the next solution

Innovation Incentive: How can you benefit?

Opportunities for Innovative Companies and their Investors

A member of Nexia International

What happened?

This alert serves as a Roadmap to the Innovation incentive that applies from 1 July 2016

The innovation incentive is now law and applies from 1 July 2016[1].

This "ideas boom" incentive aims to stimulate innovation and entrepreneurial activity in Australia[2] by creating a system to entice investors to invest in Australian early-stage innovation companies (ESICs) – thereby enabling ESICs to attract investors to bridge any funding gaps and improve their cash flows.

To fully grasp the impact of this incentive on innovation activities in Australia - as well as whether you may qualify as either an investor or an ESIC - the rest of this alert serves as a roadmap to give a more in-depth understanding of how the incentive works.

We will briefly discuss:

1. What are the incentives?
2. What type of investors can qualify for the incentives?
3. What is an ESIC?

This alert will give more practical information and a broad understanding about how the incentive will operate so that we can continue our conversation with you about potential opportunities and benefits that may exist or become available for you and/or your business in the innovation space.

What does the investment incentive mean for you?

1. What are the incentives?

Investor incentive when making & disposing of investment

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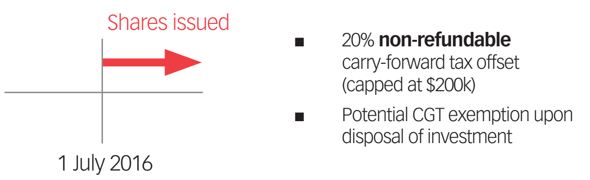


The drawcard of the investment incentive is that investors in ESICs can potentially be incentivised at two different times:

- **when they invest** in new shares of an ESIC (i.e. a 20% non-refundable offset subject to certain caps); and
- **when they dispose** of their investments in ESICs (i.e. a CGT exemption for capital gains on investments held for at least 1 year but less than 10 years)

1(a) Incentive when making the investment = non-refundable offset

Offset limited to:

- **$200,000 (for sophisticated investors); and**
- **$10,000 (for non-sophisticated investors)**

In broad terms, eligible investors who purchase new shares in an ESIC will be entitled to a non-refundable carry forward tax offset equal to 20% of the amount paid for the shares in the ESIC.

However, there is a cap on either the amount of the offset available or the amount that may be invested, depending on whether the investor is a **sophisticated investor** (e.g. an investor with net assets of at least $2.5 million or gross income for each of the last 2 financial years of at least $250,000[3]) or not.

If an investor qualifies for an offset, the offset can be claimed in the investor's tax return against the investor's tax liability – note that even if the offset is claimed, any capital loss resulting from an eventual disposal of the investment within 10 years cannot be deducted from assessable capital gains or other income. Equally, capital gains made on the sale of the investments within 10 years of acquisition of the investment may not be taxable – see below.

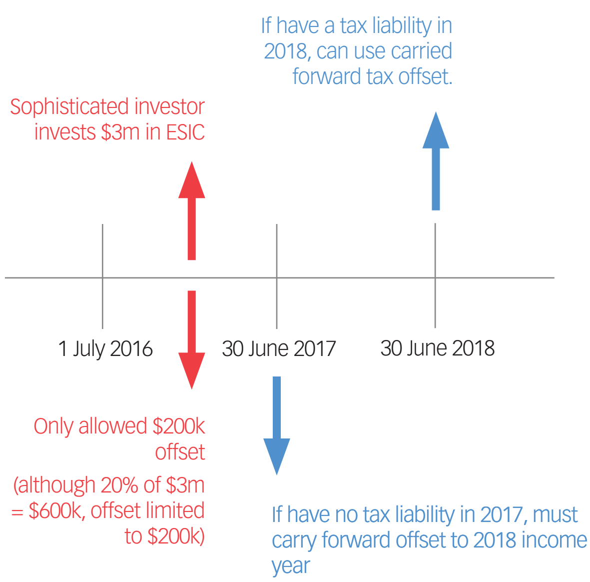
Investor is a sophisticated investor

A sophisticated investor will qualify for a maximum offset capped at $200,000 per investor per year (i.e. 20% of $1 million investment made by sophisticated investor and its affiliates) less the sum of previously claimed offsets that have been carried forward.

This means that any investment in excess of $1 million will still only qualify for an offset of $200,000 maximum per year.

However, because the offset is <u>non-refundable</u> (i.e. the offset cannot be used in years when the investor does not have sufficient tax liabilities to absorb the offset), the offset may be carried forward to a later year when the investor will have tax liabilities again. Practically this means that even if more investments are made in later years (e.g. another $1 million in investment), the maximum offset will still be limited to $200,000 per year.

