



## TAXATION

### TAX INCENTIVES FOR EARLY STAGE INVESTORS

  
Paper 012-058  


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## TAXATION

### TAX INCENTIVES FOR EARLY STAGE INVESTORS

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#### 1. Tax Incentives Available For Investors

The tax incentives for early stage investors have been legislated and implemented from 1 July 2016. This legislation will allow investors to qualify for two separate tax incentives if they invest in Australian Innovation companies.

The end result is that an investor will qualify for two incentives:

- When they invest they will be eligible to an immediate 20% of their investment value as a non refundable tax offset capped at \$200,000.
- When they dispose of their investments they may be exempt from any Capital Gains Tax as long as certain time related conditions are satisfied.

#### 2. Qualifying For The Tax Incentives

To qualify, you firstly need to purchase new shares, in a company that is an Early Stage Innovation Company (ESIC). This means the company needs to pass two out of three tests:

(a) Provisional Test (Our term)

1. To be incorporated generally under three years old, although in some circumstances an eligible ESIC can be under six years old.
2. The company must have expenses under \$1,000,000 in the previous income year.
3. The company must have assessable income under \$200,000 in the previous income year (excluding any amount from an Accelerating Commercialisation Grant).
4. The company shares must not be listed on a stock exchange.

(b) Gateway Test

1. The company must earn at least 100 points from seven subjects to pass the Gateway Test including:
  - Research and Development
  - Accelerating Commercialisation Grant recipient
  - Participant in an Accelerator Program
  - Received investment of at least \$50,000 from arms-length investors
  - Registered patent or plant patent
  - Registered innovation patent or registered design
  - Has an agreement for assistance in commercialisation activities from an institute or body listed in the *Higher Education Funding Act 1988* or an entity registered under the *Research and Development Act*
2. If the company does not accumulate 100 points it can then move into the Principles Based Test.

(c) Principles Based Test

1. The company must be able to positively answer each of the following five questions:
  - (i) Is the company generally focused on commercialising one or more new or significantly improved products, processes, services, marketing or organisational methods?
  - (ii) Does the business have “high growth potential”?
  - (iii) Does the business have the ability to successfully “scale the business”?
  - (iv) Has the business potential for sales to a “broader market” then “local market”?
  - (v) Is there potential for “competitive advantage”?

When conducting your own due diligence, you should ensure that the company has created a special file of the supporting evidence for each question.

### 3. Self Assessment

The Early Stage Innovation Company legislation has a “self-assessment” provision.

This should be fairly straightforward for the “Provisional Test” and the “Gateway Test”. In the “Principles Based Test” the company directors will undoubtedly require a supporting report from an independent consulting organisation that the company is adequately committed to the achievement of positive results for each of the five questions.

As an investor you will need to ensure that the company has adequately conducted the self assessment process.

Companies can apply to the Australian Taxation Office/AusIndustry for a ruling – but the companies will need to submit all of their supporting evidence for the Australian Taxation Office to objectively conduct an assessment. This process could take a significant amount of time. Many companies will be anxious to secure commitments to investment and therefore investors need to be very careful to ensure that, if you are going to make an investment prior to the company having submitted its income tax return, you conduct your own due diligence review on the file that has been developed by the company to ensure that the self-assessment process has been conducted in a professional manner.

If you are unsure about whether a company is going to meet the Early Stage Innovation Company requirements, the best thing for you to do will be to advise the company that you are unable to make an investment until such time as they have received an Early Stage Innovation Company assessment from the Australian Taxation Office and AusIndustry.

### 4. Investment Amounts

A taxpayer, who is not a sophisticated investor, is only able to invest up to \$50,000 per annum per company to be able to access the tax concessions. If an investment is made by this investor which exceeds the \$50,000 investment threshold, they will not receive the early stage investor tax offset nor the capital gains tax concessional treatment. This is designed this way to discourage retail investors from being over exposed to the risk that is inherent in investing in early stage investment companies.

## 5. Sophisticated Investor

A sophisticated investor is determined by the *Corporations Act* and are those who meet certain requirements to ensure that they do not have to be provided with a disclosure document when being offered shares in a company, for example a Prospectus or Product Disclosure Statement.

