FinTech Alert

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Government responds to Australia's FinTech priorities with tax concessions to drive innovation

Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 (Bill) was recently introduced into the House of Representatives. The Bill proposes to provide tax incentives to encourage investment in Australian innovative high growth potential start-ups. In order to make the existing Early Stage Venture Capital Limited Partnership (ESVCLP) and Venture Capital Limited Partnership (VCLP) regimes more attractive to investors, the Bill also provides an additional tax concession for investors and relaxes the restrictions on ESVCLP investments and fund size.

The introduction of this Bill is in addition to the release by Treasury on 1 and 6 April 2016 of two sets of exposure draft legislation to remove features of the Australian tax system that may impose extra costs on innovative business by relaxing the current strict same business test for the utilisation of company losses and improving the tax treatment of intangible depreciable assets.

In addition to these tax incentives, Treasury released proposals to the treatment of Bitcoin for GST purposes. These changes will ensure certainty on the treatment of Bitcoin and remove the possibility for double taxation.

What the proposed tax measures will do

All of these reforms were announced as part of the Australian Government's National Innovation and Science Agenda (NISA) on 7 December 2015 to incentivise and reward innovation by aligning the tax system and business laws with a culture of entrepreneurship and innovation.

Key tax measures

1. Tax incentives for early stage investors in innovation companies

(a) A 20% tax offset

Under the Bill, entities that acquire (directly or indirectly through a trust or partnership) new shares in an Australian early stage innovation companies (ESIC) will be entitled to a non-refundable carry-forward tax offset of 20% of contributions made to the ESIC (with an annual cap of A$200,000 in respect of shares held by an investor and its affiliates). Therefore, investments of more than A$1 million per year will not give rise to any additional tax benefits for an investor.

In addition, a total annual investment limit of A$50,000 applies to retail (non-sophisticated) investors.

The tax offset will not be available if:

- the investor and ESIC are affiliated (broadly, neither party could reasonably be expected to act in accordance with the wishes of or in concert with the other);
- the investor holds more than 30% of the shares in the ESIC (or an entity connected with the ESIC);
- the shares are issued under an employee share scheme; or
- the investor is a widely held company or a wholly owned subsidiary thereof.

(b) A 10 year capital gains tax exemption on subsequent disposal of investments (provided investments are held for at least 12 months)

If an investor is entitled to the 20% tax offset as a result of acquiring a share in a ESIC, the investor will be deemed to hold the share on capital account. If the shares is held for between 12 months and less than ten years, any capital gain arising from the share is disregarded. Any incremental gains in value after 10 years may be assessable as a capital gain (with the cost base of the share reset to market value on the tenth anniversary).

If the investment fails, any capital losses made by the investor will not be available.

(c) What is an eligible ESIC?

For the purpose of these two tax concessions described above, a company is an ESIC if it satisfies both the 'early stage' and 'innovation' limbs.

A company will satisfy the early stage limb if:

- it was incorporated in Australia or registered in the Australian Business Register in the last three years (or incorporated in the last six years and it and its wholly owned subsidiaries incurred total expenses of up to A$1 million in the last three years);
- it and its wholly owned subsidiaries have expenditure and income of less than A$1 million and A$200,000 in the previous income year, respectively; and
- it is not listed on any stock exchange.

A company satisfies the 'innovation' limb if it meets either of the following tests:

- a principles-based test which, broadly, requires the company to establish that it is developing a new or significantly improved innovation that displays high growth and commercialisation potential, potential to address a broader than local market, scalability and competitive advantages; or
- an objective, activity-based test which requires a score of at least 100 points for meeting certain objective innovation criteria (such as meeting R&D expenditure thresholds, receiving Accelerating Commercialisation Grants, participating in eligible accelerator programmes, or holding certain enforceable intellectual property rights).

These two incentives are proposed to apply to shares issued from 1 July 2016.

2. 10% ESVCLP tax offset

In order to make ESVCLPs more attractive, the Bill introduces an additional tax incentive for limited partners in new ESVCLPs consisting of a non-refundable carry-forward tax offset of up to 10% of contributions made to the ESVCLP (directly or indirectly through a trust or partnership) during an income year. To the extent contributions are not used by the ESVCLP to make eligible venture capital investments (taking account of associated incidental costs and administrative costs) within two months after the income year in which the contribution is made, the amount of the tax offset is reduced accordingly.

These changes are proposed to broadly apply in relation to contributions made from 1 July 2016 to an ESVCLP that becomes unconditionally registered on or after 7 December 2015.

