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Australian Government
Australian Taxation Office

MindHive Pty Ltd
C/- BDO QLD Pty Ltd – Team MWM
GPO Box 457
Brisbane QLD 4001

Reply to: GPO Box 9977
ADELAIDE SA 5001
Our reference: 1051627003133
Contact officer: Simon Su
Phone: (08) 820 82057

ABN: 83 618 732 862

15 January 2020

We are notifying you of your private ruling

Authorisation number: 1051627003133
Authorising officer: Erc Pepicelli

Dear Mark,

On 29 July 2019, you applied for a private ruling relating to ESIC eligibility.

Please find:

- below your private ruling and the reasons for our decision
- attached a fact sheet giving information about private rulings including how to have the decision reviewed by objecting, and
- attached an edited version of your ruling that we will publish on our website.

You have:

- 60 days (longer in some cases) to object to the private ruling if you disagree with it and have not had an assessment for the relevant period, and
- 28 days to comment on the edited version.

More information is included in the *Private rulings* fact sheet.

Notice of private ruling

This ruling applies to:

Client name: MindHive Pty Ltd
ABN: 83 618 732 862

Question

Does MindHive Pty Limited ('MindHive') satisfy the criteria of an Early Stage Innovation Company (ESIC) pursuant to subsection 360-40(1) of the *Income Tax Assessment Act 1997* ('ITAA 1997')?

Answer

Yes

This ruling applies for the following period:

1 July 2017 to 30 June 2018

The scheme commences on:

1 July 2017

Relevant facts and circumstances

This ruling is based on the facts stated in the description of the scheme that is set out below. If your circumstances are materially different from these facts, this ruling has no effect and you cannot rely on it. The fact sheet has more information about relying on your private ruling.

1. MindHive Pty Limited ('Mindhive') is a proprietary company incorporated and registered in the Australian Business Register in Western Australia on 26 April 2017.
2. MindHive issued shares to investors on 2 December 2017.
3. MindHive is a standalone company with no subsidiaries.
4. For the financial year ending 30 June 2017, MindHive incurred and earned the following:
 - Total expenses of nil.
 - Total income of nil.
5. For the financial year ending 30 June 2018, MindHive incurred and earned the following:
 - Total expenses of \$613,108
 - Total income of \$64,190
6. MindHive's equity interests are not listed for quotation in the official list of any stock exchange, either in Australia or a foreign country.
7. MindHive is commercialising an Idea Management Software that use the power of crowdsourcing for problem solving and idea generation. The product has particular focus on:
 - Serving the opportunities presented in the growth of civic- tech; and
 - Participatory design and agile development process.
8. The software allows organisations to gather, share and evaluate ideas.
9. The key functions of the product are to operate as conduit where universities, government, not-for profits entities and other entities can use the knowledge of expert contributors.
10. MindHive has outlined its four objectives for the commercialisation of the software as:
 - Development and innovation'
 - Sales and marketing;
 - International expansion; and
 - New product and features.
11. Furthermore, MindHive also outlines its short, medium and long term objectives for the commercialisation of the software product.

12. The short term objectives include:

- Quick and efficient customer acquisition at scale by offering a great product whilst keeping prices low to reach the largest market;
- Analysis of user and user-engagement data, to improve customer experience and customer expansion;
- Pursue a large volume of customers by selling online, thereby removing friction for some customers;
- Employing certified enterprise experts to provide further premium support and account management programs as MindHive software grows; and
- Supporting a lower price point, therefore offering products for a lesser price than competitors to increase sales and increase market share.

13. The medium term objectives include:

- Growth through acquisition of value-added technology, crowdsourcing platforms and consolidation of internal expansion; and
- Penetration in the 1000+ Australian government departments and agencies with a focus on international expansion into global market.

14. MindHive's long term objectives is to continue to enhance the MindHive product with a significant emphasis on product innovation research and development.

Development of the Mindhive product

15. The 'MindHive' platform was first launched in 2014 by an unrelated entity.

16. The 'MindHive' Intellectual Property was transferred to MindHive Pty Ltd in October 2017.

17. After MindHive was incorporated, MindHive sought to improve the platform through the development and integration of algorithms and analytical tools in order to:

- Improve automation through data driven and matchmaking artificial intelligence;
- Implement a reputational design to incentivise engagement and participation;
- Improve the tools marketplace to allow third party to providers to contribute their tools and services to the platform; and
- Improve the referral system to enable rapid community growth.

18. MindHive continues to develop the platform, including aspects such as machine learning and Artificial Intelligence to enhance the functionality.

19. Mindhive considers that its addressable market includes government, university, not-for-profit organisations and corporates both domestically and internationally.

