variations will require a new notification from the vendor based on the adjusted "contract price".

In our discussions, the ATO has indicated that this is an area where there may be some room for manoeuvre in practice - watch this space for a new Practical Compliance Guide.

Incorrectly paid amounts

The final LCR clarifies a concern arising from the earlier draft - a vendor can claim a refund (or if they don't, then they can get a withholding credit) if the purchaser incorrectly pays or overpays GST withholding. This confirmation avoids vendors having to call off completion until the purchaser gets a refund for such incorrect or overpayments in order to pay the full contract price on settlement.

A link to LCR 2018/4 can be found here.

Manufactured homes

The LCR does not provide any further clarification regarding whether sales of manufactured homes should be subject to purchaser withholding. Operators in this area will be relying upon the Explanatory Memorandum, legislative headings and express statements made by Treasury during the consultation process for the new legislation that the withholding should not apply to those sales.

New forms for purchasers

The long-anticipated forms for purchasers to complete in the GST withholding process were published on 29 June 2018. The 2 forms are:

- GST property settlement withholding notification; and
- GST property settlement date confirmation.

Changes from early drafts means that some standard "Vendor Notifications" require information that is not necessary (e.g. the vendor's email address). Links to the forms and detailed instructions regarding their completion can be found on the ATO's website.

[926] ESICs and the problem with company group structures

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It is now 2 years since the tax incentives for early stage innovation companies (**ESICs**) in Division 360 of the ITAA 1997 were introduced. In that time, we understand that 97 private rulings have been issued by the Commissioner, with at least 8 companies receiving unfavorable rulings and failing to qualify as ESICs. However, many more applications have been withdrawn for various reasons including the Commissioner's refusal to rule.

This might lead one to ask whether the rules are operating as intended or whether the level of uncertainty in how these provisions are meant to apply have led many astray.

This article seeks to provide readers with a practical insight into a nuanced issue that is fast becoming a significant roadblock for companies aiming to qualify as ESICs. In particular, significant doubt remains as to how the rules apply to group company structures - an issue that has been recognised by the Commissioner of Taxation in his discussion paper entitled '*Do the early stage innovation tests need to be satisfied by the company that issues shares to investors*' (**Policy Paper**).

Background

The ESIC rules provide investors with the following key benefits:

- a 20% non-refundable carry-forward tax offset on investment, capped at $200,000 per investor, per year; and
- a 10-year CGT exemption for qualifying investments held for at least 12 months.

Who is eligible?

To be eligible for the incentives, an investor must meet the 'sophisticated investor' test under the *Corporations Act 2001* or, if

the investor does not meet this test, their total investment in qualifying companies must be $50,000 or less for that income year.

The incentives will be available for investments where the company is:

- 'early stage', determined against criteria related to expenditure, assessable income, stock exchange listing and incorporation; and
- 'innovative', determined by allowing the company to self-assess against either a principles-based test or a points-based gateway test, or by receiving a ruling from the ATO.

When is a company innovative?

Pursuant to s 360-40(1)(e) of the ITAA 1997, an Australian unlisted company will be 'innovative' where either (emphasis added):

*e) at the test time [being at the time of issuing shares], **the company** has at least 100 points under section 360-45 ['**100 points innovation test**'], or [it satisfies the '**principles based test**']:*

*(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; and*

*(ii) **the business** relating to those products, processes, services or methods has a high growth potential; and*

*(iii) **the company** can demonstrate that it has the potential to be able to successfully scale that business; and*

*(iv) **the company** can demonstrate that it has the potential to be able to address a broader than local market, including global markets, through that business; and*

*(v) **the company** can demonstrate that it has the potential to be able to have competitive advantages for that business.*

What's the issue?

For an investor to receive the benefits afforded to it under this regime, it is clear on the face of the provision that the company issuing the shares to the investor must also be the company that meets the above criteria.

It is also apparent that in each of the abovementioned tests, the focal entity is 'the company'. In other words, the company that is seeking to qualify as an ESIC must, arguably, be ***the*** company that is actually carrying on the innovative activities (or holding the relevant rights). Whilst somewhat controversial, this is certainly the Commissioner's current view (see below). If correct, then any holding company structure is likely to fall foul of the rules. This is because in a group structure, the relevant entities that hold assets and carry on activities are generally the subsidiaries and ***not*** the company in which investors will acquire shares (ie the head company).

Choosing the right operating entity and holding structure of course involves striking a fine balance between several factors including asset protection, tax minimisation, control, setup cost, compliance costs, access to capital, employee ownership, suitability for offshore expansion and loss preservation.

However, for businesses of the kind that these provisions are targeting, we would expect most advisers to recommend a multi-tiered holding structure. This ensures that any valuable intellectual property that is being developed is not exposed if the operating entity enters into insolvency.

Was this contemplated?

The objective of the ESIC rules, as stated in the original policy discussion paper, '*Tax incentives for early stage investors*', released in February 2016 (**2016 Discussion Paper**) was:

… to encourage investment into Australian innovation companies (innovation companies) at earlier stages, where a concept has been developed, but the company may have difficulty accessing equity finance to assist with commercialisation.

The 2016 Discussion Paper did not indicate that the rules should be read down as applying to single company structures or your 'garage style' start-ups. In fact, these

types of entities are unlikely to be at a stage where they are sophisticated enough to attract angel funding.

Instead, the proposed policy setting in the 2016 Discussion Paper was that smaller ventures could be targeted by including gateway provisions. These gateway provisions now find form in the 'early stage limb', which explicitly acknowledges that subsidiaries are to be taken into account when applying the monetary threshold tests in the 'early stage limb' (see subsections: 360-40 (1)(a)(ii), 360-40(1)(b), and 360-40(1)(c)).

