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I N F O R M A T I O N A N D R E S E A R C H S E R V I C E S

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Nos. 77–78 2002–03

Venture Capital Bill 2002

Taxation Laws Amendment (Venture Capital) Bill 2002

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Economics, Commerce and Industrial Relations Group
9 December 2002

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Venture Capital Bill 2002

Taxation Laws Amendment (Venture Capital) Bill 2002

Date Introduced: 14 November 2002

House: House of Representatives

Portfolio: Treasury

Commencement: 1 July 2002

Purpose

The Taxation Laws Amendment (Venture Capital) Bill 2002 (the TLA(VC) Bill) amends the *Income Tax Assessment Act 1936* (ITAA 1936) and the *Income Tax Assessment Act 1997* (ITAA 1997) to extend the scope of the existing tax exemption for venture capital investment to registered Venture Capital Limited Partnerships (VCLPs) and Australian Venture Capital Funds of Funds (AFOFs). The measures also propose to tax the venture capital manager's share of gains made by a VCLP or an AFOF on the sale of eligible venture capital investments (the carried interest) as a capital gain instead of as income.

The Venture Capital Bill 2002 (the VC Bill) provides the administrative measures for the registration and revocation of registration of VCLPs and AFOFs.

Background

The Bills give effect to the Government's November 2001 Election commitment to improve incentives for foreign investment in the venture capital sector.

Recognising that access to venture capital is a critical factor in facilitating the growth of Australian companies, the Prime Minister foreshadowed during the 2001 election campaign that the Government would review taxation arrangements for venture capital investment:

One of the more pressing issues facing business leaders is how to operate and expand their companies in an increasingly competitive global environment. My Government

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remains firmly of the view that Australian companies can successfully compete on the global stage while remaining based in Australia. But to achieve this, we need internationally competitive taxes and taxation systems.

If re-elected, the Coalition Government will, as a matter of priority, examine whether features of the current taxation arrangements adversely affect the capacity of business to remain in Australia. This will be done in consultation with key stake holders and industry representatives.

Particular attention will be paid to whether Australia's international tax regime acts as an impediment to:

- Australian companies attracting domestic and foreign equity;
- Australian companies expanding offshore; and/or
- holding companies and conduit holdings being located in Australia.

In an increasingly competitive global environment, reducing taxes on equity flows will significantly enhance the ability of companies to manage their capital base.

The Government intends to extend the previously announced exemption for capital gains on venture capital investments by providing venture capital limited partnerships with flow through taxation treatment.

These changes, which will apply from 1 July 2002, stem from the Government's commitment in *Backing Australia's Ability* to ensure that venture capital investment is encouraged.¹

At the time the cost to Government of the proposed new tax incentives was estimated at \$60 million over three years beginning in 2003–04. This initial estimate was revised in the Explanatory Memorandum to the Bills and is now put at \$76 million over three years.²

Overview of legislation

The key features of the new legislation are:

- venture capital limited partnerships will be able to access flow-through taxation treatment – allowing the income, profits, gains and losses of the partnerships to flow through to partners
- the current Capital Gains Tax (CGT) exemption provided to certain foreign pensions funds on profits or gains from the sale of investments in eligible venture capital investments will be extended to a wider pool of foreign investors

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- general partners of limited partnerships must apply to the Pooled Development Funds (PDF) Registration Board to qualify for tax exemption, and
- a venture capital manager's 'carried interest' or entitlement to a distribution from a limited partnership will be taxed as a capital gain, rather than as income.

As noted in the Minister's Second Reading Speech, limited partnership structures are the investment vehicle of choice in overseas venture capital markets:

The measures recognise that venture capital limited partnerships with flow through taxation treatment are the preferred investment vehicles internationally and that countries competing with Australia for capital offer exemption from taxation on gains from the sale of those investments.

Taxing the carried interest of venture capital managers as capital is also consistent with the international tax treatment of those gains. An internationally consistent tax treatment is critical in attracting highly skilled international venture capital managers to Australia. Such managers will contribute to the expertise and competitiveness of Australia's venture capital industry which, in turn, will attract venture capital funds by offshore investors.

These measures will therefore bring Australia into line with what is currently recognised as 'best practice' within the international market. As a result, it is anticipated that there will be a strong increase in venture capital by non-residents over the medium term and that these measure will lay the foundation for greater participation by experienced venture capital funds managers in the Australian venture capital market.

