CROWD-SOURCED FUNDING – WAS TAX CONSIDERED?

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ABSTRACT

The *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) allows 'eligible CSF companies' to 'crowdfund', provided they meet the Act's threshold eligibility and other requirements. Unfortunately, as passed, the Act excludes all proprietary companies (and most public companies) from its operation, a defect that is being rectified, at least in part, by the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth). Unlike other measures that have been introduced to assist innovative start-ups, however, neither the 2017 Act nor the present Bill provide any taxation incentives for either investors or the company. Nor do they address any of the possible tax problems that may arise because of the reform. This paper considers both the reforms and those possible issues.

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I INTRODUCTION

The *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) was passed on 22 March 2017, received Royal Assent on 28 March 2017, and commenced operation on 29 September 2017 (the practical effect of which was that crowd-sourced platforms were able to apply for a licence[1] to allow them to accept 'CSF [crowd-sourced funding] investments' from small investors from that date[2]).

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

The Act 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 fundraising companies and investors, there were major regulatory barriers to small businesses using it as an effective means of fundraising.

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

The end result was that CAMAC recommended that CSF should be facilitated for small businesses in Australia, but that a modified regulatory regime should be introduced to allow it to occur in a cost-effective way.[3]

Treasury then issued a Discussion Paper in December 2014 seeking submissions on three identified 'Policy Options' (the CAMAC Model, a 'Regulatory Framework Based on the

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[1] Persons intending to operate a CSF platform are required to hold an Australian Financial Services Licence and may be required to hold an Australian Markets Licence: Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) para 3.4.

[2] The first CSF intermediaries (through which all CSF investment applications must be channelled) were only licensed on 11 January 2018 – nearly three and a half months after the Act came into force. See Australian Securities and Investments Commission (ASIC), Australian Government, *18-004MR ASIC Licenses First Crowd-Sourced Funding Intermediaries* (11 January 2018) <http://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-004mr-asic-licenses-first-crowd-sourced-funding-intermediaries>.

[3] Reducing the regulatory impediments to crowdfunding was also a specific recommendation of the 'Murray Inquiry': Treasury, Australian Government, *Financial System Inquiry: Final Report* (November 2014) Recommendation 18, 177. It was also supported by the Productivity Commission: Productivity Commission, Australian Government, *Business Set-up, Transfer and Closure: Draft Report* (21 May 2015); Productivity Commission, Australian Government, *Business Set-up, Transfer and Closure: Final Report* (7 December 2015) Recommendation 6.1, 150. The government also included CSF as a FinTech priority: Australian Government, *FinTech Statement* (21 March 2016) 18–19.

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[4] was introduced into Parliament in December 2015[5] and passed the House of Representatives. However, as it had not passed the Senate before the 2016 Federal Election was called, it 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[6] and passed in March 2017. It inserted a new pt 6D.3A into the *Corporations Act 2001* (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 of Part 6D.2'.[7]

That is, if their offers qualify for the modified disclosure regime, small unlisted public companies can access concessions in relation to not holding annual general meetings, only reporting to shareholders online, and not appointing auditors – concessions that are not generally available to public companies.

The aim of the new regime, as detailed in the Explanatory Memorandum, is to 'provide an additional funding option for small businesses and start-ups in particular, that may otherwise struggle to obtain affordable finance'.[8] 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'.[9]

II Crowd-Sourced Funding

A *What is crowd-sourced funding?*

CSF typically involves raising funds from a (normally) large number of small contributors to finance some specific objective.[10]

One of the earliest modern examples of CSF was its use to finance the erection of the Statue of Liberty in New York. While the French donated the statue itself, the Americans

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[4] Corporations Amendment (Crowd-sourced Funding) Bill 2015 (Cth).

[5] It was also included as one of the measures aimed at encouraging funding for start-ups that were announced in: Department of Education and Training, Australian Government, *National Innovation and Science Agenda* (7 December 2015); and included in: Australian Government, *Mid-Year Economic and Fiscal Outlook 2015–16* (15 December 2015). The others included providing tax breaks for early-stage investors in innovative start-ups (implemented in 2016 through the insertion of sub-div 360-A into the *Income Tax Assessment Act 1997* (Cth) (ITAA97)), and augmenting already-existing measures to encourage venture capital investment (implemented through the *Tax Laws Amendment (Tax Incentives for Innovation) Act 2016* (Cth) and the *Treasury Laws Amendment (2017 Measures No 1) Act 2017* (Cth)).

[6] Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth).

[7] *Corporations Act 2001* (Cth) s 738A, inserted by *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) s 14.

[8] Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) para 1.6.

[9] Ibid para 1.8.

[10] Ibid para 1.5.

were required to provide the site and build the pedestal on which it would be erected. In 1885 the statue had been delivered and was awaiting assembly, but New York City had not yet raised the entire US$250 000 that was needed to pay for the pedestal. The then Governor, Grover Cleveland, refused to use city funds to meet the shortfall and the United States Congress was unable to agree on an alternative source of funds. Other cities (notably Boston, Philadelphia, Baltimore and San Francisco) were actively circling, offering themselves as alternative locations. To prevent that happening, 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 raised US$101 091 from over 160 000 donors, each of whom donated, on average, less than US$1, but collectively that was more than enough to cover the shortfall.

A more recent well-known example was the Veronica Mars Movie Project, which was launched in March 2013 through 'Kickstarter' (a US 'Benefit Corporation' that runs a global crowdfunding platform 'to help bring creative projects to life'). It hoped to raise US$2 million to fund a movie-length continuation of the Veronica Mars television series and offered potential contributors a range of 'rewards' varying from a digital pdf copy of the movie script for a US$10 pledge to a small walk-on speaking part in the movie for a US$10 000 pledge (an offer taken up by one backer). It was spectacularly successful and raised the entire US$2 million that it had sought within 11 hours of opening. By the time it closed, exactly a month later, 91 585 fans had pledged a total of US$5 702 153.

Crowd-sourcing has also recently been extensively (and successfully) used to raise substantial funds for (especially) blockchain start-ups,[11] for companies involved in hardware,[12] software[13] and video game[14] development and for a range of other innovation projects.[15]

B *Types of CSF*

There are four models for CSF:

- 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 fundraising 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 offered are graduated, with higher rewards for greater contributions – as with the Veronica Mars Movie

[11] See, for example, Filecoin (US$257 million), EOS (US$185 million), The DAO (US$150 million), Polkadot (US$144 million), TenX (US$80 million) and BANKEX (US$70.6 million).
[12] See, for example, Coolest Cooler (US$13.3 million), Ubuntu Edge (US$12.8 million), PonoMusic (US$6.2 million), Micro Drone 3.0 (US$3.6 million) and The Dash (US$3.4 million).
[13] See, for example, Firstblood Crowdsale (US$6.3 million), Lisk (US$5.7 million), The Grid (US$5.5 million), and Mastercoin (US$5 million).
[14] See, for example, Star Citizen (US$181 million), Prison Architect (US$19 million), Shroud of the Avatar: Forsaken Virtues (US$12.6 million), Ouya (US$8.6 million) and Shanmue III (US$6.3 million).
[15] See, for example, ELIO Motors (US$102 million), Glowforge (US$28 million), Pebbletime (US$20 million), BauBax (US$10.3 million) and Exploding Kittens (US$8.8 million).

