million to $200 million, they 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 they allow 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.

[64] 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).

[65] Those problems are dealt with in detail in Stephen Graw, 'Encouraging Innovation – The Tax Laws Amendment (Tax Incentives for Innovation) Act 2016' (Paper presented at the ATTA Conference, Masterton, 18-20 January 2017.

[66] See, in particular, *Treasury Laws Amendment (2017 Measures No. 1) Act 2017* (Cth) Schedule 1.

to be at least an adequate start point to respond to the problems that ESICs have in attracting early stage investment.

The Role of 'Risk' in the Rationale for Tax Incentives

It is clear that 'risk' has been a significant factor in the government's decisions to provide tax incentives for particular types of investment in innovation. That was particularly (and clearly) the case with the tax incentives for early stage investors (TIFESI) that were introduced in 2016. As the Treasurer noted in his Second Reading Speech, the aim of the *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* (Cth) was, specifically, to 'foster a shift towards a culture of innovation, whereby entrepreneurial risk-taking is encouraged and rewarded'.

That approach was eminently justified because providing finance to innovative start-ups is inherently risky. It is estimated that more than 98% of all innovation attempts end in failure[67] (with about 90% failing before they reach the market and about 90% of those that do reach the market also failing)[68].

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. 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,'[69] 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 innovation in Australian businesses.[70] The seriousness of the problem is reflected in the *Startup Muster* 2017 report which reported that, in 2017, while 22.3% had tried to raise funds and had raised as much as they were seeking, 10% had tried but had not raised as much as they were seeking and 5.8% had tried but had not been able to raise any funding at all, 42.8% of all startups had never tried to raise funding at all. For startups overall, only 34.2% had equity held by investors.[71]

Therefore, anything which encourages investors to support innovation is to be welcomed – particularly in the period between the initial stage of the business's life-cycle (where finance is normally provided through self-funding, family, friends and, potentially, through government

[67] 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).
[68] 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.
[69] 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.
[70] 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'.
[71] Available at https://www.startupmuster.com/. These figures were an improvement on results from earlier years where startups had reported much worse outcomes.

support and/or tax incentives - such as those discussed above),[72] 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.

So where does crowd-sourced funding fit in? Clearly the government's intent was that it would facilitate the raising of finance in the initial stages of the company's existence (as evidenced by the fact that, to qualify for the governance and reporting concessions, the company registering as, or converting to, a public company had, both, to state in its application that it intends to make a CSF offer after registration or conversion and must then complete a CSF offer within 12 months[73]).

Therefore, as with the venture capital and, in particular, the more recent ESIC tax regimes it might have been expected that there would be significant tax concessions attached to CSF investments.

After all, the Explanatory Memorandum to the new Act specifically noted that 'start-ups generally present higher risks for investors compared to larger, more established companies [and] CSF investments may be largely illiquid reducing the ability of investors to exit their investment'.[74]

The 'risk statement' that s 738ZA(1) requires CSF intermediaries to publish ***prominently*** on its offer platform – the detailed wording of which is set out in Regulation 6D.3A.03 also specifically states, in part):

> Crowd-sourced funding is risky. Issuers using this facility include new or rapidly growing ventures. Investment in these types of ventures is speculative and carries high risks.
>
> You may lose your entire investment, and you should be in a position to bear this risk without undue hardship.
>
> Even if the company is successful, the value of your investment and any return on the investment could be reduced if the company issues more shares.
>
> Your investment is unlikely to be liquid. This means you are unlikely to be able to sell your shares quickly or at all if you need the money or decide that this investment is not right for you.
>
> Even though you have remedies for misleading statements in the offer document or misconduct by the company, you may have difficulty recovering your money.
> …

ASIC also specifically warns on its website (in 'MoneySmart') that, because the businesses that raise money through CSEF 'are new or in the early stages of development … there's more risk that the business will be unsuccessful and you may lose all the money you invested'. It also specifically notes that because of the nature of the company structures involved '[y]our investment is also unlikely to be 'liquid', so if you decide you need the money you've invested, you may not be able to sell your shares quickly, or at all'.

[72] See, for example, figures on sources of funding for startups in 2017 in 'Startup Muster 2017' available at https://www.startupmuster.com/.
[73] *Corporations Act 2010* (Cth) s 738ZI.
[74] Explanatory Memorandum to the *Corporations Amendment (Crowd-sourced Funding) Bill 2016* (Cth), para 1.8.

