

# Innovation Capital's submission to the Review of Tax Arrangements Applying to Collective Investment Vehicles

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## **Innovation Capital Introduction**

Innovation Capital is a venture capital manager based in Sydney. We are a manager of two funds, the first is a PDF and the second is a VCLP. In aggregate we have AUD\$100m assets under management and have invested in over 15 venture deals in Australia

We are a traditional Venture Capital manager with no mandate to concentrate on any one particular industry. As a Venture Capital manager our views may differ from the Private Equity manager who may be using a VCLP for purposes beyond its original intent

We offer the following comments on specific questions in this discussion paper.

## **A comment regarding Active versus Passive Investment Portfolios**

The paper states that in Section 2.20

*"It is important to distinguish between passive investment activity and trading Activity (as mentioned in the preceding paragraph) on the one hand, and control of a trading business by the CIV on the other. Control is the factor that indicates active involvement in the trading business and so funds such as private equity funds would not typically be considered to be undertaking passive investment activity."*

The paper then goes on to state that in Section 2.23

*"Collective investments that undertake primarily 'active business' activities, regardless of the type of entity utilised, are not considered as part of this review unless they come within the scope of the specific venture capital limited partnership regime (see Chapter 6)."*

Despite Section 2.23 stating that active business activities are outside your review, we would like to comment that due to restrictions within the VCLP legislation, outlined further in our responses below, often Venture Capital managers utilise Trusts as a collective investment vehicle or CIV.

Venture Capital managers like to align their investment goals alongside the Founders of the technology companies that we invest in and thus together the Venture Capital Manager and the Founders share in the gains or losses that result in the building of innovative technology businesses. While Venture Capital managers rarely hold greater than 50% of the companies they invest in, we are investing in young companies with immature management. Therefore we implement a governance structure and sometimes we have additional shareholder rights. Further, a key skill set of a Venture Capital manager is that they know how to launch, build and grow businesses and therefore they need a clear governance structure and decision making procedures to achieve these outcomes.

Typically Venture Capital managers invest for a period of 7 to 10 years before returns are evident. This is much longer than in the Private Equity asset class and would be further evidence that the gain are more capital in nature than as a result of short term buying and selling of assets. Further a Venture Capital manager rarely earns any income during the holding period, usually there is insufficient cash and profits to declare any dividends, and any interest on debt facilities, such as convertible notes, is typically capitalised.

Yet the gains that result from a successful exit from these technology businesses can be assessed differently for different investors. In the hands of the Founder(s), gains of the sale of their equity positions would be characterised as capital in nature. Yet in the hands of the Venture Capital CIV, these gains could be characterised as income in nature, due to the governance regime we put in place in our investee companies.

As your discussion paper already indicates in Section 6.18, this uncertainty about the classification of such gains from a Venture Capital investment, either in a Trust or a non-VCLP Limited Partnership is a negative on the ability to attract foreign investors, who would most likely be exempt from Australian capital gains tax. We also feel that it is a negative for potential domestic investors who seek to take advantage of the capital gains discount under either a Trust, a non-VCLP LP or even within a VCLP structure.

We also consider it inequitable that under the VCLP legislation foreign investors have been guaranteed that capital gains would be assessed as capital, yet the legislation remains silent for domestic investors and there exists common and case law suggests all gains for the domestic investors could be assessed on the revenue account.

## **Q 2.2 Issues / Questions**

*The Board seeks stakeholder comments on:*

*• the appropriateness of the widely held definition contained in the MIT legislation as a characteristic for a wider range of CIVs, and whether there any compelling reasons to have non-widely held vehicles included as CIVs;*

We feel that the 'widely held' definition, being on a formulaic look through or indirect basis, contained in the MIT legislation is a good step as there is now the ability to look through at the indirect number of participants in the CIV as opposed to ensuring there were greater than 25 Limited Partners or Trust members that have directly invested into a CIV.

Institutional investors have numerous members or beneficiaries, who usually can only access the Australian Venture Capital asset class via such institutional investors, thus it was important that a look through definition was adopted.