Project. 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 those contributors 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).
- 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).

III The Australian Provisions

A *The background*

Crowd-sourced equity funding schemes currently exist in a number of other countries including the US, the UK, Canada and New Zealand.[16] In general, they seem to be less restrictive in their application than the new Australian model[17] 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 yet been used successfully to raise large amounts of equity funding.[18] Italy also introduced a new crowdfunding regime in 2013, which was initially restricted to 'innovative start-ups' but was extended to 'innovative small to medium enterprises' in 2015, a change that seems to have had a very limited (if any) effect on its success. On the evidence to date, it has not been particularly successful in allowing its targeted companies to raise significant sums.[19]

B *CSF covered by the new legislation*

The new Australian legislation only covers online equity-based CSF (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

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[16] In 2014–15, the first 12 months of the New Zealand scheme, 21 innovation companies raised NZ$12.3 million using CSF (a 78 per cent success rate), in 2015–16, 16 companies raised NZ$10.8 million (a 57 per cent success rate) and, in 2016–17, 18 companies raised NZ$13 million (a 64 per cent success rate).

[17] In the US, the *Jumpstart Our Business Startups Act 2012* (US) provides two exceptions to the standard prohibition preventing issuers of private securities from 'advertising their offerings or generally soliciting investors'. Rule 506(b) allows an unlimited number of 'accredited investors' and up to 35 'non-accredited investors' to invest via CSF, 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.

[18] Angelo Delivorias, 'Crowdfunding in Europe – Introduction and State of Play' (European Parliamentary Research Service, 2017) <http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/595882/EPRS_BRI(2017)595882_EN.pdf>.

[19] Marina Nehme, 'Australia Needs to Learn from Italy's Mistakes', *The Conversation*, 25 February 2016, <https://theconversation.com/crowd-sourced-funding-australia-needs-to-learn-from-italys-mistakes-55130>.

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.'[20] Even then, though, the entities that can access funding by using the new regime are restricted.

IV How the CSF 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[21]), it can access the regime[22] – and *Corporations Act 2001* (Cth) pt 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 a specific provision under which they continue to apply to them).[23]

A ***Qualifying as an 'eligible CSF company'***

To qualify as an 'eligible CSF company' the entity must:[24]

- be a public company limited by shares;[25]
- have its principal place of business in Australia;
- have a majority of its directors resident in Australia;
- comply with the assets and turnover test;

[20] Australian Government, *Parliamentary Debates*, House of Representatives, 24 November 2016, 4306 (Scott Morrison, Treasurer).
[21] *Corporations Act 2001* (Cth) s 738B.
[22] Ibid s 738G.
[23] Ibid ss 703B, 704 and 706 (in relation to pt 6D.2) and s 725A (in relation to pt 6D.3). Section 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 whom disclosure is not required anyway – such as venture capital funds and angel investors: see Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) para 2.7.
[24] *Corporations Act 2001* (Cth) s 738H(1).
[25] To be eligible for the regime's limited governance requirements a company must, at present, either register as a public company limited by shares or convert from a proprietary company to a public company limited by shares: *Corporations Act 2001* (Cth) s 738ZI. While existing public companies (which are already covered by the *Corporations Act*'s more stringent governance requirements) may be able to make a CSF offer, they are not eligible for the new concessions and, therefore, cannot, thereby, escape their existing corporate governance and reporting requirements: Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) para 7.20. Legislation currently before Parliament will extend the availability of CSF to proprietary companies: see Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth).

- not be a listed corporation[26] (a restriction that applies to both the company and any related party of the company[27]); and
- not have a substantial purpose of investing in securities or interests in other entities or managed investment schemes (a restriction that applies not only to the company itself but also to any related party).

The 'assets and turnover test' is satisfied if, at the 'test time',[28] the value of the consolidated gross assets of the company and all of its related entities is less than AU$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 crowdfund,[29] is less than AU$25 million (or, if the regulations specify a different amount, that amount).[30]

Offers can also only be made by or on behalf of already existing companies; they cannot be made if they relate to 'a company that has not been formed or does not exist'.[31]

B *Eligible offers*

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;[32]
- 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[33] – but that requirement only appears in the regulations so it can readily be changed if it is found to be unnecessarily restrictive[34]);
- the offer complies with the 'issuer cap'; and

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[26] 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.

[27] 'Related party' is defined in *Corporations Act 2001* (Cth) s 738G(3) as 'a related body corporate of the company' or 'a person who controls the company or an associate of that person'.

[28] The time when the shares are issued and, therefore, the time at which the company must be an 'eligible CSF company': see *Corporations Act 2001* (Cth) s 738ZH(1).

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

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

[31] Ibid s 738ZF.

[32] 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.

[33] *Corporations Regulations 2001* (Cth) reg 6D.3A.01(1).

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

- the company does not intend that the funds raised will be used, either by itself or by a related party, to invest in securities or interests in other entities or schemes.[35]

The 'issuer cap' is AU$5 million or, if the regulations specify a different amount, that amount. The 'cap' is the maximum that the company can raise in a single year and includes not only the maximum amount that it intends to raise through its current offer but also any amounts that it, or a related party, raised through other CSF offers – together with all other amounts they raised within the immediately preceding 12 months in circumstances where *Corporations Act 2001* (Cth) ss 708(1) or (10) did not require disclosure.[36]

A company (and its related parties) can also have only one CSF offer open at a time.[37]

If an offer does not qualify as a CSF offer, it then generally defaults to being an offer that does require disclosure under *Corporations Act 2001* (Cth) pt 6D.2 – so failing to lodge the required disclosure documents with the Australian Securities and Investments Commission (ASIC) becomes an offence.[38]

C *The offer document*

A 'CSF offer document' must be prepared and it *must* contain all of the information required by the regulations.[39] Perhaps surprisingly, that does not include full details of the 'CSF offer'[40] – though, if it does not, a separate CSF offer must be published together with the 'CSF offer document'.[41] Among other things, the 'CSF offer document' must set out both the 'maximum subscription amount' and the 'minimum subscription amount' being sought through the offer.[42]

