AVCAL
Australian Private Equity &
Venture Capital Association Limited

16 May 2018

Committee Secretary
Standing Committee on Economics
House of Representatives
PO Box 6021
Parliament House
Canberra ACT 2600

Dear Sir/Madam,

Parliamentary inquiry into impediments to business investment

The Australian Private Equity and Venture Capital Association Limited (AVCAL) appreciates the opportunity to contribute its views to the House of Representatives Standing Committee on Economics in relation to the committee inquiry into Impediments to Business Investment (the Inquiry), initiated in March 2018.

1. Overview

AVCAL has focussed the views of the private equity (PE) and venture capital (VC) industry to address the issue of lower than expected levels of business investment recently seen across the Australian economy. As highlighted by the Intergovernmental Review of Business Investment (the Review), prepared by Heads of Treasuries in September 2017, business investment such as spending on new productive capacity, hiring more staff, or investment in new business innovation is critical to Australia's economic growth.

Business investment can be affected by a wide range of structural and cyclical factors, both domestic and global, which means that government's ability to influence business investment levels isn't independent of external pressures. However, Australia must participate in the global business environment and compete against the market globally for capital and investment. That is why governments at the Federal and State level should be looking to put in place policies that help businesses and investors get on with pursuing their commercial goals.

Part of the government response to the problem identified in the Review should be to address some of the issues and burdens faced by companies that are at the early startup stage, as well as high-growth companies that have graduated from the startup phase and are now expanding their workforce, increasing sales growth and investing in research and development.

Regionally, Australia more than punches above its weight in terms of performance by such high-growth companies. A report by the Financial Times included 115 Australian companies on its list of the top 1,000 high-growth companies in the Asia-Pacific region,[1] with five of the top ten places claimed by Australian businesses in terms of percentage growth in annual revenue between 2013 and 2016. These Australian companies employed close to 42,000 people in 2016, and generated more than US$17 billion in total revenue. A substantial number of the

[1] *FT 1000: High-Growth Companies Asia-Pacific*, Financial Times, February 2018

Australian companies highlighted in the report have benefited from VC or PE investment in order to achieve such significant growth.

PE and VC investment isn't just a capital injection into businesses that need it to hit the next stage of growth. This is 'smart capital' that brings with it industry expertise, access to networks, and other elements that businesses wouldn't get with other forms of funding or financing. The majority of PE and VC investment is directed into SMEs and early stage businesses. PE and VC fund managers partner with entrepreneurs who often lack the experience and resources to fulfil their companies' potential, or to properly navigate risk and uncertainty. PE and VC funds regularly meet those funding and experience gaps, providing crucial support at critical stages of a company's life cycle.

A study by the Australian Small Business and Family Enterprise Ombudsman in November 2017[2] identified access to finance as a significant barrier to greater levels of investment by SMEs, despite theoretically favourable conditions. The study also noted: "There appear to be constraints on attracting domestic and foreign capital for private equity (PE) and venture capital (VC) that are acting as a handbrake on business growth and investment. There is a strong, healthy pipeline of candidate businesses for PE and demand is perceived to be outstripping supply and availability of capital. The estimated gap is about **double** the number of existing businesses currently receiving investment." (emphasis in original)

Governments at all levels have an important task in making sure that businesses are given all the necessary tools to grow and succeed, including a stable policy and regulatory environment to operate within, access to capital and the expertise of professional business managers and operators. The Inquiry should therefore consider ways in which changes in policy settings could unlock greater levels of PE and VC investment that would in turn allow for businesses backed by PE and VC to expand and grow through investment in capital stock, innovative technology, and in their employees.

Our submission is focused on three key areas specifically referred to in the Inquiry's terms of reference. These are set out below:

- *the interaction between regulatory frameworks across all levels of Government and how the cumulative regulatory burden can be reduced to support greater business investment;*
- *the impact of innovation policies, at the Commonwealth and State government levels, on business investment and the role of innovation policies in encouraging greater business investment, having regard to approaches taken in other countries;*
- *the role that taxation policy, at the Commonwealth and State government levels, can have on the encouragement of new business investment.*

Further details in respect to each of the above three topics are set out in the following three sections.

