The Senate

Economics Legislation Committee

Tax Laws Amendment (2004 Measures No. 3) Bill 2004

June 2004

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CHAPTER 1

INTRODUCTION

Background

1.1 The Tax Laws Amendment (2004 Measures No. 3) Bill 2004 was introduced into the House of Representatives on 27 May 2004 by the Hon Ross Cameron MP, Parliamentary Secretary to the Treasurer. It was passed by the House of Representatives on 3 June 2004, and was introduced into the Senate on 15 June 2004.

Purpose of the Bill

1.2 The bill is an omnibus bill, introducing a range of measures to amend various pieces of taxation legislation. It contains three schedules of amendments, only one of which (schedule 1) is considered in this report.

Reference of the Bill

1.3 On 16 June 2004, the Senate adopted the Selection of Bills Committee Report No. 8 of 2004 and referred the provisions of the bill to the Senate Economics Legislation Committee for consideration and report.

1.4 While the Senate referred the bill as a whole to the Committee, the Selection of Bills Committee Report makes it clear that not all of the measures in the bill required consideration by the Economics Legislation Committee. The Selection of Bills Committee Report stated that the Economics Legislation Committee was to:

> [provide] adequate consideration of the proposed changes to the venture capital regime.[1]

Purpose of Schedule 1

1.5 Schedule 1 relates to the tax concessions extended to venture capital investments. In his second reading speech, the Parliamentary Secretary to the Treasurer described the effect of schedule 1 as follows:

> The venture capital regime was introduced to encourage new foreign investment into the Australian venture capital market and to further develop the venture capital industry. It provides a tax exemption to eligible nonresident investors on the gains made on eligible equity investments.
>
> The amendments expand the range of venture capital investments that will qualify for the tax concession and remove minor impediments to ensure that the regime operates as intended. The tax concession will now be available for eligible investments that have been made in a holding company of a

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1 Selection of Bills Committee Report No. 8 of 2004.

> corporate group. Companies being spun-off from a corporate group or institution may also be eligible as they will be treated independently in determining eligibility for the concession.[2]

Submissions

1.6 The Committee advertised its inquiry into the Tax Laws Amendment (2004 Measures No. 3) Bill 2004 on the internet. In addition the Committee contacted a number of organisations, alerting them to the inquiry and inviting them to make a submission. A list of submissions appears at **Appendix 1**.

Hearings and Evidence

1.7 The Committee held one public hearing at Parliament House, Canberra, on 18 June 2004. Witnesses who appeared before the Committee at that hearing are listed in **Appendix 2**.

1.8 Copies of the Hansard transcript are tabled for the information of the Senate. They are also available through the internet at http://www.aph.gov.au/hansard.

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2 House of Representatives, Hansard, Mr Ross Cameron MP, 27 May 2004, p. 29138.

CHAPTER 2

SCHEDULE 1 OF THE BILL

Venture Capital

2.1 Venture capital is a means by which innovative, start-up companies can acquire the necessary financial backing to commercialise new technologies. As such, the maintenance of a healthy environment for venture capital is an important element of the national innovation system. Bivell outlines the purpose and characteristics of venture capital as follows:

> A venture capital investment is an equity investment in a private company. Venture capitalists invest for the medium to long term, generally between three and seven years. They look for capable, committed and honest management, and a business with a strong position in its market, competitive advantages, and good prospects for growth.
>
> A typical venture capital investment will be in the order of $0.5 million to $20 million and is for a minority or significant minority equity position. Some firms will invest outside these parameters or form a syndicate for larger deals.
>
> […]
>
> Venture capitalists invest for capital gain. However, a venture capital investment can have a higher level of risk for the investor than other forms of investment, for example, because it is in a private company, may have little or no security and limited liquidity. To compensate for this higher risk, venture capitalists seek to make a higher rate of return than what is offered by more secure types of investments.[1]

2.2 Like other forms of capital, venture capital is mobile. Consequently, Australian innovators and entrepreneurs compete for investment support against those in other economies. Australia's regulatory environment, and in particular its taxation system, have a substantial impact on the profitability of venture capital investments in Australia and, therefore, on access to capital for Australian entrepreneurs.

Recent policy relating to venture capital in Australia

2.3 The need for Australian entrepreneurs to have access to venture capital has been recognised in a series of industry statements in recent years. The 1997 statement *More Time for Business* introduced the Innovation Investment Fund (IIF), a program under which the Government has acted as a significant venture capitalist, providing funding to innovative start-up companies.