20. Mindhive's customer includes 27 government departments, 4 universities and 1,200 corporates.
21. MindHive has identified that Australian government spending is beyond \$6.2 billion in 2018, and the government is targeting to spending \$900 million each year on entrepreneurial technology.
22. MindHive has identified that it has the ability to rapidly expand its business given that its product appeals to a wide range of business and organisations.
23. MindHive has also identified that it has high growth within its addressable market and could be expanded into international market, given the software has minimal barriers to entry into.
24. MindHive has produced a forecasted financial modelling which predicts the revenue of the company will grow to \$35,938,000 in 2022.
25. MindHive has identified its product has two sources of competitive advantage:
 - Different advantage, where MindHive could deliver benefits to customers greater than those offered by its competitors; and
 - Cost advantage, where MindHive has a lower cost per unit than its competitor.
26. The MindHive has identified the following factors differentiate its product over its competitors:
 - The MindHive product has a focus on participatory design and agile development processes which deliver a market unique product that continuously improves with user feedback and needs:
 - The MindHive product incorporates a 'grading' system for growing crowd of experts;
 - The nature of the product allows MindHive to cater to client specific needs and price points' and
 - The MindHive problem solving method is honed, proven and co-designed from over 12 years client engagement and feedback.

Information provided

27. You have provided a number of documents containing detailed information in relation to MindHive, including:
 - a. Private Binding Ruling ('PBR') Application dated 19 July 2019.
 - b. Your replies to our further information requests, including details of development work being undertaken and relevant financial statements.
28. We have referred to the relevant information within these documents in applying the relevant tests to your circumstances.

Assumption(s)

Not applicable.

Relevant legislative provisions

<i>Income Tax Assessment Act 1997</i>	Subdivision 360-A
<i>Income Tax Assessment Act 1997</i>	section 360-15
<i>Income Tax Assessment Act 1997</i>	section 360-40
<i>Income Tax Assessment Act 1997</i>	section 360-45

Further issues for you to consider

We have limited our ruling to the questions raised in your application. There may be related issues that you should consider including:

Not applicable.

For more information

If you have any questions, please phone **13 28 69** between 8.00am and 5.00pm, Monday to Friday, and ask for Simon Su on extension **82057**, or call direct on **(08) 820 82057**.

When you phone us, please have the reference number **1051627003133** ready so we can quickly access your details.

Yours sincerely

Tim Dyce
Deputy Commissioner of Taxation

Per
(Erc Pepicelli)

Reasons for Decision

These reasons for decision accompany the *Notice of private ruling* for MindHive Pty Ltd.

While these reasons are not part of the private ruling, we provide them to help you to understand how we reached our decision.

Summary

MindHive meets the eligibility requirements of an ESIC pursuant to subsection 360-40(1).

Detailed reasoning

29. Subsection 360-40(1) outlines the criteria required for a company to qualify as an Early Stage Innovation Company (ESIC) at a particular time in an income year. This time is referred to as the 'test time'. The criteria are based on a series of tests to identify if the company is at an early stage of its development and it is developing new or significantly improved innovations to generate an economic return.

'The early stage test'

30. The early stage test requirements are outlined in detail within paragraphs 360-40(1)(a) to (d).

Incorporation or Registration – paragraph 360-40(1)(a)

31. To meet the requirement in paragraph 360-40(1)(a), at a particular time (the test time) in an income year (the current year) the company must have been either:
- i. incorporated in Australia within the last three income years (the latest being the current year); or
 - ii. incorporated in Australia within the last six income years (the latest being the current year), and across the last three of those income years the company and its 100% subsidiaries incurred total expenses of \$1 million or less; or
 - iii. registered in the Australian Business Register (ABR) within the last three income years (the latest being the current year).

32. The term 'current year' is defined in subsection 360-40(1) with reference to the 'test time'; the 'current year' being the income year in which the company issues shares to the investor.

33. A company that does not meet any of these conditions will not qualify as an ESIC.

Total expenses - paragraph 360-40(1)(b)

34. To meet the requirement in paragraph 360-40(1)(b), the company and its 100% subsidiaries must have incurred total expenses of \$1 million or less in the income year before the current year.

Assessable income - paragraph 360-40(1)(c)

35. To meet the requirement in paragraph 360-40(1)(c), the company and its 100% subsidiaries must have derived total assessable income of \$200,000 or less in the income year before the current year.

No stock exchange listing - paragraph 360-40(1)(d)

36. To meet the requirement in paragraph 360-40(1)(d), the company must not be listed on any stock exchange in Australia or a foreign country.

INNOVATION TESTS

37. If the company satisfies the early stage test, the company must also satisfy one of two innovation tests: the objective (100 point) test or the principles-based test.

'100 point test' – paragraph 360-40(1)(e) and section 360-45

38. To satisfy the 100 point test the company must obtain at least 100 points by meeting the innovation criteria in the table within section 360-45. The criteria are tested at a time immediately after the relevant shares are issued. If a company satisfies this test it does not need to satisfy the principles-based test.

