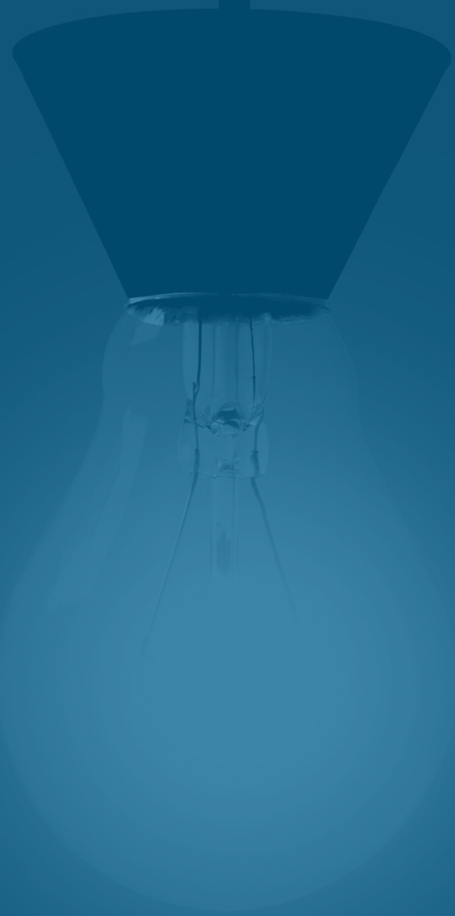
A GUIDE TO:

COMMON CAPITAL RAISING STRUCTURES IN AUSTRALIA



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ABOUT THIS GUIDE

Access to capital is a critical issue for all businesses. In this guide, our capital raising experts provide an overview of the most commonly used unlisted capital raising structures in Australia.

Part 1 summarises the structure and regulation of fundraising using a company structure.

Part 2 summarises the structure and regulation of fundraising using a trust structure (managed investment schemes).

Part 3 broadly sets out the tax treatment for each type of structure.

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PART 1
COMPANY STRUCTURE

Of course, a commonly used structure for raising capital in Australia is via a company. This section focuses on some of the key rules to keep in mind when raising funds in this way.

The general position under Chapter 6D of the *Corporations Act 2001* (Cth) (**Corporations Act**) is that an offer of securities by a company must be made pursuant to a regulated disclosure document, such as a prospectus. However, the Corporations Act provides a number of exemptions where funds can be raised from the issue of shares without the company having to prepare a prospectus[1]. The more common exemptions are summarised below.

20/12/2 RULE

A company may raise no more than $2 million from no more than 20 investors in any 12 month period pursuant to personal offers (**20/12/2 rule**)[2].

A personal offer is one which may only be accepted by the person to whom it is made and is made to a person who is likely to be interested in the offer, having regard to:

- previous contact between the offeror (i.e. company) and any investor;
- some professional or other connection between the offeror and the investor; or
- statements or actions by that investor that indicate they are interested in offers of this kind.

Advertising offers pursuant to the 20/12/2 rule are prohibited[3].

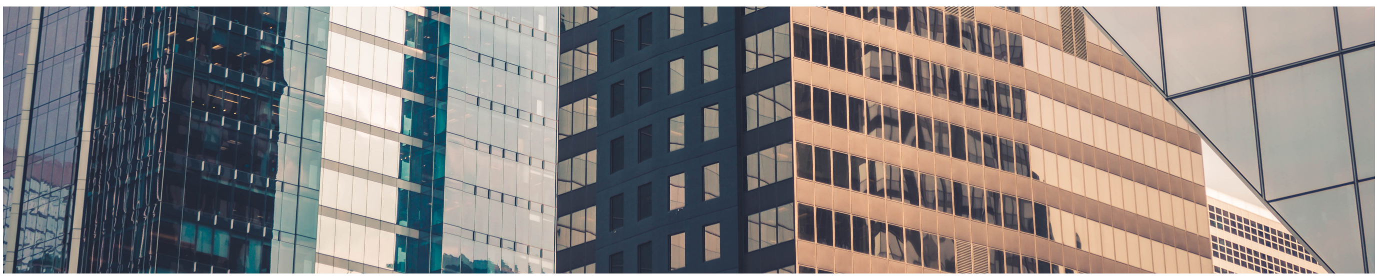
[1] Section 708 of the Corporations Act.
[2] Sections 708(1) and 708(2) of the Corporations Act.
[3] Section 734 of the Corporations Act.

