Australian Government

The Board of Taxation

REVIEW OF TAXATION ARRANGEMENTS UNDER THE VENTURE CAPITAL LIMITED PARTNERSHIP REGIME

A Report to the Assistant Treasurer

the board of taxation

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The Board of Taxation

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FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its review of the effectiveness of the special tax treatment accorded under the Venture Capital Limited Partnership regimes. This report forms part of the Board's review of tax arrangements applying to Collective Investment Vehicles which is due for reporting to the Government by 31 December 2011.

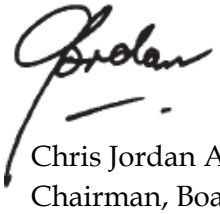
The Board has made a number of recommendations that seek to improve the operation of the Venture Capital Limited Partnership and Early Stage Venture Capital Limited Partnership regimes in accordance with their policy objectives of increasing investment in high-risk start-up and expanding businesses in the Australian venture capital sector.

The review of these two regimes has raised the question of the relationship between them and, in particular, issues concerning the original policy rationale of the earlier of the regimes, namely the Venture Capital Limited Partnership regime. The Board has made some observations on this, raising some issues on the matter for the consideration of the Government.

The Board established a Working Group, chaired by John Emerson AM, to conduct the review. The Board held discussions with a range of stakeholders, issued a discussion paper, and received 35 submissions, 15 of which provide input in relation to the Venture Capital Limited Partnership regime. The Board would like to thank all of those who so readily contributed information and time to assist in conducting the review.

The Board would also like to express its appreciation for the assistance provided to the Working Group by Andrew Mills, Karen Payne and Ken Woo as members of the Expert Panel and by officials from the Treasury, the Australian Taxation Office and the Department of Innovation, Industry, Science and Research.

The *ex officio* members of the Board — the Secretary to the Treasury, Martin Parkinson PSM, the Commissioner of Taxation, Mr Michael D'Ascenzo AO, and the First Parliamentary Counsel, Mr Peter Quiggin PSM — have reserved their final views on the recommendations in this report for advice to Government.



Chris Jordan AO
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John Emerson AM
Chairman of the Board's Working Group
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EXECUTIVE SUMMARY

In accordance with the terms of reference, the Board has reviewed the effectiveness of the special tax treatment accorded under the Venture Capital Limited Partnership (VCLP) regime and the Early Stage Venture Capital Limited Partnership (ESVCLP) regime (together referred to as 'the VCLP regimes') in a way that recognises their policy objectives.

The broad policy objectives of the VCLP regimes are:

- to attract increased investment (particularly foreign investment) into high-risk, start-up and expanding businesses in the Australian venture capital sector that would otherwise have difficulty in attracting investment through normal commercial means; and

- to develop Australia's venture capital industry by providing a vehicle of choice to pool venture capital investment and to develop skills and experience in venture capital management in Australia.

The VCLP regime was established in 2002 and the ESVCLP regime was introduced in 2007. The Board has found through its review process that the lifecycle of venture capital investment is typically seven to 15 years and that it is too early to adequately assess the overall effectiveness of the VCLP regimes. Many non-tax factors have impeded growth in the sector, such as the Global Financial Crisis (GFC), a risk averse investment climate and the fact that amendments to most State and Territory partnership legislation to accommodate the ESVCLP were only completed in 2009.

However, the Board considers that there are a number of changes that could be made to improve the effectiveness of the VCLP regimes.

VCLPs

Subject to a satisfactory revenue costing (that would result in revenue neutral or near revenue neutral outcomes), the Board recommends that:

- Deemed capital account treatment should apply to eligible domestic partners on gains or profits made by a VCLP on the disposal of eligible investments.

  – Eligible domestic partners should be defined in a way that is consistent with the definition of eligible foreign partners.

  - This reduces uncertainty in the tax treatment of domestic limited partners and it is likely to lead to greater investment in VCLPs. Domestic investors are an important source of capital for the development and growth of the Australian venture capital sector.

  - The Board acknowledges that the terms of reference require it to make recommendations that bring revenue neutral or near revenue neutral outcomes and notes that this recommendation may come at a significant cost to revenue.

- An Australian MIT should be able to invest as a limited partner in a VCLP and retain its MIT status.

- The restriction on investment levels for foreign venture capital fund of funds should be removed provided the fund is widely held.

  - The policy reason behind a foreign venture capital fund of funds being restricted to a 30 per cent interest in a VCLP is to ensure that the VCLP is prevented from being used as a wholly owned single purpose investment vehicle. The Board considers that this requirement is not necessary for widely held fund of funds.

Consistent with the terms of reference, these recommendations are based on improving the effectiveness of the VCLP regime in a way that recognises the broad policy objectives of the regime when it was introduced in 2002.

The Board has, at the same time, reflected on the design features of the VCLP regime including, in particular, the scope of this regime as originally implemented. The Board has not made recommendations on this but, as noted below, has made some observations on the ongoing appropriateness of the regime.

ESVCLPs

The Board considers that the ESVCLP regime broadly has the right design features to facilitate investment into venture capital and develop skilled venture capital managers. The more favourable tax treatment together with the lower permitted entity value ensures that the special tax treatment is targeted to investment that is focussed on the early stage high risk venture capital sector. The Board does not believe that there are any major design impediments in the ESVCLP regime but believes that some restrictions could be relaxed to make the vehicle more effective going forward.

- An investee entity should have greater flexibility to invest in other complementary ventures, provided the investee acquires a controlling stake in the venture and the venture is otherwise an eligible investment.

  - Under the current law, an investee entity is restricted from making investments in another entity unless it has an existing controlling stake in that other entity.

This rule is unnecessarily restrictive and should be removed, as long as the other entity meets the requirements of being an eligible venture capital investment.

- The holding company exception should be modified to allow an ESVCLP to invest in a holding company which has existing interests in multiple subsidiaries, as long as those subsidiaries satisfy the eligible venture capital investment requirements.

- The 20 per cent restriction on the level of expansion into foreign markets and direct foreign investments should be clarified and Innovation Australia should have discretion to allow ESVCLPs to exceed the cap on foreign investment provided the investment, in its view, is to likely to have material national benefit.

  – The Board understands that there is often a need for investee entities to expand offshore in order to commercialise Australian innovation. The Board considers that the introduction of discretion for Innovation Australia to allow foreign investment of an ESVCLP to exceed 20 per cent will provide greater flexibility for ESVCLPs to respond to these opportunities as they arise. The investment must, in the view of Innovation Australia, provide a material national benefit associated with commercialising Australian research and development (such as employment, royalties from intellectual property and sales).

- An Australian MIT should be able to invest as a limited partner in an ESVCLP and retain its MIT status. To this extent, an exception to Division 6C should be provided.

- Where a limited partner in an ESVCLP is a trust (that is not taxed as a corporate) the investors in that trust should not be prevented from accessing the special tax treatment accorded under the ESVCLP regime. That is, the exemption should not be clawed back through the operation of CGT event E4.

OTHER RECOMMENDATIONS

The Board is also recommending for both VCLPs and ESVCLPs:

- Innovation Australia should have the power to give binding advice in relation to the definition of ineligible activities.

  – Stakeholders have expressed concern as to the scope of what would be considered an ineligible activity, as defined in the law. The Board considers the current definition in the law for an ineligible activity is sufficient, but that Innovation Australia should be able to provide binding advice in relation to eligible investments.

Some issues raised by stakeholders appear to be the exception rather than the rule and therefore the Board considers they do not warrant potentially complex changes to the regimes. For VCLPs, this includes the holding company exception which may prevent

acquisitions of venture capital businesses using multiple-tier acquisition structures. The Board considers it unnecessary to introduce added complexity into the law to allow the special case of a multiple-tier acquisition structure. A change such as this would also increase the administrative costs associated with monitoring compliance.

OBSERVATIONS ON THE APPROPRIATENESS OF THE VCLP REGIME

After considering submissions, reviewing the nature of venture capital, having regard to the ESVCLP regime and looking at the various other mechanisms for promoting the venture capital sector (as normally understood), the Board considers that the design of the VCLP regime extends too far. In particular, it allows investments to be made into the later stage private equity sector and still access the special tax treatment accorded under the regime. The Board understands support for the later stage private equity sector goes beyond what is typically necessary to address the market gap in terms of the venture capital sector (as normally understood).

The Board suggests that the Government consider phasing out the VCLP regime (for example, by closing the VCLP regime to new registrations) and re-directing policy support to the earlier stages of venture capital activity.

CHAPTER 1: INTRODUCTION

BACKGROUND

1.1 The Venture Capital Limited Partnership (VCLP) regime was introduced under *Venture Capital Act 2002* and *Taxation Laws Amendment (Venture Capital) Act 2002*. The Early Stage Venture Capital Limited Partnership (ESVCLP) regime was introduced under *Tax Laws Amendment (2007 Measures No. 2) Act 2007*.

1.2 On 11 May 2010, the then Assistant Treasurer and the then Minister for Financial Services, Superannuation and Corporate Law announced that the Government would ask the Board to review the tax arrangements applying to Collective Investment Vehicles (CIVs). Under this review, the Board would:

- review the tax treatment of CIVs, having regard to the new Managed Investment Trust tax framework and including whether a broader range of tax flow-through vehicles should be permitted, consistent with the Government's objective of developing Australia as a leading financial centre; and
- as part of the CIV review:
  - examine the tax treatment of VCLP vehicles; and
  - consider the issues raised by the recommendation by the Australian Financial Centre Forum (AFCF) that an investment manager regime (IMR) be introduced into the tax law.

TERMS OF REFERENCE

1.3 On 12 July 2010 the then Assistant Treasurer announced the terms of reference for the review of the taxation arrangements applying to CIVs.

1.4 In relation to the VCLP component of the review, the Board was asked to examine the effectiveness of the special tax treatment accorded under the VCLP regime in a way that recognises its policy objectives.

1.5 The terms of reference also asked that the Board's recommendations should seek to enhance Australia's status as a leading regional financial centre and support growth

and employment in the Australian managed funds industry while maintaining the integrity of the tax system and revenue neutral or near revenue neutral outcomes.

1.6 The Board was initially asked to report to the Assistant Treasurer on its recommendations from its review of tax arrangements applying to CIVs by December 2011. The Board subsequently agreed to a request from the Assistant Treasurer to bring forward the reporting date of the VCLP component of the review to June 2011.

THE REVIEW TEAM

1.7 The Board appointed a Working Group of its members comprising John Emerson AM (Chair of the Working Group), Dick Warburton AO (until his retirement from the Board), Chris Jordan AO and Annabelle Chaplain to oversee the review. The Working Group was assisted by members of the Board's Secretariat, the Treasury, the Australian Taxation Office (ATO) and the Department of Innovation, Industry, Science and Research (DIISR).

1.8 The Board also received assistance from Andrew Mills, Karen Payne and Ken Woo as members of the Expert Panel.

REVIEW PROCESSES

1.9 The Board has consulted widely in developing the recommendations in this report. The Board's consultation processes involved:

- preliminary consultations with a range of stakeholders;
- the release of a discussion paper on the broader CIV review issues in December 2010 to invite and facilitate submissions;
- holding two public consultation meetings to provide information on the discussion paper and to seek feedback from participants; and
- holding targeted consultation meetings with a number of key stakeholders.

Submissions

1.10 The Board received 35 written submissions in response to the discussion paper, 15 of which provide input in relation to the VCLP regimes.

Board's report

1.11 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings, and the views of the above named members of the Expert Panel. However, the Board's recommendations reflect its independent judgment.

CHAPTER 2: BACKGROUND ON AUSTRALIA'S CURRENT VCLP AND ESVCLP REGIMES

THE VENTURE CAPITAL INDUSTRY

2.1 Venture capital is recognised as an essential element of Australia's innovation system, for the competitiveness of Australian businesses and the growth and vitality of the domestic economy. Support for venture capital through tax concessions was identified as an appropriate policy response in the *Review of Business Taxation: A Tax System Redesigned* in July 1999 (the Ralph Report). The Ralph Report broadly supported the introduction of tax measures that would increase Australia's international competitiveness. The Report stated that:

> In today's environment Australian businesses can only survive by being internationally competitive. Measures aimed at increasing international competitiveness, therefore, do not have to focus only on cross-border transactions, or even on import competing or exporting industries. Any tax measure which results in lower costs for Australian business, or the development of new products or new markets, contributes to improving our international competitiveness.

2.2 The Report recommended that targeted tax relief be provided (by a capital gains tax exemption) for venture capital investment:

> A major motivation for reform of the capital gains tax arrangements was the desire to increase the international competitiveness of Australian business and to encourage greater investment by Australians. The Review believes lower capital gains tax will improve the workings of Australian capital markets and encourage a greater level of investment and innovation. The constraint on lowering capital gains tax to maximise investment is that imposed by the need to maintain revenue neutrality. The measures recommended in this report are also designed to encourage greater investment in venture capital and so support new high growth businesses in Australia based on innovation and development of new markets.

