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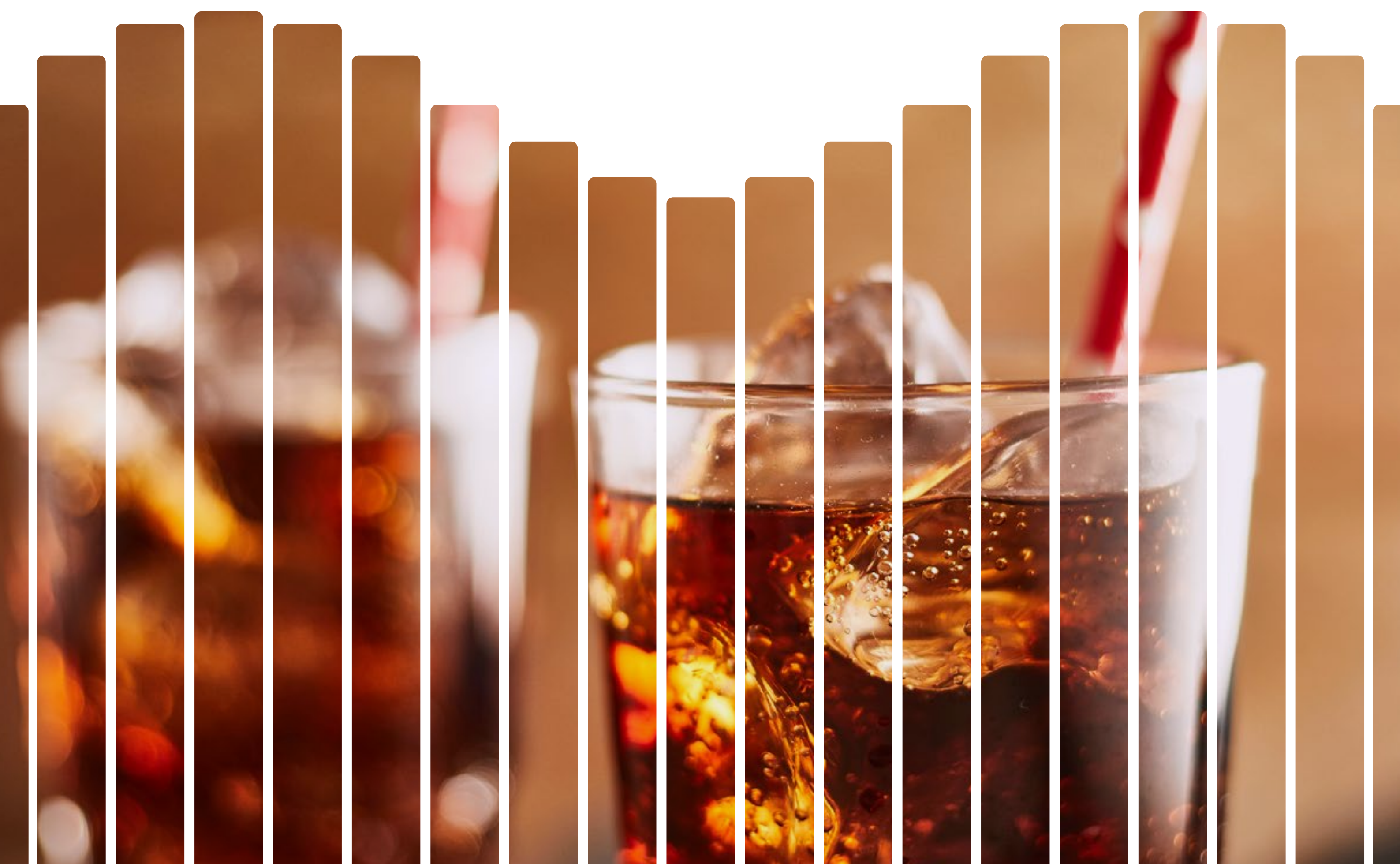

Revisiting the ESIC measures

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It has now been a number of years since the early-stage innovation company (ESIC) measures were first introduced in 2016, and the ESIC measures have garnered somewhat little attention among the mainstream tax community during this time. The ESIC measures can provide powerful outcomes for investors in ESICs and, therefore, advisers should endeavour to keep the ESIC measures at the forefront of their minds in order to maximise the availability of the concessions for their clients. This article seeks to revisit the ESIC measures while highlighting the planning opportunities and pitfalls experienced by the authors in practice. The article covers a range of issues, including corporate groups seeking ESIC eligibility, structuring investments in ESICs, and technical issues with the principles-based test, among others.

Introduced by the Turnbull Government in 2016, the early-stage innovation company (ESIC) measures have steadily ticked along, garnering somewhat little attention among the mainstream tax community.

The significance of the ESIC concessions may appear understated. This article seeks to revisit the powerful outcomes that can be achieved for investors in ESICs, while highlighting the planning opportunities and pitfalls experienced by the authors in practice.

