# Innovation Australia

Australian Government

Department of Innovation
Industry, Science and Research
AusIndustry

Industry House, 10 Binara Street
CANBERRA CITY ACT 2601
GPO Box 9839
Canberra ACT 2601 Australia
Phone: +61 2 6213 7308
Facsimile: +61 2 6213 7677
Email: InnovationAustralia@innovation.gov.au
Web: www.ausindustry.gov.au
ABN: 74 599 608 295

The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

Email: taxboard@treasury.gov.au

Dear Sir/Madam

Attached for the consideration of the Board of Taxation is Innovation Australia's submission on the review of the tax arrangements applying to collective investment vehicles.

The Board appreciates this important opportunity to provide its input and has drawn on its experience and expertise in administering the Venture Capital program in developing its position.

Yours sincerely

David Miles AM
Chairman
28 February 2011

# INNOVATION AUSTRALIA SUBMISSION TO THE BOARD OF TAXATION REVIEW OF THE TAX ARRANGEMENTS APPLYING TO COLLECTIVE INVESTMENT VEHICLES
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## General Comments

Importance and Differentiation of Venture Capital and Later Stage Private Equity

Private equity covers the range of professionally managed pools of funds seeking investment in high risk/high return opportunities. Based on investment characteristics, private equity can be broadly split (with some overlap) into two subsets, venture capital (VC) and later stage private equity (LSPE)[1]. VC covers investment in early stage developing businesses (e.g. investment at the seed, start-up and early expansion stages) with prospects for rapid growth while LPSE is concerned with restructuring existing, established businesses (e.g. investment at later stage expansion, turnaround, leveraged buy-outs, management buy-outs, management buy-ins). VC and LSPE operate in different areas of the investment continuum, have different requirements for financial support and target different outcomes.

- LSPE invests in improving the productivity of existing businesses through a number of mechanisms which may or may not provide broad economic benefit.
- VC invests into new companies which are commercialising innovation from universities, public research agencies and the private sector to introduce new products, services and processes. Without VC, many high risk, innovative technologies would either never reach market or be delayed in doing so.

The importance of VC to Australia's economy and entrepreneurial activity and the innovation system needs to be understood. Successive Australian Governments have acknowledged the need for a properly functioning VC sector and have provided a range of programs aimed at addressing the local market failure. Australian Governments have stimulated or supported areas of weakness through programs including the Venture Capital Limited Partnerships (VCLP) and Early Stage Venture Capital Limited Partnerships (ESVCLP) that use tax incentives to encourage private sector investment.

While there may be some overlap in the later stages of venture capital (i.e. in the expansion stages) with LSPE, generally it is possible to differentiate a venture capital investment from a LSPE investment. Simple variables that indicate the difference between the two investments are tabulated below.

| Variable | VC | LSPE |
|---|---|---|
| Risk | Very high | Lower |
| Type of capital (leverage) | Generally equity | Generally significant debt ar equity |
| Investment timeframe | Long (e.g. up to 10 years) | Considerably shorter |
| Availability of capital | Difficult to raise, Low reserves | Easier to raise, Considerable reserves |
| Failure rate | High | Much lower |
| Average investment return | Low | Much higher |
| Activity | Establishing and building companies, commercialising new innovations | Restructuring established companies |

[1] LSPE is often referred to as private equity. Any reference to private equity in this text means LSPE and does not include venture capital.

The differences mean that VC and LSPE can be treated as separate investment activities. A treatment that is appropriate to LSPE is generally not appropriate for VC (and vice versa). For this reason Innovation Australia would prefer that VC is treated separately from LSPE or other investment regimes.

VCLP and ESVCLP Programs

The ESVCLP and VCLP programs were developed to attract investment into venture capital and to provide globally accepted contemporary investment vehicles (program objectives are at **Attachment A**).

The VCLP program was introduced in 2002 as part of *Backing Australia's Ability* to "provide Australia with a world's best practice vehicle for venture capital".

The ESVCLP was introduced in 2007 as a result of the 2005 Review into the Venture Capital Industry in Australia.

The 2005 Review into the Venture Capital Industry in Australia also examined the VCLP program and a number of changes were recommended. All but one of these changes were implemented. Currently 38 VCLPs are registered under the *Venture Capital Act 2002* of which 18 have been registered since 2006. There are seven ESVCLPs currently registered.

Innovation Australia does not see any significant problems inherent in the design of either the ESVCLP or the VCLP, and has not been approached by individual VCLPs requesting changes to the program be made  However, Innovation Australia does acknowledge that AVCAL has raised a number of concerns about the VCLP (e.g. the $250 million investment cap and anti-aggregation issues), but consider that these concerns relate more to LSPE interests than to VC (e.g. at the cross section between VC and LSPE where companies may be looking to acquire synergistic IP or service delivery channels). The ESVCLP program is specifically directed to early stage venture capital.