2.3 The Organisation for the Economic Co-operation and Development (OECD) describes venture capital as a special type of equity finance for typically young, high-risk and other high technology firms. These mostly smaller enterprises need capital to fund start-up, product development or growth and must, by the nature of their business, obtain this capital largely in the form of equity. Heavy reliance on intangible assets, uncertain operating environments and negative cash flows makes it

unlikely that start-up firms can access bank loans or use other debt financing instruments.1

2.4 Internationally, tax relief may take the form of front-end relief in the form of tax credits or a reduced rate of tax, or back-end relief in the form of capital gains tax reductions or exemptions for qualifying investments. The OECD paper observes that capital gains tax relief rewards only winners or successful investments and may thus be less expensive to governments than front-end incentives. The relief may be targeted to investments in or by pooled venture capital funds or may be available for direct investment. The OECD paper stated that:

> In terms of design, more schemes are being geared to capital gains tax relief, which tends to encourage risk-taking rather than tax evasion.2

2.5 While a number of countries in addition to Australia operate venture capital type programs, a meaningful comparison between foreign programs and the Australian programs is problematic. In the main, each country has a number of different incentives for their respective venture capital markets including tax expenditure programs, grant programs and loan programs. The differences in the target objectives of these programs also means it is difficult to make a useful comparison.

2.6 Venture capital is sometimes seen as a subset of private equity. However, the venture capital sector (as normally understood) can be distinguished from the later stage private equity sector as follows:

- Venture capital is generally characterised by high-risk, start-up, early stage and early expansion businesses. Typically, venture capital businesses are small and have relatively little income in the initial stages. Consequently, it is usually difficult to obtain debt through normal commercial means; financing is typically by way of a form of equity finance.

- Later stage private equity can also involve expansion of an existing business, and there can be some overlap between venture capital and private equity. However, later stage private equity often involves the acquisition of stable and mature businesses with strong cash flows, accompanied by significant levels of debt.

2.7 Venture capital is defined by the Australian Bureau of Statistics (ABS) as high-risk private equity capital for typically new, innovative or fast growing unlisted companies. By contrast, later stage private equity (LSPE) is defined by the ABS as investment in companies in later stages of development, as well as investment in underperforming companies. Data on both sectors is provided in a consolidated form

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1 OECD, Directorate for Science, Technology and Industry 'Entrepreneurship and Growth: Tax Issues' (February 2002) pg 15.

2 OECD, Directorate for Science, Technology and Industry 'Entrepreneurship and Growth: Tax Issues' (February 2002) pg 19.

by the ABS in their Venture Capital and Later Stage Private Equity publication (Cat 5678.0). It is important to recognise that venture capital investment is also thought to include an investment of skills and management into the development of businesses in Australia.

2.8 As noted in the submission from Innovation Australia, simple variables that indicate the difference between the two investments are shown in the Table below.

Table 1: Differences between venture capital and later stage private equity

Variable	Venture Capital	LSPE
Risk	Very high	Lower
Type of capital (leverage)	Generally equity	Generally significant debt and equity
Investment timeframe	Long (for example 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

2.9 Before the introduction of the VCLP and ESVCLP programs, the pooled development fund (PDF) program was introduced to develop the market for patient equity capital, including venture capital, for small to medium-sized enterprises (SMEs). A PDF is a venture capital fund (a limited liability company that is registered as a PDF) that provides capital and management assistance to growing Australian SMEs. The initiative was launched in July 1992 in response to strong anecdotal evidence that capital markets were failing to adequately service the equity funding needs of growing Australian SMEs. That is, investment in venture capital tended to fund later stage, less risky enterprises. The main features of the regime are that the PDF is concessionally taxed on returns of SMEs' income and capital. The benefit of the special tax treatment can be passed on to investors by treating franked dividends as exempt or providing a full 30 per cent franking credit.[3] The average size of SMEs into which PDFs invest is $2.44 million.

2.10 The *Pooled Development Fund Act 1992* was amended in 2007 and registration is no longer available. Existing PDFs are unaffected and the PDF Act and relevant tax law provisions continue to operate. The intention is that PDFs would be progressively replaced by the ESVCLP program.[4]

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3 A PDF is subject to a range of restrictions: SME is a company with total assets of less than $50 million and its primary activity is not retail or property development. The PDF cannot invest in another PDF and must invest more than 30 per cent of the capital of the investee company.

4 Innovation Australia: *Activities of the Venture Capital Registration Board Annual Report* 2006-07.

2.11 There are a number of other programs directed at venture capital including the Innovation Investment Funds (IIF) program. The objectives of the IIF program are:

- to develop fund managers with experience in the early stage venture capital industry;
- to encourage the development of new companies which are commercialising research and development by addressing capital and management constraints;
- to establish in the medium term a 'revolving' or self-funding program; and
- to develop a self-sustaining Australian early stage venture capital industry.

2.12 IIF fund managers are licensed through a competitive merit assessment process undertaken by Innovation Australia. Funds that are licensed may structure themselves as an ESVCLP, VCLP or any other acceptable investment vehicle. Program restrictions apply to ensure that fund managers invest in early stage venture capital and that they have diversified investment portfolios. Appendix C provides further detail about the range of programs available to support innovation.

2.13 As further background on the VCLP regimes, Appendix D provides a summary of the legal structure and tax treatments for partners in the VCLP and the ESVCLP programs and Appendix E provides a list of registered VCLPs and ESVCLPs, with a brief indication of their main focus of activities. It could be seen from Appendix E that some VCLPs are more oriented to provide funding for mid-market buyouts and capital expansion.

POLICY OBJECTIVES OF THE VCLP AND ESVCLP REGIMES

2.14 The Venture Capital Limited Partnership (VCLP) regime was introduced under *Venture Capital Act 2002* and *Taxation Laws Amendment (Venture Capital) Act 2002*. As outlined below, the regime was designed to support investment into venture capital entities at the high-risk, start-up and early expansion stages that would otherwise have difficulty in attracting investment through normal commercial means. Support was provided by offering special tax treatment to eligible investors.

2.15 The VCLP regime was developed to fill a gap in the funding for entities commercialising innovative Australian research. The gap was identified particularly in the early stage venture capital space as opposed to the more mature later stage private equity space.

2.16 Australia's VCLP regime provides special taxation treatments for partners in certain limited partnerships which invest in entities in the Australian venture capital sector. A VCLP receives flow-through tax treatment. Eligible foreign investors in a VCLP are exempt from income tax on profits or gains derived from the sale of eligible

investments by the VCLP. Certain amounts received by general partners in a VCLP for their successful management of the partnership's investments (the carried interests) are taxed as capital gains.

2.17 The Board understands a number of restrictions are intended to ensure that eligible investments are made into high-risk, start-up or expansion stage entities in the Australian venture capital sector. A key restriction is that only entities under $250 million are eligible investments of VCLPs.

2.18 The objective of the VCLP regime was noted in the explanatory memorandum:

> 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. 5

2.19 The regime was broadly aimed to develop Australia's venture capital industry by providing a vehicle of choice to pool venture capital investment and to develop skills and experience in venture capital management in Australia. The limited partnership structure adopted by the VCLP regime is recognised internationally as the vehicle of choice for venture capital investment. Barkoczy and Sandler wrote in their 2006 report that:

> If Australia wants to attract foreign investment, it is important that it allows such investment to be made through vehicles that are both suitable and familiar to foreign investors. The use of flow-through vehicles should also produce a much 'cleaner' delivery of tax concessions than using the more complicated corporate structure, which is coupled with dividend and capital gains tax exemptions and is superimposed upon a complex imputation system.6

2.20 Increased investment in these entities is sought in order to leverage Australia's research and development capabilities, facilitating the development of Australia's venture capital industry and increasing Australian economic growth and job creation. In a second reading speech to the Taxation Laws Amendment (Venture Capital) Bill 2001, the then Senator Alston said that:

> The Australian venture capital market plays a significant role in providing patient equity capital to start-up and expanding companies. It also supports the rejuvenation of more mature companies through managed and leveraged buy-outs.

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5 Explanatory Memorandum, *Taxation Laws Amendment (Venture Capital) Act 2002.*

6 Barkoczy, S and Sandler, D Glover, J and Kowalski J, Venture Capital Tax Expenditure Programs, An International Comparative Analysis of Legal Structures and Benefits, A Report Prepared for the Department of industry Tourism and Resources Commonwealth of Australia Government Venture Capital Incentives: A Multi-Jurisdictional Comparative Analysis Australian Tax Research Foundation, Research Study No 46 (2007) 2006 page 191-74193-5.

> This market has experienced significant growth over the past decade, including through foreign investment. By unlocking the potential for more rapid growth of Australia's venture capital market the measures in this bill will assist in realising Australia's innovation potential which this Government has recognised as a key element to Australia's future prosperity.
>
> In recognition of this potential, this bill, together with the Venture Capital Bill 2002, contains measures to encourage additional foreign investment into the Australian venture capital market and to facilitate the development of the venture capital industry by encouraging leading international venture capital managers to locate in Australia.7

2.21 This statement suggests that the original design of the VCLP regime did not clearly distinguish between the features of venture capital (as normally understood), on the one hand, and those of later stage private equity, on the other. In particular, the speech can be taken as an indication that it was contemplated that the VCLP regime would extend beyond the venture capital sector to an element of the later stage private equity sector; this element was essentially defined by permitting investee entities to have a value of up to $250 million at the time of any VCLP investment. The Board's recommendations are made on the basis that this was contemplated, although in Chapter 6 the Board makes some observations about the current appropriateness of this original design.

2.22 One of the purposes of the VCLP regime is to provide a vehicle that pools funds specifically for venture capital investment. Further to this, Senator Lundy said on 12 December 2002 that:

> The main benefit of this bill is that it does create parity between Australia and comparable Western economies where venture capital is a crucial part of the capital food chain that provides sustenance to new start-up companies and to the growth prospects of companies that, for whatever reason, cannot get the capital they need through commercial banking and loans. ... That is the sort of capital they need to get them through those phases. We have the opportunity to strengthen our economy in the area of research and development and innovation, and venture capital is essential in allowing the initial commercialisation of good ideas to become commercial entities.

2.23 The Early Stage Venture Capital Limited Partnership (ESVCLP) regime was introduced under *Tax Laws Amendment (2007 Measures No. 2) Act 2007*. The ESVCLP regime was introduced to provide further support for new business ventures and the promotion of industry innovation.8 The ESVCLP targets investment towards entities under $50 million in recognition that the threshold for VCLPs was not directing investment into seed or high-risk start-up entities.

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7 Senate, 9 December 2002.

8 Senator Johnston, second reading speech, Taxation Laws Amendment (2007 Measures No. 2) Bill 2007, Senate, 9 May 2007.

2.24 The ESVCLP was designed to progressively replace the PDF program. An ESVCLP receives flow-through tax treatment. Both resident and foreign limited partners (investors) in an ESVCLP will be exempt from income tax on all income or gains from eligible venture capital investments made by the ESVCLP. General partners will also be exempt if they are residents of Australia or a double tax agreement country. The general partner of an ESVCLP has their carried interest taxed as a capital gain.

2.25 The 2005-06 *Pooled Development Funds Annual Report* stated that the ESVCLP program was expected to provide a welcome stimulus to the early stage venture capital industry in Australia by making the industry more attractive to both managers and investors. As mentioned above, the ESVCLP regime is a replacement for the PDF program, which commenced in 1992. The 2006-07Annual Report states that:

> Although the PDF program has served its original aims well, its policy objectives are likely to be better served in the future via the internationally accepted limited partnership model.

CHAPTER 3: VENTURE CAPITAL LIMITED PARTNERSHIPS

3.1 The Board has been asked to review the effectiveness of the tax treatment accorded under the VCLP regime in a way that recognises its policy objectives. As noted in Chapter 2, it appears that the main policy objectives of the VCLP regime are:

- to attract increased investment (particularly foreign investment) into entities in the Australian venture capital sector which are at the high-risk, start-up and expansion stages that would otherwise have difficulty in attracting investment through normal commercial means; and
- to develop Australia's venture capital industry by providing a vehicle of choice to pool venture capital investment and to develop skills and experience in venture capital management in Australia.

CURRENT LEVELS OF INVESTMENT

3.2 Since its introduction in 2002, the VCLP regime has seen the registration of 41 VCLPs with a further five being conditionally registered.[9] At 31 December 2010 VCLPs had total committed capital of $4.2 billion,[10] of which $1.6 billion has been invested in eligible venture capital investments. During 2009-10,[11] VCLPs reported making 113 deals, with $141 million invested into 59 businesses (12 initial investments and 101 follow-on investments which provide further capital to existing investments). The primary source of capital continues to be domestic institutional investors, with around 10 per cent coming from foreign investors.