The legislative framework and key concepts

Preliminary observations

Before addressing the various planning opportunities and traps associated with the measures, it is worthwhile providing a brief overview of the relevant legislative criteria.

The ESIC measures are contained in Subdiv 360-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Where available, the measures can provide taxpayers who subscribe for new shares in an ESIC with the following tax concessions:

- a non-refundable carry-forward tax offset equal to 20% of the taxpayer's investment in the ESIC, capped at $200,000 per taxpayer per annum (for sophisticated investors); and
- concessional modified CGT treatment on the newly issued shares in the ESIC.

The concessional modified CGT treatment includes:[1]

- where the shares held in an ESIC are disposed of between the period of more than 12 months and less than 10 years of ownership, no capital gains or losses will arise on the disposal of the shares; and
- where the shares are held for more than 10 years, the shares receive a market value cost base uplift on the 10th anniversary of ownership.

It can be seen that the ESIC measures are capable of providing taxpayers with considerable income tax benefits. Having said this, given ESICs are typically high-risk prospects, care is required in seeking to classify an investment as an ESIC, as any capital losses arising from the investment will be disregarded.

Eligible investors

Investors seeking to access the ESIC measures must subscribe for, and be issued with, shares in a company that constitute equity interests under the ITAA97. It follows that the ESIC concessions will not be available where the investor acquires its shares in the investee company via share transfer.

As stated above, the maximum $200,000 per annum tax offset is available to "sophisticated investors".[2] If the investor does not qualify as a sophisticated investor, the ESIC concessions limit that investor's total investment in the investee company to $50,000 (equivalent to a maximum tax offset of $10,000).[3] If that investment amount is exceeded, the non-sophisticated investor loses the ability to claim the ESIC concessions altogether.[4]

The sophisticated investor test applied under the ESIC regime is set out in the *Corporations Act 2001* (Cth)[5] which provides a number of pathways for an investor to qualify as a sophisticated investor.

An investor most commonly qualifies as a sophisticated investor where they (or, if a company or trust, the controller) hold a qualified accountant's certificate at the time of the share issue stating that the investor (or their controller):

- has gross income of at least $250,000 for each of the last two financial years; or
- has net assets of at least $2.5m.[6]

In addition to the above, there are also a number of other requirements which, although more procedural in nature, should not be ignored. These requirements are as follows:[7]

- investors cannot be widely-held companies or early stage venture capital limited partnerships;[8]
- the investor and investee company cannot be affiliates of each other at the time of the issue of the equity interests;

- immediately after the issue of the new shares, the investor cannot hold issued share capital in the investee company (or an entity connected with the company) that carries rights to exercise more than 30% of the total voting power or receive more than 30% of any distributions of income or capital (the 30% rule); and
- the shares cannot be issued to the investor pursuant to an employee share scheme.[9]

On the basis that the above requirements are satisfied, the final requirement that needs to be met is that the investee company qualifies as an ESIC at the time of the issue of the new shares.[10]

When is a company an ESIC?

In order for the investee company to be deemed an ESIC, this requires that the company satisfies a suite of requirements that are broadly split into two distinct limbs. Those limbs are:[11]

1. the "early stage" limb; and
2. the "innovation" limb.

The early stage limb is determined against the following criteria, requiring that the company immediately before the investment (ie the issue of shares):[12]

- is not listed on any stock exchange;
- was either:
  - incorporated within the last three income years (the latest being the income year of the investment);
  - registered on the Australian Business Register within the last three income years (the latest being the income year of the investment); or
  - incorporated within the last six income years (the latest being the income year of the investment) and (together with its 100% subsidiaries) has total expenses of $1m or less over the last three income years before the income year of the investment;
- has (together with its 100% subsidiaries) assessable income of $200,000 or less in the income year before the investment;
- has (together with its 100% subsidiaries) total expenses of $1m or less in the income year before the investment; and
- is not a foreign resident.

It can be seen from the above that, as time goes on, the ESIC requirements become increasingly difficult for an existing company to satisfy.

The innovation limb requires the investee company to meet one of two tests,[13] being the "points-based test" or the "principles-based test".

The points-based test requires that the investee company falls within certain objective innovation criteria which are contained in s 360-45 ITAA97 and are repeated in the Appendix to this article for ease of reference. There are eight different criterion, each of which, when satisfied, awards the company with points that range between 25 and 75 points per criterion. If the investee company can accumulate 100 points, the points-based test and innovation limb are satisfied.

The principles-based test requires the company to demonstrate that:[14]

- the company is genuinely focused on developing for commercialisation one or more new or significantly improved products, processes, services, marketing or organisational methods;
- the business relating to those products, processes, services or methods has a high growth potential;
- the company has the potential to be able to successfully scale that business;
- the company has the potential to be able to address a broader than local market, including global markets, through that business; and
- the company has the potential to be able to have competitive advantages for that business.

None of the above words and phrases are defined in the tax legislation. The principles-based test is therefore highly subjective but is far less rigid in its application than the points-based test.

