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Tax insights
Creating Australia's future innovation landscape?

Snapshot

On Monday 7 December 2015, the Government released its anticipated Innovation Statement badged as the National Innovation and Science Agenda (NISA)(the Agenda), which contains a number of innovation recommendations that were widely anticipated by the media.

The Agenda is the first step seeking to transform Australia's innovation landscape, with a whole of government approach, to be attractive to mobile, high-value businesses and retain globally-successful businesses onshore.

At the outset, the Agenda rightly acknowledges Australia's existing strengths in research and weaknesses in commercialisation, and broadly addresses itself to four themes, being talent and skills, culture and capital, collaboration, and government as an exemplar.

Although we believe that these announcements are a welcome first step to encouraging greater innovation, the success of the Agenda will lie in the detail of the measures and their sustainable implementation. We also believe that the Government will need to commit to further reform measures to improve Australia's poor record in commercialisation; Australia's standing in the OECD ranks will fail to improve unless specific measures seek to ensure that Australia is an attractive place for Australian companies, as well as global multinationals, to commercialise their research in and from Australia.

The announced measures are anticipated to cost $1.1bn over 4 years, with the Treasurer also confirming that savings measures of an equal amount to fund these initiatives will be announced in the mid-year budget update expected on 15 December 2015. It is understood that this modelling may also seek to anticipate the revenue benefits of second-round modelling, given the globally recognised spill-over effects of innovation and undertaking R&D.

Introduction

The key tax related innovation measures announced are:

- New investor incentives based on a hybrid of the long-standing and successful UK enterprise investment scheme models
- Changes to the existing Early Stage Venture Capital Partnerships (ESVCLP) rules and certain VCLP rules
- Improving access to losses and R&D tax offsets - a key issue for start-ups moving from research to commercialisation, given their need to raise funds through issuing equity
- Changes to the tax depreciation of intangible depreciating assets
- Changes to the employee share scheme rules to make them more 'user-friendly' for smaller innovative businesses.

A framework for crowd-sourced equity funding was also introduced into Parliament days before the Agenda and is also discussed below.

No changes to the existing R&D tax incentive have been mooted as yet, given that there are ongoing reviews and inquiries into innovation and research yet to report back. We also understand that the possibility of further tax reform based on an Australian patent box model is to be considered in the next tranche of innovation tax reform, a key commercialisation incentive.

Innovation has been the flavour of the month with the Federal Opposition taking the opportunity to announce its own measures in the innovation arena with similar focuses on incentives for start-ups, education, funding and collaboration, and government procurement.

New investor incentives

The cornerstone of the Agenda is the introduction of investor incentive measures, a fundamental tax policy initiative which can, given the synergies between the two, serve to drive significant participation in the complementary equity-based crowdfunding platforms that will take shape in Australia.

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Effectively, individual investors will be entitled to a 20% non-refundable tax offset on eligible investments, capped at $200,000 per investor per income year. Tax offsets are perceived to be more equitable than a tax deduction since the tax benefit remains the same regardless of the taxpayer’s marginal income tax rate.

There will also be a capital gains tax (CGT) exemption for eligible investments, which are held for more than 3 years and less than 10 years. Presumably, this exemption will cease to operate where the shares are held for more than 10 years, potentially, to discourage illiquidity of funds and such investments becoming passive vehicles.

By way of example, if a taxpayer invests $100,000 in an eligible investment, they can claim a tax offset of $20,000 in the income year of investment, and reduce their income tax payable by the same amount.

If the investor subsequently sells their shares between three and ten years later, the profit or return on the initial investment will also be exempt from CGT.

Although a welcome exemption, we believe that this ten year threshold may not be appropriate in some industries, such as life sciences/biotech, where the necessary lead times to maximise investor returns may be longer. This threshold could encourage artificial behaviours that may not be in the best interest of the shareholders, the company, or, indeed, Australia.

These proposed incentives will be available for investments in companies that:

- Undertake an eligible business, with the eligibility criteria to be determined via consultation
- Have been incorporated during the last 3 income years

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- Are not listed on any stock exchange
- Had expenditure of less than $1m and income of less than $200,000 in the previous income year.

Again, we believe that the expenditure threshold is fairly restrictive, with companies in many industries needing to spend more than a $1m per year to develop and commercialise their innovation.

We also believe that not opening up the scheme to super funds, including self-managed super funds, is a missed opportunity, where funds could be invested from a low taxation environment (superfunds are generally taxed at 15%) into areas where the funds will necessarily be used to invest in innovative enterprises, employing highly-skilled staff in turn earning taxable salaries and wages.

It is clear that the equity crowdfunding platforms in the UK value the UK Government's support in the form of tax relief for investors, and appreciate the sizeable impact it has had both on their business and the ventures raising funds on their platforms. It is to be hoped that the Australian measures, although less generous than expected UK incentives, will enjoy equal success in Australia.

These arrangements will apply from the date of Royal Assent of the relevant legislation, and are expected to commence with effect from 1 July 2016.

Changes to existing VCLPs

The Government will also encourage more venture capital investment in Australia by introducing a 10% non-refundable tax offset for any capital invested in new ESVCLPs.

Under the new ESVCLP arrangements:

- partners can claim a 10% non-refundable tax offset on capital invested into an ESVCLP
- the maximum fund size for new ESVCLPs will be increased from $100m to $200m
- ESVCLPs will no longer need to divest from a company when the company's value exceeds $250m.