'Principles-based test' – subparagraphs 360-40(1)(e)(i) to (iv)

39. To satisfy the principles-based test, the company must meet five requirements in paragraph 360-40 (1)(e). This is tested at a time immediately after the relevant new shares are issued to the investor.

40. The company can demonstrate that it meets each requirement through existing documentation such as a business plan, commercialisation strategy, competition analysis or other company documents. The company must be able to show that tangible steps have been or will be taken in relation to each of the requirements.

41. The five requirements of the principles-based test, as outlined in paragraph 360-40(1)(e) are:

- i. the company must be genuinely focussed on developing for commercialisation one or more new or significantly improved products, processes, services or marketing or organisational methods
- ii. the business relating to that innovation must have a high growth potential
- iii. the company must demonstrate that it has the potential to be able to successfully scale up the business relating to the innovation
- iv. the company must 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 must demonstrate that it has the potential to be able to have competitive advantages for that business.

Developing new or significantly improved innovations for commercialisation

42. For the purposes of Subdivision 360-A, the Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 ('EM') provides the following at paragraph 1.76 in relation to the definition of innovation:

"Implicit in the definition of innovation is the requirement that the company is developing a new or significantly improved type of innovation such as a product, process, service, marketing or organisational method. This list of various types of innovations provides flexibility for innovation

companies and is adaptable to current and future innovations. The Oslo Manual, published by the Organisation for Economic Co-operation and Development (OECD) provides a description of these different types of innovations...

43. The innovation being developed by the company must either be new or significantly improved for an applicable addressable market.¹ The company's addressable market is the revenue opportunity or market demand arising from the innovation or the related business. The addressable market must be objective and realistic.
44. Improvements must be significant in nature to meet this requirement. Significant is defined in the online Macquarie Dictionary as "*important; of consequence.*" Customising existing products or minor changes resulting from software updates, pricing strategies or seasonal changes are examples of improvements that would not be considered significant.
45. The OECD Oslo Manual, in relation to defining innovative services, states at paragraph 161 that "innovations in services can include significant improvements in how they are provided (for example, in terms of their efficiency or speed), the addition of new functions or characteristics to existing services, or the introduction of entirely new services."
46. The company must be genuinely focussed on developing the innovation for a commercial purpose in order to generate economic value and revenue for the company. This requirement draws the distinction between simply having an idea and commercialising an idea.
47. For a company to qualify as an ESIC under the principles based test, the company must be "genuinely focussed on developing for commercialisation" their innovation. That is, the central activities of the company must be truly concentrated on developing their innovation for a commercial purpose. 'Commercialisation' includes a range of activities that involve the implementation or sale of a new or significantly improved innovation that will directly lead to the generation of economic value for the company.

High growth potential

48. The company must be able to demonstrate that the business relating to the innovation has a high growth potential within a broad addressable market. This refers to the company's ability to rapidly expand its business. Companies that are limited to supplying local customers will not meet this requirement.

Scalability

49. The company must be able to demonstrate that it has the potential to successfully scale up the business relating to the innovation. The company must have operating leverage, where as it increases its market share or enters into new markets, its existing revenues can be multiplied with a reduced or minimal increase in operating costs.

Broader than local market

50. The company must be able to demonstrate that it has the potential to address a market that is broader than a local city, area or region. The company does not need to have a serviceable market at a national, multinational or global scale at the test time. However, it does need to

¹ Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016, paragraph 1.79.

show that the business is capable of addressing a market that is broader than a local market and that the business can be adapted to a broader scale in the future.

Competitive advantages

51. The company must be able to demonstrate that it has the potential to have competitive advantages, such as a cost or differential advantage over its competitors which are sustainable for the business as it expands. The company can analyse what competitors in the market offer, and consider whether the company has a differentiating advantage that would allow it to outperform these competitors.

APPLICATION TO YOUR CIRCUMSTANCES

TEST TIME

52. For the purposes of this ruling, the 'test time' for determining if MindHive is a qualifying ESIC, will be upon the issue of qualifying shares on a particular date or dates on or after 1 July 2017, and on or before 30 June 2018. In particular MindHive issued shares to investors on 2 December 2017 and this will be a test time for the purposes of subsection 360-40(1) *ITAA 1997*.

Current year

53. Therefore, for the purposes of subsection 360-40(1) *ITAA 1997*, the current year will be the year ending 30 June 2018 (the 2018 income year). For clarity, in relation to particular requirements within subsection 360-40(1), the last 3 income years will include the years ending 30 June 2018, 2017 and 2016, and the income year before the current year will be the year ending 30 June 2017 (the 2017 income year).