The explanatory memorandum to the legislation[15] that introduced the ESIC measures does, however, provide some guidance on the test, and for now is the primary source of aid in applying the above phrases.

In this regard, the plain language of the principles-based test and the explanatory memorandum make it clear that there must be an innovation being developed by the ESIC and a business that aims to exploit that innovation.[16]

Other key takeaways from the explanatory memorandum include that:[17]

- the innovation needs to be "new or significantly improved" for the applicable addressable market (eg the Australian market);
- improvements resulting from the customisation of existing products and minor extensions such as updates will not be considered "new or significantly improved" innovations;
- the requirement that the company is developing an innovation "for commercialisation" requires that there is a spectrum of activities leading to the sale of the innovation or the generation of economic value for the company; and
- the need for the company to be able to demonstrate that the innovation is able to address a broader than local market means a market that is broader than a local city, area or region, so a capability of addressing in the future a national, multinational or global market would suffice.

Planning issues for ESICS

While the policy intent of the ESIC measures is to "encourage new investment in small Australian innovation

companies with high-growth potential",[18] in the authors' experience, there are a number of technical issues that may be considered counterproductive to this statement. Some of these issues are fleshed out below.

Corporate groups

In order for a taxpayer to qualify for the ESIC concessions, the company issuing shares must be the same company that meets both the early-stage limb and the innovation limb.

A historic point of contention among some advisers has been whether the principles-based test requires that the company in which the investment is being made must itself carry on innovative activities, or whether such activities can instead be carried on by other members of a broader corporate group.

This issue often arises in the context of multi-tiered corporate structures involving a holding company and one or more subsidiary companies. Sometimes the subsidiary companies will hold valuable intellectual property relating to the innovation and/or carry on the business of commercialising the innovation, while the holding company plays a passive or limited role (such as providing finance to the subsidiaries). In these situations, the issue becomes whether an investment in the holding company can qualify for the ESIC concessions.

It has been the authors' view that the language contained in the provisions of the principles-based test does require the investee company to carry on innovative activities in its own right (eg developing the innovation for commercialisation).

In the first decision of any court or tribunal to consider the ESIC measures, the Administrative Appeals Tribunal (AAT) has recently taken the same view. To this effect, the decision in *ZWBX and FCT*[19] (*ZWBX*) involved the following corporate structure:

- IP Co — which held the intellectual property being developed as the innovation;
- Trading Co — which licensed the innovation from IP Co in order to carry on a business in relation to the innovation, including the innovation's development and commercialisation; and
- Holding Co — which wholly owned IP Co and Trading Co and therefore acted as the "head company" for the corporate group.

Investors who were issued with shares in Holding Co sought to claim the ESIC concessions on their investment.

Although Holding Co was a passive holding company, the taxpayer reasoned that, by reference to policy intent and the inclusion of references to "100% subsidiaries" in the early-stage limb of the ESIC criteria, the principles-based test in the innovation limb could be satisfied where subsidiaries of Holding Co carried on the innovative activities. This was, in the taxpayer's view, on the basis that the objective purpose of the criteria allowed for there to be a "unity of purpose" concept such that the actions of a corporate group as a whole could be relied on to satisfy the principles-based test (ie the collective activities of Trading Co and IP Co could be attributed to Holding Co).

The AAT, agreeing with the Commissioner of Taxation, rejected this approach, finding that the principles-based test is to be applied to the activities of the specific investee company. As there was no evidence of Holding Co undertaking any innovative-related activities in its own right, Holding Co was not an ESIC and an investment in the company was ineligible for the ESIC concessions.

In reaching the above conclusion, it is important to note that there were no agency, joint venture or partnership agreements in place between Holding Co, IP Co and Trading Co.[20] In the authors' view, having such agreements in place may have assisted in establishing that the relevant investee company was genuinely engaged in the innovative activities and was therefore an ESIC.

Income tax consolidated groups

It appears in *ZWBX* that, at the time the investment was made by the investors, the corporate group was not an income tax consolidated group.[21] This has since raised whether consolidating the corporate group might have resolved the issues raised in *ZWBX*.

In short, it might be viewed that as the "single-entity rule"[22] applies to treat a consolidated group as one taxpayer, this in effect might impute the activities of all subsidiary members to the head company for the purposes of determining its status as an ESIC. In the authors' view, this is unlikely to be of any assistance in establishing that the activities of a subsidiary are the activities of a head company.

Although the single-entity rule dramatically alters the income tax treatment of both a head company and its subsidiaries, this is limited to two narrow purposes:[23]

1. the head company core purposes; and
2. the entity core purposes.

The single-entity rule should therefore arguably have no application in the above circumstances and, as such, the activities of the subsidiaries should not be imputed to the head company (and vice versa).