Effect of offset being non-refundable



Investor is not a sophisticated investor

Ensure non-sophisticated investor does not invest more than $50,000 in an ESIC

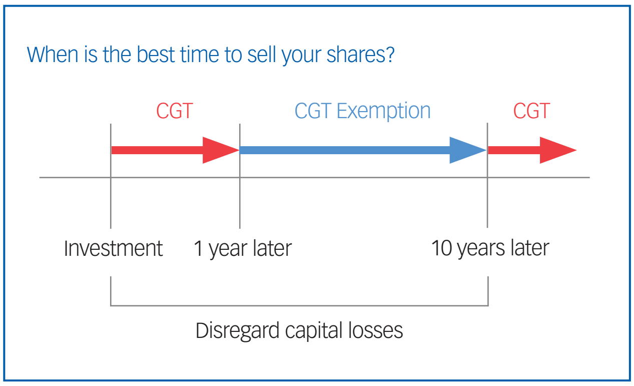
In contrast, a **non-sophisticated investor** will only be allowed a maximum investment of $50,000 a year (thereby capping the individual non-sophisticated investor's offset at $10,000 per year – 20% x $50,000).

A word of caution - if a non-sophisticated investor invests more than $50,000 in the ESIC, there will be no offset[4] (they will not even qualify for a 20% offset on the first $50,000 invested in the ESIC).

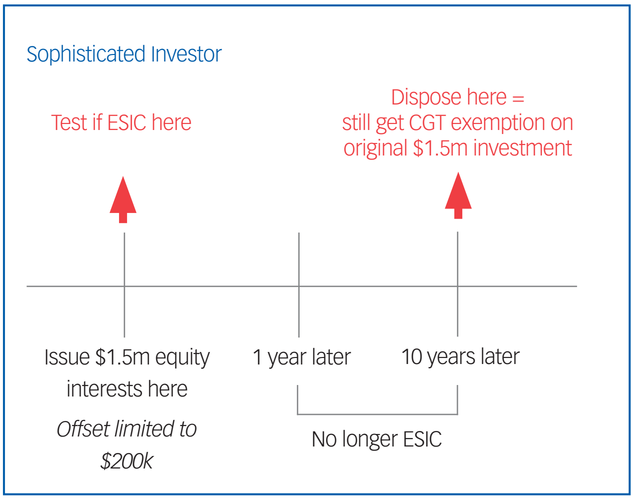
1(b) Incentive when you dispose of the investment = CGT exemption

Exemption for capital gains (but also lose capital losses)

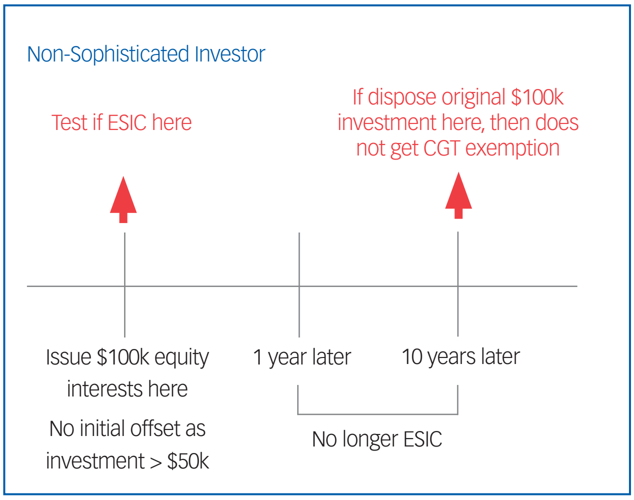
On disposal of the investment (held for at least 1 year but less than 10 years), the holder of the shares may be entitled to a CGT exemption (i.e. pay no CGT upon disposal of the investment). However, any capital losses realised before this 10 year period will also not be allowed.



Note that unlike the non-refundable offset, investments over $1 million will still benefit from the CGT exemption. That means that even if a sophisticated investor purchased $1.5m of shares and sells them after 5 years, the whole capital gain will be exempt – even though the investor was only entitled to an offset of $200,000 (and not 20% of $1.5 million). Also, even if the company is no longer an ESIC at the time of disposal of the shares, the investor will still qualify for the CGT exemption.



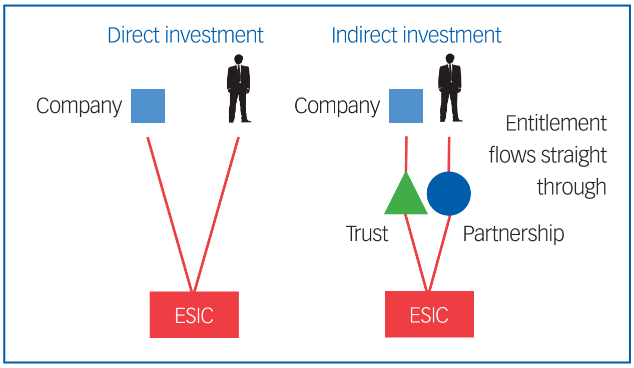
Note however that if a non-sophisticated investor initially invested more than $50,000 in an ESIC, there will be no CGT exemption if the investment is disposed of between 1 and 10 years.



If shares are held for more than 10 years, any gain arising from year 10 onwards, will be subject to CGT (cost base will be the market value of the shares at year 10).