THE 'EARLY STAGE TEST' – paragraphs 360-40(1)(a) - (d) ITAA 1997

Incorporation or Registration – paragraph 360-40(1)(a) ITAA 1997

54. MindHive was incorporated on 26 April 2017 which is within the 3 income years outlined above, therefore the requirements of subparagraph 360-40(1)(a)(i) are satisfied.

Total expenses – paragraph 360-40(1)(b) ITAA 1997

55. In applying the requirements of paragraph 360-40(1)(b), MindHive and any of its 100% subsidiaries must have incurred total expenses of \$1 million or less in the 2017 income year, being the income year before the current year.

56. MindHive incurred nil expenses in the 2017 income year. Consequently, paragraph 360-40(1)(b) is satisfied.

Assessable income – paragraph 360-40(1)(c) ITAA 1997

57. In applying the requirements of paragraph 360-40(1)(c), MindHive and any of its 100% subsidiaries must have derived total assessable income of \$200,000 or less in the 2017 income year, being the income year before the current year.

58. MindHive earned nil assessable income in the 2017 income year. Consequently, paragraph 360-40(1)(c) is satisfied.

No Stock Exchange listing – paragraph 360-40(1)(d) ITAA 1997

59. In applying the requirements of paragraph 360-40(1)(d), MindHive must not be listed on any Stock Exchange in Australia or a foreign country at the test time.
60. MindHive was not listed on any Stock Exchange in Australia or a foreign country at any test time during the 2017-18 year, so paragraph 360-40(1)(d) is satisfied.

CONCLUSION FOR EARLY STAGE TEST

61. MindHive satisfies the early stage test for the 2018 income year, as each of the requirements within paragraphs 360-40(1)(a) to (d) have been satisfied.

THE ‘100 POINT TEST’ – paragraph 360-40(1)(e) and section 360-45

62. MindHive has not provided sufficient evidence of satisfying the 100 point test under section 360-45 for the year ending 30 June 2018. For MindHive to be a qualifying ESIC, it will need to satisfy the principles-based test.

THE ‘PRINCIPLES-BASED TEST’ – paragraph 360-40(1)(e) ITAA 1997

Developing new or significantly improved innovations for commercialisation – subparagraph 360-40(1)(e)(i) ITAA 1997

63. In applying the requirements of subparagraph 360-40(1)(e)(i), at the test time, MindHive must be developing an innovation which is either new or significantly improved for an applicable addressable market.
64. MindHive is commercialising an Idea Management Software that use the power of crowdsourcing for problem solving and idea generation. The product has particular focus on:
- Serving the opportunities presented in the growth of civic- tech; and
 - Participatory design and agile development process.
65. The ‘MindHive’ platform was first launched in 2014 by an unrelated entity.
66. The MindHive Intellectual Property was transferred to MindHive in October 2017.
67. After MindHive was incorporated, MindHive sought to improve the platform through the development and integration of algorithms and analytical tools in order to
- Improve automation through data driven and matchmaking artificial intelligence;
 - Implement a reputational design to incentivise engagement and participation;
 - Improve the tools marketplace to allow third party to providers to contribute their tools and services to the platform; and
 - Improve the referral system to enable rapid community growth.

68. MindHive has demonstrated that, at the test time, it was developing an innovation which is either new or significantly improved for an applicable addressable market

Genuinely focussed on developing for commercialisation - subparagraph 360-40(1)(e)(i) ITAA 1997

69. In applying the requirements of subparagraph 360-40(1)(e)(i), at the test time, MindHive must be genuinely focussed on developing an innovation for a commercial purpose in order to generate economic value and revenue for the company.

70. MindHive has outlined its four objectives for the commercialisation of the software as:

- Development and innovation'
- Sales and marketing;
- International expansion; and
- New product and features.

71. Furthermore, MindHive also outlines its short, medium and long term objectives for the commercialisation of the software product.

72. The short term objectives include:

- Quick and efficient customer acquisition at scale by offering a great product whilst keeping prices low to reach the largest market;
- Analysis of user and user-engagement data, to improve customer experience and customer expansion;
- Pursue a large volume of customers by selling online, thereby removing friction for some customers;
- Employing certified enterprise experts to provide further premium support and account management programs as MindHive software grows; and
- Supporting a lower price point, therefore offering products for a lesser price than competitors to increase sales and increase market share.

73. The medium term objectives include:

- Growth through acquisition of value-added technology, crowdsourcing platforms and consolidation of internal expansion; and
- Penetration in the 1000+ Australian departments and agencies with a focus on international expansion into global market.

74. MindHive's long term objectives are to continue to enhance the MindHive product with a significant emphasis on product innovation research and development.

75. MindHive has demonstrated that, at the test time, it was genuinely focussed on developing an innovation for a commercial purpose in order to generate economic value and revenue for the company.