Taxation and the New CSF Regime

Surprisingly, there are *no* taxation incentives attached to the new CSF regime. Investment transactions under it will be taxed exactly as if the funds were raised by a normal issue of shares.[75]

What this means is that, for companies using CSF to raise funds, the funds they raise will not be income but simply part of the company's share capital. There are therefore no income tax consequences for the receiving company at that stage. Use of those funds for non-capital business purposes will give rise to deductions which they can then offset against current or future income and, even if the funds are used for capital expenditure, an immediate or accelerated write-off under s 40-880 ITAA97 may be available. If the funds are used for eligible R&D expenditure then a self-assessed tax offset may be available under Div 355 ITAA97, in lieu of a deduction.

For the CSF intermediary, the fees that they receive for providing the CSF offer platform will be income from carrying on a business and therefore taxable in full. The fees that they pay to acquire and maintain their AFSL and AML licences in order to provide crowd-source funding services will, of course, be deductible, as will all other non-capital expenses they incur in carrying on their crowd-sourced funding intermediary business. Capital expenses may give rise to depreciation deductions under Div 40 (including, if they are 'small business entities', the immediate or accelerated write-offs that are available under s 40-880).

For contributors, the investments they make will not be immediately deductible (being outgoings of capital or of a capital nature) but, if the shares they receive are subsequently disposed of, any profit will be taxable (as either a capital gain, as a gain on disposal of a revenue asset or as ordinary income, depending on how the shares were acquired and held). Any loss will also be treated as either a capital loss to be dealt with under s 102-10 ITAA97 or as a loss on income account to be deducted under s 8-1 ITAA97 (again depending on how the shares were acquired and held). Any return that they get on their investment in the way of dividends will, of course, be taxable as ordinary income.

There may also be GST consequences.[76] The supply of shares itself is an input taxed financial supply and is therefore not subject to GST (so the investor receives no input credits). The services that the CSF intermediary supplies to the company are, however, a taxable supply and, provided the intermediary is carrying on an enterprise, is registered or required to be registered for GST, provides the services for consideration and the services are connected to Australia (as they will be because of the eligibility requirements for CSF offers), they will be subject to GST. Input tax credits are not normally available for acquisitions that relate to the making of input taxed supplies unless certain circumstances exist. Whether the company will be entitled to input credits will therefore depend on whether the provision of the intermediary's services falls within the accepted circumstances (mainly the *de minimis* exception under s 11-15(4) or the 'reduced credit acquisitions' detailed in Reg 70-5.02).

Will the Absence of Tax Concessions be a 'Deal Breaker'?

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

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[75] For the ATO view see https://www.ato.gov.au/individuals/income-and-deductions/income-you-must-declare/crowdfunding/.

[76] For the ATO view see https://www.ato.gov.au/Business/GST/In-detail/Rules-for-specific-transactions/GST-and-crowdfunding/.

The most obvious difference is in relation to the types of investors and the amounts that they are likely to invest. There is no legislated minimum investment for CSF offers but there is an 'issuer cap' that limits the total amount that individual companies (and any related parties) can raise under the CSF regime in any 12 month period to a maximum of $5 million.[77] There is also a $10,000 'investor cap' on the amount that an individual retail client can invest in all CSF offers made by the same company in any 12 month period (and, under s 738ZC(1) a responsible intermediary *must reject* an application made by a retail client if it would breach that cap).

That provision does not apply to sophisticated and/or professional investors - though offers to them are already exempt from disclosure under ss 708(8) and 708(11) and it is more likely that companies would seek investments from those investors under the general fund-raising provisions rather than the CSF regime – especially as those other investments are not counted towards the $5 million issuer cap,[78] which can then remain intact for bona fide small retail 'mum and dad' investors.

Individual investments are therefore likely to be small and the people who make them are less likely to be concerned about possible tax concessions than the potential for anticipated gains (or be motivated to assist family or friends who are behind the company seeking the funds – albeit with a desire to protect their investment by acquiring equity rather than simply providing 'loan' funds).

The lack of tax 'concessions' such as those applicable to investors in ESICs may also operate in favour of CSF investors. One of the problems with the ESIC concessions was that in some instances they either did not apply or, alternatively, if they did, they could operate against the interests of the investors who were intended to benefit from them.