The 12 month period is a rolling period. For example, if a company issued 20 people $100,000 worth of shares each (i.e. total of $2 million) in January 2021, the company would be unable to raise further funds and issue further shares pursuant to the 20/12/2 rule exemption until January 2022, at which time it could again raise up to $2 million from a maximum of 20 investors.

Alternatively, if a company issued 10 people $100,000 worth of shares each in January 2021 and another 10 people $100,000 worth of shares each in June 2021, the company could not raise further funds pursuant to the 20/12/2 rule exemption until January 2022. At this time it could raise a maximum of $1 million from up to 10 investors and subsequently raise another $1 million from up to 10 investors in June 2022.

In calculating the amount raised for the purposes of the $2 million threshold, the following amounts must be included:

- the amount paid for the securities at the time they are issued;
- for partly paid shares, any amount payable at a future time if a call is made (in addition to the initial instalment paid at the time of issue);
- where the security is an option, any amount payable on the exercise of the option (as well as the amount paid for the option); and
- if the securities carry a right to convert into other securities – any amount payable on the exercise of that right.



SOPHISTICATED INVESTORS

Issuing shares to sophisticated investors can also be made without preparing a prospectus or other regulated disclosure document.

Sophisticated investors include:

- persons who invest $500,000 or more (and if further shares are issued to a person who has invested $500,000, that person continues to be classified as a sophisticated investor for those subsequent issues) [4]; or
- investors who have a gross income of $250,000 per annum for each of the last two financial years or net assets of $2.5 million and who obtain a certificate from a recognised accountant to this effect. The certificate must not be more than two years old. In determining a person's net assets or gross income, income or assets of a company or trust controlled by that person can be included. Similarly, a company or trust controlled by a person who meets the net asset or gross income test above is classified as a sophisticated investor [5].

Sophisticated investors are not counted towards the 20 investor limit for the purposes of the 20/12/2 rule. That is, a company can:

- raise a maximum of $2 million from 20 investors in any 12 month period;
- raise unlimited funds from an unlimited number of sophisticated investors at any time; or
- both (a) and (b),

without the need to prepare a regulated disclosure document.

[4] Section 708(8)(e) of the Corporations Act.
[5] Sections 708(8)(c), 708(8)(d), 708(9B) and 708(9C) of the Corporations Act.

ISSUES TO EXECUTIVES AND CONTROLLED ENTITIES

Shares may be issued to:

- a senior manager (being a person who is concerned in, or takes part in, the management of a company, regardless of their designation and whether or not they are a director or secretary) of the company or of a related body, or their spouse, parent, child, brother or sister; or
- a company controlled by a person referred to in the paragraph above[6].

Again, persons who satisfy the above criteria are not counted towards the 20 investor limit under the 20/12/2 rule.

INFORMATION MEMORANDUM

There are no formal disclosure requirements prescribed for an unregulated capital raising (being an offer of securities made either under the 20/12/2 rule, to sophisticated investors or to executives and controlled entities, or a combination of these). However, unregulated capital raisings usually occur by way of an information memorandum, which describes to investors the basis of their investment.

Although there is no obligation to issue an information memorandum, the preparation and use of an information memorandum is recommended because it provides a useful messaging tool and minimises potential uncertainty about the basis of the investment.