Taxation treatment of ESVCLP, VCLP and Unit trusts

The ESVCLP targets the early stage venture capital space and in recognition of the high risk and difficulties associated with investment within this sector, investors (whether foreign resident or domestic) do not pay tax on gains or income received (but they are unable to claim losses).

Profits for all investors participating in unit trusts are treated as capital gains.

The VCLP can invest in any eligible venture capital investment. This includes investment that overlaps with the ESVCLP (i.e. shares the same investment risks) and those that unit trusts may invest in. Eligible foreign investors are exempt from paying Australian tax on income and capital gains made by the VCLP on the disposal of qualifying investments. Domestic investors (which make up approximately 90 per cent of the VCLP investor base) pay tax on all gains and are treated on a case by case depending upon their particular situation.

The recently released Taxation Determination (TD2010/21) has introduced a degree of uncertainty to the venture industry i.e. domestic investors will not know how they will be taxed when they commence an investment which creates an uncertain environment. To illustrate this, one of the Innovation Investment Funds fund managers has recently removed its application for VCLP registration and adopted a unit trust structure for domestic investors and is contemplating adopting a VCLP structure for foreign investors. Further, the ATO interpretive Decision (ATO ID 2011/7) indicates that domestic investors in a VCLP, other than complying superfunds, will have any gains from venture capital investments taxed on revenue account rather than capital account. Superfunds on the other hand will have gains taxed on capital account. This essentially creates two classes of domestic investees with different tax treatments. This is inconsistent with the intent of the venture capital regime (that being to provide an investment vehicle that is globally understood and adopted) and may create significant transaction and duplication costs for some investors. This has the potential to undermine the Government efforts in establishing such specialised vehicles in this area.

It is the view of Innovation Australia that the core consideration for the VCLP is that returns for investment in eligible venture capital investments be treated as capital for domestic investors. This action would bring certainty for all investors and make venture capital investment vehicles more consistent with each other.

Innovation Australia does not recommend that the Taxation Determination 2010/21, where a managed investment trust can make an election to have gains treated on the capital or revenue account, be automatically applied to venture capital. Because of the differences between venture capital and private equity identified above, we recommend that a determination specific to the VCLP is desirable and this should be made.

**Response to questions identified by the Board of Taxation Review**

1. *Whether the restrictions imposed on the VCLP and ESVCLP regimes are consistent with their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses.*

   The restrictions placed on the ESVCLP and VCLP programs ensure that investment is targeted at the venture capital sector. This is the sector in which a market gap has been identified (lack of private sector engagement resulting in significant under capitalisation) and which has been shown to be a driver for innovation and economic development. The venture capital sector has been identified by Governments of all major economies as important for future growth and is strongly backed with equity and taxation based support programs.

   If restrictions were eased or removed the likelihood is that a proportion of investment would move into the much less risky LSPE sector. This sector is well capitalised (as confirmed by ABS and AVCAL data) and does not require beneficial concessional taxation treatment to attract investors.

2. *What are the restrictions that arguably require the use of some sort of companion structure to overcome shortcomings of the regime?*

The Board is not aware of any shortcomings in either the ESVCLP or VCLP programs that require the use of companion funds for them to operate. These vehicles are stand alone vehicles as long as fund managers make eligible venture capital investments as defined in the relevant program Guidelines.

The use of companion funds is entirely at the discretion of the individual fund manager. Fund managers elect to use companion funds so that they can broaden their investment horizon and invest in deals that are not eligible under the ESVCLP or VCLP programs. That is, they use companion funds to maximise their selection of possible investments and thus attract more capital to their funds (i.e. an investor may wish to spread their investment risk and not invest entirely in venture capital; to engage this investor the fund manager must have a portfolio that is broader than venture capital). This approach of having a companion fund alongside the VCLP is widely accepted and the majority (i.e. 28 out of the 38 of existing VCLPs have been structured in this manner).

3. *Suggested amendments to the tax treatments under the VCLP and ESVCLP regimes that would enhance their effectiveness in achieving their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses.*

Australian fund managers use three vehicles to make investments in venture capital i.e. these are the: ESVCLP, VCLP and unit trust structures. The ESVCLP and VCLP are based on investment vehicles used globally while the unit trust structure is (in essence) unique to Australia (and not well understood by traditional overseas investors – this creates difficulties and is one reason that the other two investment vehicles were developed).