The authors are not aware of any case law authority or binding guidance released by the Commissioner on this exact issue under the ESIC measures. However, there is a non-binding discussion paper from 2017[24] which broadly supports the position:

> "*Where the head company and its 100% subsidiaries are members of a consolidated group, the single entity rule in section 701-1 operates for the period of membership.* Under the single entity rule, transactions and arrangements between members of a consolidated group are taken to occur between parts of the head company.
>
> *However, the single entity rule only has effect for head company and entity core purposes*, being either to work out the income tax liability or loss of the head company or an entity in the group. *These core purposes do not*

include determining the income tax consequences for an investor under Subdivision 360-A." (emphasis added)

Furthermore, there are a number of other income tax measures where the same interpretation broadly applies when determining the income tax liability of a non-group entity in respect of activities concerning a consolidated group.[25]

Structuring issues

As is evident from the above, correctly structuring the investee company is critical to accessing the ESIC concessions.

In the authors' experience, due to the restrictions placed on the form that an ESIC can take, investee companies will often be structured to serve the dual purpose of holding the valuable innovation and carrying on the business of commercialising the innovation. This structure typically overcomes many of the issues associated with ensuring that the investee company is adequately involved in the activities that need to be met to satisfy the principles-based test.

Notwithstanding the above, in the authors' view, an investee company can still qualify as an ESIC where the relevant trading operations are conducted in an entity which is separate from where the valuable innovation is held.

> "… the principles-based test may still be satisfied where the ESIC engages other entities … via the general principles of agency."

In this regard, there is no requirement under the legislation for the innovation to be owned by the ESIC – that the company is commercialising the innovation and using it in a business is sufficient. In the same vein, the principles-based test may still be satisfied where the ESIC engages other entities to hold the innovation or perform activities for the ESIC on its behalf via the general principles of agency.[26]

Therefore, advisers should give thought to ESIC structures that involve the ESIC carrying on the business activities and holding the innovation for the purposes of the concessions, but engaging with other entities to develop the innovation on behalf of the ESIC. This may involve the provision of labour and plant and equipment. Where such a structure is desired, tailored written agreements should be put in place to preserve the income tax and commercial outcomes.

Maximising the tax offset

There are a number of considerations that investors should take into account so as to maximise their tax offset.

In this respect, as stated, the tax offset is capped at $200,000 per taxpayer per year. To the extent that a taxpayer carries forward any unused part of an ESIC tax offset, it is added to the cap for the next year and takes precedence over future tax offsets that can be earned on any subsequent qualifying investments in an ESIC.[27]

By way of example, if an investor subscribed for $1m of shares in an ESIC in year one, the investor would receive a tax offset of $200,000 on that investment. If the investor carried forward part of that tax offset to year two, say, $50,000, because that amount was unused, and then subscribed for a further $1m of shares in the ESIC in year two, the investor would only be entitled to receive an offset of $150,000 on that investment. This is because the investor has existing carried-forward ESIC tax offsets totalling $50,000 when making their second investment and can only have $200,000 in ESIC tax offsets at any given time.[28]

Turning to trust investors, it should be noted that, where a trust under its terms has beneficiaries or unitholders that are entitled to fixed entitlements to capital gains, the ESIC tax offset is attributable to those members in accordance with those fixed entitlements.[29]

In this regard, another planning point to raise is that, because of the $200,000 cap being determined per investor, if there is a syndicate of investors seeking to invest, in order to maximise the availability of the tax offset for the syndicate of investors, it will be preferable for each investor to invest directly in the ESIC rather than via a syndicated entity such as a company or unit trust.

Diagram 1 shows a comparison of four investors investing in an ESIC via a unit trust against each investor investing via their own separate discretionary trust structure.

It can be seen that investing via a syndicated entity significantly reduces the tax offsets available to the syndicate due to the way in which eligibility for the tax offset is determined and limited. However, if a unit trust structure is adopted by one or more investors, helpfully, any capital gains that are disregarded under the modified CGT treatment can be accessed by the unitholders without giving rise to CGT event E4 consequences.[30]