It should be noted that within the the domestically based institutional investment community there is a potential pool of only 5-8 institutional investors who actively invest in the Australian Venture Capital asset class. This pool is made up of Australian super funds or domestic 'fund of funds'. Even if all 8 potential investors were to decide to invest in a Venture Fund under the older definition such a Venture Capital MIT would fail the 'widely held' test. For this reason it is important that other CIVs, in addition to the MITs, that Venture Capital Managers could use are also allowed to use the new indirect 'widely held' definition.

However it is important to note that the current Division 6C exclusion of managers of active investment portfolios means changes the existing or further changes to the 'widely held' definition may be only a hypothetical advantage for a Trust with a Venture Capital mandate, due to the possible characterization of any gains on active portfolio investments outside the MIT regime.

*• the appropriateness of the current definition of eligible investment business in Division 6C of the ITAA 1936 as a prerequisite for a wider range of CIVs, and whether there are any compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included as CIVs;*

As we have stated above, we feel that gains on investments by Venture Capital managers are unfairly treated as under Division 6C their investments could be considered active rather than passive, and thus they have no access to an election under the MIT regime to characterise their gains as capital in nature.

Further common and case law suggest that even within a VCLP there remains ambiguity to the classification of gains for domestic investors.

We feel that there is one very good reason why Venture Capital active businesses should be included under the Division 6C eligible investments and that is Venture Capital manger contributes both investment capital and business expertise to their investees.

The business expertise comes from a deep knowledge of the requirements and pathway to develop a high risk early stage technology company into thriving long term commercially successful business. Building such businesses broadens the innovative capacity of the Australian economy and is a future source of job growth and taxable revenue. To achieve this outcome, Venture Capital Managers must be highly active within our investee companies and have in place a clear governance regime for decision making.

However if the Venture Capital manager achieves this policy outcome, the Division 6C eligible investment definition punishes the investors in such a Venture Capital CIV as it is possible these gains would be characterised as income rather than capital and it is unable to access a capital election as it cannot participate in the MIT regime.

It is interesting to note that in comparison an index equity fund which does little to develop the innovative capacity of the Australian economy can elect to opt-into the MIT regime and make a capital election ensuring their gains are characterised as capital.

Unlike Private Equity managers, the Venture Capital managers invest for a period of 7 to 10 years before returns are evident. This is much longer than in the Private Equity asset class and would be further evidence that the gains are more capital in nature than as a result of the quick flipping of assets.

Further a Venture Capital manager rarely earns any income during the holding period; usually there is insufficient cash and profits to declare any dividends, and any interest on debt facilities, such as convertible notes, is typically capitalised.

*• whether there is a need to further define 'control' in Division 6C of the ITAA 1936 to provide greater certainty for investors in MITs and other CIVs, and if so, how this could be achieved.*

As we have already stated, the Venture Capital manager's efforts to build business to make gains on its investment take both considerable time and resource with little revenue streams until the time of exit. This is self evident of a capital characterisation of any gain. However as the Venture Capital manager relies upon the control provisions set out in its investment terms to achieve these results, Division 6C could assess this as an active portfolio and therefore access to the MIT regime, with its capital election facility, would be denied.

While we offer no suggestions to the improvement of the definition of control, which has been widely debated and then resolved in accounting standards and pronouncements, an alternative could be to relax the definition of an active investment portfolio in Division 6C so that a Venture Capital CIV, as opposed to Private Equity CIV, whilst clearly active with its investments, could still opt-in to the MIT regime if the CIV was either a Trust or a similar regime for a Limited Partnership which has a Venture Capital mandate.

The existing VCLP legislation could be utilized to assist the Board of Taxation in delineating a Venture Capital fund from any other type of fund, including Private Equity funds. Such qualifying Venture Capital funds could then enjoy access to an exemption to the Division 6C exclusion of active portfolio managers regardless of the CIV structure utilized.

As we note later in our submission, we are of the opinion that the size of any one eligible investment could be reduced from investee company assets of \$250m to \$100m without any impact on the number or size of Venture Capital deals in Australia. Such a reduction may limit the possible tax leakages from our suggested Division 6C exemption as the exemption would be more likely restricted to Venture Capital funds who perform small Venture Capital deals.