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1 Bivell, V (2004) *Australian Venture Capital Guide*, 11th ed, Private Equity Media, Sydney, p. 14.

2.4 The *Investing for Growth* statement, later in 1997, expanded the IIF, and identified various 'key elements of an effective innovation system' including 'an internationally competitive financial and venture capital market attuned to the needs of developing high technology firms.'[2] The Investing for Growth statement identified the following challenge for policy:

> Effective commercialisation of discoveries is essential if the competitiveness of Australian firms is to improve. Commercialisation efforts are often hindered by limited access to venture capital and inadequate collaboration between research institutions and business.[3]

2.5 In February 2000, the Government convened an Innovation Summit involving government and business representatives, which identified the availability of venture capital as one impediment to Australia's innovation system. The final report of the Innovation Summit Implementation Group, *Innovation: Unlocking the Future*, stated:

> Whilst Australia's venture capital market is immature, it has grown quickly in recent years and continues to do so. However, the amount we invest in the early stage of our venture capital market is small compared to international levels.
>
> Investment of the early stages of the venture capital market in the United States is 100 times that in Australia. Furthermore, the number of deals is greater and the deal size is, on average, ten times larger than in Australia. Without access to early stage finance, businesses have little hope of developing an initial concept, developing prototypes or forming management teams to drive innovation forward.[4]

2.6 The July 1999 report *A Tax System Redesigned* (the 'Ralph Report') proposed a capital gains tax exemption for venture capital projects where the receiving entity had gross assets of less than $50 million. The report stated:

> The Review accepts the argument that to stimulate venture capital funding from both domestic and non-resident sources it is necessary to make the [Capital Gains Tax] regime more competitive. The Review also accepts the argument that capital from international investors would not only have a direct effect but would be a catalyst for the development of the domestic venture capital market if the presence of experienced foreign investors spills over into enhanced local capacity for assessing and undertaking high risk assessments.[5]

2.7 The Treasurer responded to the Ralph Report recommendation by committing the government to:

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2 *Investing for Growth* (1997) p. 28.

3 *Investing for Growth* (1997) p. 34.

4 *Innovation: Unlocking the Future* (2000) p. 22.

5 *A Tax System Redesigned* (1999) pp. 611-612.

> promoting venture capital investments in Australia by exempting capital gains earned through Pooled Development Funds by Australian superannuation funds, and exempting from capital gains tax investments in venture capital projects in Australia by non-resident tax exempt pension funds, such as US and UK pension funds.[6]

2.8 The 2001 statement *Backing Australia's Ability* identified taxation as a major factor affecting the ability of Australian entrepreneurs to obtain access to venture capital. One initiative under *Backing Australia's Ability* was:

> To ensure that recent changes to the tax system will encourage venture capital investment, the Government will actively monitor the impacts of the new business tax arrangements, in particular entity taxation, on domestic and overseas investment in Australian venture capital.[7]

2.9 The 2003/04 update on the progress of *Backing Australia's Ability* made the following statement:

> One of the key factors limiting the successful commercialisation of research outcomes is the availability of early stage investment capital. While growing, the Australian venture capital market is relatively small, especially in the pre-seed stage and early stage, when funding is difficult to acquire.[8]

2.10 Latest available figures from the Australian Bureau of Statistics suggest that growth in the Australian Venture Capital Market has in fact slowed:

> The results of the third Venture Capital survey show that growth evident in 2000-01 and 2001-02 slowed during 2002-03. As at 30 June 2003, investors had $7.5b committed to venture capital investment vehicles which were either specialised venture capital funds or corporations which directly invest their venture capital. This compares with a revised $6.9b at 30 June 2002.[9]

The *Venture Capital Act 2002*

2.11 The *Venture Capital Act 2002* built on the Ralph Review taxation reforms. It extended capital gains tax exemptions for non-resident venture capital investors who fall into the following categories:

- all tax exempt non-residents from Canada, France, Germany, Japan, the United Kingdom or the United States of America;

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6 Media release, *The New Business Tax System*, the Hon Peter Costello, MP, Treasurer, 21 September 1999.

7 *Backing Australia's Ability* (2001) p. 19.

8 *Backing Australia's Ability – The Australian Government's Innovation Report 2003-04*, p. 66.