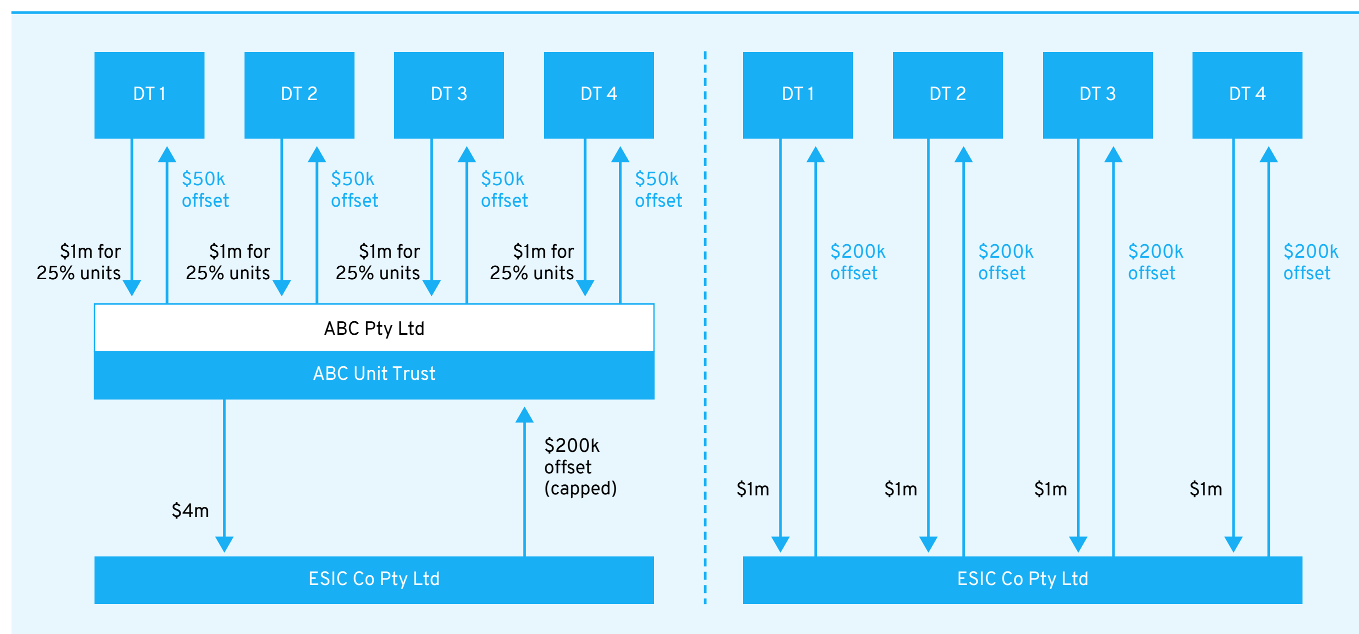
In the authors' opinion, in most circumstances, investors are often best placed to make their qualifying investment in an ESIC via a discretionary trust structure. This is not only because of the commonplace advantages that come with utilising a discretionary trust, such as asset protection and the ability to distribute income and capital to a range of beneficiaries, but also because of how a discretionary trust factors in with the rules governing the tax offset.

To this effect, where an investment is made via a discretionary trust, the trustee may elect to allocate the tax offset derived from the investment to any person that is a potential beneficiary of the trust as to income or capital.

Importantly, this means that the tax offset can be allocated to any beneficiary, regardless of whether that beneficiary receives any income or capital in the income year in which the tax offset is derived.[31]

A trap to be aware of, however, is that the trustee must make a written determination in order to allocate the offset to a beneficiary, and that determination must be

Diagram 1. Comparison: application of ESIC tax offset



made before the expiry of three months from the end of the income year in which the tax offset is derived (unless a further amount of time is provided by the Commissioner).[32] This requirement must be complied with even in circumstances where the trust has fixed entitlements and the beneficiaries or unitholders can only receive an allocation of the tax offset in accordance with those entitlements.

Failure to make a determination can potentially result in the tax offset being lost altogether. This can occur if the trustee is itself not liable to any income tax in the income year in which the tax offset is derived.[33]

Investors can also invest in an ESIC via a self-managed superannuation fund. If this is the case, it is the trustee, and not the member, that is entitled to utilise the non-refundable tax offsets against other income tax liabilities.[34] Of course, high-risk investments in ESICs would need to tie in with fund's overall investment strategy.[35]

Developing for commercialisation

When applying the principles-based test, a practice that appears to have been developed by the Commissioner in a number of private binding rulings has arguably limited the availability of the ESIC measures to investors. The issue stems from the following requirement of the principles-based test:[36]

> "(i) the company is genuinely focussed on *developing for commercialisation* one or more new, or significantly improved, products, processes, services or marketing or organisational methods;" (emphasis added)

The somewhat innocuous phrase "developing for commercialisation" is often overlooked. However, significantly, the Commissioner has taken the view that this requires that the innovation being developed by the ESIC is not yet at a stage where it has been "commercialised".[37] Rather, the innovation must be at a pre-commercialisation stage at the relevant time that the investor makes its investment.[38]

The Commissioner's reasoning for this appears to be that the ESIC measures are focused on companies which are at an "early stage" and, therefore, if the innovation has been commercialised, sufficient investment has already been made such that these measures do not provide an incentive that is consistent with the policy intent.

The authors' experience in making submissions to the Commissioner on ESIC matters is largely consistent with the above. That is, the Commissioner has required that the innovation must not yet be widely available or deployed in the market. Further, the innovation must be at a pre-market ready phase, such as a beta, alpha or pre-alpha stage, where there are levels of research and development, marketing and investment required to further develop and refine the product so that it is ready for market.

Having sufficient evidentiary material on hand, such as white papers for the innovation, business plans, forecasts, marketing plans and development roadmaps, is critical in order to establish that the relevant innovation is at a "pre-commercialised" phase and that the innovation is currently "being developed" for commercialisation by the investee company.