[2] *Barriers to Investment: a study into factors impacting small to medium enterprise investment*, Australian Small Business and Family Enterprises Ombudsman, November 2017

2. Effect of regulatory frameworks

Sensible regulation forms a necessary part of any business environment in order to ensure equitable outcomes for businesses, consumers, and any other participants within a marketplace. But regulatory compliance should not come at an excessive cost or deter activity that would benefit consumers, businesses and investors, and shouldn't create an excessive burden on marketplace participants.

Our members and stakeholders have reiterated the need for a stable and predictable regulatory environment for businesses in order to stimulate investment. Changes to rules and regulation should be implemented via sensible and well-targeted consultations, alongside the provision of practical transition arrangements to enable businesses to adapt to the new regulatory environment.

A number of recent regulatory changes have had downstream impacts on the PE and VC industry and its ability to invest into, guide, and grow more domestic enterprises. Discussed below are regulations in relation to 1) Australia's foreign investment framework, and 2) the superannuation system.

2.1 Foreign investment framework

In July 2017, changes were introduced to the foreign investment framework as a consequence of the passage of the *Foreign Acquisitions and Takeovers Regulation 2015* legislative bill. Those changes included the introduction of a new exemption certificate, whereby applicants that fall under the new foreign investment framework could gain pre-approval for their programs of investments or acquisitions if certain conditions were met.

Owing to the fact that a significant proportion of the investment capital managed by PE and VC firms is sourced from institutional investors based offshore, Australia's foreign investment policy framework is highly relevant and important to the efficient functioning of our industry. As Australia transitions away from resources to innovation as a key driver of economic growth, and business investment in non-mining sectors becomes a more important ingredient to that growth, it is essential to ensure there is adequate and timely access to capital – including capital that is sourced from overseas and which falls within the parameters of the recent changes to foreign investment rules.

The new exemption certificate is relatively recent, and industry participants are currently adjusting to the new process of applying for the exemption certificate in order to begin a program of making investments in Australian businesses. Initial feedback from our members suggests that some improvements to the process could be made.

Overall, those who have gone through the application process have emphasised the need for clarity, transparency and open communication with government and regulators, due to the time-sensitive nature of investment decisions. They have also indicated, and we recommend, that the application process is made as simple as possible given the current requirements to secure approval for each application from several government entities, including the Foreign Investment Review Board, the Australian Taxation Office, the Australian Competition and Consumer Commission – each with its own set of information and reporting requirements and questions – and a final approval from the Treasurer.

2.2 Superannuation fund regulations

A key source of capital for the Australian PE and VC industry is the pool of superannuation money, whose assets totalled A$2.6 trillion at the end of the December 2017 quarter.[3] Australian superannuation funds made almost

[3] APRA statistics for the December 2017 quarter

A$1.1 billion in capital commitments to our domestic PE and VC funds in FY2017, which amounts to a third of all fundraising by the industry in that period.

Superannuation funds are facing a number of regulatory hurdles that will detrimentally impact on their ability to allocate more capital into the PE and VC sector, namely the implementation of ASIC Regulatory Guide 97: Disclosing fees and costs in PDSs and periodic statements (RG97), and Portfolio Holdings Disclosure.

2.2.1 ASIC Regulatory Guide 97 – Disclosing fees and costs in PDSs and periodic statements

ASIC Regulatory Guide 97 (RG97) was developed and issued in February 2017 to provide guidance on how superannuation funds should disclose fees and costs in Product Disclosure Statements (PDSs) and periodic statements as part of the Stronger Super reforms. Currently, the implementation of the guide is the subject of an external expert review which is expected to be concluded before the end of June 2018.

The legislation underpinning the RG97 regime was implemented to:

- improve consistency between the terminology of the Stronger Super reforms and the disclosure provisions of the Corporations Regulations 2001; and
- promote greater fee transparency and product comparability for consumers.

AVCAL supports the policy objectives of improving fee and cost disclosure and product comparability across the superannuation and managed fund industries, recognising the importance of accurate, meaningful information being provided to consumers. However, in our view, RG97, as currently implemented, will not adequately deliver on these policy objectives.

Instead, the fee and cost disclosure regulations will make the PE and VC asset class less attractive to superannuation funds at the risk of negatively affecting their portfolio allocation decisions. Apart from the effect of artificially diminishing the attractiveness of PE and VC as an investment option, the regulations could subsequently adversely impact on the super balances of fund members, who would miss out on the strong returns that the PE and VC industry has generated over many years.