These subsections allow for the ESIC to have a layered structure with 100% owned subsidiaries. However, the legislation never envisaged the ESIC, itself, being a 100% owned subsidiary. Changes to recognise that the ESIC may be the holding company and not a wholly owned subsidiary are necessary if the legislation is to work as intended.

Let's talk - the ATO view on the issue

Shortly after the introduction of the ESIC rules, the ATO created a discussion page on its *Let's Talk* website https://lets-talk.ato.gov.au/ESIC. In March 2017, a number of discussion papers were released, including the Policy Paper, in which the Commissioner expressed the following view (emphasis added):

*[**principle-based** innovation test] … It seems to us that subparagraph 360-40(1)(e)(ii) applies to the same 'company' referred to in the other four elements of subsection 360-40(1) but, employing a broader term, also encompasses those activities **which it directs other entities to conduct**.*

*All of the items in the **100 point innovation test** make reference to 'the company'. When section 360-45 is read with paragraph 360-40(1)(e), it is apparent that these references are to the **same company** that met the requirements in the other four paragraphs in subsection 360-40(1)*

*… the actions of a 100% subsidiary may assist a potential ESIC in satisfying the innovation limb where they are performed **for or on behalf of the potential ESIC**. Whether this is so will depend on the facts in each case. The actions of a 100% subsidiary **are not** for or on behalf of a potential ESIC **merely because the potential ESIC stands to benefit from them by virtue of its share ownership**.*

… the single entity rule [section 701-1] only has effect for head company and entity core purposes [which] do not include determining the income tax consequences for an investor under Subdivision 360-A.

Whether the '*the actions of a 100% subsidiary are being performed for or on behalf of the potential ESIC*' will depend on the facts in each case. However, in our experience, the Commissioner would be unlikely to accept that a simple holding structure without any other contractual arrangement in place would satisfy this requirement. We also understand that the Commissioner is choosing to abstain from ruling on the matter. This has left many potential ESICs to either self-assess their position or simply give up. This outcome is a far from ideal.

Whilst comments were sought on the paper prior to 24 April 2017, the Commissioner is yet to release his final position - although we do not expect the Commissioner's view to change.

Legislative changes - has the issue been resolved?

In February this year, the Government introduced the *Treasury Laws Amendment (2018 Measures No 2) Bill 2018* into Parliament. The Bill, which has only just reached the Senate and won't be debated there until after Parliament resumes on 13 August 2018, includes a number of measures in relation to ESICs that are largely integrity focused. The Bill also introduces a new requirement that an ESIC must be an Australian resident (s 360-40(1)(f)). We had hoped that the Bill would seek to provide for a clear legislative fix to resolve the matters addressed in this article, but unfortunately it wasn't to be. The only introduced change in this respect is a new note to s 360-40(1):

For the purposes of paragraph (e), one way a company can demonstrate something is by engaging the services of another entity

The Explanatory Memorandum provides further colour to the above (at 2.54):

Under paragraph 360-40(1)(e), to be an early stage innovation company, a company has to engage in certain activities or hold certain interests. The amendment includes a note to clarify that, under the general principles of agency, this can include the company engaging other entities to hold these things or perform activities for it, or on its behalf.

It would seem that the new note is intended to deal with the Commissioner's position in the Policy Paper, but it is questionable whether it will operate as expected. In the context of a corporate group, it is unlikely that any internal group services (or rights held) by a subsidiary are 'for or on behalf of a head company' and generally speaking a subsidiary would not be viewed as an agent of its parent. Such a position would be inconsistent with the separate entity principle enunciated in *Salomon v A Salomon & Co Ltd* [1897] AC 22, where Lord McNaghten stated (at 51) (emphasis added):

The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, ***the company is not in law the agent of the subscribers or trustee for them***.

The more likely scenario is where the company engages a third party service provider, but this is of little assistance in the context of a corporate group where intellectual property is held by one subsidiary and operations are performed by another.

Potential solution

Because the holding company issue is a problem with the drafting of the provisions and not the Commissioner's interpretation of the law, a legislative fix is required to ensure that the company group structures are covered - as they should be. Given the current state of Parliament, it is unlikely that any legislative fix can be expected in the near future (if at all). However, the Commissioner might seek to resolve the issue by ***exercising his remedial power*** to modify the operation of the rules. By way of example, the Commissioner could interpret the term 'company' in s 360-40(1) as including all wholly-owned subsidiary entities, similar to the single entity rule in s 701-1. Such a modification may arguably be within the Commissioner's power under Division 370 of Sch 1 to the TAA because:

- it would not be inconsistent with the policy objectives of Div 360 (as noted above); and
- the cost of complying with the provision, which may require an internal restructure, is disproportionate to those intended objectives.

Any amendment would also need to have a negligible impact on the Commonwealth for the Commissioner's remedial power to be enlivened.

Final comment

There is no doubting that continued government support is paramount to increasing innovation in the Australian economy. The ESIC rules are in this sense a positive step forward. Despite this, the rules remain poorly understood by many investors and we are concerned that they are not yet operating as intended.

In most instances, both investors and ESICs will require advice to determine whether they satisfy the criteria. If a confident conclusion cannot be drawn on the criteria, the ESIC would have to apply for a ruling from the ATO to determine eligibility and satisfy concerns of investors.

For those who believe they qualify as an ESIC or those contemplating investment in an ESIC, the message is simple - do your homework, understand the rules and if in doubt, seek professional advice.