In the authors' view, seeking a private binding ruling on the principles-based test is often necessary in order to risk manage the legislative interpretative issues (see further below).

The affiliate dilemma

As stated, in order for an investor to qualify for the ESIC concessions, the investor and the investee company cannot be affiliates of each other at the time the relevant shares are issued.[39]

In other words, the ESIC must not act, or reasonably be expected to act, in accordance with the investor's directions or wishes, or in concert with the investor, in relation to the affairs of the business of the ESIC, and vice versa.

The affiliate test is not often an issue when it comes to dealing with new investors or "angel" investors that are seeking to invest into the ESIC. Sometimes, however, it is one of the "founders" of the innovation that is seeking to invest further funds into the ESIC and, in these circumstances, great care is required when assessing whether their investment qualifies for the concessions.

The explanatory memorandum to the legislation which introduced the ESIC measures states that the affiliate restriction is imposed in order to target the tax incentives to new investors in an ESIC rather than merely subsidise existing investments.[40] The explanatory memorandum goes on to provide that:[41]

> "For example, a director-owner of an ESIC would be precluded from qualifying for a tax offset, as the ESIC would be an affiliate of the director-owner."

When considering this issue, two important qualifications to the affiliate test must be borne in mind:[42]

1. entities will not be considered affiliates merely because of the nature of the business relationship shared between them; and
2. directors of a company or a company and a director will not be affiliates merely because of their relationship in relation to the affairs of the company.

As a starting point, on the basis that the founder (or their related entity) investing in the ESIC satisfies the 30% test, it will assist in substantiating that there is no affiliate relationship if the founder is one of a number of directors of the company. Further, it will also be of assistance if a majority of the directors of the board can be regarded as acting independently of the founder.

It might also be of assistance if there are shareholders agreements in place which provide that a number of significant decisions (ie acquisitions of significant assets, admission of new directors, capital raises etc) of the board cannot be done without the consent of a special majority of the shareholders.

In any event, care is required for investments in an ESIC by any founders of the innovation, and it is understood by the authors that this is an area that the Commissioner will often target on a review or an audit of an ESIC.

Points-based test — what's the point?

Having regard to the many issues raised under the principles-based test, one may query whether the points-based test might be the easier route for a company to satisfy the innovation limb of the ESIC criteria.

In the authors' experience, while the points-based test can in some instances be satisfied, advisers will often find that it is too soon in the ESIC's lifecycle for many of these criteria to be capable of being satisfied.

For instance, in the case of a start-up software company, the different items of intellectual property being developed would not typically be in the nature of patents. Further, research and development tax incentives might not yet have been sought in a previous income year by the company or Commonwealth accelerator grant programs entered into. This often leaves the principles-based test as the only viable avenue for the company to pursue in obtaining ESIC status for its potential investors at the time those investors are willing to invest.

Nonetheless, satisfying the points-based test can remove much of the uncertainty and subjectivity associated with the principles-based test. Where this is the objective, advisers should take care to avoid the common traps.

As an example, participating in an accelerator program will award companies 50 points towards the 100 point total needed to meet the test. However, not all accelerator programs meet this criteria. For example, the following accelerator programs are potentially ineligible under the points-based test:

- the accelerator's support is not time-limited;
- there is no competitive and open process to enter into the accelerator;
- the entity operating the accelerator has not operated it (or other accelerator programs) for at least six months (at the time the eligible share issue occurs); and
- the program has not been completed by at least one cohort of entrepreneurs (at the time the eligible share issue occurs).[43]

Furthermore, accelerator programs are to be distinguished from other forms of start-up based programs, such as incubator programs. Incubator programs may not strictly meet the definition of an accelerator program as defined under the points-based test.

The ESIC participating in incubator programs can, however, potentially assist in demonstrating that the company is genuinely focused on developing for commercialisation its innovation and thus contribute to meeting the principles-based test.

While there are many other common traps with the points-based test, the above should highlight to advisers that the test should not be regarded as the automatic "easy route" to obtaining ESIC eligibility.

When should a ruling be sought?

As stated, the principles-based test is highly subjective. In this context, and acknowledging the substantial tax concessions that can be afforded under the ESIC measures, there can be significant risk in accessing the concessions on a self-assessed basis.

In the authors' experience, in order to risk manage against the considerable uncertainty posed by the ESIC measures, it is often preferable to seek a private binding ruling from the Commissioner on ESIC eligibility and, in particular, on the principles-based test. This could be sought by the investor in respect of various aspects of the ESIC

criteria pertaining to their affairs, and/or by the company in respect of their eligibility as an ESIC. To this effect, company boards may be keen to obtain a private binding ruling to use in their promotions to potential investors.

If seeking a ruling, being able to produce contemporaneous and detailed evidence substantiating the investor and company's eligibility under the various requirements of the ESIC measures is imperative.

