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108 | Early Stage Innovation Companies

Early stage innovation companies (ESIC) are a high risk investment. But when successful a huge contribution to Australia's economy.

Early Stage Innovation Companies

To encourage investors to support innovation, the tax incentive for ESIC gives investors a tax offset and concessional CGT treatment.

In this episode Simon Dorevitch of A&A Tax Legal Consulting will walk you through the ins and outs of the ESIC incentive. Here is what we learned.

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Concept

It is actually the investor who receives the tax offset and CGT exemption. Not the innovating company.

Conditions

To receive the ESIC incentive, the set-up must meet seven conditions. Some are about the innovating company, some about the investor and some about the relationship between company and investor. These seven conditions are:

1 Early Stage

To be an early stage company, the company needs to be early stage. So it must be at the early stage of its life cycle. The law includes detailed rules around what early stage means. To be early stage the company must pass four conditions.

The first condition looks at the past three years. The company must either have been incorporated or registered in the Australian Business Register within the last three income years. And if the company was incorporated earlier within the last six years, then at least across the last three income years the company and its wholly-owned subsidiaries must have incurred total expenses of $1 million or less. That is the first condition to be early-stage.

The second and third condition look at the previous income year. In the previous income year the company together with any wholly-owned subsidiaries must have incurred total expenses of $1 million or less in the previous income year and had assessable income of $200, 000 or less.

And the fourth condition is that at the time of investment (called the 'test time') none of the shares of the company were quoted on a recognised Australian or overseas exchange. So the company can't already have

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gone through an IPO. An IPO means well past early stage.

2 Innovation

To be an innovation company, the company obviously needs to be innovative. There are two ways to assess whether a company is sufficiently innovative. The company needs to either get 100 points from the list of criteria set out in s 360-45 ITAA 1997 or it must satisfy a number of principle-based qualitative criteria.

Most companies qualify via the 100 points approach. The principle-based qualitative approach has a lot more grey in it. So most investors will seek a private ruling from the ATO before they will rely on this approach.

3 At Issue of Shares

Whether a company is early stage and innovative you assess on the date the company issues the shares.

4 Not an ESS

The issue of shares must not be an employee share scheme (ESS) interest. So the investor can acquire newly issued shares or acquire existing shares. But the ESIC incentive does not apply if the shares are part of an employee share scheme.

5 Not Affiliates

To qualify, the investor and company must not be affiliates with each other. Affiliate has the same meaning as for the small business CGT concessions in Div 152.

6 Investor is not….

To qualify for the ESIC incentive, the investor must not be a trust, partnership, widely-held company or a wholly-owned subsidiary of a widely-held company. So investors usually sit in a private equity company that is not widely-held.

7 Not more than 30%

The investor must not hold more than 30% of the equity interests in the company.

Incentives

The tax incentives for early stage investors are contained in Division 360 ITAA97. Eligible investors who purchase new shares in an ESIC receive two incentives. A 20% non-refundable offset subject to caps and a CGT concession.

A) Non-Refundable Tax Offset of 20%

Eligible investors who purchase new shares in an ESIC receive a non-refundable carry forward tax offset of 20% of the amount paid for their qualifying investments. This is capped at a maximum tax offset amount of $200,000 for the investor and their affiliates combined in each income year.

B) CGT Concessions

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For an eligible ESIC investment, the investor is taken to hold the shares on capital account. So even if the investor is in the business of investing as an angle investor, it is taken to not hold the shares on revenue account but capital account.

If a CGT event occurs within 10 years of the issue of shares and they have been continuously held, any capital gains or losses are disregarded. So depending on how this investment goes, it can work for or against the investor.

If, after 10 years, the shares have not been sold, the cost base is adjusted to market value at the 10-year mark.

C) But…

However, there is a huge trap. If an investor doesn't qualify as a sophisticated investor, they get nothing the moment they invest more than $50,000.

A non-sophisticated investor is not eligible for any tax incentive if their total investment in qualifying ESICs in an income year is more than $50,000. So the moment you invest one dollar more than the $50,000, you lose all entitlements to any offset or CGT concession, unless you qualify as a sophisticated investor.

So if you don't meet the sophisticated investor test, the maximum early stage investor tax offset that you can claim is $10,000, as your total annual investment in all qualifying ESICs cannot exceed $50,000.

Sophisticated Investor

So what makes you a sophisticated investor? Who qualifies as a sophisticated investor is determined under the *Corporations Act 2001.*

It is not financial literacy or having a finance or accounting or legal or any particular background. The only criteria is how many assets you have and what income you derive. In other words, if you can afford to lose the money. That's all.

All this is just our brief take on the issue, but please listen to the episode above. Simon Dorevitch explains all this in a much better way than we ever could.

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