Generally, an information memorandum will provide the following information:

- the company's business and future prospects;
- a summary of the market in which the company operates;
- details of the offer (i.e. how much is being raised, how many shares are being issued and restrictions on investors, e.g. only sophisticated investors can apply);
- the purpose for which funds are being raised;
- the company's current financial position and financial position assuming completion of the capital raising (often a balance sheet and pro forma balance sheet is included);
- a summary of the company constitution, including the rights attaching to shares;
- details of the directors, including their holdings in the company;
- the company's current issued capital;
- summaries of agreements which are material to the company's operations;
- disclosure of any related party transactions to which the company is, or will be, a party; and
- risks associated with the investment.

[6] Section 708(12) of the Corporations Act.

LIABILITY CONSIDERATIONS

In undertaking unregulated capital raisings pursuant to the exemptions discussed previously, regard should be had to potential areas of liability under the Corporations Act. Misleading and deceptive conduct is prohibited in relation to dealings in financial products and financial services[7].

These prohibitions impose liability for misleading and deceptive conduct (e.g. false statements about the company's financial position in the information memorandum) in the context of unregulated capital raisings, and no defences are provided once it is established that the conduct is misleading and deceptive.

In contrast, for regulated capital raisings, offers of securities pursuant to a prospectus, are not subject to this prohibition, but are subject to their own specific liability regime[8], for which a due diligence defence is provided.

Another issue to be considered in undertaking unregulated capital raisings is that a resale within 12 months of securities being issued pursuant to an information memorandum may be deemed to be a sale amounting to an indirect issue[9].

As a result of this, an unregulated capital raising may be deemed to be a regulated capital raising if the original recipients resell their shares within 12 months of issue in circumstances where an exemption would not apply (i.e. the on-sale to a sophisticated investor would still be exempt, but an on-sale to a person who is not a sophisticated investor may not be exempt). This would necessitate the issuance of a regulated disclosure document, such as a prospectus, at the time of the resale.

This risk can be managed by ensuring that the company does not approve any transfers of shares within 12 months of issue.

[7] Section 1041H of the Corporations Act and section 12DA of the Australian Securities and Investments Commission Act 2001 (Cth).
[8] Section 728 of the Corporations Act.
[9] Section 707 of the Corporations Act.

LICENSING REQUIREMENTS

The Corporations Act regulates the provision of financial services and the general rule is that a person involved in the business of providing financial services must either hold an AFSL or be exempt from this requirement.

For present purposes, issuing shares constitutes dealing in a financial product and such activity is a financial service. Though a company issuing its own shares is not taken to be dealing (that is, it is not providing a financial service)[10].

However, investment companies that invest funds raised after an offer to the public are unable to rely on this exemption and will be providing the financial service of dealing by issuing shares[11]. A company will be deemed to be an investment company if it carries on a business of investment in securities, interests in land or other investments.

The Australian Securities and Investment Commission (**ASIC**) has stated that it believes a company will be in the business of investing where it:

- applies money to acquire shares, interests in land or some other asset;
- expects to generate (or derive) a return from the assets;
- obtains an interest in, ownership of, or derives a benefit from the value of, the assets; and
- engages in those activities as a business.

The extent to which the activities are repetitious or systematic is relevant to whether a person is carrying on a business.

[10] Section 766C(4) of the Corporations Act.
[11] Section 766C(5) of the Corporations Act.

As indicated previously, if the issue of shares by an investment company was not made under an offer to the public, then the company will not be dealing and not providing a financial service.

Whether or not an offer is made to the public depends on the circumstances, namely whether there is a:

- subsisting special relationship between the company and the offerees; or
- rational connection between the common characteristic of the group and the offer.

Factors to take into account include the:

- number of persons in the group (the smaller the better);
- subsisting relationship between the company and the group;
- nature and content of the offer; and
- significance of any particular characteristic which identifies the members of the group and any connection between that characteristic and the offer.

An offer made pursuant to the 20/12/2 rule exemption may still be an offer to the public. Also, if you advertise the offer as an opportunity for sophisticated and professional investors, the offer will constitute an offer to the public.