Also, the Commissioner will often engage experts from AusIndustry in order to assist in analysing the technical nature of any innovation that is purported to satisfy the principles-based test. Therefore, having a sound technical basis for why the innovation meets the various principles-based test requirements is important.

If a private binding ruling is being sought on the principles-based test, the following documents will likely be key in substantiating satisfaction of the criteria:

- business/strategic plans;
- cash flow projections;
- marketing plans;
- technical white papers;
- budget and management reports;
- any records regarding trademarks, patents and other intellectual property;
- any marketing reports, industry studies or research reports;
- organisational charts; and
- any agreements with third parties for commercialisation of the innovation.

In the authors' experience, the ATO may, in some instances, also want to meet with company representatives in a "pitch" style meeting to further investigate and understand the innovation.

Capital raising issues

As stated above, the investor must be issued with *new* equity interests in the ESIC in order to be eligible for the ESIC concessions on their investment. Practically, this means that it will not be viable for a company to issue convertible notes to an investor and for the investor to claim the ESIC concessions on such an investment. This is because convertible notes would not meet the definition of an "equity interest".

On the other hand, "SAFE" notes,[44] depending on how they are structured, can potentially meet the definition of an equity interest, although care should be taken when drafting documents under this arrangement to achieve the desired outcomes.

The SAFE note typically has a conversion event (such as an initial public offering or an exit event), contains a discount and has a valuation cap. Importantly, SAFE notes do not have a term or maturity date.

Issues for the ongoing management of ESICs

There are a number of other issues that advisers should be aware of relating to the ongoing management of ESICs, including:

- ESICs must report to the ATO by 31 July each year where any investors have sought to claim the ESIC concessions in relation to the company in the prior financial year.[45] This is often satisfied by way of lodging an ESIC report via the ATO's dedicated ESIC reporting portal. The report (among other matters) details the names of any eligible investors, the quantity of qualifying shares issued to each investor, and how the ESIC has assessed its eligibility for the measures (eg self-assessment);
- care is required when undertaking subsequent restructures of the ESIC. An investor's modified CGT treatment can potentially cease if certain CGT roll-overs are used in the restructuring of an ESIC company. Such roll-overs include the Subdiv 124-M scrip-for-scrip roll-over and Div 122 wholly owned company roll-overs.[46] Given the common occurrence of restructures in the start-up space, this is a trap to be aware of in the ongoing management of the ESIC;
- one of the requirements of the early-stage limb is that the investee company has total expenses of less than $1m.[47] The Commissioner considers that the concept of "total expenses" under the ESIC measures equates to the general accounting concept of an expense (as opposed to the tax concepts of deductible expenditure versus capital).[48] It is therefore important for accountants to carefully consider the capitalisation and expensing of research and development costs associated with the innovation. Correctly capitalising costs which genuinely contribute towards the recognition of an accretion in the value of the innovation being developed will therefore greatly assist in ensuring that a company remains eligible for the ESIC measures;
- advisers should bear in mind at all times that the ESIC measures are, at their core, a "point-in-time" test. If future investments are made by investors, each individual tranche needs to be reassessed against the ESIC measures as a whole. This includes revisiting whether the potential ESIC still meets the principles-based test if that is what has historically been relied on to satisfy the innovation limb. It might be the case that the company's operations have changed to the point that it is no longer developing its innovation for commercialisation and therefore it is critical that each tranche of new shares issued are carefully assessed;
- further to the above, investors should be careful of incremental acquisitions in ESICs. As to this point, the 30% rule should be observed on any new investment to ensure that the investor does not hold more than 30% of the issued share capital in the ESIC. If future investments in the company by the investor no longer qualify for the measures, as a positive, those shares that were issued at a time when the investor did qualify will retain their

modified CGT treatment and any unused tax offsets from prior years will remain available; and

- although the benefits of obtaining ESIC eligibility have been readily established in this article, not all qualifying ESIC investments will become the next "unicorn" investment. It should be borne in mind that many ESICs are likely to fail as investments, given their high-risk nature. Where an ESIC investment does not ultimately succeed, it should be remembered that any capital losses made on the investment are lost under the modified CGT treatment (see above).

Wrapping up

The concessions available to investors via the ESIC measures are uniquely powerful and can present a number of tax planning opportunities, as well as pitfalls, for advisers.

As the ESIC framework begins to mature and interpretive issues are "ironed out", advisers should endeavour to keep the ESIC measures front of mind in order to maximise the availability of the concessions for their clients.

