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Tax insights
Tax Incentives for early stage investors

Snapshot

The Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016, containing tax incentives for early stage investors was introduced into Parliament on 16 March 2016. The Bill includes:

- A non-refundable tax offset to eligible investors, equal to 20% of the amounts paid for newly issued equity interests (shares) in a company held as Australian early stage innovation company (ESIC);
- A Capital Gains Tax (CGT) exemption for shares in companies held as Australian ESIC; and
- Changes to the Early Stage Venture Capital Limited Partnerships (ESVCLP) and Venture Capital Limited Partnerships (VCLP) regimes.

This Insight will focus upon the non-refundable tax offset and the CGT exemption.

Originally announced at the launch of the National Innovation and Science Agenda (NISA) on 7 December 2015, the framework for the proposed tax offset and CGT exemption was subsequently canvassed in a policy discussion paper released on 15 February 2016, and was expected to be released in exposure draft legislation format for further consultation. However given the short time available in Parliament before the proposed start date of 1 July 2016, and given the nature of the changes made since the policy discussion paper, the measures were introduced in Bill form directly into Parliament in March.

Deloitte was involved in the consultation process of the Policy discussion paper and prepared a submission. The important changes between the Policy discussion paper and the final Bill are discussed below. On 21 March 2016, the Governor General prorogued Parliament. As a result, the Bill will lapse. The Government could reintroduce the Bill, potentially as early as 18 April 2016 (the new session of Parliament that was announced by the Government General in the proclamation). However, at this stage there is no clear indication from Government on the timetable for this Bill.

Proposed early stage investment tax incentives

The two proposed tax incentives, once enacted, will provide:

- Concessional tax treatment for investors through a non-refundable tax offset, and
- A CGT exemption on investments that meet certain eligibility criteria.

Although both resident and non-resident investors will be eligible to claim the incentives, the relevant investments must be in Australian companies, which are held to be innovative start- up companies.

It is also notable that the provisions that would enable the set-up of qualifying innovation funds which could benefit from the proposed incentives have been removed from the final Bill.

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Non-refundable tax offset

Overview

Eligible investors would generally be allowed to claim a non-refundable carry forward tax offset equal to 20% of the amounts paid for newly issued equity interests, if the following are satisfied:

- The newly issued equity interests are shares;
- The shares are in companies that are held to be an Australian ESIC at the time of the share issue; and
- The investor does not fall within one of a list of specified exclusions.

The tax incentives are not withdrawn if the company ceases to be an ESIC at a later date.

As stated above, the new proposed tax-offset is non-refundable and must be used in priority above R&D tax offsets (for company investors) but after ESVCLP offsets.

There are provisions in the Bill that adapt the general provisions relating to the eligibility for the new tax offset to trusts and partnerships. These provisions also prescribe a method of apportionment to the members of trusts or partnerships.

Eligible investors

The new Subdivision carves out certain investors from eligibility for the non-refundable tax offset due to the relationship between the investor and the ESIC. Generally, individuals, members of trusts or partnerships, and companies that are not widely held or wholly owned by widely held companies, will be eligible to claim the tax offset. However, the investor and the company invested in must not be affiliates of each other (this thereby precludes investments by director-owners).

Further, immediately after the issue, the relevant investor cannot hold more than 30% of the equity interests in the company or any entity connected with the company. This requirement appears to apply to all equity interests, not just those that are also shares.

If shares are acquired from an issue of shares under an employee share scheme (ESS), the investor (acquirer of shares) will not qualify for the tax offset.

There are additional rules on the maximum amount of the tax offset for certain investors:

- Non-sophisticated investors (as defined in the *Corporations Act 2001)* are limited to an annual investment limit of $50,000, with no tax offset at all available if the limit is breached. This annual limit is not per ESIC but across all investments in ESICs in an income year; and
- Sophisticated investors have no such limit but the tax offset claimed in any income year is limited to a maximum of A$200,000 on an affiliate-inclusive basis (thereby allowing for a tax offset on annual investments of up to A$1m for sophisticated investors).