However, ASIC has indicated that, in its view, it does not believe an offer extended only to particular professionals in the business of investing (i.e. a person whose ordinary business is to buy or sell shares) will constitute an offer to the public.

If the company is an investment company and raises funds from an offer to the public, the company must either:

- obtain its own Australian Financial Services License (**AFSL**) authorising it to provide the financial service of dealing by issuing securities; or
- engage another appropriately authorised AFSL holder (i.e. an entity which is authorised to issue securities) to provide the dealing function on its behalf.

Generally, due to the onerous requirements and substantial initial and ongoing costs associated with obtaining and holding an AFSL, unless you intend to regularly issue securities under an information memorandum or a prospectus, the better alternative is to engage an appropriately authorised AFSL holder to provide the dealing function on the company's behalf.

PART 2
MANAGED INVESTMENT SCHEMES

WHAT IS A MANAGED INVESTMENT SCHEME?

A managed investment scheme is an arrangement that has all of the following features:

- people contribute money or money's worth as consideration to acquire rights to benefits produced by the scheme;
- any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits consisting of rights or interests in property for the scheme members; and
- the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions)[12].

A **unit trust** is caught by this definition as the general premise is that investors pool money, this money is used to purchase goods, and investors participate in returns generated by the sale of these goods.

Therefore, a unit trust is a managed investment scheme and is the typical structure used in Australia for managed investment scheme fundraising activities.

[12] Section 9 of the Corporations Act.

REGULATION OF MANAGED INVESTMENT SCHEMES

Essentially, the level of regulation a managed investment scheme will be required to comply with, and the costs associated with operating a scheme, depend on the number and 'type' of investors who acquire interests in the scheme.

There are three tiers of regulation for managed investment schemes. These are listed below in the order of least regulated to most regulated:

- **Unregulated schemes**: these schemes are legally outside the licensing, registration and disclosure requirements of the Corporations Act;
- **Unregistered schemes**: these schemes are outside the registration and disclosure requirements of the Corporations Act, but are subject to licensing provisions; and
- **Registered schemes**: these schemes are subject to the licensing, registration and disclosure requirements of the Corporations Act.

The regulatory environment of each scheme is explained overleaf.

THE REGULATORY ENVIRONMENT: UNREGULATED SCHEMES

If a scheme:

- has no more than 20 members; and
- is not promoted by a person (or their associate) who is in the business of promoting managed investment schemes,

then the operator of the scheme does not need to:

- hold an AFSL;
- register the scheme with ASIC; or
- prepare a Product Disclosure Statement (**PDS**) to offer an investment in the scheme (in such circumstances an information memorandum is usually prepared to facilitate the offer, although the Corporations Act does not mandate this)[13].

Therefore, if a scheme has 20 members or less, and the operator has not previously been involved in operating schemes, the operator can legally operate the scheme outside the requirements of the Corporations Act. However, the operator will still be subject to the misleading and deceptive conduct provisions of the *Australian Securities and Investments Commission Act 2001* (Cth) (**ASIC Act**).

[13] Sections 601ED(1) and 765A(1)(s) of the Corporations Act.

ADVANTAGES AND DISADVANTAGES OF FUNDRAISING VIA AN UNREGULATED SCHEME

Costs and timing are the main benefits of operating an unregulated scheme. It is considerably cheaper and quicker to establish and manage an unregulated scheme, compared to an unregistered scheme or a registered scheme. However, an unregulated scheme can be very limited in practice. The growth of the scheme is limited to the continued ability to raise funds from the same 20 members because of the restrictions on the number of members.

In addition, if an entity operates more than one unregulated scheme, the entity will most likely be considered to be in the business of promoting managed investment schemes and will need to hold an AFSL.