Views in submissions

3.3 The majority of submissions expressed the view that the Australian venture capital industry is under-capitalised, and that levels of investment in VCLPs are very low. These submissions state that changes could be made to a number of VCLP

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9 Data is as at June 2011. Conditionally registered VCLPs have 24 months from date of conditional registration to raise investment funds; otherwise their VCLP registration automatically lapses.

10 This is a headline figure as most VCLPs have a unit trust attached into which committed capital can be invested. This enables fund managers to acquire otherwise attractive investments that are deemed ineligible for a VCLP.

11 It is important to note that this period may have been affected by the Global Financial Crisis and may not be representative.

restrictions and to the nature of the special tax treatment offered in order to increase the levels of investment into the regime.

3.4 Mallesons Stephen Jaques (Mallesons) and CPA Australia express the opinion that it may be too early to assess the effectiveness of the VCLP regime based on the levels of investment, but it may still be appropriate for the Board to review the nature of the restrictions under the regimes. Mallesons state that:

> ... it may be premature to pinpoint a direct correlation between the shortage of early-stage venture capital funds in Australia and the restrictions placed on the VCLP and ESVCLP regimes. The global financial crisis and the relatively small size of the venture capital industry in Australia are also contributing factors limiting the investment from non-resident investors. We submit that it may also be too early to implement large scale changes to both regimes and that any structural changes proposed need to be considered carefully.

3.5 Similarly, commenting on the levels of VCLP investment, the Law Council of Australia states:

> It is important to remember that 'venture capital' is only a very small portion of the managed funds sector, and it is distinct from private equity investment. While numbers quoted as to the number of active VCLPs and amount of capital under management appear small, the number of VCLPs and capital managed under VCLPs has in fact increased three-fold since 2005, in spite of the intervening global financial crisis. This suggests that, in spite of their various limitations, VCLPs are performing a useful function for some kinds of investment. It is important to be realistic about how much venture capital investment we can expect from non-resident investors.

3.6 A number of submissions received by the Board submit that the tax treatments offered under the VCLP regime are no longer attractive to investors due to the development of other areas of the law, in particular, the non-resident CGT rules, the introduction of the Managed Investment Trust (MIT) capital account election and the planned introduction of the MIT regime. Innovation Australia also agrees with other stakeholders that uncertainty in the tax treatment for certain investors may be deterring investment into the VCLP regime. It states that:

> 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 ... [T]he ability of VCLPs to attract foreign investors will be hampered if domestic investors are seen to be using alternative investment vehicles.

3.7 A number of stakeholders state that the present capital/revenue uncertainty is the issue of greatest concern in the VCLP regime. To address this issue, stakeholders submit that a deemed capital account treatment should be provided to domestic limited partners in a VCLP.

3.8 Australian Private Equity & Venture Capital Association (AVCAL) submit that a deemed capital account treatment should be introduced for investors to provide tax certainty:

> ... there are proportionately more sophisticated investors in the domestic market for example, superannuation funds, MITs, high net worth individuals and general partners. ... making the VCLP an attractive investment vehicle to these investors by providing certainty in respect of their investments would encourage investment and promote the policy objectives of expanding Australian businesses to ultimately facilitate economic growth and job creation.
>
> The plight of the VC industry in Australia has been well [documented] in recent times. Any changes that might increase the attraction of investing in venture capital through VCLPs has the potential to improve the level of capital available to early stage and expanding companies in Australia.

3.9 Innovation Australia also recommend that domestic general partners are provided with deemed capital account treatment:

> 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 ...
>
> ... 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.

Board's consideration

3.10 A policy objective of the VCLP regime is to facilitate increased investment into early-stage and expansion-stage venture capital businesses in Australia and correct for the failure in the market to provide capital to such businesses. A significant aspect of venture capital is the commercialisation of Australian research and development. The Productivity Commission Report *Public Support for Science and Innovation* (2007) found that there is a perception that the venture capital market in Australia is still emerging and is under-developed, with relatively few investment managers with a proven track record. This is in contrast to the later stage private equity sector which is more mature, has managers with proven track records and is receiving significant investor support.

> The most significant impediments to the development of the venture capital sector in Australia are considered to be the scale of the existing venture capital industry, the relatively small pool of investment managers and the lack of a strong track record in

> delivering the kind of returns needed to attract major institutional investors to this high risk market.12

3.11 Through the consultation process the Board understands that the venture capital investment life cycle is typically from seven to 15 years. This means that many venture capital fund managers are still in the first or second round of venture capital investments under the VCLP regime. The Board is of the view that more time is needed to properly assess whether the VCLP regime has been effective in meeting the policy objectives. Nonetheless, the Board has reflected on the appropriateness of the original design of the regime and has included some observations about this in Chapter 6.

3.12 The current special tax treatment under the VCLP regime provides certain foreign partners (eligible venture capital partners) with tax exemptions for gains made when the VCLP disposes of its investments. This is regardless of whether those gains are made on revenue account or capital account for income tax purposes.

3.13 However, domestic partners and other foreign partners who are not eligible venture capital partners must determine whether the gains made by a VCLP disposing of an investment are to be taxed on revenue account or capital account.

3.14 The Ralph Report found that:

> Domestic investors are also an important potential source of venture capital funding. The Review notes that the Pooled Development Fund (PDF) program is designed to provide an incentive for local investment in venture capital projects. The Review considers that the PDF program offers an appropriate mechanism to encourage investment in venture capital by domestic investors and has noted the changes to the program announced by the Government in the 1999-2000 Budget to enhance its attractiveness as a vehicle for venture capital investment.

3.15 As explained in the Board's Discussion Paper, the Board recommended to the then Assistant Treasurer in its Report *Review of the Tax Arrangements Applying to Managed Investment Trusts* (August 2009) that a deemed capital account treatment election be available for certain MITs. This deemed capital account election was enacted in *Tax Laws Amendment (2010 Measures No. 1) Act 2010*, and deems the character of gains and losses made by a MIT on the disposal of certain investment assets to be on capital account.

3.16 Approximately 80 per cent of investors in VCLPs are domestic, with the greatest proportion (approximately 24 per cent) coming from Australian superannuation funds. The benefit of a VCLP structure for domestic investors is that it provides flow-through taxation treatment and it provides access to venture capital investment through specialised venture capital managers. The exemptions for eligible foreign limited

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12 The Productivity Commission Report Public Support for Science and Innovation (2007) pg 312.

partners and capital account treatment for carried interests of general partners were intended to make Australia's venture capital industry more competitive internationally.

3.17 The Board acknowledges that the capital/revenue distinction is causing particular uncertainty for potential domestic individual investors into VCLPs and may divert investment into MITs which can provide tax certainty. The Board also recognises that the MIT structure is not always an appropriate vehicle for investment in venture capital as it does not allow the MIT (or more specifically, the venture capital managers) to be actively engaged in the investee's business venture. The development of venture capital management skills is a key aspect of the VCLP regime and is integral to the continued development and growth of the venture capital industry in Australia.

3.18 The Board considers that where domestic investment by individuals into VCLPs is deterred due to uncertainty in the tax rules, it would be appropriate to provide deemed capital account treatment to provide this certainty for domestic investors. The addition of this feature to the VCLP regime would facilitate the attraction of additional domestic funds into VCLPs.

3.19 The Board notes that providing deemed capital treatment for non-eligible foreign partners would effectively provide a tax exemption without any of the limitations currently in the definition of eligible venture capital partner (such as that a foreign limited partner's interest must not exceed 10 per cent of the VCLP's committed capital). This also means for a foreign partner there would be no distinction in their tax treatment (effectively exempt) between investments in a VCLP and an ESVCLP. Providing deemed capital account treatment may give certainty and encourage increased foreign investment into VCLPs but this is likely to come at a cost to the success of the ESVCLP regime due to the lower risk characteristics that VCLPs typically exhibit.

3.20 Accordingly, the Board is of the view that deemed capital account treatment should only be extended to eligible domestic limited partners on gains or profits made by a VCLP on the disposal of eligible investments. This reduces uncertainty in the tax treatment of eligible domestic investors and may provide them with more favourable tax treatment. It also recognises that domestic investors are an important source of capital for the development and growth of the Australian venture capital sector.

3.21 Eligible domestic investors should be defined in a way that is consistent with the definition of eligible foreign partners. That is, individual investors should hold less than a 10 per cent interest in the committed capital of a VCLP, be tax exempt, be a widely held superannuation fund or be an Australian MIT.

3.22 The Board acknowledges that the terms of reference require it to make recommendations that bring revenue neutral or near revenue neutral outcomes and notes that this recommendation may come at a significant cost to revenue.

3.23 Australian managed investment trusts (MITs) must limit their activities in a year to eligible investment business in order to retain trust taxation treatment under Division 6 of the *Income Tax Assessment Act 1936* (ITAA 1936). Otherwise, they will be public trading trusts and taxed like companies for the year and their unit holders will be taxed like shareholders. To increase the effectiveness of the VCLP regime in achieving its policy objectives the Board is of the view that MITs should be able to invest as a limited partner into a VCLP and retain their MIT status. This has the potential to open up a significant source of capital for VCLPs noting also that superannuation funds are significant investors in Australian MITs. Achieving this outcome may require an amendment to Division 6C.

3.24 As noted above, under the VCLP regime, only foreign partners that satisfy the definition of 'eligible venture capital partners' are entitled to exemption from income tax on profits or gains derived from the sale of eligible investments by the VCLP. Eligible venture capital partners must be foreign limited partners, and:

- be exempt from tax in their own tax jurisdiction;
- be a 'foreign venture capital fund of funds' which does not hold a greater than 30 per cent interest in the committed capital of the VCLP; or
- hold a less than 10 per cent interest in the committed capital of the VCLP.

3.25 Foreign partners who do not satisfy one of these conditions are not entitled to the tax exemption treatment.

3.26 A 'foreign venture capital fund of funds' is broadly defined as a foreign limited partnership or a foreign entity with tax-flow-through status in its country of residence. The Board understands that the objective of the 30 per cent cap for foreign venture capital fund of funds is to ensure that a VCLP cannot be used by a single investor, that is, it must have at least four investors. This is an integrity measure to prevent wholly owned special purpose vehicles which may compromise the objectives of the regime. The Board considers that this requirement is not necessary for widely held fund of funds. A diversified portfolio of investments would still be required but the 30 per cent requirement could be removed.

3.27 The Board considers that changes to the definition of eligible partners will assist in providing the right environment to attract foreign investment. Therefore, the Board is of the view that the definition of eligible foreign partners should be amended to remove the upper limit on eligible fund of funds investors.

3.28 The recommendations made by the Board in respect of the VCLP regime seek to improve the effectiveness of the regime within the context of the broad policy objectives of the regime when introduced. In making these recommendations, the Board notes the need for a formal revenue costing to be considered in determining whether the recommendations are adopted.

Recommendation 1: VCLPs

Subject to a satisfactory revenue costing (that would result in revenue neutral or near revenue neutral outcomes), the Board recommends that:

- Any gains or losses made by a VCLP on the disposal of an eligible venture capital investment held for 12 months which flow through to partners should be deemed to be on capital account for eligible domestic partners.
  - Eligible domestic investors should be defined in a way that is consistent with the definition of eligible foreign partners. That is, individual investors should hold less than 10 per cent interest in the committed capital of a VCLP, be tax exempt, be a widely held superannuation fund or be an Australian MIT.
- An Australian MIT should be able to invest as a limited partner in a VCLP and retain its MIT status.
- The restriction for foreign venture capital fund of funds should be removed provided the fund is widely held.
  - For the restriction to be lifted in the context of VCLPs, the foreign venture capital fund of funds, in addition to meeting a widely held requirement, must register with Innovation Australia and must provide details of investors to show that at least 90 per cent of ultimate investors are eligible foreign investors.
- The other design features of the VCLP regime should be retained.

3.29 While the terms of reference concern the effectiveness of the special tax treatment accorded under the VCLP regime in a way that recognises its policy objectives, the review has highlighted issues concerning what are the most appropriate mechanisms for promoting the development of the venture capital sector (as normally understood). In this regard, the Board considers that other grant programs such as the pre-seed fund or seed investment are more targeted to entities that require assistance (see Appendix C). Together with the ESVCLP regime, these programs are more clearly directed towards small, high-risk early stage venture capital, raising questions about the appropriateness of the VCLP regime, which extends to a component of the later stage private equity sector.

3.30 In particular, considering the nature of venture capital and the various alternative mechanisms for promoting the development of the sector, including the ESVCLP regime itself, the Board questions whether the original scope of the VCLP regime is now too broad, thereby providing special tax treatment beyond what is required to address the market gap in the sector. The Board makes some observations on the policy objectives of the VCLP regime in Chapter 6.

3.31 The Board considered a number of other issues in its review of the effectiveness of the VCLP regime. These are discussed below.

