

Chapter 1

Introduction

1.1 On 15 February 2018, the Senate referred the provisions of the Treasury Laws Amendment (2018 Measures No. 2) Bill 2018 (the bill) to the Senate Economics Legislation Committee for inquiry and report by 15 March 2018.¹

1.2 The bill establishes an enhanced 'regulatory sandbox' to allow firms to test new products and services in the financial services sector without needing to obtain a financial services licence or a credit licence from the Australian Securities and Investments Commission (ASIC) first. The bill also makes a number of minor technical amendments to the Early Stage Venture Capital Limited Partnership, Venture Capital Limited Partnership and Tax Incentives for Early Stage Investor regimes to clarify the income tax law and ensure these provisions operate in accordance with their original policy intent.²

1.3 The Treasurer, the Hon. Scott Morrison MP, summarised the benefits of creating an enhanced regulatory sandbox for new and innovative financial technologies (FinTech):

As promised in the Budget, we are putting in place the world's most forward-leaning regulatory sandbox for FinTech development.

...

In simple terms, this will help Australians and Australian businesses to access cheaper financing and better financial products so they can grow and invest.

...

The regulatory sandbox will provide a means to test market demand...It will reduce the time it takes to make their products and services available to consumers and it will mean entrepreneurs are more informed in making decisions on their offering before applying for a licence.³

1.4 In relation to the venture capital and early stage investor tax concessions, the Treasurer concluded that:

The amendments made by this Bill will ensure that investors in innovative Australian businesses continue to benefit from effective, generous

1 *Journals of the Senate*, No. 87, 15 February 2018, p. 2739.

2 The Hon. Scott Morrison MP, Treasurer, *House of Representatives Hansard*, 8 February 2018, pp. 4–5.

3 The Hon. Scott Morrison MP, Treasurer, *House of Representatives Hansard*, 8 February 2018, p. 4.

Government support and have certainty as to how these programmes are intended to operate.⁴

Conduct of the inquiry

1.5 The committee advertised the inquiry on its website. It also wrote to relevant stakeholders and interested parties inviting written submissions by 28 February 2018. The committee received 3 submissions, which are listed at Appendix 1.

1.6 The committee held a public hearing for the inquiry in Melbourne on 6 March 2018. The witnesses who attended the public hearing are listed at Appendix 2.

1.7 The committee thanks all individuals and organisations that took the time to make a written submission.

Overview of the bill

1.8 The bill makes amendments to a variety of acts and contains two schedules:

- Schedule 1 amends the *Corporations Act 2001* (Corporations Act) and the *National Consumer Credit Protection Act 2009* (Credit Act) to expand the regulation-making powers to allow the regulations to provide for exemptions from the Australian Financial Services Licence (AFSL) and Australian Credit Licence (ACL) requirements for the purposes of testing financial and credit products and services under certain conditions.
- Schedule 2 amends the *Income Tax Assessment Act 1997* (ITAA 1997) venture capital and early stage investor tax concession provisions to make minor changes to ensure that the provisions operate as intended.⁵

FinTech Sandbox Regulatory Licensing Exceptions

1.9 Since December 2016, ASIC has provided a regulatory sandbox framework to allow new and innovative FinTech products and services to be tested in Australia without obtaining a licence from ASIC. The enhanced regulatory sandbox proposed in the bill would allow more businesses to test a wider range of new financial and credit products and services without a licence from ASIC, for a longer time.⁶

1.10 The enhanced regulatory sandbox is intended to:

- further promote Australia's FinTech capability by supporting start-ups and innovative businesses to develop, test and launch financial and credit products and services under certain conditions; and

4 The Hon. Scott Morrison MP, Treasurer, *House of Representatives Hansard*, 8 February 2018, p. 5.

5 Explanatory Memorandum, p. 3.

6 Explanatory Memorandum, p. 5.

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- strike a better balance in encouraging innovation that delivers choice for consumers and minimising risks to consumers and the integrity of the financial system.⁷

1.11 Part 1 of Schedule 1 of the bill would extend the regulation-making power in section 926B of the Corporations Act to allow regulation to provide conditional exemptions from the AFSL requirements for the purpose of testing certain financial products and services.