Changes to both the VCLP and ESVCLP rules will also seek to relax eligibility and investment requirements to allow managers to undertake a broader range of investment activities and attract a diversity of investors.

These arrangements will also apply from the date of Royal Assent, and are expected to commence with effect from 1 July 2016.

Crowdfunding framework before Parliament

A critical part of a holistic innovation regime also includes innovative and flexible ways to fund that innovation. Crowd-sourced equity funding (CSEF) is an emerging phenomenon in the online economy and is viewed as an innovative type of fundraising that could allow large numbers of individual investors to make small financial contributions towards a company, in exchange for an equity stake in the company.

Such a model is thought to have the potential to provide finance for innovative business ideas that could have difficulties in attracting funding under other more traditional models, and was a recommendation of the Murray Inquiry into the Australian financial system.

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Here in Australia, the Turnbull Government had already highlighted the development of a crowd sourced equity funding market as an “urgent priority” with a legislative framework recently introduced into Parliament in the *Corporations Amendment (Crowd-sourced Funding) Bill 2015*.

The amendments, if enacted, will effectively allow unlisted public companies with less than $5 million in assets and less than $5 million in annual turnover to raise up to $5 million in funds in any 12 month period. Effectively, individual investors will be able to invest an unlimited sum in crowdfunding more generally, but individual investors will be limited to a cap of $10,000 per issuer per 12-month period to ensure that smaller investors are not exposed to excessive risks in a single entity.

Overall, the proposed crowdfunding provisions are intended to balance the need to open up new equity sources to start-up entities and small businesses seeking to expand, and the need to maintain adequate protections for retail investors. The Federal Opposition has, however, raised concerns of excessive red-tape and administrative burdens with a report on the draft provisions due in early 2016.

Amendment of loss utilisation rules

Many submissions to government have previously lobbied for legislative solutions to ensure that SME-sized innovative companies do not inadvertently (or due to particular features of the industry they operate in) lose the benefit of both tax losses and R&D tax incentives that have been accumulated during their start-up phase as they grow and become profitable.

The ability to offset losses and excess tax offsets against other income or profits is critical for smaller start-up companies because they often have more focused income streams and less cash-flow than established businesses.

To address this issue, the current stringent ‘same business test’ (SBT) will be prospectively relaxed and substituted with a ‘predominantly similar business test’ (PSBT) to allow businesses to still access prior year losses even where they have entered into new transactions or business activities, allowing early loss-making companies to seek out different opportunities to return to (or get to) profitability. Under this PSBT, companies will be able to access losses where their business, whilst not the same, utilises similar assets and generates income from similar sources.

Notably, this change will also impact on the utilisation of future excess non-refundable R&D tax offsets, since their utilisation is also currently dependent on satisfying the SBT.

The current SBT will continue to apply to existing losses and excess R&D tax offsets.

Writing off intangible depreciating assets

Innovative companies growing in today’s economy are far more likely than other traditional companies to have intangible or knowledge-based assets—including patents, trademarks, copyrights and business models.

Since the Government recognises that investment in these assets is crucial to innovation and growth, changes will be introduced to allow faster tax depreciation where appropriate, providing more immediate tax benefits

A new option to self-assess the tax effective life of intangible assets will align the tax treatment of intangible assets with other types of assets and assist innovative companies in exploiting their intellectual property and other intangible assets.

Employee share scheme changes

In the area of employee share schemes (ESS), changes will be introduced into Parliament in 2016 to:

- Change the disclosure requirements for documents to be given to employees under an ESS to be made available to the public. This is intended to allow otherwise non-disclosing companies to offer shares to their employees without having to reveal commercially sensitive information to their competitors

- Introduce changes to ensure that the ESS rules are more 'user-friendly' for innovative companies, and allow them to attract motivated staff without substantial initial outlays.

Other announced changes

Other measures across a variety of government portfolios were also included in the Agenda, which are intended to stimulate an innovative culture in Australia; these include:

- Ways in which to fix Government procurement by redesigning the current practices, which are inherently biased towards larger enterprises, to open up government contracts to start-up companies
- Changes to the 457 visa schemes to attract entrepreneurs and highly-skilled workers to live and work in Australia and arrangements for post-graduate students with STEM or ICT talent to be fast-tracked for permanent residency
- Additional funding of $200m for CSIRO in a reversal of the recent funding budget cuts
- A relaxation of bankruptcy laws intended to encourage a culture of risk-taking but without promoting undue recklessness - the default bankruptcy period will be reduced from three years to one year
- Additional university funding incentives with $127m allocated over four years of research block grant funding towards collaboration between industry and universities, with arrangements to measure impacts and industry engagement
- Offshore 'landing pads' with funding for Australian entrepreneurs to more easily travel to Silicon Valley, Tel Aviv and three other unknown locations, likely in Europe and Asia
- Funding for a new "Cyber Security Growth Centre" and quantum computing
- A new innovation and science committee of cabinet and board in the Industry Department called Innovation and Science Australia
- Funding for increased STEM education.

With the introduction of such a broad suite of measures, the Agenda acknowledges the necessity of breadth of a successful innovation system, and the importance of integrating differing elements together in a cross-portfolio Government approach.

Overall, we welcome these announcements as a first step in transforming Australia's culture into one of true innovation.

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