VCLP PERMITTED ENTITY VALUE RESTRICTION

3.32 Eligible investments made by a VCLP must be in entities with a value below $250 million. This rule applies to investments made by a VCLP into an investee entity at any time (that is, initial investments into an entity as well as subsequent rounds of investment). The objective of this requirement is to distinguish between venture capital and later stage private equity albeit in a very rudimentary way.

3.33 The Ralph Report recommended that a limit of $50 million would appropriately target the relief to entities that face difficulty raising capital.

> A limit of $50 million on the gross assets of the firms receiving the investment will ensure that the relief is targeted to firms that may face difficulties in raising significant new capital. It will not function to limit the size of the investor's total portfolio of such investments. And there would be no limit on the total capital gain in respect of which the investor will be able to gain relief.

3.34 The following tables, provided by DIISR, give further detail about investment by VCLPs.

Table 2: VCLP Investments By Investee Asset Size (in Millions $)

Million $	2006	2007	2008	2009	2010	Total	%
0-20	40	53	127	87	70	377	25.30%
20-40	23	89	54	44	24	234	15.70%
40-60	23	34	49	7	4	117	7.85%
60-80	0	33	10	31	19	93	6.24%
80-100	49	78	51	96	0	274	18.39%
100-150	15	65	11	20	10	121	8.12%
150-200	0	160	54	8	4	226	15.17%
200-250	0	11	25	2	10	48	3.22%
Total	**150**	**523**	**381**	**295**	**141**	**1490**	**100.00%**

Table 3: VCLP Investments by Investee Activity (in Millions $)

Category	2006	2007	2008	2009	2010	Total	%
Biotech, Pharma & Health	45	118	40	56	17	276	18.52%
IT, Media, Electronics & Comms	24	55	136	50	36	301	20.20%
Energy & Mining	13	6	7	3	6	35	2.35%
Manufacturing & Transport	51	92	57	35	23	258	17.32%
Services	17	252	141	151	59	620	41.61%
Total	**150**	**523**	**381**	**295**	**141**	**1490**	**100.00%**

3.35 Tables 2 and 3 show that even though many of the VCLPs stated investment profile is in later stage private equity (including managed buy-outs), the actual investments made indicate that this may not be happening in practice. The majority of investments are being made in investee companies with a net asset size of less than $100 million. There is no way of knowing whether these investments are being made in venture capital or later stage private equity, as distinguished in Chapter 2.

Views in submissions

3.36 Submissions received from a number of venture capital managers state that the $250 million investee entity limit is too restrictive for the VCLP regime, and reduces the number of investments which can be facilitated through a VCLP. Starfish Ventures state that the requirement prevents subsequent investments into an existing investee company once its value has reached $250 million. This acts to prohibit further funding to venture capital businesses which experience rapid growth:

> Technology companies can experience very rapid growth in value as they demonstrate market traction. This growth is often multiplied by the global nature of the markets these emerging companies are addressing, as has been demonstrated by the likes of PC Tools, Hitwise, Facebook and Groupon. Limiting the ability of a VCLP to invest in a high growth business due to its entity value ignores the potential benefits that can be generated by funding and supporting businesses in the global technology market.

3.37 Starfish Ventures provide an example where a companion trust was used for a venture capital investment into a particular technology business. Although the value of the business was below $250 million at the time of the proposed investment, the business was experiencing strong revenue growth and there was a chance that the business would grow to the $250 million permitted entity value and continue to grow beyond this value requiring additional rounds of investment. It was perceived that a VCLP would not be able to provide subsequent investment into the business if it grew beyond $250 million, and consequently, Starfish Ventures chose to use a companion trust vehicle to invest into the business rather than a VCLP.

3.38 A number of other submissions also express the opinion that the $250 million restriction is too prohibitive on the investment activities of a VCLP and may decrease its attractiveness to potential investors. Four submissions propose a removal of the requirement, and five submissions suggest increasing the permitted entity value from $250 million to $500 million. Proposals were also made for the requirement to apply only to the time of an initial investment, or for the $250 million limit to be subject to annual increases for indexation.

3.39 Innovation Capital, a venture capital manager based in Sydney, expresses an alternative view on the appropriateness of the $250 million permitted entity value requirement:

> We are of the opinion that the size of the companies that can be invested in are overly generous and could lead to the VCLP structures being used by Private Equity managers to perform deals that would not be commonly associated with Venture Capital investments. We are of the opinion that the size of the investee's company assets could be reduced to AUD $100 million without any impact on the number of size of Venture Capital investments in Australia.

3.40 Innovation Australia express the view that the $250 million permitted entity value requirement is appropriate and necessary to ensure capital funding is directed into businesses in the Australian venture capital sector at the high-risk start-up and expansion stages as opposed to businesses in the LSPE sector which are generally mature, stable and receiving adequate investor support.

Board's consideration

3.41 The Board notes that the policy objective of the VCLP regime is to facilitate increased investment for high-risk, start-up and early expansion stage entities in the Australian venture capital sector. The terms of reference require the Board to assess whether the restrictions imposed by the regimes are consistent with this policy objective.

3.42 In addition, the Board considers that the real emphasis of the VCLP regime should be on early stage start-ups, which are riskier and face greater difficulty accessing other forms of finance. The Board considers that it is difficult to argue that a venture worth $250 million is truly venture capital and, as such, faces the same difficulty in accessing funds or requires the same level of involvement from the venture capital managers themselves. It is clear that the Ralph Report considered that a permitted entity value of $50 million would be an appropriate level to target the special tax treatment to venture capital.

3.43 The Board understands that the permitted entity value was set at $250 million in order to make the regime more attractive for foreign institutional investors who may be deterred by lower investment caps. For these reasons the Board is of the view that the permitted entity value of $250 million provides an important safeguard to ensure that the special tax treatment is predominantly available for investments in venture capital but also acknowledges that in order to remain attractive to foreign investors, it may be desirable to allow some investments in more established companies.

3.44 The Board acknowledges that there is not a clear distinction between entities in the venture capital stage, which should benefit under the VCLP regime, and entities in the LSPE stage, which should not be within the scope of the rules. It also acknowledges that a permitted entity value is only one means of identifying businesses in the venture capital sector which are at the start-up and early expansion stages, and that there may be other characteristics which could also be used to identify such entities. However, the Board considers that a permitted entity value is the most appropriate method of

delineating between qualifying and non-qualifying entities as it provides a bright line test which provides certainty to venture capital managers, partners and investees.

3.45 If an entity enters rapid growth necessitating subsequent rounds of investment after the investment has reached $250 million the Board does not consider that it is appropriate for the special tax treatment accorded under the VCLP regime to continue. The Board therefore considers that should the VCLP regime be retained, the maximum $250 million permitted entity value for VCLP initial investments also should be retained. This continues to limit the revenue impact for exemptions and deemed capital account treatment for disposals or carried interests claimed for investee entities.

SPECIAL TAX TREATMENT FOR CARRIED INTERESTS OF GENERAL PARTNERS IN A VCLP

3.46 Payments of carried interests received by general partners in a VCLP are deemed to be on capital account. Where a general partner is a foreign resident, this will mean that carried interests will be tax exempt as long as it is not attributable to taxable Australian property. Where a general partner is an Australian resident, carried interests may qualify for the CGT discount as long as they meet the relevant eligibility criteria.

3.47 Ordinarily, carried interests are likely to be taxed on revenue account. Under the MIT regime, specific provision is made for amounts received as a distribution on carried interests and gains on disposal of carried interests to be taxed as assessable income. The rationale for exceptional treatment for VCLP partners is to attract capital and fund manager expertise to the venture capital sector. Also, there is a need for consistency with overseas venture capital regimes in order to make Australia's venture capital industry competitive given the global nature of venture capital.

3.48 In the second reading speech, the then Senator Alston stated that:

> Unlike managers in the passive funds management industry, venture capital managers are actively involved in the management of the companies in which the funds invest and typically share in the capital gains on investments made by the fund after all the investors committed capital has been returned. This is referred to as the carried interest and is designed to strongly align the interests of the fund manager and investors. To ensure the capital gain treatment of such gains flows through to the individual fund managers, if the general partner is a limited partnership, it will also be treated as a flow-through entity for tax purposes. ... Taxing the carried interest of venture capital managers as capital is also consistent with the international tax treatment of these 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.

Views in submissions

3.49 In response to the Board's discussion paper, Starfish Ventures submit that:

> We consider that the retention of the deemed capital treatment for general partners is necessary to ensure that venture capital firms can recruit and retain the necessary expertise. If this is removed then we would expect that personnel would move from venture capital firms to 'buy-out' funds given that there is a greater expectation of a buy-out fund achieving the requisite level of return in order for the carried interest to be paid.

Board's consideration

3.50 Allowing carried interests to be taxed on capital account is an exception to general taxation principles as carried interests would generally be viewed as being on revenue account.

3.51 The Board is of the view that it is generally not desirable to depart from the general rules as to what is assessable income as this can impose complexity and can result in a risk to revenue collections from the existing tax base.

3.52 The Board understands, however, that it is difficult to attract experienced fund managers to the venture capital sector. The Board also has received input on the importance of such managers in this sector (see below) including, in particular, the need to attract foreign fund managers. For these reasons, the Board considers that carried interests for general partners of a VCLP should continue to attract special tax treatment by being treated on capital account.

3.53 This recognises that venture capital managers play an important role in the process of assessing and commercialising innovation and attracting investment. It also recognises that some VCLP investment is in the high-risk, start-up and early-stage venture capital sector. To the extent that investment is targeted to the venture capital sector, capital account tax treatment will help ensure that there is a continuing tax incentive for managers to enter and remain in the venture capital sector and to continue to develop skills and experience in venture capital management in Australia.

USE OF COMPANION STRUCTURES

3.54 Data provided to the Board indicates that almost all registered VCLPs have been set up using companion structures (such as a parallel trust structure). Broadly, these companion structures have been established to facilitate venture capital investments into some entities which meet the VCLP restrictions and others which may be ineligible.

3.55 According to Innovation Australia, broadly the constraints and requirements in the design of the VCLP regime are to:

- ensure that investment remains in the sector that the program intended to target, that is, venture capital used for eligible activities; and
- avoid financial engineering so that the tax benefit actually goes to the groups that are working to address the market gaps (failures) behind the policy intent of the programs.

3.56 These requirements were described as 'an important integrity aspect of the measures and ensure that compliance with the tax concessions may be monitored.'[13] In its discussion of capital gains tax concessions for investment in venture capital, the Ralph Report recommended that:

> To target the capital gains relief effectively, the Review considers that the benefits of the concession should accrue to those investors who bear the risk of investing in venture capital projects. Where an investor is able to enter into an arrangement whereby its investment is protected or guaranteed in some manner, it is likely that the investment would have taken place in the absence of any concession. In this case the application of the concession would just act to raise the returns to the investor rather than encourage investment that would not otherwise have taken place. Accordingly, the Review has limited the application of the concession to those investors who bear the risk of their investments.

3.57 A summary of the restrictions and requirements for special tax treatments for investors in a VCLP is provided in Appendix E.

Views in submissions

3.58 The majority of submissions say that it is the strict restrictions imposed in the VCLP regimes and the availability of other vehicles with attractive tax treatment that leads to the use of companion structures.

3.59 AVCAL believes that only one VCLP is operating as a stand-alone structure. The Law Council of Australia state that:

> ... while the current VCLP regime should not be abandoned, it is appropriate for the Board to review the layered, and complex investment, activity, employment and capital restrictions that are currently imposed on VCLPs. These restrictions may be causing investors and managers to design 'parallel' entity structures, in particular so that some investments that are ineligible for the VCLP concessions may be maintained. Such structures add complexity, in general may be used to overcome limits in the statutory

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13 The Hon Peter Slipper MP, Parliamentary Secretary to the Minister for Finance and Administration, Second Reading Speech, Venture Capital Bill 2002 (House of Representatives).

> regime — in this case, a question arises as to whether those limits are really necessary or appropriate to encourage non-resident venture capital investment.

3.60 Starfish Ventures, a fund manager, notes that uncertainty in the operation of some of the VCLP requirements also causes venture capital managers to use companion structures. It states that it has had to establish companion structures when:

> ... the investment is unable to meet the strict eligibility test of the VCLP legislation, it might be interpreted to be ineligible or may become ineligible in future.

Board's consideration

3.61 The Board considers that the prevalence of VCLP companion structures is not of itself an indication that there are shortcomings in the VCLP regime. Rather, this could be seen as an indication that the restrictions have broadly ensured that special tax treatment is targeted, as intended, to the venture capital sector. In practice most fund managers establish these companion structures to facilitate venture capital investments into some entities which meet the VCLP restrictions and others which may be ineligible.

3.62 Broadly, the Board considers that the design of a new investment vehicle to accommodate non venture capital investments does not warrant the complexity involved in the additional compliance and administration costs. It also notes that there is evidence that some venture capital managers are choosing to invest in eligible venture capital investments through companion structures, therefore foregoing the special tax treatment accorded under the VCLP regime. This suggests that the special tax treatment was not necessary to encourage investment into these particular ventures.