1.12 Part 2 of Schedule 1 of the bill extends the regulation power in section 110 of the Credit Act to enable regulations to provide conditional exemptions from the ACL requirements for the purpose of testing certain credit services or the issuance of certain credit contracts.⁸

1.13 In relation to the proposed amendments to both the Corporations Act and the Credit Act, the Explanatory Memorandum argues that it is appropriate for the conditional exemption from the AFSL and ACL requirements to be in the regulations so that the Government can make timely changes in response to the changing market. As the market changes and develops, it is important to have the flexibility to make changes to the types of eligible products and services to ensure the exemption operates appropriately. It may also be necessary to adjust the conditions under which they can be tested to maintain an appropriate balance between facilitating innovation and providing investor protections.⁹

1.14 Further, the adaptive nature of the proposed regulatory sandbox will provide consumer protections and Parliamentary oversight:

Extending the regulation making powers and prescribing the conditions in the regulations will let the regulatory sandbox evolve with the market to ensure that it stays fit for purpose, allowing for the innovation and growth of the FinTech sector over time, while providing consumer protections for investors. This flexible approach sets Australia's regulatory sandbox apart from its international equivalents. As the regulations are subject to disallowance, there will be appropriate Parliamentary scrutiny of the eligible products and services and conditions for businesses testing in the regulatory sandbox.¹⁰

1.15 ASIC would be empowered to make decisions regarding how the exemption starts and ceases to apply to a person or class of persons. This provision is necessary to allow ASIC to minimise risks and protect consumers where unintended and undesirable behaviour from firms is identified. For example, if a provider is not compliant with any of the conditions set out in the regulations, ASIC can stop the provider from relying on the exemption or seek an order from the court that a

7 Explanatory Memorandum, p. 5.

8 Explanatory Memorandum, p. 8.

9 Explanatory Memorandum, pp. 7–9.

10 Explanatory Memorandum, pp. 7 & 9.

condition should be complied with in a particular way. In appropriate circumstances, ASIC could also prevent a provider from starting to use the exemption.¹¹

1.16 By allowing ASIC to make decisions about how the exemption starts and ceases to apply, ASIC would have the flexibility to provide arrangements to transition providers effectively from the exemption to becoming licensed.¹²

1.17 In relation to Part 1, any decisions made by ASIC are subject to review by the Administrative Appeals Tribunal (AAT) under section 1317B of the Corporations Act. In relation to Part 2, decisions made by ASIC under paragraph 327(1)(i) of the Credit Act are only subject to AAT review if the regulations specifically provide for this. The Explanatory Memorandum clarifies how the review mechanism is intended to operate:

...to ensure consistency across the application of the Corporations and Credit Acts to the regulatory sandbox, the Government intends [sic] that the regulations would specifically provide for AAT review for ASIC decisions relation to exemptions for ACL requirements.¹³

Innovation measures

Background

1.18 Venture capital is a mechanism for financing new, innovative enterprises at the seed, start-up and early-expansion stages of commercialisation. The Commonwealth provides various tax concessions to support Australian venture capital investments; specifically the venture capital limited partnership (VCLP) and early stage venture capital limited partnership (ESVCLP) programs.¹⁴

1.19 The VCLP regime supports investment in venture capital entities at the start-up and expansion stages that would otherwise have difficulty in attracting investment through normal commercial means.¹⁵

1.20 VCLPs are taxed on a 'flow-through' basis rather than being treated as a company for tax purposes like other limited partnerships. This results in the partners rather than the 'partnership' being taxed. One of the key benefits is that certain foreign partners are exempt from income tax on capital and revenue gains from disposals of eligible investments made by the VCLP, with corresponding losses also being disregarded. In addition, amounts received by general partners for their successful management of the partnership's investments ('carried interests') are taxed on capital account, thus potentially entitling them to the Capital Gains Tax (CGT) discount if they have been a partner for over 12 months and meet the other eligibility requirements for the CGT discount.¹⁶

