SHOW ME THE MONEY: TAX REFORMS TO ENCOURAGE INVESTMENT IN STARTUPS

The Ideas Boom has arrived with the Federal Government's National Innovation and Science Agenda (see our summary: Allens Accelerate: Get ready for the #IdeasBoom!). Central to the new agenda are a raft of tax and regulatory measures designed to encourage greater investment in startups to help them both get off the ground and to survive the 'valley of death' with greater access to Series A capital. This client update, part of the Allens Accelerate series covering the National Innovation and Science Agenda, takes an in-depth look at newly announced tax reforms.

IN SUMMARY:

- Investors will be eligible to claim a 20 per cent non-refundable tax offset when they invest in startups and any capital gains they make on the disposal of such investments will generally be tax exempt.
- The Venture Capital Limited Partnership (***VCLP***) and Early Stage VCLP (***ESVCLP***) regimes will be enhanced by relaxing some of the eligibility requirements that have in the past limited the use of these investment vehicles.
- Businesses will be able to self-assess the tax effective life of acquired intangible assets. This will better align the tax treatment of the asset with the actual number of years the asset provides an economic benefit.
- Employee share scheme (***ESS***) disclosure obligations will be made more 'user friendly', and, in particular, the current requirement for disclosure documents given to employees under an ESS to be made available to the public will be limited.
- The integrity measures around the utilisation of tax losses will be relaxed to allow businesses to access prior year losses when they have entered into new transactions or business activities. This approach will give businesses greater ability to 'pivot' out of poorly performing areas and into (hopefully) greener pastures.

In general, the new rules will only apply to investments made after 1 July 2016.

TAX INCENTIVES FOR EARLY STAGE INVESTORS

The Government has announced that concessional tax treatment will be made available for investors who support innovative startups, including:

- a 20 per cent non-refundable tax offset on investment capped at $200,000 offset per investor, per year; and
- a 10-year capital gains tax exemption for investments held for three years.

The incentive will be available for investments in companies that undertake an eligible business (which is yet to be determined), that were incorporated during the last three income years, that aren't listed on any stock exchange and that have expenditure and income of less than $1 million and $200,000, respectively, in the previous income year. At first blush, these caps appear to be too low. Startups that would typically want to achieve strong financials before undertaking a capital raising might now find that they need to front-end their capital raising to ensure that their investors qualify for the tax concessions.

It is unclear at this stage whether the regime will apply to 'mum and dad' investors generally, or perhaps be limited to sophisticated investors (eg angels). It is also unclear what would happen if the gains are not realised within the 10 year exemption period. Perhaps there will be market value uplift to the cost base of the shares at the 10 year mark. The relevance of these concessions to investors who are potentially holding their investments on revenue account is unclear.

The scheme is expected to commence from 1 July 2016 as soon as the amendments receive Royal Assent. In the interim period, we anticipate that startups might find it increasingly difficult to raise capital from investors.

ENHANCING THE VCLP AND ESVCLP REGIMES

VCLPS

The Australian VCLP regime was introduced in 2002 with the aim of attracting foreign investment at the early and growth stages of a startup. The regime is supported by special tax concessions. For example:

- VCLPs receive flow-through tax treatment;
- eligible foreign investors in a VCLP are exempt from income tax on profits or gains derived from the sale of eligible investments by the VCLP; and
- gains made by general partners in relation to their carried interest are generally taxed as capital gains (and potentially qualify for the CGT 50 per cent discount).

In practice, it would appear that the VCLP regime has been underutilised, possibly because of the highly prescriptive eligibility requirements. For example, a VCLP must generally have at least $10 million in committed capital and can only invest in certain types of eligible investments (which are narrow and prescriptive). Further, an investment cannot represent more than 30 per cent of a VCLP's committed capital.

The Government has announced that it will relax eligibility and investment requirements of VCLPs to allow managers to undertake a broader range of investment activities and to encourage greater diversity of investors. One possibility, which was flagged by the Board of Taxation in its 2011 report, would be to amend existing legislation to permit Australian Managed Investment Trusts (***MITs***) to invest as limited partners in VCLPs and ESVCLPs and retain their MIT status. The Board noted in its report that this has the potential to open up a significant source of capital.

ESVCLPS

The Australian ESVCLP regime was introduced in 2007 and is designed to encourage seed and venture capital investment (ie funds of between $10 million and $100 million investing in eligible Australian businesses). In addition to the special tax concessions provided to VCLPs (see above), all partners in a ESVCLP (including Australian investors) are exempt from tax on any gains made on the disposal of eligible investments and any share of income derived by a ESVCLP. Given these generous tax concessions, the eligibility requirements to be a ESVCLP are even more difficult to satisfy than a VCLP.