3. Relaxing requirements under existing ESVCLP and VCLP regimes

The Bill also proposes to relax restrictions under the existing ESVCLP and VCLP regimes by:

- increasing the maximum fund size for ESVCLPs from A$100 million to A$200 million;
- removing the existing requirement that an ESVCLP divest of an investment in an investee entity once the value of the assets of the investee entity (and its connected entities) exceed A$250 million. However the existing tax concessions will not apply to any incremental gains in value after the six months after the end of the income year in which investee entity's assets first exceed this threshold;
- allowing investee entities in which an ESVCLP, VCLP or an Australian venture capital fund of funds has invested in, to invest in other entities, provided that the investee entity controls the other entity and the other entity broadly satisfies the requirements to qualify as an eligible venture capital investment (as defined in the tax law); and
- limiting the existing requirement that investee entities must have an auditor to: (a) public companies or large proprietary companies; (b) a unit trust that would have been a public company or large proprietary company if it were a company; and (c) entities with assets with a total value in excess of A$12.5 million.

These changes are proposed to broadly apply on and after 1 July 2016.

Other changes to be mindful of

The Bill also includes measures to:

- provide greater guidance to VCLPs, ESVCLPs and Australian venture capital fund of funds by permitting Innovation Australia to make public or private rulings that an activity is not an ineligible activity for the purposes of applying the CGT provisions to venture capital investments;
- clarify that a managed investment trust (MIT) may, in certain circumstances, invest in an ESVCLP or VCLP without affecting its MIT status. That is, in determining whether it is carrying on a trading trust, or carrying on or controlling a trading business, the trust may disregard its interest in a VCLP or ESVCLP so long as: (a) it is not a general partner of the VCLP or ESVCLP; and (b) it and its associates do not hold more than 30% of the committed capital of the VCLP or ESVCLP; and
- clarify that if a MIT has an interest in a CGT asset as a result of being a limited partner in a VCLP or ESVCLP, the asset is treated as an asset owned by the MIT (to the extent of its interest) for the purposes of a MIT CGT election.

The amendments are proposed to apply on or after 1 July 2016.

4. Reform to tax loss provisions

The Treasury released exposure draft legislation on 6 April 2016 to relax the current strict same business test for the utilisation of company losses.

It is proposed that if a business has changed ownership, it may still access prior year losses if it satisfies a more flexible "predominantly similar business test" where the business, while not the same, uses similar assets and generates income from similar sources. The proposed new test will involve an assessment of a range of factors, including:

- consistency in the underlying assets (tangible and intangible) of the company that generate income;
- consistency in the source of company income; and
- whether any changes to the business are of a type that might reasonably be expected from such a

company.

This will allow loss making companies to bring in new equity partners and secure new business opportunities to return to profitability with less fear of losing access to valuable prior year losses. This is particularly relevant for small innovative companies and is intended to encourage investment and growth in innovative businesses.

It is proposed that this new test will apply to losses made in the current and future income years (and current tests will continue to apply to existing losses). The reform will also be extended to listed widely held unit trusts.

5. Intangible asset depreciation

The Treasury also released exposure draft legislation on 1 April 2016 to give a taxpayer the option to depreciate some intangible assets like patents, registered designs, copyright and in-house software based on a self-assessment of the economic life of the asset, rather than use the statutory effective life. This potentially faster rate of depreciation is intended to make start-ups' investment in intangible property a more attractive investment option, which is crucial to innovation and growth. The changes are scheduled to apply to assets acquired from 1 July 2016.

6. Digital currencies - GST anomaly to be fixed

In addition to the above developments, the Australian Treasurer recently announced (in March 2016) that the Government is committed to addressing the ‘double taxation’ of digital currencies and will work with the industry on legislative options to reform the law relating to GST as it is applied to digital currencies.

This is a welcomed change. To date, the GST characterisation of digital currencies, such as Bitcoin, has meant that it is not treated as currency. In August 2014, the Australian Taxation Office (ATO) issued a ruling on the GST treatment of such currencies, whereby the treatment of digital currencies is a form of intangible (rather than money or currency). As result, digital currency transactions are akin to a barter transaction and GST can be due on the supply of Bitcoins. This has had two main consequences being, the potential for double GST reporting and double taxation. For example, businesses dealing with Bitcoin (either by using it as a method of payment or selling Bitcoin) may need to account for GST when they supply Bitcoin as a payment method and when they sell it. However, if it was treated as money, no output GST would follow.

This treatment is also inconsistent with how Bitcoin is treated in European jurisdictions for value added tax purposes (where a recent European Court of Justice case held it should be exempt).

The Treasurer's recent announcement comes after the Senate Economics References Committee’s Inquiry into Digital Currency and the Productivity Commission’s Inquiry into Business Set Up, Transfer and Closure, reported on this anomaly and recommended that digital currency such as Bitcoin should be treated as money for GST purposes.

This change will create certainty for users and dealers in digital currency and it will assist Australian digital currency transactions to become more competitive with both fiat-based competitors and international Bitcoin-based competitors.

Conclusion

This suite of new tax initiatives should make innovative start-ups more internationally competitive and attract more capital investment, thus fostering a greater culture of innovation, risk-taking and entrepreneurship in Australia.

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