3.63 Further to this, the Board's recommendation that Innovation Australia should provide supplementary guidance to clarify the scope of the law as to what activities would be considered ineligible (see Recommendation 3 below) and that any gains made by a VCLP on the disposal of an eligible venture capital investment held for longer than 12 months which flow through to partners should be deemed to be on capital account for eligible domestic partners (see Recommendation 1) should go some way to reducing the need for the use of companion structures.

RESTRICTIONS ON NON-AUSTRALIAN INVESTMENTS

3.64 An investee entity must be an Australian resident at the time of any investment made by a VCLP. At the time of an initial investment by a VCLP, the investee entity must have over 50 per cent of its employees and assets in Australia for 12 months from the date of that initial investment.

3.65 A VCLP can invest directly in non-Australian investments as long as the sum of those investments is less than 20 per cent of its committed capital.

3.66 The objective of these requirements is to ensure that the investment in venture capital is concentrated in Australia for the benefit of Australia.

Views in submissions

3.67 Almost all of the venture capital managers which provided submissions state that the restriction on non-Australian investments and the 20 per cent cap for VCLPs unnecessarily limits the practical operations of venture capital businesses.

3.68 Brandon Capital Partners makes the following comments:

> ... should a portfolio company seek follow-on financing from an overseas group of investors it is customary that the company be re-domiciled, say in the USA, where these investors are domiciled. As this is usually one of the major markets that the company's products are targeting there is sound business logic to this move. The drawback with the VCLP restrictions is that there is an artificial cap on the amount of capital that can be invested outside of Australia. Moreover, as an arbitrary cap it does mean that investors can simply use this to make some overseas investments with no Australian connection.

Board's consideration

3.69 The policy underlying the VCLP regime is to facilitate increased investment for high-risk start-up and expansion stage entities in the Australian venture capital sector. This is designed to leverage Australia's existing research and development capabilities, facilitate the development of Australia's venture capital industry and increase Australian economic growth and job creation. Therefore, the tax treatment offered under the VCLP regime should be provided where the funds invested into venture capital businesses are substantively spent on Australian research and development, assets and employees.

3.70 The Board considers that the existing non-Australian investment thresholds already provide appropriate tax treatment for VCLPs, considering that the policy objective of the regimes is to facilitate increased investment into the Australian venture capital sector. Australian venture capital businesses into which VCLPs invest have flexibility to expand overseas using branch operations, overseas subsidiaries, or re-domicile under certain thresholds.

3.71 For example, the restrictions on investing in non-Australian entities should only ever be relevant to an investment that does not meet the residency requirement at the time of the investment and stay predominantly within Australia for the relevant time period. As such, it has no application to 'follow-on' investments into an entity that did

meet these tests at the time of the initial investment. For follow-on investments, only the residency[14] requirement is required to be met.

3.72 The Board considers that it would be inappropriate for the regimes to provide special tax treatment for venture capital funds whose investments have minimal or no required connection with businesses, employees or assets in Australia. Accordingly the Board considers that these safeguards should be maintained for VCLPs.

RESTRICTIONS AGAINST INVESTING IN LISTED COMPANIES

3.73 A VCLP is prevented from investing in a company listed on a stock exchange, unless the company is delisted within 12 months of the time the VCLP makes its initial investment. The objective of this requirement is to attract new capital to developing companies, not to give special tax treatment to companies which already have access to wider capital by way of listing.

Views in submission

3.74 A number of submissions state that the restriction against VCLPs investing in listed companies unnecessarily limits the investment choices of venture capital managers.

3.75 Innovation Capital makes the following comments:

> We often find that innovative Australian technology companies are listing on the ASX as there is limited other capital sources, that is, they are performing funding IPOs [initial public offerings] rather than exit IPOs. Subsequent to listing, these companies face the struggle of supporting exiting or increasing share price while dealing with illiquid stock and limited to no broker coverage. Continued low stock prices and shallow trading liquidity is a barrier to further public capital issues. Despite being listed, these companies face the same issues as the unlisted companies that we are permitted to invest in; that is how to best commercialise the technology they possess, launch new products or enter new markets and how to find and build a better management team. However, as a manager of a VCLP we are unable to invest in such companies, therefore depriving them and their technologies of additional capital and management expertise they need to succeed. The policy objectives should be agnostic about whether the company is listed or not.

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14 Where the entity is incorporated in Australia, this will always be met (as residency via this means cannot change).

Board's consideration

3.76 The Board considers that ASX listed companies are less likely to need assistance through special tax treatment to raise capital and consequently there is no need to lift this restriction. In addition, the current rules provide for a VCLP to invest in a listed company that is otherwise an eligible investment provided that company is delisted within 12 months of the time the VCLP makes the initial investment.

RESTRICTIONS ON ACQUISITIONS AND USE OF HOLDING COMPANIES

3.77 Entities into which a VCLP invest are restricted from making acquisitions in other entities unless certain conditions are satisfied. Specifically:

- where an investee entity seeks to invest in another entity (a 'bolt-on' acquisition), it must have an existing controlling stake in that other entity, and the other entity must meet the requirements of being an eligible venture capital investment; and
- an investee entity cannot be used as a vehicle which predominantly invests in other entities. Broadly, this restriction operates by preventing the investee entity from having over 25 per cent of its assets used for 'making investments, whether made directly or indirectly, that are directed to deriving income in the nature of interests, rents [or] dividends'.15 An exception applies where the investee entity is used as a holding company under certain circumstances (the 'holding company exception').

3.78 The 'holding company exception' allows an investee entity to be used as a holding company as long as it invests solely into *one* other company or unit trust which satisfies the requirements for being an eligible venture capital investment.

3.79 The Board understands that the policy reason for these requirements is because venture capital businesses were not envisaged as wanting to undertake multiple acquisitions. Complex structures may make it difficult for administrators to identify non-compliance with the venture capital eligibility rules. In addition, it was envisaged that VCLPs should not need to use complex structures to acquire venture capital businesses. These restrictions are designed to stop financial engineering which adds complexity and unnecessary detail as a way of getting around VCLP regime restrictions.

Views in submissions

3.80 A number of submissions state that the requirement for a VCLP investee entity to have a controlling stake in an entity into which it seeks to invest is an inappropriate restriction on the activities of the investee entity.

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15 Section 118-425(3) and (13) of the ITAA 1997.

3.81 Innovation Capital makes the following comments:

> This section effectively reduces the ability of a VCLP investment to improve its value by way of a 'roll-up' investment or acquisition of a synergistic business. This strategy is often used by venture capital managers to achieve critical mass in the marketplace or otherwise acquire a strategic advantage.

3.82 Some stakeholders propose that bolt-on acquisitions be allowed regardless of whether an investee entity has an existing controlling stake in a new target entity, as long as the target entity meets the requirements for permitted entity values and other eligible investment requirements.

3.83 A number of submissions raise issues with the holding company exception rule in that the rule permits a holding company to invest solely in one other company or unit trust, but not into multiple entities.

3.84 Brandon Capital Partners makes the following comments:

> ... investments are often structured using a holding company, in particular when there are separate companies holding the IP [intellectual property] and another company being the operating company ... These situations are currently accommodated through the use of a parallel trust.

3.85 Innovation Capital explain that many venture capital businesses are structured using a holding company which holds shares in multiple entities, one being used to hold intellectual property. In this instance, the holding company exception would not be met, the investee company would breach the eligible venture capital investment requirements, and the VCLP could be deregistered resulting in its partners losing access to the VCLP tax treatment.

Board's consideration

3.86 The Board considers that allowing complex structures could make it difficult to monitor compliance in relation to the special tax treatment accorded to VCLPs. It is not clear that the commercial imperative to use holding company structures outweighs the potential compliance risks of allowing complex structures.

THE DIVERSIFIED PORTFOLIO REQUIREMENT

3.87 A VCLP must not invest more than 30 per cent of its committed capital into an investee entity or its connected entities. If a VCLP breaches this requirement after it is registered, it must rectify the breach within a set period of time after which it will be deregistered. If deregistered, the VCLP's partners will lose access to special tax treatment for all investments made by the VCLP.

3.88 This requirement ensures that the VCLP holds a diversified portfolio of investments. The requirement is also aimed to prevent a VCLP from targeting one investee company so that it minimises risk, and to do more to develop the venture capital sector as a whole instead of backing just one venture.

Views in submissions

3.89 Two submissions state that this requirement causes problems for the operation of VCLPs.

3.90 AVCAL provides the following explanation regarding difficulties with the diversified portfolio requirement:

> Whilst it may be the intent of the legislation to impose a requirement for a diversified portfolio, AVCAL strongly disagrees with this approach, as it hinders cost-effective investments into niche industries. The inherent consequences of being required to make multiple investments as a result of the cap are increased fund, transaction and ongoing management costs. For smaller, early stage venture capitalists, this may cause Australian investments to be uneconomical with the result that the flow of foreign and domestic capital in Australia is diminished.

3.91 Harbert Fund Advisors (Harbert Australia) is an advisor to two registered VCLPs. Its submission elaborates further on problems with this requirement:

> It is our firsthand experience that this provision actually limits the investment opportunities of a VCLP and creates a further layer of uncertainty and administration for investors into the VCLP. It assumes that all the committed capital is raised before investing which is not the case for our VCLPs, nor do we expect that it is the case for others ...
>
> Committed capital is not a static amount and neither is the amount a VCLP invests in a company. This provision results in the VCLP having to compare its committed capital to the amount of each of its investments every time it increases its stake in an investment, and every time capital is injected into the VCLP to ensure that all of its investments are eligible for the purposes of the regime.

Board's consideration

3.92 The Board notes that the diversified portfolio requirement appears to be consistent with the commercial practice of venture capital funds. Funds typically tout diversification in their prospectus as a feature of their investment strategy.

3.93 The 30 per cent rule is designed to ensure spread of investments, to prevent closed type investments involving associated parties effectively using the regime to gain unintended benefits. Noting the policy intention of the rules, and the practical

issues raised by stakeholders, the Board considers that the 30 per cent rule is appropriate.

CHAPTER 4: EARLY STAGE VENTURE CAPITAL LIMITED PARTNERSHIP

CURRENT LEVELS OF INVESTMENT

4.1 Nine ESVCLPs have been registered since the introduction of the ESVCLP regime in 2007, with total committed capital of $80 million. Six of the ESVCLPs are conditionally registered and seeking capital.16 $5.5 million has been invested under the ESVCLP program to September 2010.17

Views in submissions

4.2 In relation to the ESVCLP regime, Innovation Australia submits that although introduced in 2007, amendments to most State and Territory partnership legislation to accommodate the ESVCLP were only completed in 2009 after which the global financial crisis saw a significant reduction in venture capital financing. More recently, Innovation Australia has received an increasing number of enquiries regarding the ESVCLP and it expects there will be an increased adoption of the vehicle as market conditions improve in the near future.

Board's consideration

4.3 As noted above, the VCLP regimes have been designed to support investment into venture capital entities at the high-risk, start-up and early expansion stages that would otherwise have difficulty in attracting investment through normal commercial means. Support has been provided by offering special tax treatment to investors.

4.4 The ESVCLP is an important addition to implement the policy intent as it specifically encourages investment to the seed and start-up venture capital space. The Board considers that the ESVCLP broadly has the right design features to facilitate investment into venture capital in order to attract and develop skilled venture capital managers. The more favourable tax treatment together with the lower permitted entity value helps ensure that the special tax treatment is targeted to investment that is focussed on the early-stage, high-risk venture capital. The Board does not believe that there are any major design impediments in the ESVCLP but believes that some

16 Data is as at June 2011.
17 Data provided in preliminary consultations with Innovation Australia.

restrictions could be relaxed to make the vehicle more effective going forward, as set out in the following paragraphs.

4.5 Under the current law, an investee entity is restricted from making investments in another entity unless it already has an existing controlling stake in that other entity. The Board considers that this rule is unnecessarily restrictive and should be removed, as long as the investee entity acquires a controlling interest in the other entity and the other entity meets the requirements of being an eligible venture capital investment.

4.6 Likewise, the Board considers that the holding company exception (which allows investments to be made into a holding company that has one subsidiary that is an eligible investment) should be modified to allow an ESVCLP to invest into a holding company which has existing interests in multiple subsidiaries, as long as those subsidiaries satisfy the eligible venture capital investment requirements.