A number of issues with respect to the fees and costs disclosure regime have been identified as being of most concern to our sector, and these are outlined below:

Lack of comparability

It is our view that the implementation of RG97 has resulted in a decline in quality of disclosure to consumers, which has a negative impact on product comparability. By applying a uniform set of rules for fee and cost disclosure across all product types that does not account for the different ways in which funds across asset classes are structured and operate, it has led to different treatment of different asset classes. For example, a listed equities fund would be treated differently to a PE or VC fund, even though both types of funds are buying shares in businesses but one discloses less information than the other. There are many other similar examples of comparability irregularities.

Overly complex

When the original legislation underpinning RG97 was implemented it was generally considered to be straightforward to understand and implement in a disclosure document. However, the current RG97 regime has 70 pages of regulatory guide, 34 pages of complex class order drafting and numerous pages of website FAQs. This, on top of the circa 22 pages of related legislation, has resulted in nearly 140 pages of prescription for what is often no more than 2 or 3 pages in a product disclosure statement. As a result, an overly complex regime has emerged, evidenced by the multitude of revisions to the class order and FAQs and the numerous implementation deadline changes.

This is a stark departure from the typically effective approach of having principles-based legislation (which the original legislation was considered to be) and then regulatory guidance on the regulator's (in this case, ASIC) view of the application of that legislation. The reason why this principles-based approach is so often used in the corporations law is that it allows for uniform application to different situations.

Less effective disclosure

In our view, RG97 has become more focused on prescriptive detail aimed at closing perceived loopholes, rather than promoting accurate and effective disclosure for consumers. RG97 has led to an increase in inaccurate, potentially misleading data being disclosed, thereby reducing consumers' ability to appropriately compare financial products. For example, where a product has fee or cost changes for an upcoming year, it has been prescribed that issuers must still use data from the past financial year. This means consumers will be clearly misled as to what the actual fees and costs are. The current approach is inconsistent with the general disclosure standard for PDSs – to be clear, concise when providing disclosure.

This has become a particularly significant issue for PE and VC funds where fees paid by investors across the life of a fund (typically a 10-year period) will vary depending on a variety of factors, including the age of the fund, the number and size of investments made relative to the capital raised within the fund, and how successful fund divestments have been.

It is far more effective disclosure to retail investors to provide either an estimate of fees that they will bear over the life of the typical PE or VC fund or to provide the actual fees for a period – depending on which tells the most accurate story. Consequently, we believe that applying the 'one-size fits all' prescriptive disclosure regime imposed by RG97 across all product types and asset classes reduces the quality of the disclosure to investors and fails to provide a sound basis for consumer comparability.

An overemphasis on fees and costs, rather than returns

The policy and regulatory push towards low-cost superannuation has encouraged superannuation funds to focus much of their attention on a single investment metric (fees associated with investments), rather than the over-riding goal of maximising risk adjusted, net-of-fee returns for members. This has resulted in lower allocations to PE and VC that would otherwise make sense from a pure investment return perspective, funds that should increase their allocations, are not doing so, and funds that should commence a PE and VC programme, are not doing so.

This means the regime has resulted in investment decisions that are driven by fees and costs rather than maximising returns to investors, which is what Parliament was initially trying to achieve through Stronger Super and related fee disclosure initiatives.

The important role that PE and VC plays in generating investment returns, particularly to the superannuation sector, is demonstrated by a strong track record of performance. According to Cambridge Associates data, as of 30 September 2017, the Australian PE & VC Index outperformed, net of fees, the S&P/ASX 300 Index by 7.4% per annum over the three-year period, 7.2% per annum over the five year period, and 6.6% per annum over the 10-year period.

Despite this, institutional investors, in the face of significant fee pressures arising from the RG97 regime, are having to reduce their allocations to PE and VC to minimise fees to third party managers. Ultimately this dampens investment in high-growth Australian businesses typically backed by PE and VC funds across the economy.