We wish to stress that Venture Capital managers face increased difficulty in attracting both foreign and non-Superfund domestic investors under the current CIV legislation (including the MIT and VCLP legislation) due to the uncertainty in the characterization of any gains.

It should be noted that large institutional domestic Superannuation Funds are currently the largest contributor of Venture funds in Australia as they are less concerned with a capital or revenue classification of their returns due to their already lightly taxed regime. It may be possible to expand the pool of domestic investors beyond Superannuation investors if such uncertainty was removed.

### **Q 3.1 Issues / Questions**

*The Board seeks stakeholder comments on:*

*• the nature and extent of, and the reasons for, any impediments to investments into Australia by foreign investors through MITs;*

We outline below why a Venture Capital manager might chose to establish a CIV other than a VCLP, yet under current legislation if such a CIV was a Trust it would not be able to opt-in to the MIT regime as its portfolio would likely be considered active.

Thus the current MIT legislation is of little use to a Venture Capital manager as we cannot provide assurance to potential investors that gains would be characterized as capital in nature. Therefore it would not be attractive to foreign investors and of limited attractiveness to domestic investors, especially non-Superannuation funds and high net worth individuals.

*• suggestions on how the complexity of character and source retention under flow-through taxation could be alleviated through alternative CIV vehicles that are more attractive or user-friendly to non-resident investors.*

As outlined above in response to question 2.2, one suggestion would be to allow Venture Capital CIVs, as opposed to Private Equity CIVs, who invest for a longer timeframe (7-10 years) and who generate limited revenue streams during the holding period, (as rarely are earnings or cash flow sufficient to declare any dividends, and any debt interest is capitalised), to be treated not as active investment but as either passive or exempt from the active prohibition in Division 6C. The VCLP legislation could be used as a guide to delineate Venture Capital funds from other funds, including Private Equity funds.

This would allow the ability for the Venture Capital CIV to opt into either the MIT regime, if a Trust structure was used, , thus make a capital election this providing assurance to both foreign and domestic investors.

We also note that further changes should be made to the VCLP legislation to ensure that domestic investors have enshrined the same flow through taxation rights as foreign investors currently enjoy. We are the opinion that the VCLP legislation is quite user friendly to the foreign investor, however there exists clear uncertainty for the *domestic* investor.

### **Q 3.3 Issues / Questions**

*The Board seeks stakeholder comments on:*

- *generally, what changes could be made to the LP regime to provide for an appropriate LP CIV;*

We discuss later in our submission specific improvements that could be made to the existing VCLP legislation.

- *whether LPs are suitable vehicles for widely held, primarily passive, collective investments;*

Under the current definition in Division 6C it is possible that Venture Capital investments would be considered to be active, therefore we see limited value in using non-VCLP Limited Partnerships today, as at least the VCLP legislation provides some tax characterization certainty for foreign investors.

However the Limited Partnership CIVs are a known quantity in the US market and they have been successful in raising funds both from US domestic and foreign (primarily European and Asian) investors. A Limited Partnership CIV operating in a Limited Partnership regime where the Venture Capital manager can provide assurance that gains are capital in nature, would be an attractive vehicle to attract potential foreign investors, especially US and Asian investors.

- *whether it is desirable to introduce changes to the LP regime, so that flow-through taxation is allowed for those widely held LPs that restrict their investment activities to primarily passive investments;*

Such proposed changes are unlikely to be beneficial to the Venture Capitals manager as their investment portfolio is likely to be classified as active.

Therefore we offer no direct response, except to say that flow through taxation to any Venture Capital CIV is a worthy goal and would be attractive to both domestic and foreign investors.

*• if flow-through were allowed for LPs marketed at the wholesale level or for sophisticated investors that restrict their investment activities to primarily passive investments, would it be appropriate not to require these LPs to be 'widely held' (as defined in the MIT regime)? What would be the rationale for allowing this when compared to MITs which are required to be widely held; and*

Flow through taxation is a very beneficial outcome for any Limited Partnership, and this applies to either a VCLP or a Limited Partnership with a mandate for Venture Capital investing.

