Starfish Ventures

7 March 2011

John Emerson
Chairman of Review of taxation arrangements applying to Collective Investment Vehicles
Board of Taxation
C/- Treasury
Langton Crescent
CANBERRA ACT 2600
Dear Mr Emerson

Review of taxation arrangements applying to Collective Investment Vehicles

Starfish Ventures Pty Ltd (**Starfish Ventures**) welcomes the opportunity to provide a submission in respect of the Review of Collective Investment Vehicles (**CIVs**).

1 About Starfish Ventures

Starfish Ventures is a Melbourne based fund manager, specialising in investment in high growth companies, primarily in software and information technology, biotechnology and life sciences, and environmental and clean technology.

Starfish Ventures has raised and manages approximately $400m. To date, Starfish Ventures has raised three principal funds, two of which have been structured to involve a venture capital limited partnership (**VCLP**). However, the second VCLP has two trusts 'stapled' to it. The inclusion of two trusts was necessary to overcome some of the shortcomings we experienced in raising and operating the first VCLP. Unfortunately the addition of the trusts is less than ideal as it adds significant complexity to the fund structure, resulting in increased logistics in fund establishment, managing investor interests and meeting reporting requirements.

The first fund, Starfish Technology Fund I, raised $138.25m and through the VCLP has made investments in 16 companies. The second fund, Starfish Technology Fund II, a VCLP with stapled trusts, raised $185m and to date has invested in 12 technology companies.

Starfish Ventures' preferred investment vehicle is the VCLP. An investment is only made through the stapled trust structure 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 the future. Of the 12 investments made by Starfish Technology Fund II, three investments have been made through the stapled trusts due to constraints of the VCLP. Those three investments were made through the trusts for the following reasons:

(a) Company 1 operates in the energy sector and leverages technology to manage demand for energy, particularly during peak demand periods. The company generates revenues from a variety of activities, including via creation of financial hedges which are sold into the energy market. Even though we believe that the activities of the company meet the broad objectives of the VCLP regime we were concerned that a conservative interpretation of section 118-425 (3) of Income Tax Assessment Act 1997 would deem that a small

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proportion of the company's activities were ineligible activities. If so, this would destroy the effectiveness of the entire VCLP. The risk of this company failing the ineligible activities test led us to choose the stapled trusts as the investment vehicle.

(b) Company 2 operates an internet based business servicing consumers in the selection and acquisition of insurance products. While the company is a technology business generating revenue through the innovative use of internet technologies, the risk of this company failing the ineligible activities test led us to choose the stapled trusts as the investment vehicle. Furthermore the company was experiencing strong revenue growth and its growing enterprise value introduced the risk of failing the Permitted Entity Value test.

(c) Company 3 provides automated retail solutions for merchants and consumer goods brands. The company was founded in Australia and continues to be led by its founder, however as the company pursued its market opportunity it migrated its operations to the USA. All of the company's employees are now based in the USA. At the time of the fund's investment the assessment of section 118-425(12A) and the reference to section 118-425(2), requiring investments be made in an Australian resident, led to the decision to choose the stapled trusts as the investment vehicle. Due to the uncertainty surrounding other investments in the fund, it was considered prudent to invest via the stapled trusts despite the carve out of section 118-425(12A) applying to up to 20% of the fund's committed capital.

Starfish Ventures remains a committed supporter of the VCLP structure and we consider an ideal investment structure would be a single VCLP vehicle through which all investments could be made. Unfortunately as of today the scope of investment opportunities we pursue limits our ability to rely solely on the VCLP. We hope the following comments assist in building on the strong platform of the VCLP program.

2 General comments about CIVs

In our view, the general principles that should be used to develop a CIV that would work for the venture capital industry would require among other things the following attributes:

(a) provide certainty of tax outcomes for both domestic and international investors;
(b) allow the fund manager the ability to control the investee;
(c) have sufficient flexibility to allow the CIV to invest funds both domestically and offshore;
(d) provide incentives for the fund managers to attract the requisite expertise; and
(e) be simple to administer.

While the MIT regime achieves some of these outcomes to a degree, there are considerable problems with the MIT regime from a venture capital perspective including, but not limited to:

- The use of a trust structure rather than a limited partnership. The limited partnership model is the internationally preferred structure for private equity and venture capital investment;

- Difficulties with applying the definition of MIT participation interest to private equity and venture capital funds where the fund manager is entitled to a carried interest. In particular there is significant uncertainty as to how to calculate an

MIT participation interest in respect of a carried interest and how the various widely held and closely held tests are satisfied when the fund is in 'catch up mode' in relation to the payment of the fund manager's carry[1];

- In applying the various 'membership' tests, the inability to trace through limited partnerships' investors to their ultimate investors;
- The application of the 'control' test in Division 6C. For venture capital funds, a structure that prohibits control of the investee (either positive or 'negative' control via veto powers) is simply impractical; and
- The MIT regime does not provide any incentive for managers to move into the venture capital area.

These problems are leading to domestic funds establishing a number of trusts to form one 'fund' as specified widely held investors are insisting on investing via their own trust to ensure that that trust will qualify as a MIT. This leads to complexity and administrative difficulties.