9 ABS (2003) *Venture Capital Australia*, December 2003, cat. 5678.0, p. 3.

- non-resident venture capital funds of funds established and managed in Canada, France, Germany, Japan, the United Kingdom or the United States of America; and
- taxable non-residents, which are resident in Canada, Finland, France, Germany, Italy, Japan, the Netherlands, New Zealand, Norway, Sweden, Taiwan, the United Kingdom or the United States of America, holding less than 10% of the equity in a venture capital limited partnership.[10]

2.12 The *Venture Capital Act 2002* also provided for the registration of three specific types of partnership, the Venture Capital Limited Partnership (VCLP), the Australian Venture Capital Fund of Funds (AFOF), and the Venture Capital Management Partnership (VCMP). These partnerships are the preferred vehicle for international venture capital investments.

2.13 Prior to the passage of the *Venture Capital Act 2002*, these forms of corporate limited partnership would have been taxed as though they were companies. Following this legislation, VCLPs, AFOFs and VCMPs were taxed as normal partnerships (thus providing 'flow-through' taxation, where the partner is the entity taxed, rather than the partnership). Introducing the Taxation Laws Amendment (Venture Capital) Bill 2002, which was packaged with the Venture Capital Bill 2002, the Parliamentary Secretary to the Minister for Finance and Administration stated:

> The measures recognise that venture capital limited partnerships with flowthrough 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.[11]

2.14 The current bill makes a number of largely technical amendments to the *Venture Capital Act 2002*, the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*.

Provisions of the current bill

Venture capital investment in holding companies

2.15 Section 118-425 of the *Income Tax Assessment Act 1997* sets out the meaning of an eligible venture capital investment, for tax concession purposes. Currently, the provisions of that section prevent investments in a holding company from being regarded as eligible venture capital investments, even when the investment in the holding company is made specifically for reinvestment in an eligible venture capital investment.

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10 Explanatory Memorandum, Venture Capital Bill 2002, Taxation Laws Amendment (Venture Capital) Bill 2002, p. 3.

11 House of Representatives, *Hansard*, Mr Peter Slipper MP, 14 November 2002, p. 9021.

2.16 Subsection 118-425 (3) (e) currently states that, in order to be an eligible venture capital investment, the investee company must not have as its primary activity:

> (e) making investments, whether made directly or indirectly, that are directed to deriving income in the nature of interest, rents, dividends, royalties or lease payments.

2.17 Consequently, investment in a holding company which makes a venture capital investment (with the intention of deriving income in the form of dividends) would not be an eligible venture capital investment.

2.18 In addition, subsection 118-425(4) provides that if a company is the recipient of an eligible venture capital investment, the company may not invest in another entity unless the investee is a connected entity[12] which also meets the other requirements of the section.[13] Consequently, even if investments in a holding company were held (for the purposes of subsection 118-425(3)(e)) to be eligible, the holding company would be unable to invest in unconnected entities.

2.19 The Revenue Minister has, however, noted that 'holding companies are a popular investment structure used in the venture capital industry.'[14] The current bill seeks to amend the *Income Tax Assessment Act 1997* to permit investment in holding companies, under certain circumstances, to be eligible venture capital investments.

2.20 Mr Mark Goldsmith, Legal Adviser to the Australian Venture Capital Association, stated in evidence:

> It is common practice in the venture capital industry, when making an investment, to essentially set up a special purpose company to acquire the venture capital company. Predominantly that is … to achieve a combination of debt and equity funding. You can't achieve the debt and equity funding, really, without putting in a special purpose company.[15]

2.21 Schedule 1, Part 1, Item 11 of the current bill addresses this issue by inserting a new subsection, 118-425(11), setting out an alternative path under which an investment may be deemed to satisfy the requirements of subsections 118-425(3) and (4). Under the proposed section, an investment in a newly created holding company will be an eligible venture capital investment if:

- the investor is a VCLP, an AFOF or an eligible venture capital investor registered under the *Venture Capital Act 2002*;

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12 s. 118-425(4)(a)(i).

13 s. 118-425(4)(a)(ii).

14 Media Release, *Venture Capital Regime Now Complete*, Senator the Hon Helen Coonan, Minister for Revenue and Assistant Treasurer, 6 May 2004.

15 *Evidence*, Goldsmith, 18 June 2004.

- the holding company was formed specifically as a vehicle for reinvestment; and

- within 6 months, the holding company uses the money from the eligible investment to make an eligible venture capital investment in another company, which meets the requirements of subsections 118-425(2) through 118-425(7).

2.22 Essentially, the section allows investment in a holding company, so long as the money invested is used to make an eligible venture capital investment within 6 months.