Venture capital in Australia

According to the Australian Venture Capital Journal (AVCJ), total capital in the Australian venture capital sector rose \$1.05 billion from \$8.2 billion to \$9.3 billion in 2001–02 (see graph below).³

The \$9.3 billion comprises \$7.01 billion with fund managers and listed companies, and \$2.34 billion with firms that are private, government or local offices of offshore groups.

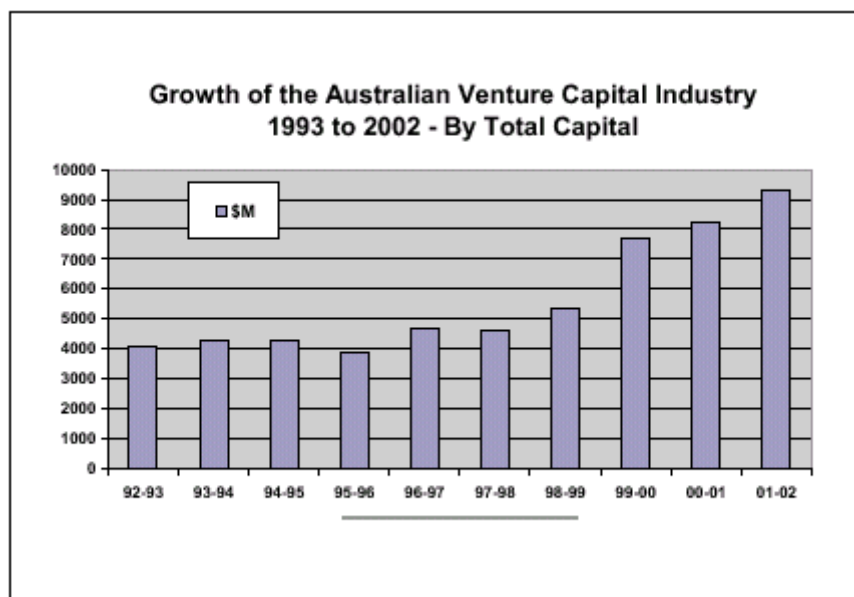
The AVCJ 10th Annual Venture Capital Survey shows that the sector has grown 126 per cent in the ten years since 1992–93, when investments totalled \$4.1 billion.

However, the 13 per cent increase in total investments in 2001–02 and the 7 per cent rise in 2000–01 represent a much slower rate of growth compared to the record 44 per cent increase in 1999–2000 during the information technology boom.

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Source: Australian Venture Capital Journal

The survey also shows that despite 126 per cent growth in the sector over the last decade, the level of privately managed capital has remained the same, being \$2.38 billion in 1992–93 and \$2.34 billion in 2001–02.

While the sector has more capital and more investments than before, exits are a constant feature of the sector’s activities.

During 2001–02, the sector exited from 82 investments. Of these, 41 or 50 per cent were at a profit, 38 or 46 per cent were at a loss, and three broke even. In 2000–01, there were 62 exits, of which 34 or 55 per cent were at a profit, 25 or 40 per cent were at a loss and five broke even.

Fall in venture capital funding

Although Australia has been insulated from the economic downturn affecting other developed economies, venture capital funding is an area that suffered as a result of the loss of investor confidence in global equity markets after the technology-bust.⁴

In 2001–02, \$894.7 million was raised in venture capital, compared to \$1.27 billion in 2000–01 and \$1.75 billion in 1999–00. The \$894.7 million was raised by 18 firms, down from 34 firms each in 2000–01 and 1999–00.

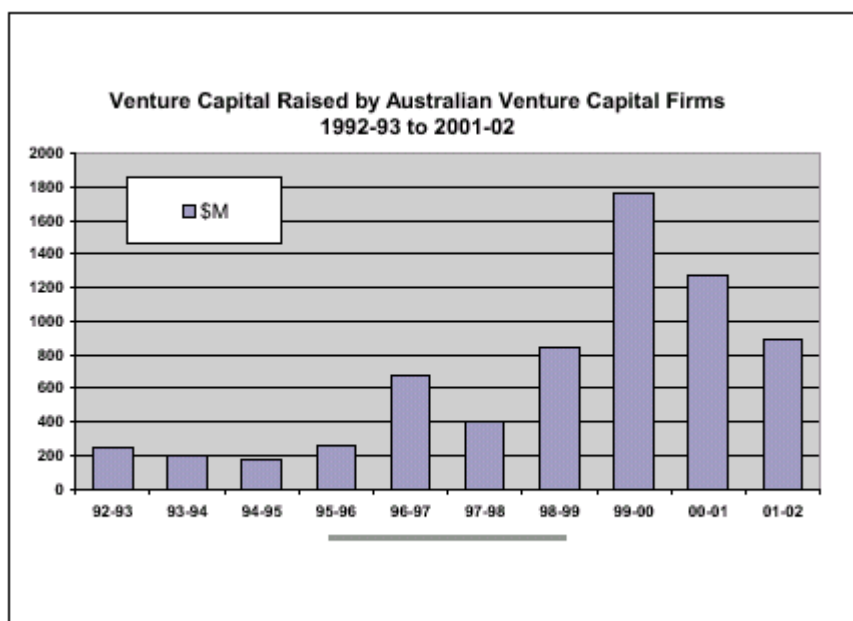
According to the AVCJ, the decline in venture capital funding over previous years “shows a smaller number of managers raising large amounts, a shorter tail of managers small amounts, and very few first funds by new managers”. Another factor is the role of institutional investors:

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The reluctance of super funds and other institutions to invest in private equity since the tech bust highlights that institutions and professional investor[s] are not immune from herd investing. Happy to commit while the market was rising and the bubble building, many now lack the stomach for countercyclical investing just when venture capital history shows that periods of low business valuations ultimately provide the best vintage years and superior returns.⁵



Source: Australian Venture Capital Journal

Despite the current slow market conditions, there are good prospects for continued growth in the sector. The Australian Venture Capital Association estimates, based on an economic analysis by Econtech, that the imminent limited partnerships and tax changes will attract an additional \$1 billion in foreign capital over the next five years.⁶

Anticipated impact of measures in the Bills

By extending the current CGT exemption, the venture capital sector should experience an increase in funds flowing into the sector from foreign tax-exempt entities, including overseas superannuation funds, and from tax paying entities. The only drawback is that the exemption applies to a restricted list of countries, although the Government has indicated it will consider adding other appropriate countries as required.

The new provisions in respect of the carried interest paid to investment managers, which will be treated as capital gain rather than income, will make it easier to attract US or UK

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expertise in managing funds in Australia. Venture capitalists will be taxed at 24.25 per cent, the same as in the US.

The registration procedures for limited partnerships and the ongoing reporting obligations will result in higher running costs for venture capital funds that qualify for tax exemption. While the registration and reporting processes ensure the integrity of the measures, in time the ongoing obligations may become a cost burden for some small funds.

Main Provisions

New venture capital vehicle – flow-through limited partnerships

Part 2 of the VC Bill 2002 provides for the registration of two types of limited partnerships by the PDF Board established under the *Pooled Development Funds Act 1992* (PDF Act 1992).

Venture Capital Limited Partnerships (VCLPs)

Proposed section 9-1 sets out the requirements for the registration of a limited partnership by the PDF Board. A VCLP may be registered if:

- it is established in Australia, Canada, France, Germany, Japan, the United Kingdom, United States or any other country prescribed by regulations
- all the general partners are resident in one of the above mentioned countries
- the partnership agreement specifies that the partnership will remain in existence for at least 5 years but no more than 15 years
- the committed capital of the partnership is at least \$20 million
- its only investments are eligible venture capital investments, and
- every debt interest that the partnership owns is a permitted loan.

Australian Venture Capital Fund of Funds (AFOFs)

A limited partnership may be registered by the PDF Board as an AFOF under **proposed section 9-5** if:

- it is established under a State or Territory law in Australia
- all the general partners are Australian residents
- its partnership agreement specifies that the partnership will remain in existence for at least 5 years and not more than 20 years, and

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- its only investments are in a VCLP or eligible venture capital investments in a company in which a VCLP (in which the AFOF is a partner) already holds an investment.

The following proposed definitions inserted into section 995-1 of the ITAA 1997 apply:

- A general partner means a partner of a limited partnership whose liability in relation to the partnership is not limited. (**Item 16** of **Schedule 1** of the TLA(VC) Bill), and
- A limited partner means a partner of a limited partnership whose liability in relation to the partnership is limited (**Item 18** of **Schedule 1** of the TLA(VC) Bill).

The above definitions will also be inserted into subsection 6(1) of the ITAA 1936 by **Items 2** and **3** of **Schedule 2** of the TLA(VC) Bill.

Limited partnership means a partnership where the liability of at least one of the partners is limited. This definition of limited partnership in section 94B of the ITAA 1936 will be inserted into subsection 6(1) of the ITAA 1936 by **Item 4** of **Schedule 2** of the TLA(VC) Bill.