It must also 'be worded and presented in a clear, concise and effective manner'[43] and it must be 'published'. It is here that the role of the 'CSF intermediary' comes into play. A CSF offer can only be made[44] by publishing a complying CSF offer document 'on a platform

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[35] *Corporations Act 2001* (Cth) s 738G(1).
[36] Ibid s 738(2).
[37] Ibid s 738R. A company having more than one offer open at a time commits an offence: s 1311(1).
[38] Ibid s 727(1). See also Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) paras 2.53–2.54.
[39] *Corporations Act 2001* (Cth) ss 738J(1) and (2).
[40] The 'information required by the regulations' includes a Table of Contents, Risk Warnings, information about the offering company, information about the offer, and information about investor rights: *Corporations Regulations 2001* (Cth) regs 6D.3A.02–6D.3A.06. The CSF offer document *may* also set out the CSF offer itself: *Corporations Act 2001* (Cth) s 738J(2).
[41] *Corporations Act 2001* (Cth) s 738L(1).
[42] Ibid s 738L(7) and (8), respectively. Once the offer is fully subscribed to the maximum subscription amount, the responsible intermediary must close the offer: s 738N(4)(c). If the applications that are received (and not withdrawn) do not at least equal the minimum subscription amount, the responsible intermediary must refund all application money received: s 738ZB(3). Failure to comply is a strict liability offence: s 738ZB(5).
[43] Ibid s 738K.
[44] Ibid s 738L(3) provides that companies 'must not make the CSF offer otherwise than in accordance with [the requirement to make it through a CSF intermediary]'. If they do they commit an offence: s 1311(1).

of a single CSF intermediary'[45] – an entity defined as 'a financial services licensee whose licence expressly authorises the licensee to provide a crowdfunding service'.[46]

D *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, it has a defined statutory 'gatekeeper' role.[47] It must not publish a CSF offer document unless it has first conducted the checks required by the regulations[48] and is satisfied as to the identity and bona fides of both the company making the offer and its directors and officers. It must also be satisfied that the offer is eligible to be made under pt 6D.3A and is not misleading or deceptive.[49] If it fails to conduct those checks (or to conduct them to a reasonable standard) it commits a strict liability offence with a penalty of up to 50 penalty units.[50]

Second, 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.[51] The general risk warning is a statement in terms that are prescribed by the regulations.[52]

Third, the responsible entity must 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;[53] that any application made other than through that facility is rejected;[54] and that a 'communication facility' is 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.[55]

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[45] Ibid s 738L(1). While advertising a CSF offer or intended CSF offer is generally prohibited (s 738ZG(1)), that prohibition does not apply to publishing a CSF offer or a CSF offer document on a responsible intermediary's platform: s 738ZG(2).

[46] Ibid s 738C. CSF intermediaries are therefore required to hold an Australian Financial Services Licence. 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': Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) para 3.8. The Minister has power under ibid s 791C to exempt operators from the requirement to hold an Australian Market Licence.

[47] *Corporations Act 2001* (Cth) s 738Q.

[48] Ibid s 738Q(1).

[49] Ibid s 738Q(5).

[50] Ibid ss 738Q(3) and 1311(1).

[51] Ibid s 738ZA(1). The detailed wording of the risk warning is set out in *Corporations Regulations 2001* (Cth) reg 6D.3A.03.

[52] *Corporations Act 2001* (Cth) s 738ZA(2). See also *Corporations Regulations 2001* (Cth) reg 6D.3A.03.

[53] *Corporations Act 2001* (Cth) s 738ZA(3).

[54] Ibid s 738ZA(4).

[55] 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.

Fourth, it must ensure that statements drawing investors' attention to their rights to withdraw their applications during the cooling off period[56] and the process by which that can be done, appear prominently on the platform.[57]

Fifth, 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.[58]

Failing to comply with any of those obligations is also an offence and renders the CSF intermediary liable to a penalty of up to 60 penalty units and/or one year's imprisonment.[59]

Finally, the arrangement between the company and the CSF intermediary (the 'hosting arrangement') must require that all applications 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 *Corporations Act 2001* (Cth) pt 6D.3A.[60]

E *Opening and closing a CSF offer*

A CSF offer remains 'open' until it is 'closed'.[61] 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 since the offer opens; the specified end date for the offer; the intermediary considers that the offer is fully subscribed; the company notifies the responsible intermediary that it wants the offer withdrawn; or the Act prohibits the continued publication of the CSF offer document.[62]

F *Accepting a CSF offer*

Investors can only accept a CSF offer by making an application through the responsible intermediary (using the 'application facility' provided). 'Retail clients' must also first complete an 'acknowledgement' that complies with the requirements of the regulations.[63]

The responsible entity must reject any application that is made otherwise than through the application facility (and, as retail clients *cannot* make an application without completing the required acknowledgement, that also effectively means that the

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[56] Investors may withdraw their application within five business days: *Corporations Act 2001* (Cth) s 738ZD.
[57] Ibid s 738ZA(8).
[58] Ibid s 738ZA(9).
[59] Ibid s 1311(1). See also Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) para 3.56.
[60] *Corporations Act 2001* (Cth) s 738L(2). The responsible entities' obligations in relation to application money are set out in s 738ZB. It provides that the general obligations in pt 7.8 div 2 sub-div A continue to apply, with some modifications provided for in that section.
[61] Ibid s 738N(1), (2) and (3).
[62] Ibid s 738N(4). Failing to close the offer when required is an offence: s 1311(1).
[63] Ibid s 738ZA(3)(b). The detailed wording of the 'acknowledgement' (which acknowledges that the retail client has read the offer document, understands the risk warning and is aware of the availability and operation of the communication facility) is set out in *Corporations Regulations 2001* (Cth) reg 6D.3A.07(2).

responsible entity must reject any application that is not accompanied by a completed acknowledgement).[64]

In addition, the legislation provides a number of other protections for investors. First, individual 'retail clients'[65] are limited to investing a maximum of AU$10 000 in CSF offers by the same company in any 12-month period and the responsible intermediary must reject applications that exceed that amount.[66]

Further, neither the company, nor any related party, nor the responsible intermediary, may provide financial assistance to allow that investor to make the investment.[67]

G *The regulatory concessions*

For companies whose offers qualify under the CSF rules there are a number of regulatory concessions that are intended to remove what the Treasurer referred to in his Second Reading Speech for the 2016 Bill as 'unnecessary regulatory barriers … [to] Australia's innovative early-stage businesses to obtain the capital they need to turn good ideas into commercial successes'.[68] These include, for a concession period of up to a maximum of five years:

- modified disclosure obligations in the CSF offer document;
- an exemption from the requirement to hold an AGM;
- an option to provide reports to shareholders merely by making them available online; and
- an exemption from the requirement to appoint an auditor until the company has raised at least AU$1 million[69] from CSF offers.