All investors in an ESVCLP are exempt from Australian tax on income and capital gains made by the ESVCLP. Gains accrued through trusts which qualify as MITs are subject to an election by the trustee to be treated on capital account. However, tax treatment on gains through the VCLP is different for domestic and foreign investors – eligible foreign investors are exempt from Australian income tax on profits or gains while domestic investors are taxed according to their personal circumstances (which maybe on the capital or revenue account). The carried interest of the general partner of an ESVCLP or VCLP is treated as a capital gain and attracts the CGT discount, in contrast to that of the manager of an MIT which is treated as income. While all three vehicles are used to invest into venture capital their tax treatments differ significantly.

Taxation Determination TD2010/21, although directed at LSPE, has created uncertainty in both the LSPE and VC sectors. Two prospective fund managers applying for VCLP registration have cancelled their applications and indicated that they will use a unit trust structure because of the tax treatment certainty this latter vehicle provides. Several other conditionally registered VCLPs (i.e. those that meet the registration requirements except for having the $10 million committed capital) which are in the market place raising capital have also advised that the uncertainty is preventing their investors from coming on board. As a consequence, Innovation Australia fears that the VCLP vehicle may cease to be used as an investment vehicle of choice.

Managed Investment Trusts can now elect to have gains taxed on the capital or income account. We do not consider this appropriate for venture capital investment and the VCLP in particular (for the reason provided in the general introductory discussion). We recommend that the gains made by domestic investors in VCLPs be treated on capital account. This would remove the uncertainty of tax treatment and help ensure fund managers use the VCLP structure.

4. *Are the current levels of investment through VCLPs and ESVCLPs consistent with what would be expected normally for these types of programs compared to similar programs in other jurisdictions?*

The enabling legislation for VCLPs was introduced in 2002 and since then 38 VCLPs have been registered. Eighteen VCLPs have been registered since adoption of the review's recommendations in 2006, however, it is not possible to identify that the increase is in fact due to the changes that were announced at that time. The ABS Venture Capital and Private Equity Survey indicates that there are approximately 120 managers with venture capital funds of various sizes (many below $10 million) operating in Australia. Considering that a number of these funds were in place before 2002 and that funds must have a minimum of $10 million capital (originally $20 million before 2006) the take up of the VCLP program has been acceptable.

Over the past six years the VCLP program has delivered $1.46 billion into venture capital investments – of which 90 per cent has come from domestic (predominately institutional) investors. As it now stands, continued investment by domestic investors may be at risk. Further, the ability of VCLPs to attract foreign investors will be hampered if domestic investors are seen to be using alternative investment vehicles.

There is now a threat to the continued take up of the VCLP due to the uncertainty of tax treatment for domestic investors and as the tax treatment is not consistent with that of other vehicles which can be used for investing in venture capital.

The ESVCLP became available in 2007 and required amendments to state and territory partnership legislation before ESVCLPs could be registered. This was not completed until 2009 (with the exception of Western Australia and Tasmania). Following on from this was the global financial crisis (GFC) which had a significant effect on fund raising for venture capital (Innovation Australia is only aware of two venture capital funds raised throughout the GFC – both at the very beginning). There has been a significant number of enquires regarding the ESVCLP. Currently there are seven registered ESVCLPs (four conditionally registered as they attempt to raise capital) and some managers under tranche 3 of IIF Round three have indicated their preference to structure as an ESVCLP. Our expectation is that as market conditions improve and capital is more readily available and new venture capital funds are raised the ESVCLP will become more widely utilised and contribute by encouraging venture capital investment in early start-up and expanding businesses with high growth capital.

AVCAL has submitted that the VCLP should be restructured into a format consistent with that being offered by New Zealand Limited Partnership regime (2008). It is our understanding that the intent of the New Zealand Limited Partnership regime is not focused on venture capital but is available to both venture capital and private equity investors; in short it is to attract investment into New Zealand. The partnership is a flow through structure which allows partners to take gains and losses of the limited partnership at their personal level based on their share proportion. Limited partners are not able to take a deduction that is greater than the total capital committed.

While such a limited partnership structure provides a globally consistent investment vehicle for both VC and LSPE, we believe that the LSPE sector in Australia is reasonably mature and well catered for in terms of capital commitments and thus do not believe that concessional tax treatment is warranted for LSPE.