The concept of an interposed entity

Following the global financial crisis, and prominent financial failures that occurred as a result of local retail funds investing into opaque offshore structures (or a series of structures), the concept of interposed entities was a key focus for closer attention by regulators. However, in applying this concept to superannuation fund fee and cost disclosure, the regulations have inadvertently disrupted the disclosure for several other asset classes including property, infrastructure, PE and VC. Instead of disclosing in accordance with the original disclosure test standard set by Parliament – the cost of a product that an investor would not bear if it invested in the underlying assets directly – the costs outside of the product were also being captured. This has created unintended outcomes such as the costs of businesses that a fund might invest in being captured as product costs. In seeking to close loopholes, sufficient regard has not been paid to other asset classes such as PE and VC and how products in those sectors operate.

Whilst AVCAL supports the intention of these regulations to enhance fee and cost transparency, the disclosure regime imposed by RG97 has led to a number of adverse outcomes, as identified above, not only for PE and VC funds that invest into businesses on behalf of superannuation funds (and other investors), but also for the super funds themselves and for their individual members. Addressing these regulatory barriers would enable greater investment to flow to PE and VC, and ultimately to their investment portfolio companies.

2.2.2 Portfolio Holdings Disclosure

In September 2017, the Government introduced draft portfolio holdings disclosure legislation which largely replicated the bill put forward prior to the 2016 federal election (which itself lapsed as a result of the proroguing of the 44th Parliament). As of the date of lodgement of this submission, the legislation is still before the Senate.

The legislation and associated reforms would be significant to the superannuation and broader funds management sector. In the interests of business certainty, AVCAL advocates that the proposed reforms be legislated as soon as possible in 2018. AVCAL has welcomed moves to introduce a regulatory framework that seeks to strike the appropriate balance between transparency and usability in terms of disclosure of superannuation funds' portfolio holdings. Accordingly, we are pleased that a 5% exemption for commercially sensitive investments remains in the draft bill, which is important for the PE and VC investment strategies of superannuation funds.

We look forward to further consultation with government and regulators on aspects of the proposed regime that will be dealt with in the regulations, especially how any materiality threshold might operate.

With respect to the commencement of the new regime, we note that the draft legislation states that its date of effect will be 31 December 2018. Given the effluxion of time, AVCAL recommends that any new portfolio holdings regime should have a deferred implementation date of 1 July 2019, in order to allow adequate time for further consultation with the sector on detailed regulations and allow a reasonable transition period.

Pressing ahead with a 31 December 2018 implementation date could give rise to significant compliance costs and compliance risks given the compressed timeframe in which funds would have to adjust to the new requirements. This would also come at the same time as the superannuation sector is grappling with the implementation ASIC's RG97, discussed above.

3. Impact and role of innovation policy

Governments around the world have recognised the fundamentally important role that a cohesive and well-thought out innovation policy plays in boosting investment into our most productive sectors, fostering competitiveness, creating jobs and helping build and future-proof the economy.

It was widely recognised that the past lack of a comprehensive long-term innovation strategy resulted in Australia falling behind other economies across a number of innovation measures. While the Government's National Innovation & Science Agenda (NISA), announced in December 2015, was a necessary step in getting us back on track to compete with the rest of the developed world, more should be done to spur on Australia's transition to an economy grounded in world-leading innovations.

As has been the case in other markets around the world, PE and VC can help drive this transition, providing both capital and expertise to promising innovations and businesses. In particular, as the OECD stated in its 2016 Entrepreneurship at a Glance Report, "the development of the venture capital industry is considered an important framework condition to stimulate innovative entrepreneurship," illustrating that our sector plays a vital role in the growth of a healthy innovation ecosystem.

This section of our submission will focus on a number of innovation policy settings, including those specific to the PE and VC sector, that the Inquiry should consider not only in helping to overcome impediments to business investment but also to supporting the wider transition to a knowledge-based economy.

3.1 R&D Tax Incentive

Australia's Research and Development (R&D) Tax Incentive program is vital in supporting the growth and expansion of early stage, innovative companies. Before the recent uncertainty around the future settings of the program, it was seen as being one of the world's best. The spill over effects of the scheme, in generating jobs and investment inflows as offshore companies brought their R&D activities to Australia, were also significant.

Recent reforms to the R&D Tax Incentive program, as part of the 2018-19 Federal Budget measures announced earlier in May 2018, have alleviated some of the uncertainty around the future of the program. But we must ensure the program is appropriately maintained and enhanced so that R&D continues to be carried out by Australian companies, and that those offshore companies that undertake R&D activity (such as clinical trials) in Australia continue to do so, while maintaining the program's long-term sustainability.