V Availability of the CSF Regime

A *Initially limited to a select group of public companies*

As indicated above, as the CSF regime was originally intended to operate, it was only available to unlisted public companies limited by shares, with less than AU$25 million in both gross assets and annual revenue. Consequently, all proprietary and many public

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64 *Corporations Act 2001* (Cth) s 738ZA(4).

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

66 Ibid s 738ZC(1). An intermediary who fails to reject an application that exceeds the retail investor cap commits an offence: s 1311(1). There are, however, no penalties for investors who make, or purport to make, applications that exceed that cap: see Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) paras 6.15–6.17.

67 *Corporations Act 2001* (Cth) s 738ZE. Failure to comply with this prohibition is an offence: s 1311(1).

68 Australian Government (Morrison), above n 20.

69 Under the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth) the audit threshold is to be raised from AU$1 million to AU$3 million to align it with the audit threshold being proposed for proprietary companies once they are permitted to raise funds through CSF.

companies were automatically excluded. This meant that the option of raising funds through crowd-sourcing was denied to about 99.7 per cent of all Australian companies.[70]

However, even for companies that did qualify, the available concessions had a limited lifespan (and therefore conferred a limited benefit).

B *Problems with eligibility and the limited 'concession period'*

While unlisted public companies can raise funds through crowd-sourcing, and are granted a number of exemptions from the *Corporations Act*'s standard public company regulatory obligations to allow them to do so (reduced disclosure obligations, exemptions from the requirement to hold an AGM, ability to provide reports to shareholders simply by making them available online, and exemptions from the requirement to appoint an auditor until the company had raised at least AU$1 million from its CSF offers), those exemptions only apply for a maximum five-year concession period (starting once 'a successful CSF round' has been completed).[71]

The facts that CSF is only available to that limited group of companies and that the available concessions are 'time-limited' both have a number of negative effects:

1. 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.

2. As the concessions only last for a maximum of five years, the small business (especially if it is a start-up) needs to consider, carefully, where it would be at the end of the concession period before deciding to register or convert. The risk is that, having registered as (or converted to) a public company to attract initial capital, it could be stranded with a structure that, because of the 'standard' compliance burdens that will apply to it once the concession period ends, is not really appropriate for its business (especially if it does not achieve the sort of scale that would justify such a structure).[72]

3. Because 'investors (especially venture capital) generally consider public companies a less attractive target due to the complexities and shareholder consent associated with takeover laws',[73] the requirement to register as, or convert to, a public company could also adversely affect companies if they intend to exit their business via a trade sale after it matures.

4. Because the type (and therefore the number) of companies that can use the new rules is limited, the number of CSF intermediaries that can expect to operate

[70] Marina Nehme, 'Australia Finally Has Crowd-Sourced Equity Funding, But There's More to Do', *The Conversation*, 22 March 2017 <https://theconversation.com/australia-finally-has-crowd-sourced-equity-funding-but-theres-more-to-do-74921>.
[71] See Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) paras 7.8, 7.25 and 7.31.
[72] This problem is expressly recognised in the Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth) para 2.41.
[73] Ibid para 2.38. See also paras 2.6 and 2.16.

profitably as commercially successful businesses is also limited. That, in turn, can lead to reduced competition and increased costs for capital-raising companies.[74]

5. To some extent, the available concessions also limit investors' 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 cases, winding it up).

6. The fact that the company must be unlisted raises an additional problem in that 'bailing out' can be difficult and shareholders wanting or needing to extract their investment may find it difficult (or even impossible) to sell their shares.[75]

C *Problems with excluding proprietary companies*

About 98 per cent of all companies in Australia are proprietary companies.[76] The proprietary company structure is also the one that is most favoured by start-ups and early-stage companies.[77] Therefore, excluding proprietary companies from the CSF regime was always going to be problematic – and that has long been known.

For example, even in his Second Reading Speech for the 2016 Bill the Treasurer referred to the possibility of extending the availability of CSF 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.[78]

The problem was, of course, that proprietary companies are generally prohibited from offering shares to the public[79] – so allowing them to crowdfund immediately raised a number of basic issues with the very concepts under which they are allowed to operate.

D *Solving the 'proprietary company problem'*

Despite that, in the 2017 Budget the Treasurer announced that the availability of crowd-sourced equity funding would be extended to proprietary companies. The reason, he said, was to make it possible for a greater number of innovative companies and start-ups to access that option.

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[74] Ibid para 2.41. In Italy, where the availability of CSF is restricted, only one CSF intermediary equivalent currently exists. Similarly, in New Zealand a number of intermediaries were established initially, and some have already withdrawn from the field: see Nehme, above n 70.

[75] The Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth) para 2.37 does suggest, though, that, 'as public companies maintain a more consistent flow of information to the public, it is more likely that a secondary market in shares in public CSF companies could be developed in time.'

[76] Ibid para 2.38.

[77] Ibid paras 2.38 and 2.40.

[78] Australian Government (Morrison), above n 20.

[79] *Corporations Act 2001* (Cth) s 113(3) effectively prohibits a proprietary company from offering its shares to other than its existing shareholders or employees of itself or of a subsidiary.

Draft legislation to give effect to that announcement was released in May 2017 and was introduced into Parliament on 14 September 2017.[80] It passed the House of Representatives on 26 February 2018.

Under the proposed legislation, proprietary companies that meet the Act's requirements will be permitted an unlimited number of CSF shareholders but, in exchange, will have to meet higher governance and reporting obligations.

In particular, they will have to have a minimum of two directors (at least one of whom must reside in Australia), will have to prepare financial reports in accordance with accounting standards (whether or not they are 'large proprietary companies' – the only proprietary companies that are currently subject to that requirement), will be required to have those statements audited (at least after they raise more than AU$3 million from CSF offers), will have additional reporting obligations (they will have to record details of their CSF offers and CSF shareholders and report any changes to those details to ASIC) and, to protect investors, will be subject to restrictions on related party transactions.

If proprietary companies do qualify to undertake CSF, the process under which they can raise capital using CSF offers 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 will all be the same for them as they are for eligible public companies.

One change that will be made to the existing CSF regime is that, once the new legislation is passed, the temporary concessions (those applicable to AGMs, reporting and audit) that currently apply will be removed – subject to a grandfathering of those arrangements for companies that registered or converted to public companies prior to the regime being extended to proprietary companies.[81] This is a direct consequence of the proposed change because those concessions 'were initially only granted on the assumption that proprietary companies would not have the opportunity to access crowd-sourced funding'.[82]

E *Taxation considerations*

Making CSF available is merely one of many measures that have been introduced, especially in the last 20 years, to assist innovation-based enterprises, especially in their start-up phase.