High growth potential - subparagraph 360-40(1)(e)(ii) ITAA 1997

76. In applying the requirements of subparagraph 360-40(1)(e)(ii), MindHive must be able to demonstrate that it has the potential for high growth within a broad addressable market.

77. MindHive has identified that it has the ability to rapidly expand its business given that its product appeals to a wide range of business and organisations.

78. MindHive has also identified that it has high growth within its addressable market, given the software has minimal barriers to entry into.

79. MindHive has demonstrated that it has the potential for high growth within a broad addressable market, so subparagraph 360-40(1)(e)(ii) is satisfied.

Scalability - subparagraph 360-40(1)(e)(iii) ITAA 1997

80. In applying the requirements of subparagraph 360-40(1)(e)(iii), MindHive must be able to demonstrate that it has the potential to successfully scale up the business.

81. MindHive has identified that Australian government spending is beyond \$6.2 billion in 2018, and the government is targeting to spending \$900 million each year on entrepreneurial technology.

82. MindHive has produced a forecasted financial modelling which predicts the revenue of the company will grow to \$35,938,000 in 2022.

83. MindHive has demonstrated that it has the potential to successfully scale up the business, so subparagraph 360-40(1)(e)(iii) is satisfied.

Broader than local market - subparagraph 360-40(1)(e)(iv) ITAA 1997

84. In applying the requirements of subparagraph 360-40(1)(e)(iv), MindHive must be able to demonstrate that it has the potential to be able to address a broader than local market, including global markets.

85. MindHive indicates that its product will be expanded to international markets therefore it has the potential to address a market that is broader than a local city, area or region.

86. MindHive has demonstrated that it has the potential to be able to address a broader than local market, so subparagraph 360-40(1)(e)(iv) is satisfied.

Competitive advantages - subparagraph 360-40(1)(e)(v) ITAA 1997

87. In applying the requirements of subparagraph 360-40(1)(e)(v), MindHive must demonstrate that it has the potential to be able to have competitive advantage for that business.

88. MindHive has identified its product has two sources of competitive advantage:

- Different advantage, where MindHive could deliver benefits to customers greater than those offered by its competitors; and
- Cost advantage, where MindHive has a lower cost per unit than its competitor.

89. The MindHive has identified the following factors differentiate its product over its competitors:

- The Mindhive product has a focus on participatory design and agile development processes which deliver a market unique product that continuously improves with user feedback and needs:
- The MindHive product incorporates a 'grading' system for growing crowd of experts;
- The nature of the product allows MindHive to cater to client specific needs and price points' and
- The MindHive problem solving method is honed, proven and co-designed from over 12 years client engagement and feedback.

90. MindHive has demonstrated that it has competitive advantages over its competitors, so subparagraph 360-40(1)(e)(v) is satisfied.

CONCLUSION FOR PRINCIPLES BASED TEST

MindHive satisfies the principles based test as it has satisfied the requirements within subparagraphs 360-40(1)(e)(i) to (v) for the period commencing 1 July 2017 until 30 June 2018.

CONCLUSION

MindHive meets the eligibility criteria of an ESIC under section 360-40 for the period 1 July 2017 until 30 June 2018.

Edited version of your private ruling

Authorisation Number: 1051627003133

This edited version of your ruling will be published on the *ATO Legal database* after 28 days from the issue date of the ruling. The attached private rulings fact sheet has more information.

Please check this edited version to be sure there are no details remaining that you think may allow you to be identified. If you have any concerns, you will find our contact details in the fact sheet.

Ruling

Subject:

Question

Does Company A satisfy the criteria of an Early Stage Innovation Company (ESIC) pursuant to subsection 360-40(1) of the *Income Tax Assessment Act 1997* ('ITAA 1997')?

Answer

Yes

This ruling applies for the following period:

X XX 20XX to Y YY 20YY

The scheme commences on:

X XX 20XX

Relevant facts and circumstances

1. Company A is a proprietary company incorporated and registered in the Australian Business Register on x XX 20XX.
2. Company A issued shares to investors on x XX 20XX.
3. Company A is a standalone company with no subsidiaries.
4. For the financial year ending x XX 20XX, Company A incurred and earned the following:
 - Total expenses of \$xx.
 - Total income of \$yy.
5. For the financial year ending x XX 20YY, Company A incurred and earned the following:
 - Total expenses of \$xx
 - Total income of \$yy
6. Company A equity interests are not listed for quotation in the official list of any stock exchange, either in Australia or a foreign country.
7. Company A is commercialising an Software.
8. The software allows organisations to gather, share and evaluate ideas.

9. Company A has outlined its four objectives for the commercialisation of the software.
10. Company A also outlines its short, medium and long term objectives for the commercialisation of the software product.