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6 S 708(8)(c) and (d) of the *Corporations Act 2001* (as modified by regs 6D.2.03 and 6D.5.02 of the *Corporations Regulations 2001* (Cth)). The certificate must be issued no more than two years before the offer to subscribe for shares in the investee company was made.
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8 As defined under ss 995-1(1) and 118-407(4) ITAA97.
9 As defined under s 83A-10(2) ITAA97.
10 S 360-15(1)(c) ITAA97.
11 S 360-40 ITAA97.
12 S 360-40(1)(a) to (d) ITAA97.
13 S 360-40(1)(e) ITAA97.
14 S 360-40(1)(e) ITAA97.
15 Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.
16 Paras 1.76 and 1.77 of the explanatory memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.
17 Paras 1.76 to 1.85 of the explanatory memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.
18 S 360-10 ITAA97.
19 [2024] AATA 2065.
20 [2024] AATA 2065 at [65].
21 [2024] AATA 2065 at [77].
22 S 701-1 ITAA97.
23 S 701-1 ITAA97.
24 Australian Taxation Office, *Issue: Do the early stage innovation tests need to be satisfied by the company that issues shares to investors*, discussion paper, 2017.
25 See para 6 of TR 2004/11, TD 2004/68, TD 2007/D5 and TD 2004/50.
26 See the note to s 360-40(1), and para 2.54 of the explanatory memorandum to the Treasury Laws Amendment (2018 Measures No. 2) Bill 2019 (Cth).
27 Ss 360-25(2) and 360-30(1A) ITAA97.
28 S 360-25(2) ITAA97.
29 S 360-30 ITAA97.
30 S 104-71(3)(e) ITAA97.
31 Para 1.55 of the explanatory memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.
32 S 360-30(4) ITAA97.
33 Ss 360-15(3) and 360-35 ITAA97, and para 1.60 of the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.
34 S 360-15(3) ITAA97.
35 S 52B(2)(f)(i) of the *Superannuation Industry (Supervision) Act 1993* (Cth).
36 S 360-40(1)(e)(i) ITAA97.
37 See para 48 of PBR 1013101503609, para 48 of PBR 1051688563918, and PBR 1013105587343.
38 See para 45 of PBR 1051431243434, PBR 1013101503609, PBR 1051688563918 and PBR 1013105587343.
39 S 360-15(1)(d) ITAA97.
40 Para 1.34 of the explanatory memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.
41 Para 1.35 of the explanatory memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016.
42 S 328-130(2) ITAA97.
43 Item 4, column 2 of the table in s 360-45(1) ITAA97.
44 SAFE notes are a relatively new form of financial instrument being used in the start-up space. SAFE notes enable investors to provide capital to a start-up company in exchange for a contractual right to future equity in the company. No interest is typically payable on the SAFE note. The word "SAFE" is an acronym for a "simple agreement for future equity".
45 S 396-55 of Sch 1 to the *Taxation Administration Act 1953* (Cth).
46 Ss 360-50 and 360-55 ITAA97.
47 S 360-40(1)(a)(ii) and (b) ITAA97.
48 Paras 9 to 13 of TD 2023/6.
49 S 360-45(1) ITAA97.

Appendix. 100 point innovation test[49]

Item	Points	Innovation criteria
1	75	At least 50% of the company's total expenses for the previous income year is expenditure that the company can notionally deduct for that income year under section 355-205 (about R&D expenditure).
2	75	The company has received an Accelerating Commercialisation Grant under the program administered by the Commonwealth known as the Entrepreneurs' Programme.
3	50	At least 15%, but less than 50%, of the company's total expenses for the previous income year is expenditure that the company can notionally deduct for that income year under section 355-205 (about R&D expenditure).
4	50	(a) the company has completed or is undertaking an accelerator program that: (i) provides time-limited support for entrepreneurs with start-up businesses; and (ii) is provided to entrepreneurs that are selected in an open, independent and competitive manner; and (b) the entity providing that program has been providing that, or other accelerator programs for entrepreneurs, for at least 6 months; and (c) such programs have been completed by at least one cohort of entrepreneurs.
5	50	(a) a total of at least $50,000 has been paid for equity interests that are shares in the company; and (b) the company issued those shares to one or more entities that: (i) were not associates of the company immediately before the issue of those shares; and (ii) did not acquire those shares primarily to assist another entity become entitled to a tax offset (or a modified CGT treatment) under this Subdivision; and (c) the company issued those shares at least one day before the test time.
6	50	(a) the company has rights (including equitable rights) under a Commonwealth law as: (i) the patentee, or a licensee, of a standard patent; or (ii) the owner, or a licensee, of a plant breeder's right; granted in Australia within the last 5 years (ending at the test time); or (b) the company has equivalent rights under a foreign law.
7	25	Unless item 6 applies to the company at the test time: (a) the company has rights (including equitable rights) under a Commonwealth law as: (i) the patentee, or a licensee, of an innovation patent granted and certified in Australia; or (ii) the owner, or a licensee, of a registered design registered in Australia; within the last 5 years (ending at the test time); or (b) the company has equivalent rights under a foreign law.
8	25	The company has a written agreement with: (a) an institution or body listed in Schedule 1 to the *Higher Education Funding Act 1988* (about institutions or bodies eligible for special research assistance); or (b) an entity registered under section 29A of the *Industry Research and Development Act 1986* (about research service providers); to co-develop and commercialise a new, or significantly improved, product, process, service or marketing or organisational method.