An unregulated scheme is the ideal vehicle in terms of timing and costs to carry out an initial small unit trust fundraising, and we find this is the best course for start-ups with a limited number of investors to fundraise their first project, and during the course of this first project prepare and apply for an AFSL in anticipation of their business growing.

THE REGULATORY ENVIRONMENT: UNREGISTERED SCHEMES

If a scheme:

- has more than 20 members; or
- is promoted by a person, or an associate of a person, who is in the business of promoting managed investment schemes; and
- the offer of interests in the scheme does not require the issue of a PDS, then:
    - the scheme will not require registration; and
    - a PDS is not needed to facilitate offers of interests in the scheme,

however, the operator will generally need to hold an AFSL[14].

A PDS is not required for an offer of interests in a managed investment scheme to:

- **Wholesale clients:** people who either purchase $500,000 worth of interests, or who have net assets of $2.5 million or earned a gross income of $250,000 per annum over the past two financial years and provide an accountant's certificate confirming they satisfy the net asset or gross income threshold.

  In determining whether a person meets the net asset or gross income threshold, the income or assets of companies or trusts controlled by that person are also counted.

  Also, if a person is a wholesale client, a company or trust controlled by that person is deemed to be a wholesale client. If a company is a wholesale client, a related body corporate of the company is also deemed to be a wholesale client[15]; and

- **Retail clients:** investors who are not wholesale clients (i.e. 'mum and dad' investors), where no more than $2 million (in total) is raised from a maximum of 20 clients in any rolling 12 month period (**20/12/2 rule**). However, the 20 clients must be 'personally known' to the operator[16].

[14] Sections 601ED(2) and 764A(1)(bc) of the Corporations Act.
[15] Section 761G(7) of the Corporations Act and regulations 7.1.19, 7.1.28, 7.6.02AB to 7.6.02AD of the *Corporations Regulations 2001* (Cth) (**Regulations**).
[16] Section 1012E of the Corporations Act.

Therefore, a scheme could be established with, for example, 50 members, 30 of whom are wholesale clients contributing a total of $50 million (or any other amount) and 20 of whom are retail clients who have acquired their interests in the scheme under a 'personal offer' and contributed a maximum of $2 million in total. Importantly, note that whilst a PDS is not required, the scheme operator would still need to be authorised under an AFSL to offer interests in a managed investment scheme to retail clients even if the offer is under the 20/12/2 rule.

In order for an offer to qualify as a personal offer, the offer:

- *'may only be accepted by the person to whom* [the offer] *is made*; and
- *is made to a person who is likely to be interested in the offer, having regard to:*
    - *previous contact between the person making the offer and that person; or*
    - *some professional or other connection between the person making the offer and that person; or*
    - *a statement or action by that person that indicates that they are interested in offers of that kind'*[17].

It is an offence for a person to advertise a personal offer made under the 20/12/2 rule[18].

[17] Section 1012E(5) of the Corporations Act.
[18] Section 1018B of the Corporations Act.

Other exceptions to the requirement to provide investors with a PDS include:

- **Large business use:** the scheme interests are provided for use in connection with a large business. A large business is a manufacturing business which employs 100 or more people or any other type of business which employs 20 or more people[19];

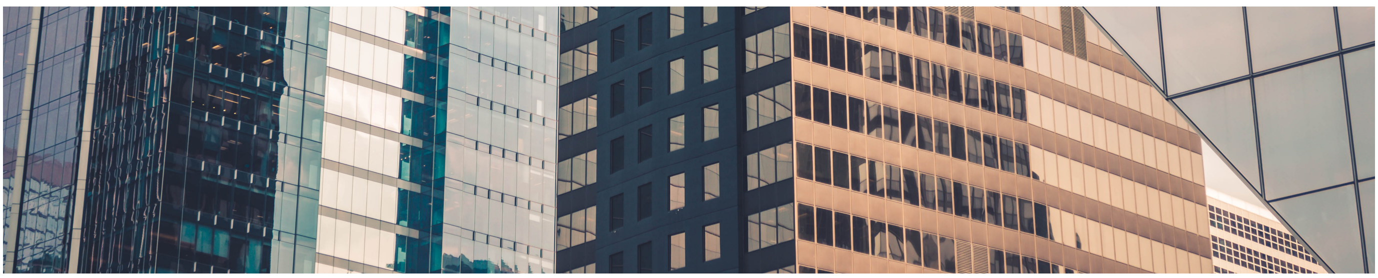
- **Sophisticated investors:** an AFSL holder provides the client with a written statement confirming that it is satisfied on reasonable grounds that the person acquiring the financial product has previous experience in using financial services and investing in financial products that allows the client to assess:

  - the merits of the product;
  - the value of the product;
  - the risks associated with the product;
  - their own information needs; and
  - the adequacy of the information given by the AFSL holder and the product issuer.

  To rely on this exemption, the AFSL holder must give the client a written statement of the AFSL holder's reasons for being satisfied with the above.

  Further, the client must sign an acknowledgment that they have not received a PDS, Financial Services Guide, Statement of Advice, or other document to which a retail client is entitled, and that the AFSL holder does not have any obligation to the client under Chapter 7 of the Corporations Act that the AFSL holder would have if the client was a retail client[20]; and

- **Professional investors:** interests are issued to professional investors, which include AFSL holders, persons who have or control gross assets of at least $10 million (including any assets held by an associate or under a trust that the person manages), listed entities and their related bodies corporate, certain investment entities, certain Australian Prudential Regulation Authority (**APRA**) regulated bodies and trustees of superannuation funds and pooled superannuation trusts where the fund or trust has net assets of at least $10 million[21].



[19] Section 761G(7)(b) of the Corporations Act.
[20] Section 761GA of the Corporations Act.
[21] Sections 761G(7)(d) and 9 of the Corporations Act.

ADVANTAGES AND DISADVANTAGES OF FUNDRAISING VIA AN UNREGISTERED SCHEME

The benefits of an unregistered scheme are that there is less regulation than for a registered scheme (for example there is no legal requirement to audit the scheme accounts) but still has an ability to grow the scheme through the introduction of further wholesale clients and gradual increases in retail clients (in accordance with the 20/12/2 rule).

The disadvantages are that:

- the operator is unable to access the ‘mum and dad’ investor market;
- the operator will most likely need to hold an AFSL (or enter into contractual arrangements with an AFSL holder), which increases the cost and compliance for the operator;
- the scheme will need to be registered if you wish to list on ASX (which gives members an exit mechanism); and
- financial advisers are usually reluctant to recommend wholesale clients invest in an unregistered scheme.

THE REGULATORY ENVIRONMENT: REGISTERED SCHEMES

If a scheme does not meet the requirements of an unregulated or unregistered scheme (i.e. it has more than 20 members or is promoted by a person in the business of promoting schemes and the offer of interests in the scheme requires a PDS), then the scheme must be registered[22].

The operator of the scheme, referred to as the responsible entity, will be required to obtain an AFSL issued by ASIC. In order to obtain an AFSL, the operator must satisfy ASIC that the people who will operate the scheme (referred to as responsible managers) have sufficient qualifications and practical experience to ensure that the responsible entity is competent to provide the financial services required to operate the scheme. A responsible entity must be a public company (i.e. an 'ltd' company rather than a 'pty ltd' company).

In order to be granted the AFSL required to operate a registered managed investment scheme, the responsible managers of the operator must satisfy ASIC that they meet the educational and experience requirements set out in ASIC Regulatory Guide 105 Licensing: Organisational competence. In summary, there are two limbs to satisfy:

- asset experience; and
- funds management experience.

Typically, a responsible manager must have, in addition to relevant qualifications (e.g. university degree, diploma, short industry course etc.), at least three years relevant experience over the past five years in, for the asset experience limb, the industry associated with the assets of the proposed scheme (for example, the real estate industry for a property scheme) and, for the funds management experience, in operating managed investment schemes.