Development of the product

11. The software was first launched in 20xx by an unrelated entity.
12. The 'Software' Intellectual Property was transferred to Company A in XX 20XX.
13. After Company A was incorporated, Company A sought to improve the software.
14. Company A is developing their products to address a number of discrete markets and is continuing to develop their products.
15. Company A's products have been identified as having an international addressable market.
16. Company A has identified that it has the ability to rapidly expand its business
17. Company A has identified its product has two sources of competitive advantage:

Information provided

18. You have provided a number of documents containing detailed information in relation to Company A, including:
 - c. Private Binding Ruling ('PBR') Application dated x XX 20XX.
 - d. Your replies to our further information requests, including details of development work being undertaken and relevant financial statements.
19. We have referred to the relevant information within these documents in applying the relevant tests to your circumstances.

Relevant legislative provisions

<i>Income Tax Assessment Act 1997</i>	Subdivision 360-A
<i>Income Tax Assessment Act 1997</i>	section 360-15
<i>Income Tax Assessment Act 1997</i>	section 360-40
<i>Income Tax Assessment Act 1997</i>	section 360-45

Reasons for decision

QUESTION:

SUMMARY

Company A meets the eligibility requirements of an ESIC pursuant to subsection 360-40(1).

DETAILED REASONING

Qualifying Early Stage Innovation Company

1. Subsection 360-40(1) outlines the criteria required for a company to qualify as an Early Stage Innovation Company (ESIC) at a particular time in an income year. This time is referred to as the 'test time'. The criteria are based on a series of tests to identify if the company is at an early stage of its development and it is developing new or significantly improved innovations to generate an economic return.

'The early stage test'

2. The early stage test requirements are outlined in detail within paragraphs 360-40(1)(a) to (d).

Incorporation or Registration – paragraph 360-40(1)(a)

3. To meet the requirement in paragraph 360-40(1)(a), at a particular time (the test time) in an income year (the current year) the company must have been either:
 - i. incorporated in Australia within the last three income years (the latest being the current year); or
 - ii. incorporated in Australia within the last six income years (the latest being the current year), and across the last three of those income years the company and its 100% subsidiaries incurred total expenses of \$1 million or less; or
 - iii. registered in the Australian Business Register (ABR) within the last three income years (the latest being the current year).
4. The term 'current year' is defined in subsection 360-40(1) with reference to the 'test time'; the 'current year' being the income year in which the company issues shares to the investor.
5. A company that does not meet any of these conditions will not qualify as an ESIC.

Total expenses - paragraph 360-40(1)(b)

6. To meet the requirement in paragraph 360-40(1)(b), the company and its 100% subsidiaries must have incurred total expenses of \$1 million or less in the income year before the current year.

Assessable income - paragraph 360-40(1)(c)

7. To meet the requirement in paragraph 360-40(1)(c), the company and its 100% subsidiaries must have derived total assessable income of \$200,000 or less in the income year before the current year.

No stock exchange listing - paragraph 360-40(1)(d)

8. To meet the requirement in paragraph 360-40(1)(d), the company must not be listed on any stock exchange in Australia or a foreign country.

INNOVATION TESTS

9. If the company satisfies the early stage test, the company must also satisfy one of two innovation tests: the objective (100 point) test or the principles-based test.

'100 point test' – paragraph 360-40(1)(e) and section 360-45

10. To satisfy the 100 point test the company must obtain at least 100 points by meeting the innovation criteria in the table within section 360-45. The criteria are tested at a time immediately after the relevant shares are issued. If a company satisfies this test it does not need to satisfy the principles-based test.

'Principles-based test' – subparagraphs 360-40(1)(e)(i) to (iv)

11. To satisfy the principles-based test, the company must meet five requirements in paragraph 360-40 (1)(e). This is tested at a time immediately after the relevant new shares are issued to the investor.
12. The company can demonstrate that it meets each requirement through existing documentation such as a business plan, commercialisation strategy, competition analysis or other company documents. The company must be able to show that tangible steps have been or will be taken in relation to each of the requirements.
13. The five requirements of the principles-based test, as outlined in paragraph 360-40(1)(e) are:
 - i. the company must be genuinely focussed on developing for commercialisation one or more new or significantly improved products, processes, services or marketing or organisational methods
 - ii. the business relating to that innovation must have a high growth potential
 - iii. the company must demonstrate that it has the potential to be able to successfully scale up the business relating to the innovation

- iv. the company must 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 must demonstrate that it has the potential to be able to have competitive advantages for that business.

Developing new or significantly improved innovations for commercialisation

14. For the purposes of Subdivision 360-A, the Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 ('EM') provides the following at paragraph 1.76 in relation to the definition of innovation:

"Implicit in the definition of innovation is the requirement that the company is developing a new or significantly improved type of innovation such as a product, process, service, marketing or organisational method. This list of various types of innovations provides flexibility for innovation companies and is adaptable to current and future innovations. The Oslo Manual, published by the Organisation for Economic Co-operation and Development (OECD) provides a description of these different types of innovations..."