11 Explanatory Memorandum, p. 8.

12 Explanatory Memorandum, p. 8.

13 Explanatory Memorandum, pp. 8–10.

14 Explanatory Memorandum, p. 13.

15 Explanatory Memorandum, p. 13.

16 Explanatory Memorandum, p. 13.

1.21 The ESVCLP regime provides additional tax concessions for high-risk start-up entities with a value of no more than \$50 million. Like VCLPs, ESVCLPs are taxed on a 'flow-through' basis. However, the tax concessions are more generous given the higher degree of risk involved. Both Australian and foreign investors are exempt from income tax on capital and revenue gains from disposals of investments made by ESVCLPs, with corresponding losses also being disregarded. Income derived from the partnership's investments, such as dividends, is also exempt from tax.¹⁷

1.22 A separate incentive was also introduced for early stage investors outside the venture capital framework. Broadly, this incentive allows eligible investors that acquire shares in an innovation company in an income year to receive a carry forward tax offset for that income year equal to 20 per cent of the amount paid for the shares. However, the total amount of this offset to which an entity and its affiliates is entitled in an income year cannot exceed \$200 000.¹⁸

Capital Gains Tax amendments

1.23 Part 1 of Schedule 2 would make changes to the concessional CGT treatment for investments in ESVCLPs and VCLPs to ensure they operate as intended.

1.24 The proposed amendment to subsection 118-408(2) of the ITAA 1997 clarifies the extent to which tax concessions are available to ESVCLPs disposing of investments made once the \$250 million threshold has been exceeded by the investee. Specifically, it makes clear that the capital gain valuation is determined based on what the capital proceeds would have been if the events resulted in the gain happening at the end of the period six months after the end of the relevant valuation year. Other matters relating to the amount of the gain would be determined on a reasonable basis taking into account this premise.¹⁹

1.25 A further proposed amendment to subsection 118-428 clarifies that ESVCLPs can only acquire a pre-owned investment if the sum of all pre-owned investments following the acquisition does not exceed 20 per cent of the partnership's committed capital.²⁰

Early stage investor tax offsets

1.26 Part 2 of Schedule 2 would amend early stage investor tax offset provisions to ensure they operate as originally intended.

1.27 To ensure that where an investor is entitled to the ESVCLP tax offset they do not also qualify for the early stage investor tax offset, an eligibility requirement is to be included in Division 360 of the ITAA 1997. This has the effect that an investor will only qualify for the offset if they are not an ESVCLP.²¹

17 Explanatory Memorandum, p. 14.

18 Explanatory Memorandum, p. 14.

19 Explanatory Memorandum, p. 15.

20 Explanatory Memorandum, p. 16.

21 Explanatory Memorandum, p. 18.

1.28 In order to qualify for the early stage investor tax offset, an investor must not hold more than 30 per cent of the equity interests in an early stage innovation company or any entities connected with that company. The proposed amendment clarifies what is meant by 30 per cent of the equity interests in the company or entity. This change would ensure that the equity test for early stage investor tax offset applies in a manner that is consistent with its application in other parts of income tax law.²²

1.29 In relation to widely held companies, an amendment is proposed that would make clear the restriction on tax offsets for widely held companies and their subsidiaries also applies for investments made by these companies indirectly through trusts and partnerships.²³

1.30 Where investments have been made through a chain of trusts or partnerships, a proposed amendment would clarify that the early stage investor tax offset is available to members of trusts and partnerships as long as they are eligible.²⁴

1.31 For the purposes of calculating the amount of early stage investor offset, a proposed amendment sets the offset at 20 per cent of the amount of the sum of any money and non-cash benefits received or entitled to be received by the company in return for the issue to the shareholder of the shares. The value of the non-cash benefits is their value at the time the shares were issued to the shareholder.²⁵

