

EARLY STAGE INVESTMENT TAX INCENTIVES BILL INTRODUCED

Date: 15 April 2016

Corporate and Transactional, Investment Management and Tax Alert

By: Daniel Atkin

As an update to our Legal Insight of December 2015 'New Tax Incentives for Early Stage Investment', on 16 March 2016 the Turnbull Government introduced legislation providing significant tax incentives to promote local and foreign investment in innovative start-ups as part of the National Innovation and Science Agenda.

The changes contained in the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 (Bill), are modelled on the British Seed Enterprise Scheme, which resulted in more than AUD500 million of early stage investment into almost 2,900 companies in its first two years.

The new incentives aim to encourage new investment in Australian Early Stage Innovation Companies (ESICs) with a high growth potential.

The changes will provide qualifying investors with a tax offset and modified CGT treatment in relation to their qualifying investment.

The Bill also introduces a number of key reforms to the tax regime for qualifying investments in Venture Capital Limited Partnerships and Early Stage Venture Capital Limited Partnerships (VCLPs and ESVCLPs) and may be of particular interest to the FinTech and start-up sectors.

WHAT ARE THE NEW TAX INCENTIVES FOR EARLY STAGE INVESTORS?

Non-Refundable Carry Forward Tax Offset

Qualifying investors who 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 AUD200,000 per investor per year. The maximum offset would be available on an investment of AUD1 million.

Capital Gains Tax (CGT) Exemption

Qualifying investors may disregard capital gains realised on shares in qualifying ESICs provided the shares have been held for between 1 and 10 years. Capital losses on shares held for less than 10 years must be disregarded.

WHICH INVESTORS WILL QUALIFY FOR THE TAX INCENTIVES?

The new tax incentives will generally be available to all types of investors, regardless of their investment method including:

- individuals
- body corporates (other than a listed company or a company with more than 50 members unless certain conditions are met)

- partnerships (significantly, the new rules will apply so that the value of the tax incentives can flow through to partners of the partnership)
- any other unincorporated association or body of persons
- trusts (significantly, the new rules will apply so that the value of the tax incentives can flow through to the ultimate beneficiaries of the trust)
- superannuation funds
- approved deposit funds.

Importantly, there are no restrictions based on an investor's residency.

WHICH INVESTMENTS QUALIFY FOR THE TAX INCENTIVES?

Shares Must be in a Qualifying ESIC

To qualify as an ESIC, an Australian incorporated company must show that it is:

- at an early stage of its development (the early stage limb)
- developing new or significantly improved innovations with the purpose of commercialisation to generate an economic return (the innovation limb).

The early stage limb requires that the company:

- subject to certain exceptions, was incorporated in Australia in the last three years
- together with any of its wholly-owned subsidiaries, has incurred less than AUD1,000,000 in expenses in the previous income year
- together with any of its wholly-owned subsidiaries, has assessable income of AUD200,000 or less in the previous income year
- is not listed on a stock exchange.

In determining whether the company satisfies the innovation limb to qualify as an ESIC, companies may choose to either (i) self-assess against the principles-based test set out in the legislation (ii) apply their circumstances against the objective activity based criteria in the legislation or (iii) seek a ruling from the Commissioner of Taxation to confirm whether they satisfy the principles-based test.

The company must be a qualifying ESIC at the time immediately after the relevant equity interests are issued. If the company subsequently ceases to be a qualifying ESIC, the qualifying investor will not be disqualified from accessing a tax offset in relation to those shares nor will they miss out on the CGT exemption.

Investment in new Shares

Investors must be issued with new shares in the qualifying ESIC. The carry forward tax offset will be received by the investor for that income year in which the shares are issued to the investor.

Shares acquired under an employee share scheme are not eligible.

Certain limitations apply depending on the relationship between the ESIC and the investor. For example, a director-owner of an ESIC will be precluded from qualifying for a tax offset, as the ESIC would be an affiliate of the director-owner.

30% Equity Interest Restriction

To qualify, an investor must hold no more than 30% of the equity interests of the ESIC.

WHAT ARE THE NEW TAX INCENTIVES FOR VENTURE CAPITAL INVESTMENTS?

A number of new reforms will also be introduced in relation to investments made in VCLPs and ESVCLPs. These reforms include:

- Allowing for a non-refundable carry-forward tax offset for limited partners in ESVCLPs, equal to up to 10% of contributions made by the partner to the ESVCLP's investment expenditure during an income year. The rules will apply so that the value of the tax incentives may flow through to the ultimate beneficiaries of a trust investor or partners of a partnership investor.
- An increase in the maximum fund size of an ESVCLP from AUD100 million to AUD200 million.
- Subject to certain conditions, allowing a managed investment trust (MIT) to disregard its interests as a limited partner in VCLPs or ESVCLPs for the purposes of determining if it is a trading trust (or carrying on or controlling a trading business). Further, the reforms will allow the MIT to treat assets held through VCLPs or ESVCLPs as an asset it owns for CGT election purposes.
- Ensuring that the ultimate investors in ESVCLPs (for example beneficiaries of a trust or partners of a partnership) receive the same CGT outcome on disposals of eligible capital investments of the ESVCLP regardless of whether they invest directly or through a trust or another partnership.
- Removing the requirement that an ESVCLP must divest an investment in an entity once the investee entity's market value exceeds AUD250 million (while restricting tax concessions for such investments).

WHEN WILL THE CHANGES TAKE EFFECT?

Tax Incentives for Early Stage Investors

The changes will take effect on or after the later of 1 July 2016 or the date the Bill receives Royal Assent. The Bill is currently at second reading stage in the House of Representatives and it is hoped that the Bill will be passed prior to any election later this year. If not, the Bill will need to be reintroduced to Parliament following the election. Once the Bill receives Royal Assent, the incentives will apply to the 2016-17 income year.

Reforms in Relation to VCLPs and ESVCLPs

The amendments will generally apply from 1 July 2016.

However, the tax offset is only available for qualifying contributions made to ESVCLPs that become unconditionally registered as an ESVCLP on or after 7 December 2015.

For advice in relation to the above, please contact Dan Atkin in the Corporate and Transactional team, Matthew Watts in the Financial Services team or Betsy-Ann Howe in the Tax team.

KEY CONTACTS



DANIEL ATKIN
PARTNER

SYDNEY
+61.2.9513.2356
DANIEL.ATKIN@KLGATES.COM



BETSY-ANN HOWE
PARTNER

SYDNEY
+61.2.9513.2365
BETSY-ANN.HOWE@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.