- 15. The innovation being developed by the company must either be new or significantly improved for an applicable addressable market.² The company's addressable market is the revenue opportunity or market demand arising from the innovation or the related business. The addressable market must be objective and realistic.
- 16. Improvements must be significant in nature to meet this requirement. Significant is defined in the online Macquarie Dictionary as *"important; of consequence."* Customising existing products or minor changes resulting from software updates, pricing strategies or seasonal changes are examples of improvements that would not be considered significant.
- 17. The OECD Oslo Manual, in relation to defining innovative services, states at paragraph 161 that "innovations in services can include significant improvements in how they are provided (for example, in terms of their efficiency or speed), the addition of new functions or characteristics to existing services, or the introduction of entirely new services."
- 18. The company must be genuinely focussed on developing the innovation for a commercial purpose in order to generate economic value and revenue for the company. This requirement draws the distinction between simply having an idea and commercialising an idea.
- 19. For a company to qualify as an ESIC under the principles based test, the company must be "genuinely focussed on developing for commercialisation" their innovation. That is, the central activities of the company must be truly concentrated on developing their innovation for a commercial purpose. 'Commercialisation' includes a range of activities that involve the implementation or sale of a new or significantly improved innovation that will directly lead to the generation of economic value for the company.

² Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016, paragraph 1.79.

High growth potential

20. The company must be able to demonstrate that the business relating to the innovation has a high growth potential within a broad addressable market. This refers to the company's ability to rapidly expand its business. Companies that are limited to supplying local customers will not meet this requirement.

Scalability

21. The company must be able to demonstrate that it has the potential to successfully scale up the business relating to the innovation. The company must have operating leverage, where as it increases its market share or enters into new markets, its existing revenues can be multiplied with a reduced or minimal increase in operating costs.

Broader than local market

22. The company must be able to demonstrate that it has the potential to address a market that is broader than a local city, area or region. The company does not need to have a serviceable market at a national, multinational or global scale at the test time. However, it does need to show that the business is capable of addressing a market that is broader than a local market and that the business can be adapted to a broader scale in the future.

Competitive advantages

23. The company must be able to demonstrate that it has the potential to have competitive advantages, such as a cost or differential advantage over its competitors which are sustainable for the business as it expands. The company can analyse what competitors in the market offer, and consider whether the company has a differentiating advantage that would allow it to outperform these competitors.

APPLICATION TO YOUR CIRCUMSTANCES

TEST TIME

24. For the purposes of this ruling, the 'test time' for determining if Company A is a qualifying ESIC, will be upon the issue of qualifying shares on a particular date or dates on or after x XX 20XX, and on or before y YY 20YY.

Current year

25. Therefore, for the purposes of subsection 360-40(1) ITAA 1997, the current year will be the year ending y YY 20YY (the 20YY income year). For clarity, in relation to particular requirements within subsection 360-40(1), the last 3 income years will include the years ending y YY 20YY, 20XX and 20ZZ, and the income year before the current year will be the year ending x XX 20XX (the 20XX income year).

THE 'EARLY STAGE TEST' – paragraphs 360-40(1)(a) - (d) ITAA 1997

Incorporation or Registration – paragraph 360-40(1)(a) ITAA 1997

26. Company A was incorporated on x XX 20XX which is within the 3 income years outlined above, therefore the requirements of subparagraph 360-40(1)(a)(i) are satisfied.

Total expenses – paragraph 360-40(1)(b) ITAA 1997

27. In applying the requirements of paragraph 360-40(1)(b), Company A and any of its 100% subsidiaries must have incurred total expenses of \$1 million or less in the 20XX income year, being the income year before the current year.
28. Company A incurred expenses of \$xxx in the 20XX income year. Consequently, paragraph 360-40(1)(b) is satisfied.

Assessable income – paragraph 360-40(1)(c) ITAA 1997

29. In applying the requirements of paragraph 360-40(1)(c), Company A and any of its 100% subsidiaries must have derived total assessable income of \$200,000 or less in the 20XX income year, being the income year before the current year.
30. Company A earned nil assessable income in the 20XX income year. Consequently, paragraph 360-40(1)(c) is satisfied.

No Stock Exchange listing – paragraph 360-40(1)(d) ITAA 1997

31. In applying the requirements of paragraph 360-40(1)(d), Company A must not be listed on any Stock Exchange in Australia or a foreign country at the test time.
32. Company A was not listed on any Stock Exchange in Australia or a foreign country at any test time during the 20XX-YY year, so paragraph 360-40(1)(d) is satisfied.