All of the responsible managers do not have to satisfy both limbs. That is, one responsible manager can meet the asset experience limb and another responsible manager can satisfy the funds management limb. Generally, ASIC requires an AFSL holder to have at least two responsible managers.

[22] Sections 601ED(1) and 1012B of the Corporations Act.

ADVANTAGES AND DISADVANTAGES OF FUNDRAISING VIA A REGISTERED SCHEME

The benefit of operating a registered managed investment scheme is that operators have the opportunity to raise capital from retail clients under a PDS.

However, there are considerable start up and ongoing expenses associated with being an AFSL holder and operating a registered scheme. A general guide is that operators should only enter into the regulated regime if they intend to undertake an ongoing operation of significant size (i.e. at least $30 million in funds under management).

PART 3
TAX

The different taxation treatment that may apply to a company versus a unit trust in Australia is another relevant consideration in deciding which structure is best suited to your capital raising circumstances. The most appropriate structure from a tax perspective will often be driven by considerations such as the type of investments that will be made and whether or not you wish to attract non-resident investors with your capital raising.

COMPANIES

From 1 July 2020, most companies with an aggregated annual turnover below $50 million are taxed at 26%, provided that 80% or less of their income for the relevant year is 'passive income'. The corporate tax rate will be further reduced for such entities from 1 July 2021 to 25%.

Companies with an aggregated annual turnover of $50 million or more, or which derive more than 80% passive income in any year, will be taxed at a rate of 30%.

Dividends are used as the mechanism for distributing company profits to shareholders and the company does not receive any tax deduction for providing a dividend to shareholders.

However, Australia has an imputation system which prevents the double taxation of company profits when dividends are paid to Australian resident shareholders. In effect, franked dividends reflect distributions of the corporate entity's taxed profits. The tax that is paid by a company before distributing a dividend to a shareholder is claimable as a credit in the shareholder's income tax return against tax payable on dividends and other income received.

Franked dividends paid to non-resident shareholders are not subject to any further withholding tax.

Unfranked (or untaxed) profits distributed to non-resident shareholders will be subject to withholding tax at the rate specified in the double tax agreement between Australia and the shareholder's country of residence, or 30%.

UNIT TRUSTS

Unit Trusts may be subject to tax in Australia in a number of different ways, but for present purposes will commonly be taxed as managed investment trusts (**MITs**), attribution managed investment trusts (**AMITs**), or Public Trading Trusts (**PTTs**), depending on their ownership and investments. As such investment vehicles can give rise to complex tax issues, it is important to consider which form is the most appropriate in the circumstances.

MANAGED INVESTMENT TRUSTS

MITs are investment vehicles that allow resident and foreign resident investors to invest in passive income activities such as shares and property, subject to satisfying the eligible criteria which requires that the:

- trustee is an Australian resident; and the trust,
- does not carry on or control an active trading business;
- is a managed investment scheme;
- meets the widely held requirement (of having at least 50 members for a retail trust, and at least 25 members for a wholesale trust);
- meets the ‘closely held’ restriction; and
- is operated or managed by an appropriately regulated entity.

MITs are generally taxed under the trust taxing provisions, where Australian resident beneficiaries are taxed at their marginal tax rates on their share of the net income of the trust.

However, a key benefit of an MIT is the ability for foreign investors (who are a resident in a country with which Australia has a tax information and exchange agreement in place) to access a reduced rate of 15% withholding tax on fund payments. Where a payment is made to a resident of a country that does not have an exchange of information agreement with Australia, the withholding tax rate is 30%.

However, 30% withholding tax will continue to apply to income distributed to foreign investors that is attributable to classes of certain ‘non-concessional MIT income’, regardless of the investors' country of residence.

Currently, MITs are eligible for the 50% capital gains discount. However, legislation is expected to be released which will prevent MITs from applying the 50% capital gains tax discount at the trust level.