The UK VC tax regime provides concessions to VC entities and investors. Investors in an approved Venture Capital Trust (VCT) are entitled to income tax and CGT reliefs. VCTs are exempt from corporation tax on any gains arising on the disposal of their investments. Individual investors enjoy exemption from tax on dividends and income tax relief (currently at 30%) on amounts subscribed for shares (up to £200,000 currently for new, ordinary, non-preferential shares with no right of redemption). Gains on disposal are CGT exempt. At least 70% (by value) of the VCT's investments must have been qualifying holdings meeting the VCT scheme conditions and at least 30% (by value) of the VCT's qualifying holdings must have been of ordinary shares with no preferential rights to dividends or to the company's assets on its winding-up, and no right to be redeemed.

Among the conditions applying to the investee of a VCT for the shareholding to be part of the VCT's qualifying holding is that the value of the investee company's gross assets must not exceed £7 million (previously £15 million) immediately before the VCT makes its investment and £8 million (previously £16 million) immediately afterwards. Therefore the UK VCT regime is far more tightly focused on the early stage VC sector (cf. ESVCLP gross assets of investee not more than $50 million and for VCLP not more than $250 million).

Under the UK Enterprise Investment Scheme individuals investing in unlisted UK SMEs engaged in qualifying activities are entitled to tax relief on the amount subscribed for shares and are exempt from tax on capital gains from the disposal of their shares.

Both of these schemes are credited with attracting significant capital into the UK early stage sector.

5. *Would the introduction of a deemed capital account treatment for domestic limited partners investing in a VCLP contribute or detract from its policy objectives? What other considerations would be relevant to introducing such a deemed capital account treatment; given the carried interests of general partners are already deemed to be on the capital account, should general partners receiving gains made by a VCLP on the disposal of eligible venture capital investments also be deemed to be on capital account?*

For the reasons identified in the general introductory discussion we consider that investment in VC should not be treated the same as investment in LSPE or other managed investment trusts (MIT). Innovation Australia does not support using an election consistent with that introduced for MITs for application to the venture capital program. Because of the issues facing VC investment, not the least being that the fund manager is able to raise sufficient funds for investment, the VCLP warrants adoption of its own separate tax treatment.

The tax treatment of the VCLP should at least be consistent with the tax treatment of other vehicles which can be used to invest in venture capital.

Innovation Australia recommends that domestic partners investing in a VCLP have deemed capital account treatment for all gains (foreign partners already enjoy exemption under existing legislation).

If general partners have capital invested in their fund then that capital contributes equally to developing the venture capital market and faces the same risks as capital provided from limited partners in the fund. Consequently, any gain made on the disposal of an investment should be treated the same regardless of whether it flows to a general or a limited partner.

6. *The desirability of further changes to the tax treatments in the VCLP and ESVCLP regimes to enable them to better achieve their policy objectives.*

Taxation incentives for investment into venture capital should reflect the difficulty in attracting investment to the particular sector (the market gap the Government is addressing) and the risk associated with investing in that sector.

The ESVCLP targets the early stages of venture capital where capital commitments are low and risk is very high. The tax benefits – no tax payable on gains - is appropriate.

The VCLP offers the facility for investment across the spectrum of venture capital, from the very early high-risk stages to the later but still quite risky stages (even some overlap into late expansion which is classified as LSPE). The tax treatment should acknowledge that due to Australia's relative isolation from global venture capital markets, domestic investment will always make up a considerable proportion of commitments to venture capital in Australia and consequently, domestic investors (whether they be limited or general partners) should be entitled to beneficial tax treatment if they invest through a VCLP. This treatment should not be as liberal as the somewhat more predictable ESVCLP, but should provide benefits consistent with the ESVCLP as the same issues are faced (lack of investment capital and high risk). Treatment of all gains on the capital account would seem appropriate.

Innovation Australia does not consider that changes to the current tax treatment of the VCLP are warranted beyond that identified (i.e. domestic investors should have all gains taxed on the capital account).

**Attachment A**

Program Objective VCLP

To facilitate non-resident investment in the Australian venture capital industry by providing incentives for increased investment which will support patient equity capital investments in relatively high-risk start-up and expanding businesses that would otherwise have difficulty in attracting investment through normal commercial means.

The Venture Capital Limited Partnership provides for a limited partnership investment vehicle with flow-through taxation treatment. This provides Australia with an investment vehicle which is understood and used by overseas investors.

Program Objective ESVCLP

The ESVCLP program is designed to stimulate Australia's early stage venture capital sector and enhance the development of skills and the formation of capital. It establishes an investment vehicle with flow through tax treatment and exemption for resident and foreign partners from income tax on all income or gains derived from eligible investments made through the vehicle. This is designed to encourage investments in start-up enterprises with a view to commercialisation of the activity. The structure of the ESVCLP is similar to that of the VCLP with additional requirements to ensure the integrity of the regime.