2.23 If the holding company is part of an existing group, an investment into that holding company may still be an eligible venture capital investment, but only if the group as a whole meets the eligibility requirements set out in the proposed new subsection (3), which appears in Schedule 1, Part 1, Item 7 of the current bill. Essentially, this means that at least 75% of the group's activities, employees, and income must relate to a course of activities which are not exempt activities such as property development, finance, insurance, construction and investment. This requirement is given effect by proposed subsection (12), which appears in Schedule 1, Part 1, Item 11 of the current bill.

2.24 Comprehending the effect of these provisions is made slightly more complicated by the fact that the ineligible activities described in the paragraph immediately above, which are currently in subsection 118-425(3), will be moved in the current bill to become subsection 118-425(13). The scope of the ineligible activities has not changed.

Investments acquiring spin-off companies

2.25 One customary strategy for companies seeking to commercialise innovative research and development is to create a new company specifically intended to undertake that commercialisation, and to spin that company off from the parent entity, using the sale of equity in the spin-off company to generate revenue to support the commercialisation process. In its current form, the *Income Tax Assessment Act 1997* allows for eligible venture capital investments which purchase spin-off companies, but only where the value of the spin-off company *and its parent company* do not exceed $250 million, immediately before the investment.

2.26 This means, for instance, that if a corporation worth $3 billion establishes a spin-off company to commercialise a new technology, and the spin-off company is worth $40 million, investment to acquire the spin-off company would be ineligible for concessional tax treatment. If, however, that $40 million company was spun off from a parent company worth $240 million, then investment in the spin-off company could be an eligible venture capital investment.

2.27 The current bill proposes to amend the *Income Tax Assessment Act 1997* so that the value of the spin-off company, not the value of its parent company, is the basis for assessing eligibility. This will be the case so long as, after the investment, there is no connection between the parent company and the spin-off company. Schedule 1, Part 1, Item 13 of the bill proposes to insert a number of additional subsections into s. 118-440 of the Act. Proposed subsection (4) gives immediate effect to this proposal:

> (4) In applying paragraphs (1)(b), (5)(b) and (7)(c), ignore the total value of the assets of an entity that, immediately after the investment is made, is not connected with the target entity.

2.28 During the Committee's hearing into this legislation, officials from the Department of the Treasury clarified that this amendment does not introduce a new policy. Rather, it corrects an oversight in the original drafting, and restores the legislation to reflect the Government's original policy intentions:

> I think our view was that this change basically is consistent with what was originally intended by the original provisions.[16]

2.29 In addition, Schedule 1, Part 1, Item 13 of the current bill contains provisions to prevent abuse of the provisions outlined above. For instance, they will prevent investors from making a series of incremental investments, each less than $250 million, to acquire a group (or parts of a group) piecemeal, in order to unfairly claim concessional tax treatment.

Other measures

2.30 The bill contains a range of other amendments which the Committee considers to be relatively technical and uncontroversial in nature:

- a range of definitional changes about what forms of relationship will result in two entities being considered 'connected entities' for the purpose of the bill;
- changes to the date at which the eligibility test is applied, where shares are acquired on the conversion of convertible notes;
- the notional place of residence of a venture capital management partnership will now be the place of its central management and control;
- interest derived by non-resident partners in VCLPs or AFOFs will be subject to withholding tax, not tax at marginal rates on net income;
- investee companies which move offshore will be able to have as their auditor a person appropriately registered in their country of residence; and
- the Tax Commissioner will be able to disclose information to the Pooled Development Fund Board in order to assist the board to administer venture capital laws.

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16 *Evidence*, Mullins, 18 June 2004.

Committee view

2.31 The Committee has considered the contents of the bill in detail. While this inquiry was conducted over a very short period of time, it is nevertheless the case that the Committee received no evidence opposed to the bill. The Committee therefore considers that this bill should proceed.

Recommendation 1

The Committee recommends that the Senate pass this bill.

SENATOR GEORGE BRANDIS
Chair

Appendix 1

ADDITIONAL INFORMATION RECEIVED

Additional information received from Australian Venture Capital Association Ltd (AVCAL)

Appendix 2

PUBLIC HEARING AND WITNESSES

FRIDAY, 18 JUNE 2004 - CANBERRA

GOLDSMITH, Mr Mark, Legal Adviser
Australian Venture Capital Association Ltd

GREEN, Mr Andrew, Chief Executive
Australian Venture Capital Association Ltd

McCARTHY, Ms Anne Patricia, Senior Adviser, Business Income Division
Department of the Treasury

MULLINS, Mr Peter Joseph, General Manager, Business Income Division
Department of the Treasury

O'MEAGHER, Mr Bruce, General Manager, Industry Policy
Department of Industry, Tourism and Resources