We are of the opinion that the widely held definition needs to be based on number of superannuates or indirect beneficiaries, not the number of direct Limited Partners. Within the Australian based institutional investment community there is a potential pool of only 5-8 institutional Limited Partners, usually made up of Australian super funds or domestic 'fund of funds'. These institutions have numerous members or beneficiaries, who can only invest in the Australian Venture Capital asset class via these institutions.

It should be noted that these institutions are passively managing their portfolios, but rely upon the Venture Capital manager to be highly active and engaged in its investments. In fact this criteria is deeply explored during due diligence and is seen as a point of difference in assessing whether to invest in a Venture Capital manager or not.

Defining widely held by only counting the number of signatures on a Limited Partnership agreement is under-estimating the number of underlying investors and could potential limit the creation of any future Venture Capital CIVs in Australia.

A definition that allows a very few number of direct Limited Partners reflect the reality on the ground that only a few number of domestic superannuation funds and fund of funds exist who actually understand the asset class and have an appetite for Venture Capital investments.

There are just not sufficient numbers of potential investors in Australia who both understand and are willing to invest in the Venture Capital assets class to meet widely held definition test that requires a high count of direct Limited Partners.

*• apart from limiting the flow-through of losses, would there be a need, in light of integrity and investor protection considerations, to apply further restrictions to*

*that modified LP regime? If so, what would be the nature of those restrictions?*

We don't agree that under a full flow through tax treatment that there should not be a full pass through of losses. This principal has already been raised in the submissions to the Mineral Council about losses incurred on early stage development projects. Early stage venture capital investments are not dissimilar to these risky projects.

With regards to other legislation, the largest investors in the Australian Venture Capital asset class are currently large sophisticated high net worth or wholesale investors which have either dedicated internal teams or external advisers who understand both the risks and the performance criteria to best select a Venture Capital manager. They perform extensive due diligence before making an investment decision. We do not believe that mandating through legislation will achieve better outcomes for investor protection.

The required use of Product Disclosure Statements, with all of its related compliance legislation would be sufficient if the asset class were actively promoted to non-sophisticated investors.

There is another aspect to investor protection we would like to draw your attention to. Your comment in Section 6.18 is very important:

*"The tax treatment of gains made by domestic partners through a VCLP is not specifically covered by the VCLP regime. These gains are taxed on a capital or revenue basis according to the particular circumstances."*

We feel this uncertainty is of more concern to potential domestic investors than any other investor protections and unfortunately this is a risk that investors cannot mitigate through due diligence.

### **VCLP submission**

The discussion paper already refers to prior submissions which indicate that equal and/or more secure tax outcomes could be achieved for domestic and foreign investors using a Trust structure without the restrictions imposed by the VCLP legislation. Such an outcome would be enhanced if, as we have suggested, changes to the Division 6C legislation allowed a Venture Capital manager to establish a Trust that would qualify to enter the MIT regime and its capital election.

Nonetheless there are certain foreign investors who are more comfortable investing in a Limited Partnership structure and therefore it is useful to offer this type of CIV in Australia.

We are of the opinion that the VCLP legislation, as it is legislated today, needs to be updated in certain areas as outlined below.



## **Q 6.1 Issues / Questions**

*The Board seeks stakeholders comments on:*

- whether the restrictions imposed on the VCLP and ESVCLP regimes are consistent with their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;*
- what are the restrictions that arguably require the use of some sort of companion structure to overcome shortcomings of the regime;*

### Size of Company Assets

As a Venture Capital manager, we are of the opinion that the existing restrictions such as maintaining the initial geographical connection or management or staff connections to Australia and the exclusion of investments in property, financial services or infrastructure are consistent with the policy objectives and desired outcomes.

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 size of the investee's company assets could be reduced to AUD \$100m without any impact on the number or size of Venture Capital investments in Australia.

[As an aside it should then be possible to use this more restricted definition of eligible venture investments and apply this also when assessing whether a MIT is a Venture Capital MIT. A Venture Capital MIT should then be able to seek an exemption from the possible Division 6C exclusion of active portfolio investors, thus enabling a Venture Capital manager using a Trust structure where it is preferred by its investors.]