1.32 Currently, there is no limit on the amount of early stage investor tax offset that can be claimed for indirect investments. A proposed amendment would ensure that the \$200 000 income year limit applies as a single combined limit to both direct and indirect investments. A minor consequential amendment would also be made to the rules setting out the amount of the early stage investor tax offset for trustees to clarify that, for the purpose of this calculation, it is not relevant if members of the trust have reached this cap.²⁶

1.33 To ensure that the entitlement to tax offset reflects the entitlement to a fixed proportion of any capital gain, the provisions setting out this requirement would be amended to specify that the relevant disposal is the disposal of the investment that would give rise to, or gave rise to, the entitlement to the early stage investor tax offset. This ensures there is no ambiguity where different entitlements exist in relation to different assets.²⁷

22 Explanatory Memorandum, pp. 18–19.

23 Explanatory Memorandum, p. 19.

24 Explanatory Memorandum, p. 19.

25 Explanatory Memorandum, p. 20.

26 Explanatory Memorandum, p. 20.

27 Explanatory Memorandum, p. 21.

1.34 A proposed amendment would modify the requirement to be recently incorporated or registered on the Australian Business Register to provide certainty to the company that the requirement is satisfied.²⁸

1.35 A proposed amendment would also ensure that foreign companies, as defined in the Corporations Act, are no longer able to be early stage innovation companies.²⁹

1.36 To clarify when an early stage innovation company is doing something, a note is added to explain that, under the general principles of agency, one way a company can demonstrate it is doing something is by engaging the services of another entity.³⁰

Managed investment trusts and public trading trusts

1.37 Proposed amendments would permit managed investment trusts (MIT) to invest in an Australian venture capital fund of funds (AFOFs) by including them in the exception that permits them to invest in VCLPs and ESVCLPs.³¹

1.38 To overcome an interaction between the MIT eligibility rules in the ITAA 1997 and the public trading trust provisions in the ITAA 1936, a proposed amendment would amend the definition of a public trading trust to ensure that, in considering if a trust is a public trading trust, investments in ESVCLPs, VCLPs and AFOFs are disregarded if trusts are MITs.³²

Scrutiny of bill and human rights implications

1.39 The Scrutiny of Bills Committee reviewed the bill in the *Scrutiny Digest 2 of 2018* and identified some concerns regarding the bill.

1.40 That committee was concerned that regulations foreshadowed in Schedule 1 would:

...confer a broad power on ASIC to determine when particular exemptions apply. The committee is concerned that, while the explanatory memorandum provides some guidance when ASIC's powers would be exercised, this guidance is not reflected on the face of the bill.³³

1.41 Similarly, that committee was also concerned that decisions made under the regulations would be disallowable instruments:

The committee is therefore concerned that proposed paragraphs 926B(5) and 110(4) would permit ASIC to make relatively significant decisions relating to the application of exemptions without subjecting those decisions to appropriate levels of parliamentary scrutiny.³⁴

28 Explanatory Memorandum, pp. 21–22.

29 Explanatory Memorandum, p. 22.

30 Explanatory Memorandum, p. 22.

31 Explanatory Memorandum, p. 16.

32 Explanatory Memorandum, pp. 17–18.

33 Standing Committee on the Scrutiny of Bills, *Scrutiny Digest 2 of 2018*, p. 52.

34 Standing Committee on the Scrutiny of Bills, *Scrutiny Digest 2 of 2018*, p. 53.

1.42 In addition, that committee highlighted the retrospective nature of the proposed amendments in Item 18 of Schedule 2:

The committee notes that the explanatory memorandum does not specify whether any person has been, or may be, adversely affected by the retrospective application...It is unclear whether trusts that complied with the law as written (including the omission) could be adversely affected by the retrospective application of the amendments in the present bill.³⁵

1.43 In all three instances, that committee requested that the Treasurer provide more detailed advice.

1.44 The Explanatory Memorandum states that the bill is compatible with human rights as it does not raise any human rights issues.³⁶

35 Standing Committee on the Scrutiny of Bills, *Scrutiny Digest 2 of 2018*, p. 54.

36 Explanatory Memorandum, pp. 11 & 23.