To qualify as a sophisticated investor you can:

- Hold a certificate issued by a qualified accountant that confirms an investor meets certain income and asset requirements (net assets \$2.5M, annual income for the last two years at least \$250,000).
- Have paid at least \$500,000 for the qualifying shares.
- Are offered the shares through a financial services licensee who is satisfied that you have previous investment experience that allows you to access the offer and you sign a written acknowledgement that the licensee hasn't given you a disclosure document in relation to the offer.
- You meet the requirements of being a professional investor under the *Corporations Act*.
- You have or control gross assets of at least \$10 million.

## 6. Limit On Tax Offset

The early stage investor tax offset is limited to 20% of the total amount you paid to acquire the shares up to a limit of \$1,000,000 of investments and capping the non refundable carry forward tax offset to \$200,000 for sophisticated investors in any one income tax year. If a sophisticated investor invests more than \$1,000,000 in an income year, the tax offset is still limited to \$200,000 although the modified CGT treatment will apply to all the shares.

If someone does not qualify as a sophisticated investor, the maximum early stage investor tax offset that you can claim is \$10,000.

As this is a non refundable tax offset, it can reduce the investor's tax payable to zero, but cannot result in a tax refund on its own. If the offset is not used in one year, the remaining amount will be carried forward to future income years.

## 7. Capital Gains Tax Treatment

When there is a disposal of shares in a qualifying Early Stage Innovation Company a capital gain will be ignored if you satisfy the time holding requirements:

- Shares held for less than twelve months and sold will give rise to a capital gains tax event.
- Shares held for longer than twelve months and less than ten years will allow the investor to disregard any capital gain in relation to the shares.
- Shares held for longer than ten years will give rise to a capital gains tax event, however a cost base uplift of the market valuation of the shares will occur on the tenth year anniversary of the shares being issued to the investor.

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## 8. Schemes to Qualify For The Tax Incentives

The general anti avoidance provision of the *Tax Act* may apply to schemes to access the Early Stage Innovation tax incentives. These rules may apply to prevent taxpayers from obtaining tax benefits by entering into contrived or artificial arrangements to access the tax incentives.

*Example 1 – Calculating the early stage innovation tax offset*

Greg, a sophisticated investor, pays \$2 million for new shares in an ESIC during the 2016-17 income year.

Although 20% of the total amount Greg has paid for the ESIC shares is \$400,000, his entitlement to the early stage innovation tax offset is capped at \$200,000 (provided the other eligibility requirements for the incentives are met).

Greg has an income tax liability of \$100,000 for the 2016–17 income year. He uses \$100,000 of the early stage innovation tax offset to reduce his tax payable to zero. Greg can carry forward the remaining \$100,000 in early stage innovation tax offset to future income years. The modified CGT treatment applies to all of the shares that he purchased.

*Example 2 – Limits for investors who don't meet the sophisticated investor test*

Christine pays \$50,000 for new shares in a qualifying ESIC on 1 December 2016. Christine is not a sophisticated investor for this share offer. This is the maximum amount that she can invest in ESICs in the 2016–17 income year to access the tax incentives

If Christine pays another \$50,000 for qualifying shares in an ESIC on 1 June 2017 and is not a sophisticated investor at this time, she won't be entitled to receive any early stage innovation tax incentives, including in relation to the shares that she purchased on 1 December 2016.

## 9. Tax Incentives Not Available When

The Tax Offset and the Capital Gains Tax Exemption are not available when:

- The shares were not purchased in the Early Stage Innovation Company directly from the company as newly issued shares.
- The shares are not an "Equity Interest" in an Early Stage Innovation Company.
- The investor is a widely held company or a wholly owned subsidiary of a widely held company.
- The total investment for the income year is more than \$50,000 and the investor is not a sophisticated investor in accordance with the Corporations Code.
- The investor and the Early Stage Innovation Company are affiliates of each other at the time the shares are issued.
- The investor holds more than 30% of the equity interests in the Early Stage Innovation Company and any other entities associated with the Early Stage Innovation Company.
- The shares in the Early Stage Innovation Company were acquired under an employee share scheme.

## 10. Professional Advice

It is desirable that you obtain professional advice relative to an investment in an Early Stage Innovation Company.

### **AN IMPORTANT MESSAGE**

The forms and commentaries contained in this paper are provided as a guide only and should not form the sole basis for any advice in relation to the particular situation of any person without first obtaining proper professional advice.

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