

## CROWD SOURCE FUNDING – NEW CORPORATIONS AND TAXATION RULES

This Alert summarises recent developments allowing companies to raise funding by way of Crowd-sourced Funding (**CSF**) in Australia and the availability of tax incentives provided to qualifying investors of early stage innovation companies (**ESICs**).

CSF is an innovative form of fundraising, typically online, that allows a large number of individuals to make small financial contributions towards a company, in exchange for an equity stake in the company.

The new CSF rules are summarised as follows:

### 1 CSF LEGISLATION

The *Corporations Amendment (Crowd-sourced Funding) Act 2017* (**CSF Act**) amends the *Corporations Act 2001* (**Corporations Act**) (and makes minor amendments to the Australian Securities and Investments Commission Act 2001 (**ASIC** and **ASIC Act**)), to provide a legislative framework for CSF (collectively the **CSF Regime**).

Broadly, the CSF Regime reduces the regulatory requirements for public fundraising while maintaining appropriate investor protection measures.

A provider of CSF services (termed a “**CSF Intermediary**” and traditionally an online platform providing CSF opportunities to the public (**CSF Platform**)) must hold an Australian financial services (**AFS**) licence.

The CSF Act received royal assent on 28 March 2017 and takes effect from 28 September 2017.

### 2 CSF OFFERS

Under the CSF Regime, eligible *public* companies are permitted to make offers of their shares, via a CSF Intermediary, using an offer document (**CSF Offer**).

Eligible companies are unlisted public companies with less than \$25 million in assets and annual turnover. Eligible companies will be able to make CSF Offers of ordinary shares of up to \$5 million in any 12-month period.

The CSF Act makes provision for newly created, or converted public companies making CSF Offers allowing such companies to satisfy reduced compliance requirements including certain reporting, audit and AGM obligations that would usually apply to public companies, for up to five years. (However, refer below regarding the draft legislation proposing to extend the CSF Regime to private companies.)

There are obligations and investor protections that apply to CSF Offers, including:

- an investor cap of \$10,000 per annum per company for retail investors (i.e. non-sophisticated investors)
- the provision of a CSF Offer document containing minimum information and a prescribed risk warning,
- may remain open for a maximum of three months;
- can only be published on a single CSF Platform; and
- a five-day cooling-off period.

The minimum information requirements for CSF Offer documents have not yet been finalised and we understand that ASIC is consulting with industry in respect of the CSF Offer information and other aspects of the CSF Regime.

### 3 PROPOSED EXTENSION OF CSF REGIME TO PRIVATE COMPANIES

In May, and following the 2017-2018 Budget, the Federal Government released the draft *Corporations Amendment (Crowd-Sourced Funding For Proprietary Companies) Bill 2017* (**CSF Bill**) for consultation.

The CSF Bill seeks to extend the CSF Regime to enable private companies to access CSF without transitioning to public company status as required under the current CSF Regime.

Currently private companies are unable to have more than 50 shareholders or make a public offer. By extending the CSF Regime to private companies, it is intended to allow small and innovative businesses easier access to capital funding.

To allow private companies to effectively use the CSF Regime, the existing shareholder cap which provides that a private company cannot have more than 50 non-employee shareholders is being amended so that CSF shareholders are not counted as part of the cap. Without this change, a private company would only be permitted to have 50 non-employee shareholders, severely limiting its ability to use the CSF Regime. However, an investor will only be a CSF shareholder if they purchase the securities as part of a CSF Offer. If the securities are sold or transferred in any other way, the new holders of those securities will no longer be CSF shareholders. The Explanatory Memorandum to the CSF Bill (**CSF EM**) provides the following example:

*“Example 1.1*

*Hannah invested \$5,000 to acquire 5,000 shares as part of a CSF offer by Kavas Pty Ltd. After a few months, Hannah is dissatisfied with the management of Kavas Pty Ltd and transfers all 5,000 shares to Nelson. Although these shares were originally purchased as part of a CSF offer, Nelson will not be a CSF shareholder of Kavas Pty Ltd as he did not acquire the shares through the CSF offer himself.*

*As Nelson is not a CSF shareholder, he will not be excluded from the 50 non-employee shareholder cap under section 113(1).”*

Consequently, in our view a private company seeking to utilise CSF will need to consider CSF shareholder exit restrictions.

Acknowledging that by making use of CSF, private companies will no longer be closely held, these companies will be subject obligations designed to increase shareholder engagement and mitigate the occurrence of fraud.