### Restriction of listed stock

We often find that innovative Australian technology companies are listing on the ASX as there is limited other capital sources i.e. they are performing funding IPOs 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.

Removing the restriction on investing in listed companies for no more than 12 months would allow more of these small caps technology companies to access further capital and management expertise to assist them become successful innovative companies. The holding period could be extended to four years to allow a Venture Capital manager to apply their expertise and additional capital to the listed business and then exit their holdings. A cap of 20-30% the Fund's committed capital could also be considered to ensure that listed stock investments are not the sole focus of the Fund.

#### Restriction of roll-up opportunities

The rules provide in Section 118-425(4) that a company that a VCLP has invested in may not invest any VCLP moneys in any other entity unless that entity is already a connected entity of the company (broadly, an associate or related company). 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.

This restriction should be removed.

- *suggested amendments to the tax treatments under the VCLP and ESVCLP regimes that would enhance their effectiveness in achieving their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;*
- *would the introduction of a deemed capital account treatment for domestic limited partners investing into a VCLP contribute or detract from its policy objectives? What other considerations would be relevant to introducing such a deemed capital account treatment;*

The most significant change would be to implement a full flow through tax treatment for both foreign and domestic investors. Such a treatment should pass through to the Limited Partners all capital gains or losses and assess them on the capital account and also any income revenues and losses on the revenue account.

While under the VCLP legislation foreign investors have enshrined that capital gains would be classified as on the capital account, common and case law has created ambiguity as to whether the gains on the sale of equity and debt positions in an investee company are going to be characterised as either revenue or capital for a domestic investor, regardless of their *prima facie* flow though tax characteristics. This is an impediment to attracting domestic potential investors beyond the current Superannuation investor pool. We do not understand why foreign investors do have legislative clarity on the treatment of their gains on eligible investments but domestic investors do not.

There is a high level disconnect in the overall policy initiative to convert the large Australian R&D expenditure into growing commercial enterprises and ultimately building long term businesses (i.e. capital growth) while there exists uncertainty in common and case law about whether such gains could be assessed on the income account rather than the capital account, regardless of their flow through tax basis. Thus potential investors, especially those domestic institutional investors who do not have complying Superannuation fund status, sit on the sidelines, an outcome which is contrary to policy initiatives to attract more funds in the Australian Venture Capital asset class.

The Venture Capital asset class is highly under-capitalised and bringing in a wider pool of potential investors (i.e. non-Superannuation investors) is a possible source of more capital, however the domestic investor tax uncertainty is a hindrance to this outcome.

Changes to the MIT regime for passive investors has clarified this characterization issue, however uncertainty remains for all CIVs with active portfolio investments and domestic investors in VCLP structures.

To characterise the gains from our efforts to build long lasting innovative businesses from the early R&D stages to successful commercial enterprises as gains on the income account is contrary to the policy positioning.

Capital deployed to develop these businesses should not be characterised as generating income gains instead we are of the opinion that we are making long term investments which generating long term benefits to Australia's economic diversity and innovative capacity, and that our gains on the exit of our positions in these companies should be characterised as capital, as they would on a *prima facie* flow through tax basis.

While an ultimate determination by the ATO may decide that this is the case, a greater level of certainty would be provided if it was quickly legislated as such, in the same manner as it is legislated for foreign investors.

In our discussions we are often told by domestic and foreign investors and institutions alike that they are highly respectful about the R&D capabilities of Australia (CSIRO, NICTA etc.) however tax uncertainty makes the domestic non-Superannuation institutional investors wary of committing support to commercial spin-outs from these institutions.

Securing a full flow through taxation treatment would be a very worthwhile for existing and future VCLP managers as it would allow these structures to be marketed to domestic non-Superannuation institutional investors and thus expanding the potential pool of funds available to the asset class. As stated earlier the VCLP potential pool of Limited Partners is currently dominated by Superannuation institutional investors who already have significant tax advantages and therefore are less concerned about the classification of their gains.