Those measures really began with the tax incentives for 'early venture capital investments' (EVCIs) that investors made through Venture Capital Limited Partnerships (VCLPs), Early Stage Venture Capital Limited Partnerships (ESVCLPs) or Australian Venture Capital Funds of Funds (AFOFs).

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[80] Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth).

[81] See proposed amendments to *Corporations Act 2001* (Cth) s 738ZI: Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth) sch 1 pt 1 items 42, 43 and 44.

[82] Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth) para 2.27. See also para 2.34

Those incentives, which were provided through a combination of the *Venture Capital Act 2002* (Cth) and amendments to both the Australian Government's taxation legislation and the individual state and territory Partnership Acts,[83] were intended to facilitate non-resident investment in the Australian venture capital industry. They did that by providing those investors with an exemption from capital gains tax (CGT) on their EVCIs (provided they had held them for at least 12 months) and an exemption from income tax on their share of the profits that were made by the businesses in which they had invested.[84]

In addition, under the *Income Tax Assessment Act 1997* (Cth) (ITAA97) div 355, businesses can access a research and development (R&D) tax offset, which is jointly administered by AusIndustry and the Australian Taxation Office (ATO).[85] It replaced the formerly available 'R&D Tax Concession' and allows eligible R&D entities that incur eligible R&D expenditure on defined 'core' or 'supporting' R&D activities to a self-assessed tax offset, the nature and extent of which depends on the size of the R&D entity's turnover and the amount of its eligible expenditure.

R&D entities with an aggregated turnover of less than AU$20 million, on a worldwide basis, are entitled to a *refundable* tax offset equal to 43.5 per cent of their total eligible R&D expenditure for the year of income; those with an aggregated turnover of AU$20 million or more on the same worldwide basis are entitled to a *non-refundable* tax offset equal to 38.5 per cent of their total eligible R&D expenditure for that year – in both cases, provided they have notional deductions of at least AU$20 000.[86] Since 2014, however, those offsets have been limited to the first AU$100 million of the affected R&D entity's eligible R&D expenditure for that year. A separate offset equal to the company tax rate is available for expenditure over AU$100 million.

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

To assist start-ups to attract staff, the ITAA97 div 83A was also amended in 2015, in line with the government's *Industry Innovation and Competitiveness Agenda*,[87] to provide, *inter alia,* a 'start-up' concession for shares and options that eligible small start-up

[83] In Western Australia, the required partnership law changes are contained in the *Limited Partnerships Act 2016* (WA). In New Zealand the same considerations led to both the passage of the *Limited Partnerships Act 2008* (NZ) and changes to taxation legislation to encourage venture capital investment into New Zealand.

[84] On the downside, losses on both capital and revenue account are also disregarded.

[85] AusIndustry has responsibility for registration and administration of programme activities under pt III of the *Industry Research and Development Act 1986* (Cth); the ATO has responsibility for administration of expenditure on what might be eligible R&D activities under the ITAA97 div 355.

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

[87] Australian Government, *Industry Innovation and Competitiveness Agenda: An Action Plan for a Stronger Australia* (2014).

companies issue to their employees in lieu of the higher salaries that they might otherwise have to pay to attract appropriate talent to their businesses.

In addition, since 1 July 2015 start-up companies, partnerships and trusts have been able to access an immediate write-off under ITAA97 s 40-880(2A) for any 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 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[88] but many of those other expenses may be deductible over five years under other provisions in s 40-880.

More recently, in 2016, the *Tax Laws (Tax Incentives for Innovation) Act 2016* (Cth) introduced a range of 'tax incentives for early-stage investors', by inserting a new sub-div 360-A into the ITAA97 to augment the other, already existing, measures – especially those applicable to the venture capital industry.

Subdivision 360-A provides tax incentives to encourage 'angel investors' to invest in innovative Australian start-up companies at a stage earlier than that at which venture capital funds are typically willing to invest.[89] In particular, the tax incentives were intended to make it easier for 'early-stage innovation companies' (ESICs) 'to attract seed and pre-commercialisation equity at an earlier stage of their development',[90] particularly to get their innovations from the concept to the commercialisation stage[91]– an interim period commonly known as 'the valley of death'.

The tax incentives that 'angel investors' can access under sub-div 360-A are a non-refundable carry-forward tax offset of 20 per cent of the value of the investment up to a maximum 'tax offset cap' of AU$200 000 (with, to protect 'non-sophisticated' investors, a total annual investment limit of AU$50 000 for retail investors), and a 'modified CGT treatment' that allows early-stage investors to disregard any capital gains they make on their shares in eligible ESICs, provided the shares have been held for between one and ten years[92] – a tax treatment that is similar to that which is already accorded Early Stage

[88] 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.

[89] Paragraph 1.4 of the Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 (Cth) 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'.

[90] Ibid.

[91] The 'tax incentives for early-stage investors' do not apply at the concept stage because, before a company can be classified as an ESIC under ITAA97 s 360-40 it must, *inter alia*, be 'genuinely focused on developing for commercialisation one or more new, or significantly improved, products, processes, services or marketing or organisational methods': s 360-40(1)(e)(i).

[92] Though, to ensure that investments are not made (to gain the offset) and then withdrawn before the company can benefit from them, any capital losses on shares held for less than 10 years are also disregarded.

Venture Capital Limited Partnerships, Venture Capital Limited Partnerships and Australian Venture Capital Funds of Funds under sub-div 118-F.[93]

There are a number of problems with the application of sub-div 360-A in a practical sense[94] but some of those have already been addressed[95] and others are in the process of being addressed.[96] In general, though, the Subdivision does seem to be a good start point to address (and redress) the problems that ESICs have in attracting early-stage investment.

VI 'RISK' AND TAX INCENTIVES

Compensating for 'risk' has been a significant factor in making tax incentives available for investment in innovation and that was particularly so with the 2016 'tax incentives for early-stage investors'. 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'.[97]

That approach was eminently justified because providing finance to innovative start-ups is inherently risky. Data shows that somewhere in excess of 50 per cent of all small businesses fail in the first four years of their operation.[98] For innovative start-ups the figures, sitting at about 60 per cent,[99] are worse. The figures are worse again for first-time entrepreneurs, for whom there is only an 18 per cent chance of success.[100]

Potential investors are therefore understandably selective, both in the innovations they are prepared to back, especially in the very early stages of the business's existence, and in the amount of capital they are prepared to risk.