3 Specific issues raised in relation to VCLPs

We set out below our submissions in relation to some of the specific issues which the Board sought comment on:

(a) ***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?***

With over $300m in commitments in funds using VCLP structures and having made nearly 30 investments via those funds, Starfish Ventures is well qualified to report on its experiences. In general Starfish Ventures is a supporter of the VCLP regime and the majority of our investments have been made via the VCLP.

When the VCLP operates as a standalone vehicle the legislation imposes a reasonably substantial but manageable reporting and management burden on the general partner. This burden alone is not an inhibitor to the use of the VCLP.

Unfortunately the VCLP has a variety of limitations when used in practice, and these impact its use in supporting early stage and expanding Australian businesses. We have detailed these limitations below and in response to those limitations Starfish Ventures elected to add significant complexity to the structure of our second major fund when we adopted a stapled trust companion structure to a VCLP.

[1] We are happy to provide examples of the problems with the MIT Participation Interest if requested.

(b) ***What are the restrictions that arguably require the use of some sort of companion structure to overcome shortcomings of the regime?***

There are some important ways in which the VCLP can be adjusted to improve the industry's ability to support Australian technology businesses.

(1) **Uncertainty on capital treatment for domestic investors**

The most pressing issue for a VCLP is providing deemed capital treatment for domestic investors. We are aware that the ATO has issued a recent interpretative decision (ATO ID 2011/7) which provides some assurance for domestic super fund investors in a VCLP that suggests their share of any profits. However, that ATO ID is not binding on the ATO and does not provide any assistance to other domestic non-super fund investors.

(2) **Australian Resident restrictions**

The risks associated with funding an early stage company are only justified by the potential return the company may generate. Often this requires a company to be addressing a global customer need with scale beyond the confines of the Australian market. In pursuing such opportunities many Australian companies relocate some and often the majority of their operations to be nearer their global customers. Paradoxically, the more global outlook a company has, the less likely it is to meet the Australian Resident restrictions.

(3) **Ineligible activities**

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 businesses. 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 restrictions on these companies accessing growth capital stifles their expansion, limits jobs growth and curtails the opportunity for Australia to grow globally competitive businesses.

(4) **Delisting requirements for publicly traded companies**

Due to the ease of listing on the Australian Stock Exchange (ASX) there are many ASX listed companies that are at a stage in their development that require both the capital and discipline that a venture capital

manager can bring. The current VCLP excludes these companies from receiving support from venture capital managers. It has been our experience that small capitalisation companies on the ASX can be managed as venture capital investments where the venture capitalist makes an investment in a company prior to, at, or after listing on a stock exchange. For example, an existing Starfish Ventures portfolio company has listed and is actively managed as a venture investment. Unfortunately the VCLP is restricted from making follow on investments into the public entity, and this is harming the company's ability to raise further capital.

(5) **Permitted entity value**

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.

In our view it is the nature of the activities that should determine eligibility, rather than size of the investee.

(c) ***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.***

(1) **Uncertainty on capital treatment for domestic investors**

Confirm the treatment of domestic investors reflects that of international investors.

Without being able to provide this certainty to domestic investors the VCLP regime will fold and future venture capital funds would need to be structured as MITs. This may not be possible given that venture capital investments typically provide for control of the investee. These two diverging requirements could effectively destroy the budding venture capital industry in Australia.

(2) **Australian Resident restrictions**

Relax the Australian Resident restrictions from VCLP funds. The restriction means the VCLP can't support Australian technology companies which have globalised, or perversely even support the simplest of start-ups, for example where three founders happen to be split with one in Australia and two offshore. The restrictions are also in

conflict with the separate, but related policy objectives of developing Australia as a financial centre.

(3) **Ineligible activities**

Relax the constraints on ineligible activities and provide Innovation Australia (or other appropriate authority) with the ability to provide an exemption for certain investments within a meaningful timeframe, eg one working week.

(4) **Delisting requirements for publicly traded companies**

Remove the delisting requirements for publicly traded companies. Additionally, in the spirit of venture capital investing, require that VCLP investments are only eligible for new share issues, being the purchase of primary shares, while providing general partners with flexibility to make transfers between funds without triggering the delisting requirements. This limitation would prevent equity and hedge funds accessing the VCLP benefits while providing venture capital managers with the flexibility to invest appropriately.

(5) **Permitted entity value**

There should be no limit on the permitted entity values for eligible venture capital investments.

(d) ***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?***

The fact that all Australian venture capital managers are not utilising a single vehicle VCLP or ESVCLP for their funds, and often not using them at all, clearly reflects that the Australian practice is out of step with the standard global practice. It is our experience that our counterparts in the US venture capital sector only use limited partnership structures for their funds. This is also our preferred position.

(e) ***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?***

As stated above we believe this is a crucial time in the evolution of the Australian venture capital industry. The industry is only just establishing itself as a viable sector and continuing uncertainty for the major source of investment funds, being domestic limited partners, runs the real risk of crippling the industry before it reaches maturity.

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(f) ***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?***

Yes – this should follow as a matter of course from all investments by a VCLP being on capital account.

In addition, 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.

(g) ***The desirability of further changes to the tax treatments in the VCLP or ESVCLP regimes to enable them to better achieve their policy objectives***

Please see the responses to section (c) above.

We would be happy to provide you with further information in relation to our comments and recommendations if you desire.

Yours sincerely

John W Dyson
Director
Starfish Ventures