In an era of mobile capital, it is essential that Australia's policy settings are internationally competitive especially given the nation's natural disadvantages include a small domestic market and relative geographic isolation (e.g. compared with Singapore or the United Kingdom which are significant R&D hubs). Indeed the R&D Tax Incentive program is the principal tool by which the Government can encourage companies to undertake R&D activities in Australia when they may not otherwise.

Similar to the views expressed by our members regarding the need for a stable and predictable regulatory framework within which businesses operate, innovation policy settings with regard to R&D should also be stable and not subject to undue changes and variances. Furthermore, the Inquiry should take into account the multi-year investment horizons used by enterprises for launching and maintaining R&D activity and note that high levels of uncertainty are likely to dissuade businesses from making long-terms R&D investments. Therefore, we recommend that no further changes are made to reduce the financial incentives for claimants making use of the program.

The effectiveness of the program should not be viewed through the prism of costs to the budget – it should be viewed as an investment into the economic future of the nation. And when second and third round economic effects are taken into account, a range of other economic outcomes emerge including the fact that R&D intensive businesses are creating more employment options which then includes flow-on affects to the economy.

3.2 Skilled Visa Program

Australia is a net importer of not only capital but talent. Skilled migration has been a key component of Australia's migration system, playing an important role in generating economic growth for a number of decades. While Australia has had a long history of supportive policies to attract business entrepreneurs, the rising global mobility of workers and heightened competition for talent means that it is important for Australia to have policy settings that are effective in attracting a critical mass of "new economy" skilled workers and entrepreneurs who will help generate new and sustainable business opportunities within the Australian economy.

Education reforms, particularly in STEM disciplines, will help build the next generation of local talent, but in the short-term immigration reforms will help facilitate the entry of much needed specialist skills not easily available locally.

Recent changes to the 457 visa program for skilled migrants reduced the flow of talent to Australian companies. Within the technology sector, for example, the number of these types of visas granted for developers and programmers dropped 31%, along with a 50% drop for analyst programmers and a 10% drop for software engineers, from July to December 2017 compared to the same time in the year prior. In this context, Australia can do more to attract skilled migrants into key economic sectors that are facing skills shortage challenges.

AVCAL has been supportive of the policy intent behind previous entrepreneur and talent-focused visas, such as the Venture Capital Entrepreneur stream of the Business Talent visa (subclass 132) (Venture Capital Entrepreneur Visa). We would be supportive of a talent visa program that targeted entrepreneurs and other highly skilled professionals (engineers, technology experts, scientists, etc.) from overseas to boost the pool of talent available to startups and scale-ups.

Over the last year or so, both the Federal Government and the Opposition have announced proposals to launch visa programs that attract talented and highly capable individuals to develop their ideas into commercial opportunities in Australia, or help existing companies get to their next growth stage. These are positive developments, but we believe these proposals should be followed through with actions, whether it’s industry consultation, pilot programs or other ways of testing these ideas and proposals.

The global search for talent is compounded by ever-more-rapid changes brought about by technology and innovation, and Australia has to stay competitive if we want to attract the best and brightest.

3.3 National Innovation Fund

In considering policy settings to enhance innovation, the Australian Innovation System Report 2017 (published by the Department of Industry, Innovation and Science) noted that some countries have been experimenting with targeted policy support for high-growth firms (HGFs), given the “disproportionate economic contribution” of those firms. A top priority should be to tackle barriers that those firms face to accessing talent as well as funding, especially from PE and VC funds.

The Innovation System Report 2017 also observed that there remains much room to grow the local VC sector, and to boost investment into high growth companies. Based on OECD data, Australian VC investment as a proportion of GDP continues to rank significantly below other OECD countries at 0.013% of GDP, compared to an OECD average of 0.054%. Therefore, although the Australian VC sector has enjoyed a resurgence over recent years (with FY2016 and FY2017 being consecutive record years of VC fundraising), there remains much ground to make up.

In light of the above, AVCAL recommends that renewed consideration be given to Government equity co-investment programs, modelled on the $500m Biomedical Translation Fund (BTF), which is currently in place. The BTF is a prime example of Government funding operating to attract private capital into a sector of the economy which otherwise would not attract adequate investment.