A larger potential pool of funds, would lead to a greater likelihood of Venture Capital managers able to access funds and build businesses and thus achieving the policy outcomes.

We wish to recommend one other potential initiative which is a disclosure requirement that large Australian complying Superannuation funds disclose how much money they have invested under Australian VCLP and ESVCLP legislation. This could then be used by potential superannuants as another selection criterion to choose where to invest their super contributions. This could drive Superannuation behaviour similar to what we see with disclosures about ethical or sustainability investment policies.

*• given the carried interests of general partners are already deemed to be on capital account, should general partners receiving gains made by a VCLP on the disposal of eligible venture capital investments also be deemed to be on capital account*

General Partners are usually compelled to invest alongside Limited Partners in order to have some 'skin in the game'. This often results in the General Partners being overweight in the risky alternative investment space when reviewing their own personal portfolio.

We strongly feel that both the Limited Partners and the General Partners are treated the same and further that any gains made on such investments are characterised as capital for all investors.

These risks being taken by the General Partners are the same as the other Limited Partners and gains should be characterised in the same manner as other Limited Partners.

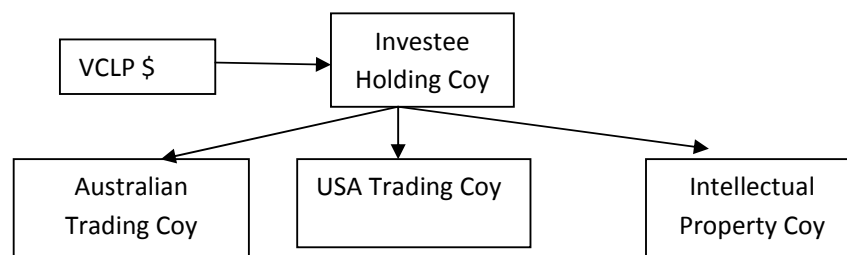
*• are the current levels of investment through VCLPs and ESVCLPs consistent with what would be expected normally for these types of programs compared to similar programs in other jurisdictions;*

We are not an expert in other jurisdictions but we know that the Australian Venture capital industry is under-capitalised and uncertainty about tax treatments is a leading factor in not being able to source funds internationally and from non-Superannuation domestic investors.

*• the desirability of further changes to the tax treatments in the VCLP or ESVCLP regimes to enable them to better achieve their policy objectives?*

- As we have repeatedly stated, domestic investors should be treated equitable as foreign investors and both should benefit from full flow through taxation regime
- We support the continuation of deductibility of management fees under both ESVCLP and VCLP.
- We support that 'carry' continues to be on capital account under the VCLP and ESVCLP.
- Generally, an investment is not an eligible venture capital investment if its sole asset is shares in subsidiary company which is used to generate interest, rents or

dividends. Specifically, section 118-425(3) and (13) would identify this as an ineligible activity. We note that section 118-425(11) provides some relief in this regard, in that it allows a VCLP to make an investment in a holding company specifically held for the purposes of acquiring a target entity. However this is not how a Venture Capital investee group uses holdings companies, instead it is used to protect the intellectual property of the investment which is the core of any venture capital investment - see diagram below of a typical structure. These holding companies do not typically earn interest or rents or dividends but may earn a capital gain if one or more of the subsidiaries are sold. While indirectly the legislation would not prohibit such a structure it would be better if the legislation was improved to explicitly state that such a typical Venture Capital structure is not subject to an ineligible investment determination.



### Concluding Remarks

The biggest anchor to a successful Australian Venture Industry is lack of funds being invested by Australian Superannuation Funds, however given their existing tax advantages we are of the opinion that they are little swayed by either MIT or VCLP tax considerations or tweaks.

However by providing a full flow through tax treatment would assist in expanding the pool of both foreign and domestic non-Superannuation funds willing to invest in the Australian venture capital asset class.

Further improving the flexibility of the investment options by allowing the investment into qualifying listed stocks increases the likelihood of higher returns, which creates a virtuous circle of attracting more potential Limited Partners and in turn continuing to raise more funds for the Australian Venture industry and thus achieve policy objectives.