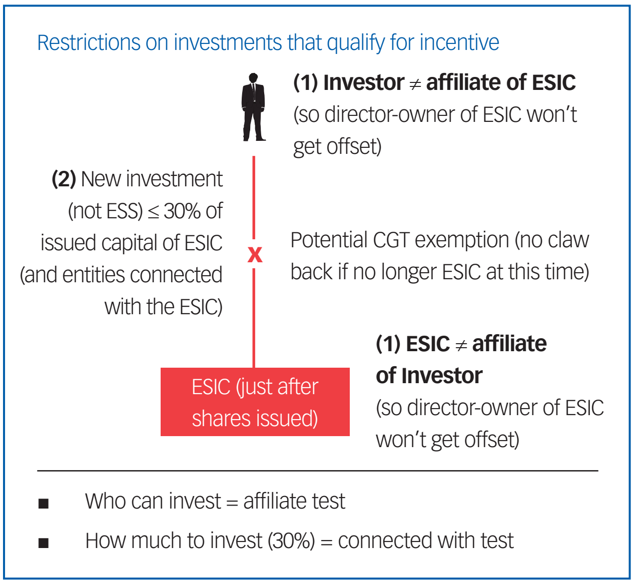
2. What type of investors can qualify for such incentives?

Generally, all types of investors (except widely held companies) can qualify for the innovation incentive and the offset will be available for both resident and non-resident investors[5]. A company or individual can either make a direct or indirect investment in an ESIC.

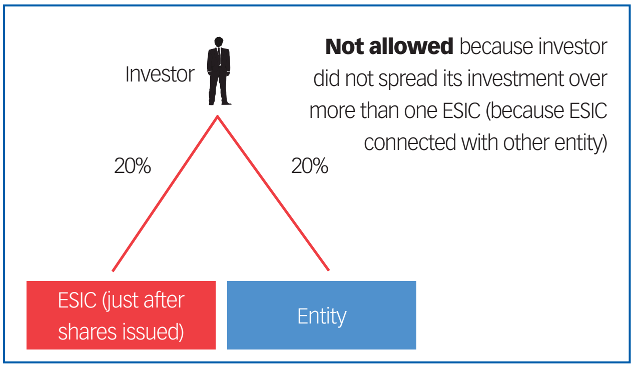


However, there are various restrictions on what kind of investments will qualify for the incentive:

1. an investor and an ESIC may not be **affiliates**[6] of each other (i.e. a director-owner who invests in his/her ESIC will not be eligible for the innovation incentive); and
2. an investor may only invest up to 30% of the issued capital of the ESIC (and entities **connected with**[7] such an ESIC)



The 30% rule aims to ensure that the investor spreads investments over more than one ESIC.



3. What is an ESIC?

An Australian company doing innovative activities will only qualify as an ESIC if both the following two limbs are satisfied (as tested immediately after the shares are issued to investors):

1. The first limb **(the early stage limb)** that looks at the characteristics of the company – e.g. the company has not been in existence for a long time, is not listed on a stock exchange and had assessable income of $200,000 or less and expenditure of $1 million or less in the prior income year; and
2. The second limb **(the innovation limb)** that looks at whether the activities carried on by the company qualify as innovative activities – e.g. through either applying a principles based test **or** a 100 Points innovation test to determine whether the activities are innovative.

Because these tests can be interpreted very subjectively, we would recommend that you speak to your Nexia tax adviser about whether your Company may qualify as an ESIC.

If required, we can submit a Ruling to the ATO on your Company's behalf to confirm whether the ATO would regard your Company as an ESIC[8].

How can Nexia help you?

Only time will tell whether the investment incentive will be successful in stimulating investment in innovative activities in Australia.

Please contact your Nexia Adviser if you are a startup, if you are involved with innovative activities or if you are an investor in businesses involved in innovative activities and would like to know more about whether this new incentive may be available to you or whether you should restructure your business.

Our team of tax specialists at Nexia Australia can assist you in undertaking such an analysis and also help you to restructure your business (if necessary) so that you can obtain the best commercial and tax outcome possible. We will ensure that you understand the application of our tax laws before embarking on any transaction or project .

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(1) The Tax Laws Amendment (Tax Incentives for Innovation) Act 2016 received Royal Assent on 5 May 2016. (2) For background, please see our 14 December 2015 client alert – Future tax breaks if you innovate – and 19 February 2016 client alert – Discussion paper for early stage investors - on the Nexia Australia website. (3) Section 708 of the Corporations Act 2001. (4) s360-20 of the Income Tax Assessment Act 1997 (ITAA 1997). (5) The fact that this incentive is also available to non-resident investors does not lead to an erosion of the tax base because the offset will only be available if the non-resident has tax payable in Australia (i.e. an offset can only be used to reduce Australian tax payable). (6) Broadly an individual or corporate investor will be an affiliate of the ESIC (and vice versa) if one of the parties would act in accordance with the wishes of the other. (7) Broadly another entity will be connected with an ESIC if the ESIC controls the entity, the entity controls the ESIC or both entities are controlled by the same 3rd entity. For tax purposes, an entity can be a person. (8) If a ruling confirms that a company is an ESIC, the company may not use this ruling as promotional material to create the impression that the ATO is guaranteeing any investment in the company or endorsing any investment in such a company.

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