If Australia's innovation ecosystem is to continue to grow, it must have sufficient VC to be able to support rapidly growing Australian companies as they mature, and take on global markets. If sufficient capital is not available locally, promising Australian firms will continue to look overseas for VC investment – sometimes relocating in the process. To illustrate the point, some of the largest VC investments into Australian companies in FY2017 (e.g. Deputy, Airwallex, and Health Engine) were led by large offshore fund managers.

There is significant potential for an Australian Government-backed equity co-investment program to help address some of the above market gaps, while driving significant growth and job creation across the economy. Other governments around the world have recognised and taken steps to address these same problems.

Despite having a VC sector that is almost twice the relative size of Australia's, the UK has recognised the importance of further developing an innovation-driven economy and has committed substantial additional funding to achieve it – developing an action plan that will unlock £20bn of capital investment into innovative firms over ten years, on the back of the HM Treasury report *Financing Growth in Innovative Firms*. Specifically, the UK Government in its Autumn (November) 2017 budget committed to the following measures:

- establishing a new £2.5 bn Investment Fund incubated in the British Business Bank;
- investing in a series of private sector funds of funds, starting with an initial commitment of £500m;
- backing new and emerging VC fund managers through the Enterprise Capital Fund programme, unlocking at least £1.5bn of new investment; and
- increasing its total direct R&D spending to £12.3bn per annum by 2021-22.

Clearly, an important part of the UK innovation policy mix is significant investment into equity co-investment programs. Accordingly, serious consideration should be given to such programs as an untapped opportunity for setting innovation policy. While they may involve some budgetary cost in the short-term, they must be viewed as an important, long-term investment in Australia's future.

Some of the suggested design features of a National Innovation Fund should include a minimum Government commitment of $500m over two years (with returns reinvested), matching capital commitments from private investors and the Government, and a competitive bid process whereby fund managers seek to obtain a license to manage capital (a Fund undertaking individual company investments would be costly to administer, pose due diligence challenges and would be inconsistent with the diversified portfolio approach of venture capital funds).

In our view, the Fund should ensure that it allocates significant capital to those sectors that do not currently attract sufficient VC investment, such as agritech, advanced manufacturing and defence. In doing so, the Fund could act as a catalyst for rapid growth in these sectors, bringing with it significant, high-skilled job opportunities.

3.4 Other innovation policy measures

A range of other innovation policy settings should be noted and considered by the Inquiry. This includes opening up the Accelerating Commercialisation program to VC-backed companies, which are currently precluded from accessing the expert advice and matched government funding that this program provides.

Another recommendation would be to extend the Early Stage Innovation Company (ESIC) tax incentives to allow corporate holding companies or other structures to invest in ESICs, which would allow angle investors to invest in a portfolio of early stage startups in order to foster greater innovation investment activity.

We would be happy to provide further details on these recommendations as requested.

4. Role of taxation policy

It is critical to Australia's economic future that Australian SMEs that are 'scaling-up' by investing in their productive capacity, investing in human capital by hiring more staff and up-skilling their workforce, or investing in innovation receive the capital they need to expand and compete globally. It is these 'scale-ups' that can be the catalyst for the next wave of national economic growth. In order to achieve this goal, important tax reforms will be necessary.

While there is no question that the funding of government expenditure through taxation is an essential aspect of the economic system, onerous tax policy can have a detrimental effect on the ability and willingness of businesses to invest in growth and is likely to produce a limited one-off gain at the expense of a larger and more sustainable future tax take for government.

A number of tax policy reforms that would be transformative for local SMEs and for the level of business investment that can be generated by this dynamic part of the economy are further discussed below.

In particular, the introduction of a world best practice limited partnership collective investment vehicle would assist the flow of capital from PE and VC into these businesses. This would enable VC and PE fund managers to invest significantly more into Australian businesses, leading to the flow-on effects of increased employment opportunities, revenue growth and economic output. As independent research has shown (see below Section 5. *About AVCAL and Australia's private equity and venture capital industry*), PE and VC are significant drivers of employment growth.