Under the proposed new arrangements:

- partners in a new ESVCLP will receive a 10 per cent non-refundable tax offset on capital invested during the year. So, for example, if a discretionary trust were to invest $200,000 in a ESVCLP in FY17, the 10 per cent tax offset available under the new arrangements would potentially reduce the tax payable by the beneficiaries of the trust by $20,000.
- the maximum fund size for new ESVCLPs will be increased from $100 million to $200 million; and
- ESVCLPs will no longer need to divest from a company when its value exceeds $250 million.

The Government will also relax eligibility and investment requirements of ESVCLPs to allow managers to undertake a broader range of investment activities and greater diversity of investors.

The new arrangements for VCLPs and ESVCLPs will take effect from the date of Royal Assent and are expected to commence from 1 July 2016.

CHANGES TO THE DEPRECIATION OF INTANGIBLE ASSETS

The Government recognises that investments in intangible assets, such as intellectual property, are crucial to innovation and growth. Under existing tax provisions, such assets are depreciated in accordance with their effective life as determined by statute, resulting in a potential mismatch between an asset's statutory effective life and its actual economic life. This can reduce the depreciation benefit and increase the cost of investment in these assets.

The new rules will allow for self-assessment of the effective life of acquired intangible assets, while providing the option of continued use of existing statutory effective life provisions. Under the new approach, the tax effective life of an intangible asset will be better aligned with its actual economic life, increasing the attractiveness of IP-reliant companies to investors. For example, a patent that has a statutory life of 20 years must, under current tax rules, be depreciated over a 20-year period. Under the proposed new rules, a company that acquires the patent will be able to self-assess a shorter effective life (eg five years), meaning that it could potentially claim larger tax deductions over a shorter period of time.

The changes will apply to assets acquired from 1 July 2016.

DISCLOSURE REQUIREMENTS FOR EMPLOYEE SHARE SCHEMES TO BE MADE MORE 'USER FRIENDLY'

Earlier this year, the Government enacted substantial changes to the taxation of employee share schemes. The new changes, which apply to options or shares granted on or after 1 July 2015, allow eligible startup companies to grant eligible options or shares to employees which are not subject to Australian tax on grant, vesting or exercise. Instead, the employee will be subject to capital gains tax (***CGT***), generally when the shares are sold and the CGT 50 per cent discount will generally be available at that time. You can read more about the tax changes here.

However, ASIC's class order for unlisted companies (which was substantially revised in October 2014) does not accommodate all offers which attract the startup tax concessions. For example, the class order provides that products must be issued for no more than nominal monetary consideration, whereas tax concessions for grants of shares are only available where the shares are offered at no more than a 15 per cent discount to their market value. In circumstances where neither the class order nor one of the other statutory exemptions from the disclosure requirements apply (eg the senior manager or small scale offering exemptions), a company may be required to lodge a disclosure document with ASIC in connection with an offer of ESS interests. At present, those disclosure documents are publicly available.

The Government has announced that it intends to introduce legislation in the first half of 2016 to limit the requirement for disclosure documents given to employees under an ESS to be made available to the public. The Government has also stated that it intends to consult on potential amendments to the disclosure requirements to make ESS more 'user-friendly'. Hopefully this translates into reduced or simpler disclosure obligations for startup companies that are required to use a disclosure document in connection with an offer of ESS interests.

INCREASING ACCESS TO COMPANY LOSSES

The utilisation of tax losses is subject to the continuity of ownership test or, if this test is failed, the same business test (which is much harder to satisfy than it sounds). For example, if an angel invests additional capital in a startup which results in a majority change in ownership, the startup company would only be able to utilise tax losses for prior years if the same business test is satisfied. Under the current rules, if the startup company were to pivot in a new direction, the same business test may not be satisfied.

To help businesses innovate and grow without fear of losing out, the Government has announced that it will be more flexible with access to company losses. In particular:

- the current 'same business test' will be relaxed to allow businesses to access prior year losses when they have entered into new transactions or business activities. This will encourage entrepreneurship by allowing loss-making companies to seek out new opportunities to return to profitability; and
- as part of these reforms, the 'same business test' will be replaced by a new and more flexible 'predominantly similar business test', under which companies will be able to access losses where their business, while not the same, uses similar assets and generates income from similar sources. The predominantly similar business test will permit businesses to more easily move into new areas.

The 'predominantly similar business test' will apply to losses made in the current and future income years.

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