In fact, investor reluctance to invest in innovation, and the resulting difficulty that innovative small businesses in particular encounter when trying to access adequate capital, has been identified as 'a major contributor to poor innovation outcomes in Australia'.[101] That problem is also confirmed by the results of the Australian Bureau of

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93 Provided the conditions in sub-div 360A are met, any capital gains or losses that result from CGT events relating to 'eligible venture capital investments' (EVCI) that partners in ESVCLPs, 'eligible venture capital partners' in VCLPs or 'eligible venture capital partners' in AFOFs have owned for at least 12 months are disregarded: ITAA97 ss 118-405, 118-407 and 118-410. Those investors are also exempt from income tax on their share of any profits (ss 51-54 and 51-55) and are denied a deduction for any losses that arise from disposal of those interests: ss 26-68 and 26-69.

94 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, New Zealand, 18–20 January 2017).

95 See *Treasury Laws Amendment (2017 Measures No 1) Act 2017* (Cth) sch 1.

96 See Treasury Laws Amendment (2018 Measures No 2) Bill 2018 (Cth).

97 Australian Government (Morrison), above n 20.

98 Matt Mansfield, Small Business Trends, *Startup Statistics – The Numbers You Need to Know* (1 November 2016) <https://smallbiztrends.com/2016/11/startup-statistics-small-business.html>.

99 Erin Griffith, 'Conventional Wisdom Says 90% of Startups Fail. Data Says Otherwise', *Fortune* (online), 27 June 2017 <http://fortune.com/2017/06/27/startup-advice-data-failure>.

100 Mansfield, above n 98.

101 G Withers, N Gupta, L Curtis and N Larkins, 'Australia's Comparative Advantage: Final Report' (Australian Council of Learned Academies, Melbourne, August 2015) 120.

Statistics *Business Characteristics Surveys*, which have consistently rated 'lack of access to additional funds' as the greatest barrier to innovation in Australian businesses.[102]

The seriousness of the problem is also clearly reflected in data in the *Startup Muster* Annual Reports. The 2017 report, for example, noted that, while success rates for fundraising by start-ups had improved over time, in the previous year only 34.2 per cent of start-ups had equity investors.[103] The difficulties that start-ups encounter when trying to raise funds was also illustrated by the fact that, in that year, only 27.5 per cent of start-ups had tried to fundraise and had either raised as much as they wanted or been oversubscribed. Ten per cent had tried but had not raised as much as they had sought and 5.8 per cent had tried but had not been able to raise any funding at all. More significantly, of all start-ups, 42.8 per cent had never tried to fundraise at all.[104]

Therefore, anything that encourages investors to support innovation is to be welcomed – particularly in the period between the initial stage of the business's lifecycle (where finance is normally provided through self-funding, family, friends and, perhaps, through government support and/or tax incentives – such as those outlined above)[105] 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.

VII Where Crowd-Sourced Funding Fits In

A *Recognition of risk*

The government's declared intent in legislating to make CSF available was to facilitate fundraising in the initial stages of a company's existence.[106] That is well evidenced by the fact that, to qualify for the governance and reporting concessions, a company registering as, or converting to, a public company in order to use the CSF regime has to state in its application that it intends to make a CSF offer after registration or conversion *and* it must then also complete a CSF offer within 12 months.[107]

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[102] See, for example, Australian Bureau of Statistics, Australian Government, *Selected Characteristics of Australian Business, 2015–16* (17 August 2017) para 8167.0 <http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/8167.02015-16?OpenDocument>. It reported that for 2015/16, as for previous years, both innovative-active businesses and businesses overall identified lack of access to additional funds as the most common barrier to innovation: 21.3 per cent of all innovation-active businesses rating it as their greatest barrier to innovation (with an even higher percentage among SMEs). For the purposes of those surveys, 'barriers to innovation' are defined as 'those barriers that significantly hampered the development or introduction of any new or significantly improved goods, services, processes and/or methods'.

[103] Startup Muster, *2017 Annual Report* (2017) <https://www.startupmuster.com/reports/Startup-Muster-2017-Report.pdf>. These figures were an improvement on results from earlier years where start-ups had reported much worse outcomes.

[104] Ibid.

[105] See, ibid, for figures on the availability and sources of funding for start-ups in 2016/17.

[106] Explanatory Memorandum to Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) paras 1.4–1.6.

[107] *Corporations Act 2001* (Cth) s 738ZI.

It is also clear that the government recognised and took steps to bring the substantial risks that can be involved with such investments to the attention of potential investors.

The Explanatory Memorandum to Corporations Amendment (Crowd-sourced Funding) Bill 2016, for example, specifically notes 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'.[108]

The legislation itself also expressly provides for a 'risk statement',[109] which must be made available to potential investors – and which CSF intermediaries must publish *prominently* on their offer platform for each offer with which they are involved.[110] 'Retail clients' must also complete an acknowledgement that, *inter alia*, they have read and understood that risk statement[111] – and responsible entities are required to reject any application from a retail client that is not accompanied by a completed acknowledgement.[112]

ASIC also specifically warns on its website that, because businesses that raise money through CSF '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'.[113] It also specifically notes that because of the nature of the company structures that are 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'.[114]

Therefore, as with the venture capital incentives and, in particular, the more recent ESIC tax regimes, it might have been expected that significant tax incentives would have been attached to CSF offers to compensate for the risks associated with them and to enhance their attractiveness to investors.

B *Taxation and the CSF regime*

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

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108 Explanatory Memorandum to Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) para 1.8.

109 The detailed wording of the risk statement is set out in *Corporations Regulations 2001* (Cth) reg 6D.3A.03. It reads 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.

110 *Corporations Act 2001* (Cth) s 738ZA(1). Failure to comply with that subsection is an offence: s 1311(1).

111 Ibid s 738ZA(3)(b). The detailed wording of the acknowledgement is set out in *Corporations Regulations 2001* (Cth) reg 6D.3A.07(2).

112 *Corporations Act 2001* (Cth) sub-ss 738ZA(3)(b) and (4). Not doing so is also an offence: s 1311(1).

113 ASIC, Australian Government, *Moneysmart: Crowd-Sourced Funding* (10 November 2017) <https://www.moneysmart.gov.au/investing/crowd-sourced-funding>.

114 Ibid.

shares.[115] That has a number of consequences. For companies raising funds through CSF offers, the money 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. Subsequent use of those funds for non-capital business purposes will give rise to deductions that they can then offset against current or future income and, if the funds are used for capital expenditure, an immediate or accelerated write-off under ITAA97 s 40-880 may be available. If the funds are used for eligible R&D expenditure then a self-assessed tax offset may be available under ITAA97 div 355, in lieu of a deduction.