CONCLUSION FOR EARLY STAGE TEST

33. Company A satisfies the early stage test for the 20YY income year, as each of the requirements within paragraphs 360-40(1)(a) to (d) have been satisfied.

THE '100 POINT TEST' – paragraph 360-40(1)(e) and section 360-45

34. Company A has not provided sufficient evidence of satisfying the 100 point test under section 360-45 for the year ending y YY 20YY. For Company A to be a qualifying ESIC, it will need to satisfy the principles-based test. Company A is electing to seek eligibility by satisfying the Principles based Innovation test under section 360-40(1)(e)(i)-(v), in order to be issued with a Private Binding Ruling.

THE 'PRINCIPLES-BASED TEST' – paragraph 360-40(1)(e) ITAA 1997

Developing new or significantly improved innovations for commercialisation – subparagraph 360-40(1)(e)(i) ITAA 1997

35. In applying the requirements of subparagraph 360-40(1)(e)(i), Company A must be developing an innovation which is either new or significantly improved for an applicable addressable market.

36. The software was first launched in 20xx by an unrelated entity.

37. The 'Software' Intellectual Property was transferred to Company A in XX 20XX.

38. After Company A was incorporated, Company A sought to improve the software.

39. Company A is genuinely focused on developing their products for an applicable addressable market, so subparagraph 360-40(1)(e)(i) is satisfied for the period x XX 20XX to y YY 20YY.

Genuinely focussed on developing for commercialisation - subparagraph 360-40(1)(e)(i) ITAA 1997

40. In applying the requirements of subparagraph 360-40(1)(e)(i), Company A must be genuinely focussed on developing an innovation for a commercial purpose in order to generate economic value and revenue for the company.

41. Company A has outlined its objectives for the commercialisation of the software.

42. Furthermore, Company A also outlines its short, medium and long term objectives for the commercialisation of the software product.

43. Company A is genuinely focussed on developing their products for a commercial purpose, so subparagraph 360-40(1)(e)(i) is satisfied for the period x XX 20XX to y YY 20YY.

High growth potential - subparagraph 360-40(1)(e)(ii) ITAA 1997

44. In applying the requirements of subparagraph 360-40(1)(e)(ii), Company A must be able to demonstrate that it has the potential for high growth within a broad addressable market.

45. Company A has identified that it has the ability to rapidly expand its business given that its product appeals to a wide range of business and organisations.
46. Company A has also identified that it has high growth within its addressable market, given the software has minimal barriers to entry into.
47. Company A has demonstrated a high growth potential for their products, so subparagraph 360-40(1)(e)(ii) is satisfied for the period x XX 20XX to y YY 20YY.

Scalability - subparagraph 360-40(1)(e)(iii) ITAA 1997

48. In applying the requirements of subparagraph 360-40(1)(e)(iii), Company A must be able to demonstrate that it has the potential to successfully scale up the business.
49. Company A has produced a forecasted financial modelling which predicts the revenue of the company will grow to \$xxx in 20XX.
50. This leverage ensures that Company A has the potential to successfully scale up its business, so subparagraph 360-40(1)(e)(iii) is satisfied for the period x XX 20XX to y YY 20YY.

Broader than local market - subparagraph 360-40(1)(e)(iv) ITAA 1997

51. In applying the requirements of subparagraph 360-40(1)(e)(iv), Company A must be able to demonstrate that it has the potential to be able to address a broader than local market, including global markets.
52. As the relevant issue is prevalent all over the world, Company A will be capable of addressing a market that is broader than a local market and that the business can be adapted to a broader scale in the future.
53. Company A has demonstrated that it has the capacity to address a broader than local market, so subparagraph 360-40(1)(e)(iv) is satisfied for the period x XX 20XX to y YY 20YY.

Competitive advantages - subparagraph 360-40(1)(e)(v) ITAA 1997

54. In applying the requirements of subparagraph 360-40(1)(e)(v), Company A must demonstrate that it has potential to be able to have competitive advantage for that business.
55. Company A has identified its product has two sources of competitive advantage:
56. Company A has identified the a few factors differentiate its product over its competitors
57. Company A has demonstrated that it has competitive advantages over its competitors, so subparagraph 360-40(1)(e)(v) is satisfied for the period x XX 20XX to y YY 20YY.

CONCLUSION FOR PRINCIPLES BASED TEST

Company A satisfies the principles based test as it has satisfied the requirements within subparagraphs 360-40(1)(e)(i) to (v) for the period commencing x XX 20XX until y YY 20YY.

CONCLUSION

Company A meets the eligibility criteria of an ESIC under section 360-40 for the period x XX 20XX to y YY 20YY.

ATO view documents

Not applicable

Other relevant comments

Not applicable

Key words

Early Stage Innovation Company

Tax incentives for Early Stage Investors