4.7 The Board understands that there is often a need for investee entities to expand offshore in order to commercialise Australian innovation. Under the current rules, Australian companies can expand offshore and remain eligible investments of the ESVCLP provided they continue to be resident of Australia. To address the case of Australian companies that need to redomicile, the Board considers that the introduction of discretion for Innovation Australia to allow foreign investment of an ESVCLP to exceed 20 per cent will provide greater flexibility for ESVCLPs to respond to these opportunities as they arise. The investment must, in the view of Innovation Australia, provide material national benefit such as commercialising Australian research and development. OneVentures, an ESVCLP, made the following comments:

> Australia has to realise that the population of the country is not sufficient to support many new high growth companies — there is a market size issue. There is sound business logic to move the domicile of the company to the market where it will receive the majority of its business and investment ... It is unfortunate that we face the likelihood of needing to restructure or buy out of the fund many investments as they go offshore — an unnecessary obligation and expense on the Funds.

4.8 As noted at paragraph 3.23 Australian managed investment trusts (MITs) must limit their activities in a year to eligible investment business in order to retain trust taxation treatment under Division 6 of the ITAA 1936. To increase the effectiveness of the ESVCLP regime in achieving its policy objectives the Board is of the view that MITs should be able to invest as a limited partner into an ESVCLP and retain their MIT status. This has the potential to open up a significant source of capital for ESVCLPs noting also that superannuation funds are significant investors in Australian MITs. Achieving this outcome may require an amendment to Division 6C.

4.9 The Board is of the view that where a limited partner in an ESVCLP is a trust (that is not taxed as a corporate) the investors in that trust should not be prevented from accessing the special tax treatment accorded under the ESVCLP regime. That is,

the exemption should not be clawed back on the ultimate disposal of interests in the trust.

- Subdivision 118-F of the ITAA 1997 provides that capital gains made by ESVCLPs from eligible venture capital investments are disregarded provided certain conditions are met. PricewaterhouseCoopers state in their submission that:

> On numerous occasions clients have asked whether it is possible for some investors to invest in an ESVCLP via a fixed or unit trust structure. That is, the trust would be one of the limited partners. However, such structures negate the tax benefits afforded to ESVCLP partners because any distributions made by the trust would be subject to CGT event E4 ... Consequently; the disregarded ESVCLP gain is effectively converted into a taxable CGT event E4 gain when distributed by the trust.

4.10 The Board considers that these rules can be relaxed for ESVCLPs, but not for VCLPs, as other restrictions on ESVCLPs ($50 million permitted entity value and the $100 million limit on committed capital of the ESVCLP) provide greater assurance that the special tax treatment is appropriately targeted. By contrast, some larger investments by VCLPs may have less need for special tax treatment to attract investment.

Recommendation 2: ESVCLPs

The Board recommends that:

- An investee entity should have greater flexibility to invest in other complementary ventures, provided the investee entity acquires a controlling stake in the other entity and the other entity is otherwise an eligible investment.
- The holding company exception should be modified to allow an ESVCLP to invest in a holding company which has existing interests in multiple subsidiaries, as long as those subsidiaries satisfy the eligible venture capital investment requirements.
- Innovation Australia should have discretion to allow ESVCLPs to exceed the 20 per cent foreign investment cap provided the investment has a material national benefit associated with the commercialisation of Australian research and development (such as employment, royalties from intellectual property and sales).
- An Australian MIT should be able to invest as a limited partner in an ESVCLP and retain its MIT status.
- Where a limited partner in an ESVCLP is a trust (that is not taxed as a corporate) the investors in that trust should not be prevented from accessing the special tax treatment accorded under the ESVCLP regime. That is, the exemption should not be clawed back through the operation of CGT event E4.

4.11 The Board considered a number of other issues relevant to ESVCLPs in more detail. These are discussed below.

ESVCLP PERMITTED ENTITY VALUE RESTRICTIONS

4.12 An ESVCLP cannot invest in an entity with a value exceeding $50 million. An ESVCLP must divest once an investee entity has grown to $250 million.

4.13 In the 2007 parliamentary debate on the ESVCLP rules, the following was said in relation to the divestment requirement:

> The $250 million divestment requirement is reasonable because the government is introducing generous tax concessions for early-stage vehicles. Given the emphasis on start-up and seed capital, the need for ongoing tax concessions once an entity reaches the size of $250 million diminishes.18

Views in submission

4.14 OneVentures is a venture capital fund manager. It makes the following comments in relation to the permitted entity restrictions in the ESVCLP regime, and the requirement for an ESVCLP to divest once an investee entity has grown to $250 million:

> We are unclear why the government needs a cap and forces divestment on the Fund for any asset that has exceeded $250 million. While we would be delighted if this happened [if an investment grows to $250 million], we would not like the Fund to be forced into a sale position if the potential for the company and Fund was greater. I believe the only metric needed is the asset value at the time of first investment (that is. below $50 million in asset value for ESVCLPs). Any restriction which limits a positive outcome should be removed. Such restrictions only serve to penalize a fund and fund manager from good performance. A forced sale that is due to a restriction could have a very negative impact on outcomes for the Fund and investors.

Board's consideration

4.15 The Board considers that the divestment requirement is a reasonable requirement (and in practice is unlikely to affect many ESVCLPs). The cap helps ensure that the benefit of the special tax treatment is limited to ventures that are still in the venture capital sector.

4.16 The Board notes that the $50 million permitted entity value restriction prevents ESVCLPs from providing further capital into an investment which expands beyond

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18 Peter Dutton MP, Tax Laws Amendment (2007 Measures No. 2) Bill 2007, Hansard, 9 May 2007.

$50 million. The Board's view is that the divestment requirement cap of $250 million is generous as it effectively allows an ESVCLP to continue to hold an investment and access the ESVCLP special tax treatment. The divestment requirement will encourage the ESVCLP to capitalise on its success and limits the special tax treatment. Accordingly, the Board considers the divestment requirement should be maintained at $250 million.

LOSS FLOW-THROUGH RULES

4.17 Under the ESVCLP regime all partners are entitled to tax exemption, that is, all gains and losses are disregarded for tax purposes.

Views in submissions

4.18 Some submissions received by the Board recommend that loss flow-through rules be provided for losses made by ESVCLPs on the disposal of eligible venture capital investments.

4.19 Brandon Capital Partners makes the following comments:

> It should be noted that the current ESVCLP regime will be unlikely to attract institutional investors so long as there is no pass through of losses. For local and overseas superannuation/pension funds the holiday from capital gains tax is not as important as the ability to offset losses against gains made in other parts of their portfolio as and when they are crystallised.

4.20 OneVentures makes a similar comment, and also adds the following points:

> In venture capital investing, the investor takes on losses well in advance of any capital return. It generally takes investors up to seven years to receive their capital back, let alone receiving profits. During this time, their investment has cost them a significant amount in fees and it is likely also some companies in the portfolio have been written down (losses happen well in advance of gains). The early stage nature of venture capital means that the government needs to encourage investors into the market. The capital gains tax free status of an ESVCLP is helpful but the inability to claim losses in such a high risk investment environment is nevertheless a hindrance to investment. The reality of 'big gains' in early stage venture is low (statistics in the industry show this).

4.21 These stakeholders propose that the ESVCLP regime should allow losses made by ESVCLPs on the disposal of investments to flow-through to partners subject to loss limitation rules, whilst retaining tax exemption for gains.

Board's consideration

4.22 The Board understands that given the high risk nature of ESVCLP investments, ESVCLPs regularly incur losses. These losses are disregarded under the ESVCLP regime and do not flow through to partners.

4.23 As noted in Chapter 2, capital gains tax relief for investment in venture capital tends to encourage risk-taking rather than tax evasion. The Board finds it difficult to see the rationale for a proposition whereby ESVCLP investors could receive tax exempt gains and at the same time be entitled to deductions for losses. The Board considers that such a change would be likely to have a significant cost to revenue. The Board does not consider losses should flow-through to partners in the ESVCLP.

CHAPTER 5: RESTRICTIONS ON INELIGIBLE ACTIVITIES

5.1 The following issue has been considered in the context of both the ESVCLP and VCLP regimes.

5.2 The VCLP regimes impose restrictions on the types of activities which can be undertaken by an investee entity. Specifically, an investee company is not permitted to engage in ineligible activities, unless (broadly) less than 25 per cent of its assets, employees or income are attributable to those ineligible activities.[19] The same requirements apply to an investee entity which is a trust.[20]

5.3 Ineligible activities comprise:

- property development or land ownership;
- finance (banking, providing capital, leasing, factoring or securitisation);
- insurance;
- construction or acquisition of infrastructure facilities; or
- making investments that derive interest, rent, dividends, royalties or lease payments.

5.4 However, these activities are permitted if they are 'ancillary or incidental' to other primary activities which are not ineligible. If an investee entity breaches the requirements temporarily, Innovation Australia can exercise discretion to determine that the investee entity does not become an ineligible venture capital investment.

5.5 The objective of this requirement is to restrict the VCLP regimes to investments in businesses normally recognised as being in the venture capital space.

Views in submissions

5.6 A number of submissions received by the Board identify problems with the restrictions on ineligible activities for investee entities.

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19 Section 118-425(3) of the ITAA 1997.
20 Section 118-427(4) of the ITAA 1997.

5.7 Starfish Ventures makes further comments on the ineligible activities restriction:

> The VCLP structure limits investments in sectors where Australia has a potential competitive advantage and where we see the emergence of a new generation of business. Specifically the internet and the evolution of the modern software can transform traditional industries. However, sector restrictions are placed on a traditional industry view. For example, providing a financial service is an excluded activity. This would have stopped Australian companies from developing on-line trading platforms and becoming global leaders in this area. We have two current portfolio companies that are held through the stapled trusts as they undertake potentially 'Ineligible Activities'. Placing restriction on these companies accessing growth capital stifles their expansion, limits jobs growth and curtails the opportunity for Australia to grow globally competitive businesses.

5.8 OneVentures raises an example of a web business providing pay day loans, which may be deemed ineligible due to the provision of loans being a financing activity.

5.9 AVCAL provide a number of other examples where, in their view, the ineligible activities restriction is inappropriate:

> 1. They hinder the growth and development of the finance sector (for example non-bank finance entities) ...
>
> 2. ... it is possible that otherwise eligible activities which may have a tangential 'ineligible' element (for example the provision of aged care services, accommodation services and the hospitality industry which also entail significant land ownership) would not satisfy the VCLP regime ...
>
> 3. Entities carrying on a trading business through the leasing of machinery or equipment under standard operating leases might fail the prohibition on leasing and do not clearly fit into the VCLP regime … and
>
> 4. Expanding technology-focused businesses that develop intellectual property and earn royalties might fail within the prohibition on investing to earn royalty income.

5.10 As a result of these problems, each of these stakeholders has requested that the definition of ineligible activities be restricted, clarified or repealed.

5.11 Starfish Ventures suggest that Innovation Australia be granted the ability to provide an exemption for certain investments within a meaningful timeframe (for example one working week).

Board's consideration

5.12 The Board agrees that, based on the numerous examples provided in submissions, the meaning of ineligible activities needs to be clarified to provide

certainty to VCLPs (and ESVCLPs) and to prevent inappropriate outcomes from arising, such as the deregistration of the VCLP.

5.13 The Board notes that the ineligible activities definition already contains a rule which permits such activities if they are 'ancillary or incidental' to other activities which are not ineligible. However, the rules do not specify what types of activities are eligible. Based on the submissions received, the Board considers that there may be many instances where the 'ancillary or incidental' test is difficult to apply, thus resulting in uncertainty for venture capital managers.

5.14 The Board notes that at the moment the potential exists for Innovation Australia to issue general guidance on the type of ineligible activities that are 'ancillary or incidental' to other activities which are not ineligible and for the ATO to issue potential conflicting binding advice. This scenario does not offer claimants a robust, certain advice system, as is needed in a self assessment environment.

5.15 While the Board does not consider that legislative change is required, it considers that Innovation Australia should provide supplementary guidance on the type of ineligible activities that are 'ancillary or incidental' to other activities which are not ineligible. The Board also considers that only one agency should have responsibility for providing advice in relation to eligible investments and that this advice should be binding. To achieve this, Innovation Australia (instead of the ATO) should be given a power to give binding advice in relation to eligible investments including the type of ineligible activities that are 'ancillary or incidental' to other activities which are not ineligible. This advice would also be binding on the ATO.

5.16 This would provide VCLPs with greater assurance as to the classification of their investments, and would reduce the risk that an investment would be treated as an ineligible and result in the VCLP being deregistered.

Recommendation 3

The Board recommends that:

- Innovation Australia should provide supplementary guidance to clarify the scope of the law as to what ineligible activities may be permitted because they are 'ancillary or incidental' to other activities which are not ineligible.
- Innovation Australia should be given a power to give binding advice in relation to eligible investments.

CHAPTER 6: THE BOARD'S CONSIDERATION OF THE ORIGINAL POLICY OBJECTIVES OF THE VCLP REGIME

6.1 In conducting this review, the Board has reflected on what the VCLP regime is intended to achieve and the extent to which it is likely to be effective in doing so.