It must be noted that in a limited partnership it is the general partner that is responsible for the day to day operation of the partnership. For this reason **proposed section 13-1** of the VC Bill requires a general partner of a VCLP and an AFOF to apply for registration.

Venture Capital Management Partnership

A venture capital management partnership (VCMP) as defined in **proposed subsection 94(3)** to be inserted into the ITAA 1936 by **Item 16** of **Schedule 2** to the TLA(VC) Bill is a limited partnership that:

- (a) is a general partner of either or both of the following:
 - i. One or more VCLPs;
 - ii. One or more AFOFs; and
- (b) only carries on activities that are related to being such a general partner.

Proposed subsection 94(3) also provides that a limited partnership ceases to be a VCMP if it ceases to meet the requirements in paragraphs (a) and (b).

Taxation treatment of VCLPs, AFOFs and VCMPs

Flow-through treatment

Under the existing law, limited partnerships are taxed as if they were companies under Division 5A of the ITAA 1936 and are referred to as corporate limited partnerships. **Item**

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16 of **Schedule 2** of the TLA(VC) Bill amends section 94D by inserting **proposed subsection 94(2)** to provide that a VCLP, an AFOF or a VCMP cannot be a corporate limited partnership. In consequence, VCLPs, AFOFs and VCMPs will be treated as ordinary partnerships for taxation purposes. This amendment will permit the flow through of profits, gains and losses to the partners of VCLPS, AFOFs and VCMPs.

Limitation of losses

Loss limitation rules will limit the deduction allowable to limited partners for partnership losses to the extent of the partner's exposure to the loss. This is calculated under **proposed subsection 92(2AA)** of the ITAA 1936 to be inserted by **Item 13** of **Schedule 2** of the TLA(VC) Bill by deducting from the capital contributed by the limited partner of the following amounts:

- the amount of contributed capital the partnership has repaid to the partner
- the total of all deductions allowed to the partner for partnership losses incurred in previous income years, and
- the amount of any debt of the partner that is secured by the partner's interest in the VCLP or the AFOF.

The Explanatory Memorandum to the VC Bill and the TLA(VC) Bill states that the loss limitation rules are necessary to protect the integrity of the measure as without this limitation limited partners would be able to claim deductions for losses to which they were not exposed to. It adds that similar limitation on loss claims are to be found in other jurisdictions including Canada, New Zealand, the UK and the US.⁷

Capital gains and losses

As in the case of capital gains made on the sale of assets held by an ordinary partnership, capital gains made on assets held by a VCLP, an AFOF or a VCMP will be taxable to a partner according to the partner's tax status. Thus individuals who are partners in a VCMP will qualify for the CGT discount on the carried interest if they satisfy the other requirements of the discount.

Proposed Subdivision 195-B to be inserted into the ITAA 1997 by **item 23** of **Schedule 2** of TLA(VC) contains rules about the income tax treatment of limited partnerships that become or cease to be VCLPs, AFOFs or VCMPs. Thus tax losses cannot be transferred to a VCLP, an AFOF or a VCMP under **proposed section 195-65**. Previous tax losses can be deducted after ceasing to be a VCLP, an AFOF or a VCMP under **proposed section 195-70**. The Commissioner may make determinations how to take account of limited partnerships having income years of less than 12 months when they become or cease to be VCLPs, AFOFs and VCMPs.

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CGT exemptions – who qualifies and when?

The current CGT exemption to certain overseas pension funds on the profit or gain from the sale of investments in eligible venture capital investments, will be extended by **proposed Subdivision 118-F** to be inserted by **Item 6 of Schedule 1** to the TLA(VC) Bill to partners in the VCLP or AFOF which are:

- tax-exempt entities (including pension funds, endowment funds and foundations) from Canada, France, Germany, Japan, the UK, the USA or any other country prescribed in the regulations. These investors may hold up to 100 per cent of the committed capital of the VCLP or AFOF
- foreign venture capital funds of funds established in Canada, France, Germany, Japan, the UK or the USA. These funds of funds may hold up to 30 per cent of the committed capital of the VCLP or AFOF
- taxable entities from Canada, France, Germany, Japan, the UK or the USA, holding less than 10 per cent of the committed capital of the VCLP or the AFOF, and
- an entity (taxable or otherwise) from Finland, Italy, the Netherlands, New Zealand, Norway, Sweden, Taiwan and which holds less than 10 per cent of the committed capital of the VCLP or AFOF.

The investment must have been held by the VCLP or AFOF for at least 12 months to qualify for the tax exemption.