The proposed obligations include:

- a minimum of two directors whilst it has CSF shareholders;
- financial reporting in accordance with accounting standards;
- audit requirements (if more than \$1 million is raised from CSF Offers);
- additional ASIC reporting requirements;
- restrictions on related party transactions (i.e. they will be subject to the existing related party transaction rules and penalties under Chapter 2E of the Corporations Act); and
- minimum shareholder rights to participate in exit events: A private company that has CSF shareholders will be exempt from the takeover rules in Chapter 6 of the Corporations Act if the company's constitution provides a minimum level of protection for investors to participate in an exit event.

To qualify for the exit concession, a private company must include a provision as part of its constitution that requires someone who acquires more than 40 per cent of the voting shares in the company to offer to purchase all other securities in the company on the same terms within 31 days. The provision must require the purchaser to offer to acquire all of the voting shares on offer but it will be up to each shareholder if they wish to sell on the terms offered.

Companies will therefore need to amend their constitutions to provide for the minimum exit arrangement, regardless of whether it was incorporated before or after they became a shareholder of the company.

Private companies making use of CSF will also be required to satisfy any further requirements specified by way of regulations issued (draft regulations were released in respect of public companies for consultation in 2015).

The CSF Bill also proposes removing the temporary corporate governance concessions for private companies that convert to or register as public companies to access the current CSF Regime.

Other than the amendments proposed and specifically addressed to private companies, private companies making use of CSF would be subject to the requirements imposed on unlisted public companies under the current CSF Regime and summarised in section 2 above.

The table in Schedule 1 sets out the comparison of key features of proposed draft and current CSF Regime (taken from the CSF EM).

#### 4 ESICS AND THE CSF REGIME - TAXATION ISSUES

New Subdivision 360-A of *Income Tax Assessment Act 1997* contains tax incentives for investors in ESICs. These tax incentives are intended to target companies facing difficulty accessing equity finance and typically do not have easy access to fundraising via listed securities.

In summary, the subdivision provides two income tax incentives:

- a tax offset at the outset for investors who invest ESICs: Investors that acquire newly issued shares in an ESIC may receive a non-refundable carry-forward tax offset of 20% of the value of their investment subject to a maximum offset of \$200,000. A total annual investment limit of \$50,000 applies to retail (i.e. non-sophisticated) investors (*Readers should note the lower threshold for CSF Offers above*); and
- an exemption for any subsequent capital gains realised on the ESIC investment, but without access to any losses realised on the investment: Investors may disregard capital gains realised on shares in qualifying ESICs that have been held for between 1 and 10 years. Investors must disregard any capital losses realised on these shares held for less than 10 years.

To be eligible as an ESIC companies have to satisfy five threshold tests as follows:

- Recently incorporated or registered in Australia
- Total expenses of \$1m or less in the previous income year
- Assessable income of \$200,000 or less in the previous income year
- Not listed on a stock exchange in Australia or overseas
- Specified innovation tests need to be satisfied by the company

##### **Limitation on Tax offset**

Broadly, the tax incentives are available to the majority of investors, whether an investment is made, directly (as a corporation or individual) or indirectly (through a trust or partnership), *other than*:

- widely held companies or their 100% subsidiaries;
- shares issued as part of an employee share scheme; or
- where the shareholder holds more than 30% of the equity interests in the company, or an entity connected with the company.

The provisions provide for certain additional requirements to be satisfied in the case of partnerships and trusts.

##### **The CSF Regime**

In our view, and subject to any further regulations setting out further requirements, making use of CSF to raise additional capital would not of itself prevent a company from being an eligible ESIC.

The CSF Regime, therefore, paves the way for exciting possibilities for raising capital by way of CSF and the potential for CSF investors in ESICs to access the ESIC income tax concessions.

##### **Disclaimer**

*The statements herein are not intended to amount to advice and should not be relied upon without first obtaining specific advice applicable to your situation.*

## Schedule 1

### Comparison of key features of proposed draft and current CSF Regime

<i>New law</i>	<i>Current law</i>
Private companies that meet the eligibility requirements will be able to access the CSF regime	Only public companies can access the CSF regime
Private companies that have CSF shareholders will have to prepare annual financial and directors' reports in accordance with accounting standards	Small private companies are generally not required to provide annual financial and directors' reports unless directed
Private companies that raise more than \$1 million from CSF offers will have to have their financial statements audited	Small private companies are generally not required to have their financial statements audited unless directed
Private companies that have CSF shareholders will be subject to the related party transaction rules in Chapter 2E [of the Corporations Act]	Private companies are not subject to the related party transaction rules in Chapter 2E [of the Corporations Act]
Private companies that have CSF shareholders will not breach the takeovers rules if their constitutions contain appropriate CSF exit arrangements that are complied with	Private companies with more than 50 shareholders are subject to the takeovers rules in Chapter 6 [of the Corporations Act]
Private companies that make a CSF offer will have to include details about the offer and the shareholders as part of their company registers	