First, there was the requirement that the company in which those investors were investing had to qualify as an 'early stage innovation company' immediately after the shares were issued. The particular problem was that it had to be genuinely involved in innovation – something that the company had to self-assess using either a highly subjective 'principles-based test' or a more objective '100-point innovation test'. If the company erred for some reason the investor lost the entitlement to both the tax offset and the modified CGT treatment. There is no such risk for either investors or the issuing company under the CSF regime. The requirements for a company to be eligible for the limited governance requirements, as they are stated in s 738ZI, are straightforward and compliance (or non-compliance) can be simply determined. If the company makes an error the only risk for investors is the indirect risk that the company may have to expend part of the funds it raises on the compliance activities from which it had thought it was exempt - and that may affect the financial viability of its ongoing operations (and perhaps necessitate further fund-raising).

[77] *Corporations Act 2010* (Cth) s 738G(2).

[78] The only offers that are exempt from disclosure under s 708 that do count towards the $5 million issuer cap are 'small scale personal offers' under s 708(1) and offers made under s 708(10) via an Australian Financial Services licensee where the licensee is satisfied on reasonable grounds that the person to whom the offer is made has previous experience in investing that allows them to assess the merits and risks of the current offer (because the investors to which those offers are made are likely to be similar to 'crowd' investors – so it is appropriate to include those capital raising within the $5 million 'issuer cap' to ensure that it is not artificially inflated by those other capital raisings from, effectively, the same group of investors).

Secondly, there was the requirement that the shares issued by the company had to be eligible for the tax incentives. Technically though, it is not the shares that qualify for the tax incentives, it is the investor and the investor only qualifies if the relevant issue meets each of the criteria detailed in ss 360-15(1)(b)-(f). Worse, the onus of ensuring that the company is in fact an ESIC at the required time rests with the investor and, if the company does not qualify as an ESIC, the investor is not entitled to the offset. The problem is that each of those things relate to matters which are not within the shareholders' control and they therefore have to rely entirely on the company 'getting them right'.

Thirdly, 'non-sophisticated' investors are limited to investing $50,000 or less, in total, in all ESICs in which they invest in any income year.[79] 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.[80] Worse, because they lose their entitlement to the tax offset they also lose their entitlement to the 'modified CGT treatment'.[81] Given that they are 'non-sophisticated' investors (a group likely to be largely co-extensive with the 'retail clients' in CSF issues) it is probable that they might not fully understand the problem, and inadvertently breach the cap.

Finally, the modified CGT treatment to which ESIC investors are entitled depends entirely on how long the shares have been held:

- If the shares have been 'continuously held' for less than 12 months from the date of issue before the relevant CGT event, any capital gain is assessed under normal principles[82] but any capital loss must be disregarded.[83]
- If the shares have been '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[84] – as is any capital loss.[85]
- 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.[86]

The major problem with the 'concessional' modified CGT treatment, especially given the statistics on the likelihood of start-ups failing, is the fact that the investor loses the potential benefit of any capital loss if the company fails (or the investor sells out to cut any possible losses) within the first 10 years of the company's life. This can have potentially draconian consequences, especially where the disposal is involuntary – as would be the case on death. Investors under the CSF regime may not get

[79] Section 360-20(1)(b).
[80] 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'.
[81] The modified CGT treatment only applies if the issuing of the share 'gives rise to an entitlement to a tax offset under this Subdivision': see s 360-50(1)
[82] 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)
[83] Section 360-50(3)
[84] Section 360-50(4)
[85] Section 360-50(3)
[86] Section 360-50(5)

the benefit of paying no CGT on gains that they realise on their shares – but they do get to keep the benefit of any capital loss that might be realised on disposal.

Conclusion

The introduction of the CSF regime seems to be a laudable addition to the already existing channels of funding that are available to small start-up companies. Whether the temporary corporate governance and compliance concessions (which are really to assist the company rather than the investors) will be enough to make such investments attractive to the small 'mum and dad' investors at whom they are aimed, or whether further tax or other incentives will be needed, is yet to be seen. The fact that the government has already demonstrated its willingness to be flexible (by introducing legislation to extend the CSF regime to proprietary companies) is a positive step which may see the introduction of appropriate taxation concessions if the take-up of such investments proves to be limited without them.