ATTRIBUTION MANAGED INVESTMENT TRUSTS

For the 2016 and later income years, the trustee of a qualifying MIT (i.e. an MIT where members have clearly defined rights to income and capital of the trust) can elect to be an AMIT. The benefits of applying the AMIT regime include:

- deemed fixed trust treatment (which will have important consequences for the ongoing availability of losses, or allowing the trust to pass the benefit of franking credits to unitholders);
- the ability to treat income and assets attributable to a class of units as a separate AMIT;
- the ability to access a statutory mechanism to address errors in distributions ('unders or overs'); and
- cost base adjustment rules to increase as well as decrease the cost base of units for Capital Gains Tax purposes.

Where the AMIT is not a withholding MIT, the MIT withholding regime outlined above will not apply. Rather, the trustee of the AMIT will be taxed on attributed income on behalf of foreign residents.

Currently, AMITs (like MITs) are eligible for the 50% capital gains discount. However, legislation is pending which will prevent AMITs from applying the 50% capital gains discount at the trust level.

PUBLIC TRADING TRUSTS

Trusts in which units are issued to the public and which satisfy certain requirements may also be classified as 'public trading trusts' for tax purposes. In particular, a unit trust will be a public trading trust where:

- the trust is a resident trust;
- any of the units were offered to the public, or are held by more than 50 persons;
- the trust meets the 'closely held' restriction; and
- the trust carries on a trading business, or controls (or is able to control) directly or indirectly, a trading business carried on by another entity.

A trust which is a public trading trust is taxed as a company for tax purposes, meaning that it is subject to the relevant company tax rate, and distributions are treated as dividends, which are frankable.

DUTY

Stamp duty is also a consideration when structuring an investment vehicle. Whilst the duties legislation differs from State to State in Australia, as a general principle:

- duty should not be payable on the transfer of shares in a company – unless that company is a 'landholder'; however
- duty may be payable on transfer of units in a unit trust.

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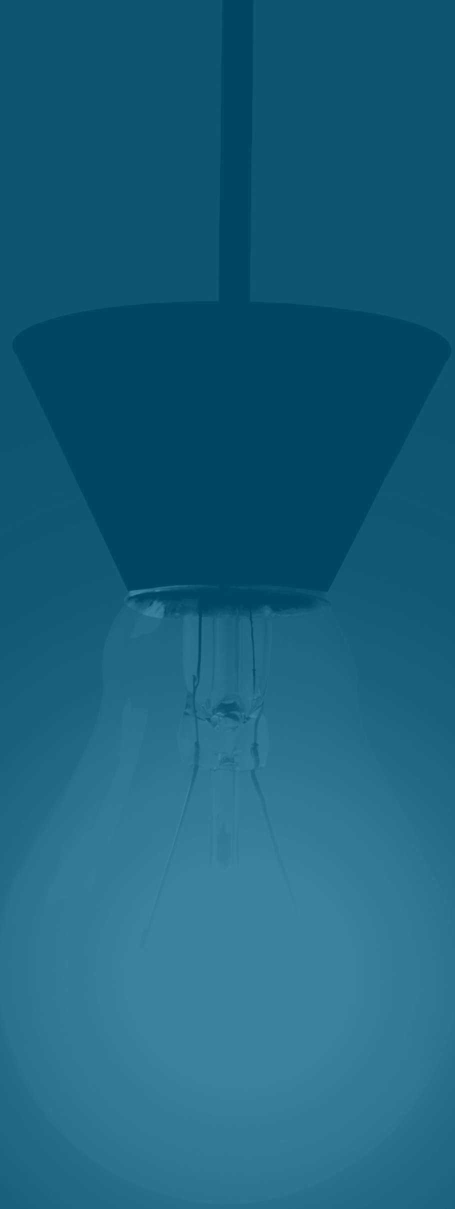

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