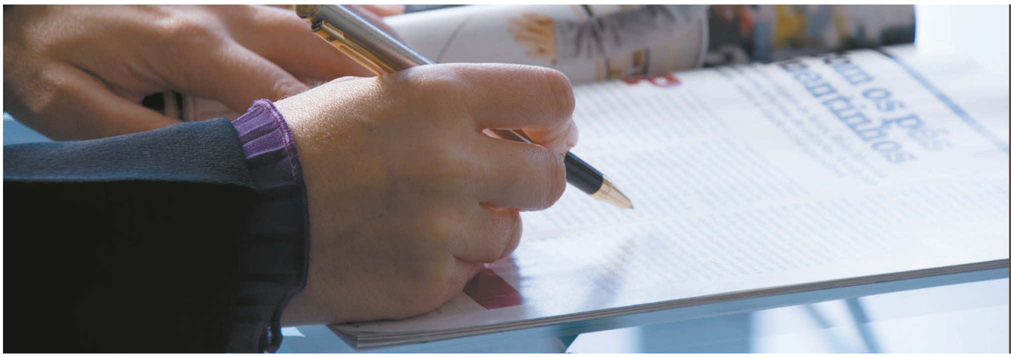

TAX INCENTIVES FOR INNOVATION – LEGISLATION INTRODUCED

THE FEDERAL GOVERNMENT HAS INTRODUCED LEGISLATION TO COMMENCE THE IMPLEMENTATION OF ITS INNOVATION STATEMENT OF DECEMBER 2015, WHICH ANNOUNCED THE PROPOSAL TO OFFER TAX INCENTIVES TO ENTREPRENEURS AND START-UPS.

***TAX LAWS AMENDMENT (TAX INCENTIVES FOR INNOVATION) BILL 2016*, WHICH WAS INTRODUCED INTO PARLIAMENT ON 16 MARCH 2016, CONTAINS THE FOLLOWING AMENDMENTS TO STIMULATE INNOVATION:**

- **TAX INCENTIVES FOR EARLY STAGE INVESTORS**
- **VENTURE CAPITAL INVESTMENT.**

Tax Incentive for Early Stage Investors (TIFESI)

The first part of this Bill introduces tax concession to encourage new investment in Australian early stage innovation companies (ESCIs) with high growth potential. The concessions are in the form of an upfront non-refundable tax offset of 20% of the investment in eligible start-up companies, as well as a CGT exemption on the subsequent disposal of the investment.

These amendments apply in relation to shares issued on or after the later of 1 July 2016 or Royal Assent.

Though the concepts of the tax incentives seem relatively straightforward, the criteria to obtain them are somewhat complex and prescriptive. This complexity is in relation to both the qualifying criteria for the investments entities themselves, as well as the investors who are able to claim the tax incentives.

The key features of the proposed amendments are as follows:

What is an Early Stage Innovation Company (ESIC)?

Broadly, an Australian-incorporated company will qualify as an ESIC if it is at an early stage of its development (the 'early stage' limb) and it is developing new or significantly improved innovations with the purpose of commercialisation to generate an economic return (the 'innovation' limb).

SECTOR

Tax

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The legislation provides tests against which it can be self-assessed whether the company is a qualifying entity.

In relation to the ‘early stage’ requirement, the legislation provides four specific objective threshold tests to determine if the company is at an early stage of its development. These are as follows:

- The company has been recently incorporated or registered in the Australian Business Register generally within the last three income years
- The company and any of its wholly-owned subsidiaries must have not incurred total expenses of more than $1 million
- The company and any of its wholly-owned subsidiaries must have derived assessable income of $200,000 or less in the previous income year
- The company must not be listed on a stock exchange (either in Australia or overseas).

The criteria to evaluate whether a company is engaged in innovation are more complex. In relation to the requirement that the company is engaged in ‘innovation’, the legislation contains a combination of tests. Firstly, the legislation imports a principles-based test to measure ‘innovation’, which requires that the company is developing a new or significantly improved type of innovation such as a product, process, service, marketing or organisational method. A qualifying ESIC will need to be genuinely focused on developing its new or significantly improved innovation for the purpose of commercialisation and show that the business relating to that innovation:

- Has the potential for high growth
- Has scalability
- Can address a broader than local market
- Has competitive advantages.

As an alternative to satisfying the principle-based test, the legislation also introduces a ‘100 point innovation test’ whereby the company has to accumulate points according to a table of objective innovation criteria. These criteria broadly include:

- Research and Development (‘R&D’) claims, based on a certain percentage of the company’s prior year’s R&D expenditure
- Receipt of an ‘Accelerating Commercialisation Grant’
- Completed or undertaking eligible ‘accelerator programme’
- Previous third party investment of at least $50,000
- Holding certain enforceable intellectual property rights
- Collaborative agreement with research organisation or university to commercialise an innovation.

Additional criterion may also be specified by regulation in the future.

Companies who do not wish to self-assess whether they are involved in ‘innovation’, may be able to seek a ruling as to whether they can satisfy this test.

There is also a new requirement for ESICs to report information about their investors to the Commissioner so that the ATO can assess whether these investors may qualify for the tax offset and the modified CGT treatment.

What Investors are eligible for the TIFESI?