6.2 After considering submissions, reviewing the nature of venture capital, having regard to the ESVCLP regime and looking at the various other mechanisms outlined in Appendix C for promoting the venture capital sector (as normally understood), the Board considers that the design of the VCLP regime extends too far. In particular, it allows investments to be made into the later stage private equity sector and still access the special tax treatment accorded under the regime. As discussed below, the Board understands support for the later stage private equity sector goes beyond what is typically necessary to address the market gap in terms of the venture capital sector (as normally understood).

6.3 The enterprises which attract what is commonly thought of as venture capital are generally small, at an early stage of their development and the investments in them are of a high risk nature, reflecting the fact that the idea, product or service is not yet commercialised or is at a very early stage of commercialisation. Often, there is little or no revenue to service debt. In this regard, venture capital is typically a form of equity finance, because it is difficult to obtain debt through normal commercial means.

6.4 By contrast, the VCLP regime permits investee entities to have a value of up to $250 million at the time of any VCLP investment. Entities of this value are less likely to be at an early stage of development, and are much more likely to have some cash flow, perhaps being sufficient to support a relatively large amount of debt. At this end of the developmental spectrum can be found later stage private equity: in a comparative sense, this sector tends to be well supported by financial markets and is not in need of support through the venture capital tax incentives.

6.5 Another feature that distinguishes the VCLP regime from the ESVCLP regime, and points to the former not having the same degree of venture capital focus, can be seen from the registration requirements. VCLPs have considerable flexibility in terms of their investment plans, while it is a requirement of registration that an ESVCLP operates in accordance with its approved investment plan. In this regard, Innovation Australia will approve an investment plan if it considers it is appropriate. Innovation Australia must take into account the extent to which the plan focuses on early stage venture capital, having regard to the requirements set out in the Venture Capital Act. The relevant considerations include cash flow levels, proportion of intellectual

property to total assets, levels of risk and return and the amount of tangible assets and collateral against which borrowings may be secured. Innovation Australia is not limited to the above matters in deciding if it considers an investment plan is appropriate. In this context, 'early stage' is considered to be a description of venture capital, which includes investment in businesses at the pre-seed, seed, start-up, and early expansion stage of development.

6.6 Policy support for entities at a later stage of development may come at the expense of support for the higher risk, start-up stage of development. Even though smaller amounts of support for each eligible start-up entity may be required, support at this level is likely to be more crucial than for more mature businesses. This support could extend to non-tax incentives such as cash grants at the stage before there is a fully developed product, idea or service ('seed investment'). A greater focus on seed investment holds out the prospect of strengthening the bridge between innovation and a vibrant commercialisation effort.

6.7 The Board considers that the ESVCLP regime was designed to provide additional tax incentives that are more targeted to the venture capital sector (as normally understood). In this light, the Board questions whether, given the introduction of the ESVCLP regime, the VCLP regime is still necessary.

6.8 The Board suggests that the Government consider phasing out the VCLP regime (for example, by closing the VCLP regime to new registrations) and re-directing policy support to the earlier stages of venture capital activity.

APPENDIX A: SUMMARY OF RECOMMENDATIONS

Recommendation 1: VCLPs

Subject to a satisfactory revenue costing (that would result in revenue neutral or near revenue neutral outcomes), the Board recommends that:

- Any gains or losses made by a VCLP on the disposal of an eligible venture capital investment held for 12 months which flow through to partners should be deemed to be on capital account for eligible domestic partners.
  - Eligible domestic investors should be defined in a way that is consistent with the definition of eligible foreign partners. That is, individual investors should hold less than 10 per cent interest in the committed capital of a VCLP, be tax exempt, be a widely held superannuation fund or be an Australian MIT.
- An Australian MIT should be able to invest as a limited partner in a VCLP and retain its MIT status.
- The restriction for foreign venture capital fund of funds should be removed provided the fund is widely held.
  - For the restriction to be lifted in the context of VCLPs, the foreign venture capital fund of funds, in addition to meeting a widely held requirement, must register with Innovation Australia and must provide details of investors to show that at least 90 per cent of ultimate investors are eligible foreign investors.
- The other design features of a VCLP should be retained.

Recommendation 2: ESVCLPs

The Board recommends that:

- An investee entity should have greater flexibility to invest in other complementary ventures, provided the investee entity acquires a controlling stake in the other entity and the other entity is otherwise an eligible investment.
- The holding company exception should be modified to allow an ESVCLP to invest in a holding company which has existing interests in multiple subsidiaries, as long as those subsidiaries satisfy the eligible venture capital investment requirements.
- Innovation Australia should have discretion to allow ESVCLPs to exceed the 20 per cent foreign investment cap provided the investment has a material national benefit as associated with the commercialisation of Australian research and development (such as employment, royalties from intellectual property and sales).

- An Australian MIT should be able to invest as a limited partner in an ESVCLP and retain its MIT status. That is, an exception to Division 6C should be provided.
- Where a limited partner in an ESVCLP is a trust (that is not taxed as a corporate) the investors in that trust should not be prevented from accessing the special tax treatment accorded under the ESVCLP regime. That is, the exemption should not be clawed back through the operation of CGT event E4.

Recommendation 3

The Board recommends that:

- Innovation Australia should provide supplementary guidance to clarify the scope of the law as to what ineligible activities may be permitted because they are 'ancillary or incidental' to other activities which are not ineligible.
- Innovation Australia should be given a power to give binding advice in relation to eligible investments.

APPENDIX B: LIST OF SUBMISSIONS

AVCAL

Brandon Capital Partners

CPA Australia

Ernst & Young

Greenwoods & Freehills

Harbert Fund Advisors (Australia) Pty Ltd

Innovation Australia

Innovation Capital

Law Council of Australia

Mallesons Stephen Jaques

OneVentures

PricewaterhouseCoopers

Starfish Ventures

The Institute of Chartered Accountants in Australia

APPENDIX C: GOVERNMENT PROGRAMS TO SUPPORT BUSINESS INNOVATION

Governments in Australia run some 155 programs to support business innovation — 45 administered by the Commonwealth and 110 by the States and Territories.[21] The Commonwealth's support for business innovation exceeded $2 billion in 2009-10.[22] The existing R&D Tax Concession — soon to be replaced with the new R&D tax incentive — is the largest component of this support.

State and Territory governments are not significant supporters of dedicated venture capital funds. Apart from support of a few smaller Commercialisation Funds aimed at universities (and generally not equity support) and one dedicated fund supported by the Queensland Government, the Australian Government is the major supporter of dedicated commercial size venture capital funds.

The Australian Government provides venture capital support through a number of equity and tax based programs. The tax concession venture capital programs include the VCLP, ESVCLP and PDF programs. The PDF is closed to new applicants and inactive funds are being closed down.

The equity programs include:

- Innovation Investment Fund (IIF);
- Pre Seed Fund (PSF);
- Renewable Energy Equity Fund (REEF); and
- Innovation Investment Follow-on Fund (IIFF).

The IIF program became operational in 1998 and promotes the commercialisation of Australian research by improving access to capital for early stage innovative companies and to develop the venture capital fund managers with experience in managing early stage investments. Under the IIF program, the Government licenses private sector fund managers through a competitive, merit based process by examining, among other issues, the applicant's capacity and experience in early stage equity investing. The Government provides capital which is matched at a minimum agreed ratio by private sector capital raised by the fund manager.

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21 Department of Innovation, Industry, Science and Research, 'Powering Ideas: An Innovation Agenda for the 21st Century' 2009, pg29.

22 Department of Innovation, Industry, Science and Research, 2011-12 Science and Innovation Tables, Table 1 (total support for the 'Business Enterprise Sector').

The capital contribution from the Government provides leverage as it assists the fund managers to attract private capital that otherwise would not have been committed to venture capital. The fund manager has access to a pool of funds in order to make investment decisions (sectors and companies in which to invest) and these decisions are made by the fund managers with no Government involvement. Investee companies benefit not only from the capital provided but importantly they also benefit from the fund manager's business and financial skills and connections.

Each IIF fund is for a fixed term of 10 years. During this period the fund manager is required to make, grow and realise investments. There have been three rounds of the IIF program (1998, 2000, 2006-ongoing):

- The Australian Government has committed $220.7 million for Rounds 1 and 2 of the program with the private sector co-investing $133.3 million under these Rounds.
- The Government has allocated $200 million for Round 3 in order to establish up to 10 funds with each fund comprising $20 million of government capital matched on at least a 1:1 basis with the private sector.

The PSF was initiated in 2002 to assist in commercialising research from universities and publicly funded research organisations. It will cease in 2012. It operates along the lines of the IIF program but with smaller investment capacity. The PSF has $104.1 million in capital, of which the Australian Government is providing $72.7 million.

The REEF program was a one-off, specifically targeted program aimed at helping establish a renewable energy sector in Australia. This program has ceased operation.

The IIFF program was a one-off, specifically targeted program to assist a cohort of innovative companies with high potential to survive through the global financial crisis. The program commenced in August 2009 and will cease in 2012.

The Department of Resources, Energy and Tourism (RET) announced a $100 million Renewable Energy Venture Capital Fund in late 2010. It is expected that up to two venture capital funds will be established to make critical early-stage equity investments that leverage private funds to help commercialise emerging renewable energy technologies. The fund will operate under similar conditions to the IIF program and will be administered through RET.

APPENDIX D: SUMMARY OF TAX TREATMENTS FOR PARTNERS IN A VCLP AND ESVCLP

The requirements and restrictions for the special tax treatment under the VCLP and ESVCLP regimes are outlined in the paragraphs below.

The VCLP regime

The VCLP regime was introduced under the *Venture Capital Act 2002* and *Taxation Laws Amendment (Venture Capital) Act 2002*. Together with supporting investment into the Australian venture capital sector entities at the high-risk start-up and expansion stages, the VCLP rules were designed in particular to encourage new foreign investment into these entities by providing special tax treatment for qualifying foreign investors.

Minor amendments were made to the VCLP rules in the *Tax Laws Amendment (2007 Measures No. 2) Act 2007* to expand the eligibility for special tax treatment to a broader range of foreign investors and to expand the types of eligible VCLP investments.

VCLP tax treatment

The tax treatment of partners under the VCLP regime comprise the following elements.

Flow-through taxation is provided to all partners in a VCLP. This means that gains and losses made by a VCLP flow-through to its partners. However, certain gains and losses are disregarded (explained further below).

Loss limitation rules apply to limit the tax losses which can be claimed by limited partners in a VCLP to the amounts they contribute into the VCLP. Given limited partners have limited liability on their investment in the VCLP, this rule ensures they cannot claim tax losses greater than their legal/economic exposure.

Foreign partners who are eligible venture capital partners are exempt from tax on gains made by the VCLP from the disposal of investments that are held for at least 12 months. Any losses made by the VCLP from the disposal of investments are also disregarded. Eligible venture capital partners must be foreign general partners or foreign limited partners, and:

- be exempt from tax in their own tax jurisdiction;
- be a 'foreign venture capital fund of funds' which does not hold a greater than 30 per cent interest in the VCLP (only for limited partners); or
- hold a less than 10 per cent interest in the VCLP (only for limited partners).

Foreign partners who do not satisfy one of these conditions are not entitled to the tax exemption treatment.

Carried interests received by general partners in a VCLP are deemed to be on capital account. Where a general partner is an Australian resident, carried interests may qualify for the CGT discount as long as it meets the relevant eligibility criteria.

The tax treatment is also available for funds of funds, that is, VCLPs that only invest in other VCLPs.

Requirements for a VCLP

A partnership must satisfy a number of requirements before its partners can access the VCLP tax treatment including that is must be registered with Innovation Australia as a VCLP. The main requirements for registration are set out as follows.

The VCLP must have a minimum partnership capital commitment of $10 million from its partners.

All foreign general partners must be resident of a country with which Australia has a Double Tax Agreement.

All investments held by the VCLP must be 'eligible venture capital investments' and must be held at risk. Eligible venture capital investments are shares, convertible notes (that are equity interests), units or options held in investment entities. Eligible venture capital investments must also satisfy a number of conditions (discussed in more detail below).

The VCLP must hold the eligible venture capital investment for 12 months before partners can be exempted from tax on gains made on disposal.

The VCLP must not invest more than 30 per cent of its committed capital in any investment (that is, the VCLP must make a spread of investments).

If a partnership does not satisfy these requirements, it cannot be registered as a VCLP and its partners will not be eligible for special tax treatments. If a registered VCLP breaches one of these requirements after registration, it must rectify the breach within a set period of time after which it will be deregistered. If deregistered, a VCLP's partners will lose access to the VCLP tax treatment for all investments.

Requirements for VCLP Investee Entities

All investments held by a VCLP must be eligible venture capital investments. To be an eligible venture capital investment, an entity into which a VCLP invests (an investee entity) must meet certain criteria. The main elements of these criteria are set out as follows.

The value of the investee entity at the time of any VCLP investment must be less than $250 million.

An investee company cannot be listed on a stock exchange or if a VCLP does invest in a listed entity, the entity must be delisted within 12 months.