For CSF intermediaries, the fees that they receive will be income from carrying on a business and will therefore be taxable in full. The fees that they pay to acquire and maintain their Australian Financial Services Licence and, if required, their Australian Markets Licence, so they can provide CSF services, will of course be deductible, as will all other non-capital expenses they incur in carrying on their CSF intermediary business. Capital expenses may give rise to depreciation deductions under ITAA97 div 40 (including, if they are 'small business entities', the immediate or accelerated write-offs that are available under ITAA97 s 40-880).

For investors, their investments will not be deductible expenses (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 ITAA97 s 102-10 or as a loss on revenue account to be deducted under ITAA97 s 8-1 (again depending on how the shares were acquired and held). Any return that they get on their investment in the way of dividends will, of course, be taxable as ordinary income under ITAA36 s 44.

There may also be GST consequences.[116] The supply of shares itself is an input-taxed financial supply and is therefore not subject to GST (so the investor receives no input credits). The services that the CSF intermediary supplies to the company are, however, a taxable supply and, provided the intermediary is carrying on an enterprise, is registered or required to be registered for GST, provides the services for consideration, and the services are connected to Australia (as they will be because of the eligibility requirements for CSF offers), they will be subject to GST.

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

[115] For the ATO view, see Australian Taxation Office, Australian Government, *Crowdfunding* (2017) <https://www.ato.gov.au/individuals/income-and-deductions/income-you-must-declare/crowdfunding>.

[116] For the ATO view, see Australian Taxation Office, Australian Government, *GST and Crowdfunding* (2017) <https://www.ato.gov.au/Business/GST/In-detail/Rules-for-specific-transactions/GST-and-crowdfunding>.

acquisitions' detailed in the *A New Tax System (Goods and Services Tax) Regulations 1999* (Cth) reg 70-5.02).

C *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?

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 AU$5 million.[117] There is also a AU$10 000 'investor cap' on the amount that an individual retail client can invest in all CSF offers made by the same company in any 12-month period (and, under *Corporations Act 2001* (Cth) s 738ZC(1), a responsible intermediary *must reject* an application made by a retail client if it would breach that cap).

The AU$10 000 'investor cap' does not apply to sophisticated and/or professional investors – though offers to them are already exempt from disclosure under *Corporations Act 2001* (Cth) ss 708(8) and 708(11) and it is more likely that companies would seek investments from those investors under the general fundraising provisions rather than the CSF regime, especially as those other investments do not count towards the AU$5 million issuer cap,[118] which can then remain intact for bona fide small retail 'mum and dad' investors.[119]

Individual investments are therefore likely to be small and the people who make them are less likely to be greatly concerned about possible tax incentives than with the potential for significant possible gains on the occurrence of an expected exit event[120] (such as a trade sale, initial public offering or other disposal of their shares). Alternatively, they may be mainly motivated by a desire to assist family or friends who are behind the company seeking the funds – albeit also wanting to protect their investment, to some extent, by acquiring equity rather than simply providing 'loan' funds.[121]

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117 *Corporations Act 2001* (Cth) s 738G(2).

118 The offers that are exempt from disclosure under *Corporations Act 2001* (Cth) s 708, and which therefore do count towards the AU$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.

119 A small number of small 'mum and dad' investors can also be catered for under the 'small scale offering' provisions in *Corporations Act 2001* (Cth) s 708(1). It exempts companies from the disclosure requirements for 'personal offers' (defined in s 708(2)) where both the number of people to whom securities are issued does not exceed 20 and the amount raised does not exceed AU$2 million in any 12-month period. Companies might therefore also elect to use s 708(1) to raise funds from such 'known' investors (if they exist) to avoid the effect of the AU$10 000 CSF 'investor cap'.

120 See Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth) para 1.61.

121 By exercising their rights as shareholders. For start-up companies equity may also be preferable to debt given that equity 'does not require immediate repayments and equity investors generally accept that returns are contingent on profits': ibid para 2.11.

Because of the probable small scale (and, concomitantly large number) of individual CSF investments that are likely to result from the AU$5 million 'issuer cap', providing (and administering) tax incentives for CSF investors (which could be similar to the incentives that are available for investments in ESICs) is also likely to involve a disproportionate administrative burden for both the fundraising company and, possibly, the ATO.

However, whatever the reason for the absence of tax 'incentives', that may, in fact, operate in the CSF investors' favour. One of the problems with the ESIC incentives is that, in some instances, they do not apply or, if they do, they can operate against the interests of the investors they were intended to benefit.

First, there is the requirement that the company must qualify as an ESIC immediately after the shares are issued. A particular problem with this requirement is that the company has to be genuinely involved in innovation – something that it has to self-assess using either a highly subjective 'principles-based test' or a more objective '100-point innovation test'. If the company errs for some reason the investors lose their anticipated entitlement to both the tax offset and the modified CGT treatment.[122]

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 *Corporations Act 2001* (Cth) 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 then have to expend part of the funds it raised 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 fundraising).

Second, shares issued by the company must 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 in ITAA97 s 360-15(1)(b)–(f). However, the onus of ensuring that the company qualifies rests with the investor, who, if the company does not qualify as an ESIC, is not entitled to the tax incentives. The problem is that each of the s 360-15(1) matters relate to things that are not within the shareholders' control – and they therefore have to rely entirely on the issuing company 'getting them right'.

Third, 'non-sophisticated' investors are limited in the amounts they can invest in ESICs.[123] If they exceed that limit, they lose not only the tax offset they might have received for the amount that exceeds the limit, they lose the entire offset – including for that part of their investment that did not exceed the limit.[124] Worse, because they lose the entitlement to the tax offset, they also lose their entitlement to the 'modified CGT treatment' – again, for their entire investment.[125] Given that they are 'non-sophisticated' investors (a group likely to be largely co-extensive with the 'retail clients' in CSF issues) it is possible that

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122 ITTA97 ss 360-15(1)(c) and 360-50(1).

123 Ibid s 360-20(1)(b). The limit is AU$50 000, which includes all investments in *all* ESICs in any year.

124 By investing more than AU$50 000 in any income year, they are deemed not to satisfy the ITAA97 s 360-15(1)(b) requirement that they have been issued with 'equity interests that are shares in the company'.

125 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 ibid s 360-50(1).

they might not fully appreciate the consequences of exceeding the cap, and might, therefore, inadvertently breach it.