4.1 Limited partnership collective investment vehicles

AVCAL has identified the proposed new limited partnership collective investment vehicle (LP CIV) regime as an area of policy focus for our industry relevant to both PE and VC fund managers, as well as the institutional investors into those funds, such as superannuation and pension funds. A globally competitive LP CIV would have a significant and profound impact on the capacity of our industry to invest billions of dollars into great Australian businesses (spanning all corners of the economy, and at all stages of development – small, medium and large scale) to help them realise their growth and expansion plans and create new employment for the future.

Set out below are some of the key recommendations that we believe should be considered in putting in place the framework for the development of the new LP CIV regime. Taking into account these issues will help to ensure that the new regime represents an attractive investment destination, and that the challenges associated with aspects of the existing common structures used in the funds management industry – which can be overly complex and often deter international investors – are addressed. This is particularly important for Australian PE funds investing into SME market Australian businesses, who have generally been dependent on sourcing around two-thirds of new commitments from offshore investors over the last five years.

<u>Key recommendations for the new LP CIV regime</u>:

- Flow-through tax treatment and consistent tax treatment of PE and VC gains
- There should be no prohibition relating to "control" of a trading company in order to retain tax transparent status

Adopting the above design features would be consistent with the recommendation of the Johnson Report (*Australia as a Financial Services Centre*) and it would ensure that foreign investors in Australian-managed PE funds are, for tax purposes, treated the same as if the investments were made directly by the non-resident without the use of any Australian intermediary. It would also support broader policy objectives of helping to boost the flow of capital into high-growth Australian businesses that leads directly to the creation of new employment opportunities for our nation. We understand that a globally competitive LP CIV regime would also be an attractive investment vehicle to promote new capital flowing into other unlisted asset classes within the Australian economy, such as infrastructure.

4.2 ESVCLP and VCLP reforms

The changes to early stage venture capital limited partnerships (ESVCLPs) and venture capital limited partnerships (VCLPs) which were made effective 1 July 2016 were supported by the PE and VC industry. However, given the speed with which they were introduced, there remain a number of areas where amendments and/or clarifications are necessary for these limited partnership vehicles to be attractive to investors.

In addition, there are a set of complementary reforms, outlined below, which would further enhance the regime and deliver on the policy objective of increasing funding of promising, early stage Australian companies. AVCAL supported a number of innovation technical amendments which were publicly consulted on by the Government in November 2017, but which were unable to be progressed through Parliament prior to the close of the year.

In addition to those innovation technical amendments which failed to be introduced in 2017 (some of which are dealt with in the *Treasury Laws Amendment (2018 Measures No. 2) Bill 2018* currently before parliament), we believe that the below measures should be pursued as a matter of priority. Some key suggested areas for reform include:

1. Clarifying the tax treatment of ESVCLP gains above the $250m threshold – currently, there is ambiguity regarding whether such gains should be on capital or rather revenue account where an ESVCLP has a gain subject to tax (i.e. where the sum of an eligible investment's asset values exceeds $250 million, any appreciation in value from six months after that point in time will be a taxable gain).;

2. Calculation of 20% concession for offshore investments – the law should clarify that the 20% offshore investment rule should apply at all times to the *original* committed capital amount rather than the evolving, changeable value of the fund over the course of its life-time, which makes it difficult for ESVCLP fund managers to assess and make offshore investments.

3. Equal tax treatment of all domestic investors in VCLPs – currently, domestic super funds and most foreign investors clearly attract deemed capital account treatment for gains or profits made by a VCLP on the disposal of eligible investments. This should be clarified via legislation to extend to all other investors in VCLPs also (primarily domestic investors including high net wealth individuals, corporates, family offices and endowment funds) so as to reduce the complexity of investment structures, attract new investors into the sector, and provide certainty to the market.

4. Allowing corporates to access the ESVCLP program – currently, no investor may contribute more than 30% of the partnership's committed capital unless Innovation & Science Australia's Innovation Committee approves otherwise. There is an exemption from this requirement for banks, life insurance companies and widely-held complying superannuation funds, but this should be extended to other large, listed Australian corporates, which come from a diverse range of sectors and are currently considering creating their own corporate venture capital arms as a means of driving innovation and gaining strategic insights from the early stage sector. This would encourage corporate Australia to play a greater role in early stage investing.

4.3 Thin capitalisation rules

The thin capitalisation regime aims to limit the capacity of multinational firms to move profits out of Australia by assigning an excessive amount of debt to their Australian operations. Australian subsidiaries can apply one of a number of thresholds under the rules, including the ‘safe harbour’ limit, the ‘arm’s length’ debt limit and a worldwide gearing ratio limit. Different safe harbour limits apply to ‘general entities’, non-bank financial entities and banks.