An investee entity must be Australian resident and must have over 50 per cent of its employees and assets in Australia for 12 months from the time of any investment made by a VCLP.

A VCLP can invest in non-Australian investments as long as the sum of those investments is less than 20 per cent of its committed capital.

An investee entity can only invest in another entity if, broadly, it has an existing controlling stake in that other entity, and the other entity meets the requirements of being an eligible venture capital investment.

An investee entity cannot be used as a vehicle which predominantly invests in other entities.23 An exception is if the investee entity is used as a holding company to invest solely into one other company or unit trust which satisfies the requirements for being an eligible venture capital investment.

An investee entity is not permitted to engage in ineligible activities (unless less than 25 per cent of its assets, employees or income are attributable to those ineligible activities). Ineligible activities comprise:

- property development or land ownership;
- finance (banking, providing capital, leasing, factoring or securitisation);
- insurance;
- construction or acquisition of infrastructure facilities; or
- making investments that derive interest, rent, dividends, royalties or lease payments.

If an investee entity does not satisfy these requirements, it will not be an eligible venture capital investment and a VCLP will not be permitted to hold the investment. If a VCLP has already invested into a number of entities but one entity breaches a requirement, the investee entity must rectify the breach within a set period of time. If the breach is not rectified, the VCLP will be deregistered and its partners will lose access to the special VCLP tax treatment for all investments held by the VCLP.

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23 An investee entity cannot have over 25 per cent of its assets and assessable income in the form of investments in other entities from which it derives dividend income (Section 118-425(3) and (13), Income Tax Assessment Act 1997).

The ESVCLP regime

The ESVCLP regime was introduced under the *Tax Laws Amendment (2007 Measures No. 2) Act 2007*. The ESVCLP rules were designed to further encourage investment into early-stage start-up enterprises in the venture capital sector by offering further special tax treatment to partners.

ESVCLP tax treatment

As a starting point, the ESVCLP regime provides the same tax treatment as those provided under the VCLP regime. All partners receive flow-through treatment with loss limitation rules applying and the carried interests of general partners are deemed to be on capital account. However, additional special tax treatment is provided in the following two areas.

Tax exemption for gains made by the ESVCLP from the disposal of investments held for greater than 12 months extends to all partners in the ESVCLP, not just eligible venture capital partners. Any losses made by the ESVCLP from the disposal of investments are also disregarded.

All partners in the ESVCLP are exempt from tax on any share of income derived by the ESVCLP.

Requirements for an ESVCLP

The registration requirements for an ESVCLP are the same as those for VCLPs, with the following exceptions.

The ESVCLP's partnership capital commitment must be greater than $10 million and less than $100 million.

The ESVCLP must have an investment plan approved by Innovation Australia, and must report to Innovation Australian annually on the progress of implementing its investment plan.

Registration is a prerequisite for investors to access the ESVCLP tax treatment.

Requirements for ESVCLP Investee Entities

Similar to VCLPs, all investments held by an ESVCLP must be eligible venture capital investments. The requirements for an investment to be an eligible venture capital investment are the same as those under the VCLP regime, with the following exceptions.

The value of the investee entity at the time of any ESVCLP investment must be less than $50 million.

The ESVCLP must divest if an investee entity's value exceeds $250 million at the start of an income year. The ESVCLP has six months in which to divest, after which time the ESVCLP must be deregistered. Innovation Australia may extend the divestment period for a further three months.

If an ESVCLP is deregistered as a result of breaching the divestment requirements or any other requirements, its partners will lose access to the ESVCLP tax treatment for all investments held by the ESVCLP.

APPENDIX E: REGISTERED ESVCLPS AND VCLPS

VENTURE CAPITAL LIMITED PARTNERSHIPS

The following limited partnerships have capital and are registered with Innovation Australia under section 13-1 of the Venture Capital Act as venture capital limited partnerships. The table also shows their target investments at the time of registration.

	VCLP	Target Investment
1.	A&B ETCF SYDNEY NSW 2000	Follow-on opportunities in portfolio or spin-offs from its pre-seed fund.
2.	Anacacia Partnership 1 DOUBLE BAY NSW 2020	Established businesses typically with revenues >$10m and earnings >$2m needing financial and strategic support to facilitate ownership change (for example retirement) and/or growth (for example acquisition).
3.	Anchorage Capital Partners Fund SYDNEY NSW 2000	Expansion capital and buy-out transactions into businesses with an enterprise value of between $50-$250 million.
4.	ANU MTAA Super Venture Capital Partnership CANBERRA ACT 2600	Commercialisation of intellectual property.
5.	Archer Capital VCLP 3 SYDNEY NSW 2000	Leveraged buy-outs with an enterprise value in excess of $50 million, generally the divisions of larger listed Australasian conglomerates, or the local subsidiaries of foreign companies. No sector specific focus.
6.	Archer Capital VCLP 4 DAWES POINT NSW 2000	No specific sector focus. Intends to target investments in larger private companies ready for the next stage of corporate development or family-owned businesses.
7.	Archer Capital VCLP GF 1 SYDNEY NSW 2000	Not identified.
8.	Arowana Capital Australasian Micro-Cap Private Equity Partnership 1 NORTH SYDNEY NSW 2060	Micro-cap growth investments.
9.	BBF1 Partnership SYDNEY NSW 2000	Life science.
10.	Cleantech Australia Fund MELBOURNE VIC 3000	Clean technologies.
11.	Crescent Capital Partners II SYDNEY NSW 2000	Buy-outs.
12.	Crescent Capital Partners III SYDNEY NSW 2000	Not identified.
13.	Crescent Capital Partners IV SYDNEY NSW 2000	Business expansions, buy-outs (revenue of at least $40m) and buy-ins, restructurings, partial sell downs, public control plays and public to private transactions.

	VCLP	Target Investment
14.	CWC Corporate Opportunity No.1 Limited Partnership SYDNEY NSW 2000	Not identified.
15.	Equity Partners Fund No. 3 SYDNEY NSW 2000	Mid market expansion and buyout segments.
16.	Fulcrum Capital Partners Fund No. 1 MOSMAN NSW 2088	Companies with enterprise values between $10 million and $100 million.
17.	Goldman Sachs Trans-Tasman Private Equity Fund 07 MELBOURNE VIC 3000	Later stage private equity transactions such as management buy-out and buy-in opportunities.
18.	Harbert Australian Private Equity Fund I MELBOURNE VIC 3000	Mid-market buyouts and expansion capital deals. Businesses with enterprise value between $20-$100 million with a preference for $20-$50 million.
19.	Innovation Capital Fund II SYDNEY NSW 2000	Technology based companies.
20.	Jolimont Secondaries Fund II MELBOURNE VIC 3000	Not specified.
21.	MRCF IIF MELBOURNE VIC 3000	New seed and early stage investments in companies originating from Australian medical research institutes and research hospitals.
22.	Next Capital 1 SYDNEY NSW 2000	Listed or unlisted companies.
23.	Next Capital II MELBOURNE VIC 3000	Unlisted Australian businesses with less than $250 million total assets.
24.	Propel Private Equity Fund II SYDNEY NSW 2000	Buy-outs.
25.	Quadrant Private Equity No 1 SYDNEY NSW 2000	Eligible venture capital investments in mid-market buyouts and expansion capital deals.
26.	Quadrant Private Equity Fund No. 2 SYDNEY NSW 2000	Mid market buy-outs and expansion capital deals (businesses with enterprise values of $50-$300 million).
27.	Quadrant Private Equity Fund No. 3 SYDNEY NSW 2000	Investments will principally be in mid-market businesses that are mature, cash flow positive and at critical mass and that generally meet the following criteria: a talented management team with a proven track record in their business; a profitable business; an established position in a well defined growing market niche; and products and services with a sustainable competitive advantage in their markets.
28.	South Australian Life Science Advancement Partnership Adelaide SA 5000	The Partnership will seek investments in the development of the bioscience industry.
29.	Southern Cross Fund No. 1 NORTH SYDNEY NSW 2060	Not identified.

	VCLP	Target Investment
30.	Starfish Technology Fund 1 JOLIMONT VIC 3002	Focus of the fund will be in a broad spread of technology based companies. The aim is to invest in early to middle state companies in a range of high growth industries, predominately information, technology and communications, and life sciences.
31.	Starfish Technology Fund II JOLIMONT VIC 3002	Technology based businesses.
32.	Triangle Resource Fund (Australia) BRISBANE QLD 4001	Not identified.
33.	Viburnum Private Equity Partnership 1 PERTH WA 6000	The Fund will target investments in Western Australian based SME's.
34.	Wolseley Partners Fund I SYDNEY NSW 2000	Not identified.
35.	Wolseley Partners Fund II SYDNEY NSW 2000	Leveraged control positions in manufacturing, services and distribution companies with enterprise values between $20-$150 million.
36.	Yuuwa Capital BENTLEY WA 6102	Life sciences (including medical devices, pharmaceuticals, biotechnology) and information technology, media and communications.

The following limited partnerships are seeking capital and are conditionally registered with Innovation Australia under s13-5 of the Venture Capital Act as venture capital limited partnerships. The table also shows their target investments at the time of registration.

	VCLP	Target Investment
1.	Allegro Private Equity II SYDNEY NSW 2000	The Fund will target investments in small mid-market businesses in Australia and New Zealand with an equity investment of up to $30 million and an enterprise value of up to $100 million.
2.	Archer Capital VCLP GF 2 Dawes Point NSW 2000	Leveraged buy-outs of growth-orientated businesses with enterprise values ranging from $20 million to $150 million.
3.	Champ Ventures Investments 7 SYDNEY NSW 2000	Australasian mid-market expansion capital, replacement capital and buy-out opportunities across a broad range of sectors. The Fund will target established companies with enterprise values up to $200 million and will typically invest between $20 million and $55 million.
4.	Elcano Sustainability Investments 1 YERONGA QLD 4104	The Fund intends to have a sustainability focus including: Waste management, recycling; Energy generation, capture, storage, use and efficiency; Water purification, storage and use; Building and community design and development, materials and construction; and Transportation design and development, materials and construction.
5.	Harbert Australian Private Equity Parallel Fund I MELBOURNE VIC 3000	Private equity and hybrid mezzanine debt investments, directly or indirectly, in Australian resident companies with substantial assets and operations in Australia and may also consider select investments in New Zealand.

EARLY STAGE VENTURE CAPITAL LIMITED PARTNERSHIPS

The following limited partnerships have capital and are registered with Innovation Australia under s13-1(1A) of the Venture Capital Act as early stage venture capital limited partnerships. The table also shows their target investments at the time of registration.

	ESVCLP	Target Investment
1.	Constant Innovation NOTTING HILL VIC 3168	Young businesses active in providing technology based products or services into local and potentially global markets (including IT businesses such as software, internet, content and related services).
2.	OneVentures Innovation Fund SYDNEY NSW 2000	Cleantech, information technology and life science.
3.	Parallel Capital No. 1 SYDNEY NSW 2000	Intellectual property and technology, software and hardware, services businesses, media both traditional and new, consumer products, and asset management services.

The following limited partnerships are seeking capital and are conditionally registered with Innovation Australia under s13-5(1A) of the Venture Capital Act as early stage venture capital limited partnerships. The table also shows their target investments at the time of registration.

	ESVCLP	Target Investment
1.	Arowana Partners Growth Australasian Fund II NORTH SYDNEY NSW 2060	Eligible ESVCLP investments in Australian businesses within three classifications, each with a different risk profile; start-up/early commercialisation, emerging and early expansion across a range of industries.
2.	BGS Early Stage Venture Capital Limited Partnership BELROSE NSW 2085	Growth businesses including those operating in the following sectors: Environmental, including water, energy production, energy storage and advanced materials, Information, media and communication technology, Sustainable environmental science, Medical and pharmaceutical innovations and Innovative manufacturing solutions
3.	Carnegie Innovation Fund PADDINGTON NSW 2021	New or emerging companies commercialising Australian research and development with a focus on the following sectors — life sciences, bio-medical technologies and innovation industries such as information technology and engineering innovation.
4.	Elcano Sustainability Investments 2 GRACEVILLE QLD 4075	Eligible entities that are at their pre-seed through to early expansion stage that are seeking equity to fund their growth. Specifically the focus is on entities with techniques and technologies that can be beneficially used in the waste, recycling, energy, water building and transport sectors.
5.	Early Stage Capital Expansion Fund AUBURN VIC 3123	Investments in Australian businesses within three classifications, each with a different risk profile; start-up/early commercialisation, emerging and expansion across a range of industries.

	ESVCLP	Target Investment
6.	Sydney Angels Sidecar Fund MELBOURNE VIC 3000	Internet/web services, biotechnology, clean technology, healthcare, IT services, media and entertainment, communications and software development sectors. The Fund will leverage an exclusive partnership with Sydney based angel investment group, Sydney Angels, to invest alongside experienced active Angels.