Any unused tax offsets in an income year can be carried forward and used in future years but also count towards the cap of A$200,000 for that later income year.

Early stage innovation companies

To be an ESIC, a company must satisfy all of the following requirements immediately after the issue of that tranche of shares, being the test time:

- Have been incorporated in Australia or registered in the Australian Business Register within the current or 2 previous income years; or have been incorporated within the current or previous 5 income years and incurred total expenses of A$1m or less in the last 3 of those income years (including the expenses of 100% subsidiaries);
- Have incurred total expenses of A$1m or less (including its 100% subsidiaries) in the income year prior to the income year in which the shares are issued;
- Have derived a total assessable income of A$200,000 or less (including its 100% subsidiaries) in the income year prior to the income year in which the shares are issued – this excludes any Accelerating Commercialisation Grants under the Entrepreneurs' program;
- Have no equity interests listed on any stock exchange; and
- Pass a 100 point innovation test, or can alternatively demonstrate that the business has a high growth and scalable potential with relevant investment in the development of new or significantly improved products, processes, services or marketing or organisational methods, that would be nationally or globally marketable with competitive business advantages.

Points are gathered for the 100 point innovation test based on prior levels of R&D expenditure, awarding of entrepreneur grants, holding of enforceable intellectual property rights, previous genuine third party investments above A$50,000, and co-development agreements with research organisations or universities.

There are provisions which require ESICs to report some minimum information about their investors to the Commissioner of Taxation so that the regime can be effectively administered.

The Part IVA and promoter penalty provisions have also been amended to ensure that artificial or contrived schemes to claim the ESIC tax offset will come within the scope of the general anti-avoidance and promoter penalty regimes.

Further modification by regulation

To ensure that the legislation, once enacted, provides flexibility in an innovative and fast moving environment, the provisions allow that regulations can, if introduced, specify:

- The exclusion of certain products or processes from being eligible to the alternative to the 100 point innovation test;
- The exclusion of certain companies undertaking prescribed activities from being an eligible ESIC; and
- Extra criteria to gain points toward the 100 point innovation test.

CGT exemption

Where the issuing of a share in a company, which is an ESIC at the time of the issue, gives rise to the entitlement to a 20% non-refundable tax offset, the following modifications to the CGT provisions occur:

- The investor is taken to hold that share on capital account;
- Any capital loss arising from any CGT event occurring before the tenth anniversary of its issue is disregarded;
- Any capital gain arising from any CGT event occurring in respect of a share held for more than 12 months but less than 10 years can be disregarded;
- On the tenth anniversary of its issue, if still held, the first element of the cost base and reduced cost base of the share becomes its market value on that day.

The original proposal required investors to hold the shares for at least 3 years to obtain this CGT exemption but the provisions as introduced have included a minimum one year holding period only for the recognition of capital gains.

Notably it is the entitlement to the tax offset that is critical, not whether the investor claimed the 20% tax offset. This means that the exemption can apply to all ESIC shares issued to sophisticated investors regardless of whether their entitlement to the tax offset was reduced under the A$200,000 cap. Similarly to the tax offset, the CGT exemption is still available even where the company has ceased to be an ESIC.

Consequential amendments

The provisions also seek to ensure that this modified treatment is fully preserved in the case of most CGT rollovers. However in the case of rollovers under Division 122 (rollovers to wholly-owned companies) or Subdivision 124-M (scrip for scrip rollovers), the modified treatment is terminated early and the replacement share will receive a market value cost base and reduced cost base.

When do the measures apply?

The amendments apply in relation to equity interests issued on or after the commencement of Schedule 1. This is the later of when the Act receives Royal Assent or 1 July 2016.

Given Parliament is prorogued at the time of this Insight, the timing of the Bill passing the Senate and receiving Royal Assent is still unclear.

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