The tax incentives introduced by these amendments are available to all types of investors, regardless of whether the investment is made directly as a corporation or individual, or indirectly through a trust or partnership. There is also no residency restrictions placed on the investing entities.

However, certain entities are not eligible for the tax incentives. These include 'widely held companies' and 100% subsidiaries of these companies.

There are special rules for members of trusts or partnerships and trustees to ensure the value of these tax incentives flow through to beneficiaries and partners.

Eligible investors must be issued with shares in a qualifying ESIC. There are limits on the scale of the investment. Entities are not allowed to hold more than 30% of the equity interest in an ESIC immediately after their share acquisition, or in an entity connected with the ESIC. Further, the investing entity and the ESIC cannot be affiliates of each other at the time the shares are issued. That is, the ESIC cannot act, nor can it be reasonably expected to act, in accordance with the investor's directions or wishes, or in concert with the investor, and vice versa.

In addition to the 30% equity and affiliate restrictions, the legislation also provides limits to the amounts that certain kinds of investors can invest, depending on how they are categorised. The legislation differentiates between two different classes of investors based on their classification under the Corporations Act 2001: sophisticated and non-sophisticated investors. The sophisticated investors test in the Corporations Act 2001 is used for investment opportunities that have reduced disclosure requirements, on the basis that such investors are more likely to be able to evaluate offers of securities and other financial products without needing the protection of a disclosure document. This means that if the investor meets the requirements of the sophisticated investor test, they have no restrictions on the amount they may invest, subject to the $200,000 cap on the value of the tax offset (see below).

Other investors (non-sophisticated investors) are limited to investing amounts of $50,000 and below in an income year. These investors will not be entitled to a tax offset if their investment exceeds this maximum threshold, even in relation to any proportion of such an investment below this threshold.

Tax offset

The tax incentive is in the form of a non-refundable tax offset. Entities that acquire newly issued shares in an Australian ESIC may receive a non-refundable carry-forward tax offset of 20% of the value of their investment subject to a maximum offset cap amount of $200,000. If the investment is acquired by a trust or partnership the beneficiaries or partners will be entitled to the non-refundable tax offset.

An investment of up to $1 million will generate the $200,000 offset cap. Any investments over $1 million will not generate any additional offset.

CGT treatment of shares in an ESIC

In addition to the tax offset, investors may disregard capital gains realised on shares in qualifying ESICs that have been held for between one and ten years.

Investors must disregard any capital losses realised on these shares held for less than ten years. The treatment of various relevant holding periods is as follows:

Shares held for less than 12 months

An investor that has held a qualifying share for less than 12 months may not disregard any capital gains arising to that share but must disregard any capital losses.

Shares held for more than 12 months and less than ten years

An investor that has continuously held a qualifying share for between 12 months and less than ten years may disregard a capital gain arising from the share. Capital losses are disregarded.

Shares held for ten years or more

An investor that has continuously held a qualifying share for at least ten years will receive a market value, as determined on the ten year anniversary date, as the first element of the cost base and reduced cost base of the share.

Providing a market value for the first element of the cost base and reduced cost base ensures that any incremental gains (or losses) in value after 10 years will be taxable. The ATO provides guidance about acceptable methods for calculating an asset's market value, including those that are not regularly traded.

Venture Capital Investment

The second part of this Bill is concerned with introducing tax changes to attract more investment into venture capital.

The Bill seeks to amend the early stage venture capital limited partnership (ESVCLP) and venture capital limited partnership (VCLP) regimes to improve access to venture capital investment and make the regimes more attractive to investors. The amendments provide an additional tax incentive for limited partners in new ESVCLPs, relax restrictions on ESVCLP investments and fund size and clarify the legal framework for venture capital investment in Australia.

These amendments will broadly apply on and after 1 July 2016.

The reforms include:

- Providing an ESVCLP offset – this is a non-refundable carry-forward tax offsets for limited partners in ESVCLPs, equal to up to 10% of contributions made by the partner to the ESVCLP during an income year
- Increasing the maximum fund size for ESVCLPs from $100 million to $200 million
- Removing the requirement that an ESVCLP divest an investment in an entity once the value of the entity's assets exceeds $250 million, but restricting tax concessions for such investments
- Allowing entities in which a VCLP, ESVCLP or an Australian venture capital fund of funds (AFOF) has invested (the investee entity) to invest in other entities, provided that after the investment:
  - The investee entity controls the other entity
  - The other entity broadly satisfies the requirements to be an eligible venture capital investment.

Integrity Rules to Deter Tax Evasion and Tax Avoidance

These amendments insert a reference to an innovation tax offset in Part IVA, which ensures that the innovation tax offsets come within the scope of the Part IVA general anti-avoidance rules.

These rules will apply to prevent taxpayers from being able to obtain tax benefits by entering into artificial or contrived arrangements to access the TIFESI tax offset or the ESVCLP tax offset.

In addition, entities that seek to promote schemes relating to the TIFESI may be subject civil and/or criminal penalties under the promoter penalty regime.

BDO comment

These concessions should give further incentive for investment in innovative start-ups. However, some of the eligibility requirements are overly restrictive and time consuming for start-ups to comply with.

The restrictions on capital losses for investments of less than 12 months is a sting in the tail as it has the effect of denying capital losses for anyone who has to exit an investment early, whereas if it were a capital gain, it would be an assessable capital gain.

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