Specifically, the Board of Taxation carefully considered a number of submissions as part of its review of the arm’s length debt test, with its final report provided to the Government in December 2014 (publicly released in June 2015). To date, no Government response has been issued despite stakeholders and industry generally welcoming the recommended changes.

AVCAL has put forward the case to the Board of Taxation and Treasury to reduce the compliance cost and improve tax certainty associated with the existing arm's length debt test. Reforms in this area would go a long way to lifting Australia’s relative competitive position against other jurisdictions in this key area of the tax system.

Accordingly, in the interests of business certainty, we encourage the Government to clarify its intention with respect to the recommendations made by the Board of Taxation as part of its review of the thin capitalisation arm’s length debt test. AVCAL would support reforms aimed at reducing compliance costs and increasing certainty for business.

Further, AVCAL does not see a compelling case for further changes to be made to the thin capitalisation safe harbour limits. The changes implemented in recent years with regard to tightening the safe harbour rules effectively amounted to the introduction of retrospective tax laws, because they did not provide any transitional relief for existing debt arrangements that were the subject of multi-year agreements entered into between parties acting on a commercial basis.

The changes to the debt deduction rules resulted in taxpayers that had entered into binding agreements not being entitled to claim deductions for costs that, under the rules which were in place at the time of investment, they were able to. This change was contrary to a long-standing principle of tax policy making in Australia that appropriate transitional arrangements are implemented as part of the introduction of any tax changes that diminish the position of taxpayers. These changes directly impact the rate of return of existing Australian investments by PE funds and compromise Australia’s international standing as a stable and predictable investment location, to the detriment of Australian businesses that need more capital inflows to thrive and expand.

4.4 Widening of the definition of significant global entities

As part of the 2018-19 Federal Budget, the Government announced that it will be widening the definition of ‘significant global entity’ (SGE) in relation to Australia’s multinational tax integrity rules. The SGE definition identifies entities which are required to prepare Country-by-Country reports and is used to determine entities which may be subject to Australia’s multinational tax integrity rules, such as the Multinational Anti-Avoidance Law and the Diverted Profits Tax.

Currently, the definition applies only to an entity which is a member of a group headed by a public company or a private company required to provide consolidated financial statements. The definition will be broadened to include members of large multinational groups headed by private companies, trusts and partnerships (which may include offshore PE funds). It will also include members of groups headed by investment entities. The measure is set to apply to income years commencing on or after 1 July 2018.

This announcement has raised some concern within the PE industry as to whether global PE funds and offshore pension funds would be included in this widened definition, potentially affecting both global PE firms that typically look to invest sizeable amounts of capital into Australian businesses, and overseas pension funds that invest into Australia-based PE and VC funds. We await further details on this new announcement.

5. About AVCAL and Australia's private equity and venture capital industry

AVCAL represents PE and VC industry in Australia, which has a combined total of around $30 billion in funds under management on behalf of domestic and overseas investors including Australian and offshore superannuation and pension funds, sovereign wealth funds, and family offices. VC and PE firms invest billions of dollars in early stage and established businesses spanning across almost every sector of our national economy. In the financial year ending 30 June 2017 alone, PE and VC invested around $3.6 billion into Australian businesses.

An April 2018 study by Deloitte Access Economics provides some deeper insights into the economic contribution of PE including:

- In FY2016, private-equity backed businesses contributed $43 billion in total value added to the Australian economy – equal to 2.6% of Australian GDP;
- PE-backed businesses supported 327,000 FTE jobs (172,000 directly, and 155,000 indirectly);
- In FY2016, private equity-backed businesses added almost 20,000 FTE jobs, accounting for 11% of total Australian employment growth in FY2016;
- PE-backed businesses typically delivered annual revenue growth of 20%, while boosting the size of their workforce by 24%;
- More than 85% of private-equity businesses introduced some type of process or product innovation in FY2016, far greater than the average profile of non-PE backed businesses.

6. Next steps

We would like to thank you for the opportunity to provide a submission in relation to the Inquiry.

Yours sincerely,

Yasser El-Ansary
Chief Executive
AVCAL