Eligible venture capital investment

To qualify for the tax exemption, the investment in either shares or options must be an eligible venture capital investment and the investment must be at risk (that is, investors must bear the risk of owning the shares or options themselves) as required in **proposed paragraph 118-425(1)(a)** to be inserted by **Item 6 of Schedule 1** of the TLA(VC) Bill.

Proposed sections 118-425 to 118-445 to be inserted by **Item 6 of the** TLA(VC) Bill sets out the requirements for an eligible venture capital investment and these cover listing, size, auditor, primary activity and residency requirements. Broadly the company seeking the capital must:

- be an unlisted Australian company, or a listed Australian company that will be delisted within 12 months of the date of the investment (**proposed paragraph 118-425(7)(a)** and **(b)**)
- have assets not exceeding \$250 million at the time of the investment (**proposed subsection 118-425(6)** and **proposed section 118-440**)
- have a registered company auditor (**proposed subsection 118-425(5)**), and

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- not have any of the following as its primary activity:
 - property development
 - finance — to the extent that it is banking, providing capital to others, leasing, factoring or securitisation;
 - insurance
 - construction or the acquisition of infrastructure activities, and
 - investments that generate interest, rents, dividend, royalties or lease payments (**proposed subsection 118-425(3)**).

Additionally under **proposed subsection 118-425(2)**, if the investment is first made in the investee company, for 12 months following the investment, that company must:

- have more than 50 per cent of their employees in Australia, and
- retain more than 50 per cent of its assets in Australia.

Venture Capital Managers

What is a partner's carried interest?

A carried interest is a partner's entitlement to a distribution from a VCLP, an AFOF or a VCMP which is contingent on profits being made for the limited partners of the VCLP or AFOF.

The meaning of carried interest is provided in **proposed section 104-255** to be inserted into the ITAA 1997 by **item 5** of **Schedule 3** of the TLA(VC) Bill. A carried interest can be held by a general partner of a VCLP or an AFOF under **proposed subsection 104-255(4)** and by a limited partner under **proposed subsection 104-255(5)** to be inserted by **Item 5** of **Schedule 3** of the TLA(VC) Bill.

Taxation of carried interest

When a venture capital manager becomes entitled to receive a payment of carried interest it becomes liable to CGT. The carried interest is not ordinary income of the venture capital manager. At the same time a deduction is not allowable to a VCLP, an AFOF or a VCMP for a carried interest payment. These outcomes are achieved by amendments to sections 10-5, 12-5 of the ITAA 1997 and by **proposed section 118-20** of the ITAA 1997 by **Items 2, 3** and **13** respectively of **Schedule 3** of the TLA(VC) Bill.

A carried interest entitlement can be a discount capital gain if the partnership agreement under which it arises was entered into at least 12 months before the payment of carried interest.

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Registration with the PDF Board

To qualify for the exemption, a limited partnership must apply to the PDF Registration Board for registration as a VCLP or AFOF under **proposed Part 2** of the VC Bill.

The application must be in writing or lodged electronically and must include information in relation to the general partner, the fund, the limited partner investors and the fund's broad investment plans. The PDF Board must decide the application within 60 days of the application being lodged, although it has discretion to extend the period by up to 60 days.

It is the duty of the PDF Board to register VCLPs or AFOFs and to monitor their activities for compliance with the new legislation. Once a limited partnership is registered, the general partner must lodge quarterly and annual returns with the PDF Board, and any further information requested by the Board.

Concluding Comments

The Bills implement a key election commitment by providing new venture capital incentives for foreign investment.

The removal of tax impediments may allow Australian companies seeking venture capital funding to source funds from the hitherto elusive overseas venture capital markets.

Endnotes

- 1 Prime Minister, Press Release, *Securing Australia's Prosperity*, 15 October 2001.
- 2 Explanatory Memorandum, p. 4.
- 3 See Australian Venture Capital Journal, *10th Annual AVCJ Venture Capital Survey 2002*, October 2002, No. 114, pp 6–19.
- 4 See 'Venture capital drying up', *The Australian*, 1 October 2002.
- 5 Australian Venture Capital Journal, *10th Annual AVCJ Venture Capital Survey 2002*, October 2002, No. 114, p. 12. See also "Venture capital funds a drag on super returns", *Australian Financial Review*, 26 June 2002.
- 6 See 'The golden chance', *Business Review Weekly*, June 6–12, 2002, p. 55.
- 7 Explanatory Memorandum, paragraph 2.19, p. 19.

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