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, any capital gain on the occurrence of a CGT event is assessed under normal principles[126] but any capital loss must be disregarded;[127]
- 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[128] – as is any capital loss;[129] or
- 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 10th anniversary of their issue instead of their actual cost at issue.[130]

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

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

D *Investing under both ESIC and CSF regimes concurrently*

From the legislation, it appears that there is nothing to stop investors investing in the same company under both the ESIC rules (to get the tax concessions) and the CSF rules.[131] It also seems that they could do so in respect of the same investment, provided the company meets both the requirements to qualify as an ESIC,[132] immediately after the relevant share issue, and the requirements to be an 'eligible CSF company' (which, at the

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[126] This is because the investor is taken to hold the share on capital account under ibid 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).
[127] Ibid s 360-50(3).
[128] Ibid s 360-50(4).
[129] Ibid s 360-50(3).
[130] Ibid s 360-50(5).
[131] That possibility also seems to be indirectly suggested by the Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (Cth) para 2.42.
[132] Which it would be so long as it was 'early-stage' (ie, if it satisfied the requirements in ITAA97 sub-ss 360-40(1)(a)–(d)) and was genuinely involved in innovation (something that it self-assesses under either a principles-based test under s 360-40(1)(e) or the '100 point innovation test' in s 360-45).

latest, must be 'at the time when the offer is made'[133]). The offer would also have to be both 'eligible to be made' and 'expressed to be made' under the CSF rules,[134] and the shares issued under that offer would have to be eligible for the tax incentives under the ESIC rules.

None of that would seem to involve insurmountable hurdles. In broad terms, to be 'early-stage', the potential ESIC 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 six years. In addition, it and its subsidiaries must have incurred *total* expenses of AU$1 million or less across the last three years *and* it and its 100 per cent subsidiaries must have had a total income of AU$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.

These requirements all align neatly with the requirements that 'eligible CSF companies' not be foreign companies and must satisfy their own, somewhat more liberal, gross assets and revenue tests.

The major differences between the two sets of requirements are that there is no requirement for an ESIC to be a public company (a requirement that is in the process of being removed for CSF companies anyway[135]), it has no principal place of business or resident director requirement to satisfy, it has a less liberal 'assets and turnover' test to meet and, unlike 'eligible CSF companies', it is not subject to any specific requirement that it not have a substantial purpose of investing in securities and interests in other entities (though the same practical effect is likely to be achieved through the requirement that ESICs be 'genuinely involved in innovation').

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

One major difference is that ESIC offers are not subject to an 'issuer cap' (as opposed to CSF offers, under which companies, including related parties, are limited to raising a maximum of AU$5 million in a single year from CSF and other offers where disclosure is not required).

Another difference is the 'investor' cap that applies in each case[136] – and the different consequences of breaching those caps. Companies that want their offers to meet both CSF and ESIC requirements would have to structure those offers so that they met both sets of requirements (including limited maximum acceptance to AU$10 000 for each 'retail

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133 *Corporations Act 2001* (Cth) s 738G(1)(b).
134 Ibid s 738B.
135 See Corporations Amendment (Crowd-Sourced Funding for Proprietary Companies) Bill 2017 (Cth).
136 A maximum AU$50 000 for 'non-sophisticated' investors in ESICs (in total in any one year) as opposed to a AU$10 000 cap for retail clients applying for shares under a CSF offer in any one company in any year.

client'/'non-sophisticated' investor) – but that would not seem to be too onerous (depending on the level of funds that the company wanted to raise).

1 *Was the possibility of meeting both regimes intended?*

The problem seems to be that neither the CSF nor the ESIC legislation appears to have identified the potential for the two regimes to operate in tandem – or to make provision for that to occur.

In theory, there is no reason why the two regimes should not coexist. In fact, as was noted earlier, the Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 specifically stated that the aim of the new regime was to 'provide an *additional funding option* for small businesses and start-ups in particular, that may otherwise struggle to obtain affordable finance'[137] (emphasis added).

The Treasurer also expressly stated in his Second Reading Speech for that Bill that the CSF option was simply 'a new funding option for small businesses', that it was not intended to displace 'other forms of crowdfunding already available, such as rewards-based crowdfunding and peer-to-peer lending' and that 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'.[138]

However, the CSF legislation does specifically make it clear that eligible CSF companies can also only have one CSF offer open at a time[139] – so allowing them to raise funds through a concurrent capital raising under the ESIC rules could be regarded as both inappropriate and, at least, at odds with the spirit of the new law.

2 *Potentially 'unintended' tax consequences*

There are a number of potentially unintended tax consequences flowing from the possibility that a single offer might qualify under both the ESIC and CSF rules. They arise mainly because of uncertainty about how the ESIC tax incentives are activated.

An 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 within 31 days after the end of the financial year in which the shares were issued (ie, normally by 31 July of that income year). The stated reason is to allow the ATO to assess whether investors are entitled to those tax incentives.[140]

However, if the issue of shares does create an entitlement to the tax offset (and through it, to the modified CGT treatment), does that mean that investors are then, immediately,

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[137] Explanatory Memorandum to the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth) para 1.6.

[138] Australian Government (Morrison), above n 20.

[139] *Corporations Act 2001* (Cth) s 738R.

[140] Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 (Cth) para 1.15. *Taxation Administration Act 1953* (Cth) sch 1 s 396-55 Item 10 in the Table and sch 1 s 396-60(1)(a) note that, if a 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 per cent or because the shares were acquired through an employee share scheme – all express prohibitions under the ESIC legislation), that issue of shares need not be reported.

and simply by virtue of the issue of shares to them, automatically covered by the ESIC rules, or does it mean that the issue of shares to them simply raises a possible entitlement that the shareholder must choose to activate (by claiming the tax offset) before the ESIC rules can apply. That is not clear from the legislation and that lack of clarity gives rise to at least two problems.

First, if accepting a 'CSF offer' does also qualify as an ESIC investment (because the company has aligned the terms of its offer to achieve that effect), 'retail clients' who accept the CSF offer could inadvertently lose their entitlement to claim a capital loss if their investment later fails (or if they dispose of those shares at a loss for any other reason – including through an involuntary disposal, such as might occur on death) within the first 10 years of their investment. This is because, under the ESIC rules, capital losses within that period must be disregarded.[141] That outcome is technically possible, even though those investors may not have invested with the ESIC incentives in mind – and may not even have been aware of them, or of the potential problem.

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

As a minimum, if a single issue of shares was to qualify under both the CSF and the ESIC rules, there would appear to be some justification for amending the legislation to require investors to elect to claim (or not to claim) the ESIC tax incentives, and to do so (preferably) in the first tax return that they lodge after the issuing company reports that issue to the ATO.

VIII Conclusion

The introduction of the CSF regime is a laudable addition to the already existing channels of funding that are available to small start-up innovation companies. However, whether the temporary corporate governance, reporting 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 the new provisions are notionally aimed, or whether further tax or other incentives will be needed, is yet to be seen. Other refinements, especially to eliminate possible taxation complications resulting from the new rules, would also seem to be desirable.

However, 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

[141] ITAA97 s 360-50(3).

a positive sign that may also see the introduction of appropriate taxation or other incentives if the take-up of CSF investment proves to be limited without them.

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