BRANDON CAPITAL PARTNERS
creating value in the life sciences

28 February 2011

The Board of Taxation
The Treasury
Langton Crescent
CANBERRA ACT 2600

By email to: taxboard@treasury.gov.au

Dear Sir/Madam,

Submission on the Review of Tax Arrangements for Collective Investment Vehicles

Please find the attached submission from Brandon Capital with our feedback on the Board of Taxations "Review of Tax Arrangements for Collective Investment Vehicles" paper of December 2010.

Yours sincerely,

Steph Thompson

Stephen Thompson
Managing Director

T +61 2 9247 2577
F +61 2 9247 7344
E info@brandoncapital.com.au

Brandon Capital Partners Pty Limited
Level 2, 210 George St, Sydney NSW 2000
PO Box R1168, Royal Exchange NSW 1225

www.brandoncapital.com.au
ABN 82 128 415 903
AFSL 344082

Brandon Capital Partners Submission on the Review of Tax Arrangements Applying to Collective Investment Vehicles

Introduction

Brandon Capital Partners (Brandon) is a venture capital fund manager based in Sydney and Melbourne. Brandon currently manages the $50 million Brandon Biosciences Fund 1 (BBF1) and the $30 million Medical Research Commercialisation Fund (MRCF).

- BBF1 is a $40 million VCLP with a parallel $10 million Unit Trust that has made an MIT capital election. The BBF1 VCLP is an IIF licensed as fund under Round 3 tranche 1 of the Commonwealth Government IIF scheme.
- The MRCF is a Unit Trust that has made an MIT capital election. Brandon and the MRCF collaboration have recently been awarded an IIF licence under tranche 3 of Round 3. This new $40 million fund will be structured as a VCLP.

As a stakeholder managing Australian domestic venture capital funds Brandon welcomes the Tax Board's initiative to review the tax arrangements applying to Collective Investment Vehicles. The Principals at Brandon have many years of venture funds management experience both here in Australia and abroad. This submission is in response to the Discussion Paper of December 2010 and its intention is to provide input around some of the points raised, and to address relevant questions raised in the Discussion Paper. This submission will solely address the questions raised in Chapter 6 of the Discussion Paper relating to Venture Capital Limited Partnerships.

6.1 Issues / Question regarding VCLPs

1. *"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?"*

The restrictions placed on VCLP's and ESVCLP's (especially under an IIF License) do encourage investment behaviour that is consistent with the policy objectives of promoting early stage, high risk Australian start-up companies.

2. *"What are the restrictions that arguably require the use of some sort of companion structure to overcome shortcomings of the regime?"*

The primary reason to employ a parallel trust alongside a VCLP is to be able to support investee portfolio companies that find themselves ineligible for support from a VCLP. This occurs in the following relatively common situations:

a. Where the portfolio company has listed on the ASX, but is still a cash negative development company and needs to raise further capital from its shareholders. If the original fund invested was a VCLP it is prevented from participating in any rights issue or capital raising. In these instances a parallel trust has the opportunity to take up the rights of the VCLP.

Additionally, there is a well-established practice in the USA and, to a lesser extent Europe, of venture funds investing in publicly listed companies using PIPES / VIPES to make active venture like investments in public companies. This is another compelling reason for removing the restriction of VCLPs investing in publicly listed companies.

It is our recommendation that the restriction on VCLPs investing publicly listed be removed.

b. Secondly, 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.

It is our recommendation that this cap be removed and altered so that VCLP's can invest in portfolio companies that have re-domiciled so long as they are continuing to commercialise Australian originated R&D.

c. Thirdly, investments are often structured using a holding company, in particular when there separate companies holding the IP and another company being the operating company. Under the current VCLP legislation VCLP's cannot invest in holding companies. These situations are currently accommodated through the use of a parallel trust.

It is our recommendation that the restriction on investing in holding companies be loosened so that where there is a holding company by virtue of separate IP and operating subsidiaries a VCLP could invest in the top holding company.

3. *"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."*

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. *"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?"*

There is a current cap on a VCLP's that means they cannot invest in companies with assets of more than $250 million. As technology based companies can take time to reach profitability and, thus may raise capital over many years, this seems an artificial cap to place on the activities of a VCLP. It is even more onerous in the context of an ESVCLP where once the investee company has $250 million in assets the "fund" must divest itself of the asset.

It is our recommendation that this cap be removed or else raised to $500 million.

5. *"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 introduction of a deemed capital account treatment for domestic limited partners investing into a VCLPs is very important. There is tremendous uncertainty, especially in the light of the ATO Tax Determination (TD2010/21), amongst local and overseas investors as to how the realisations from VCLPs will be treated.

It is our recommendation, for domestic and foreign investors that it is clear that all limited partners, domestic and overseas, are treated equally and assured that all capital investment realisations are indeed on their capital account.

6. *"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?"*

One of the most attractive features of the VCLP regime is the deemed capital account treatment of gains that the general partners receive under carried interest plans following the successful realisations of venture capital investments.

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

Final general comments

1. In order for Australian private equity (as distinct from venture capital) to be internationally competitive in its fund raising it should have a simple bare Partnership structure as is common in most other jurisdictions it operates in. It is our experience that overseas investors do not understand (and indeed are wary of) trust structures. Private equity should not really be using VCLPs as a mechanism to get around the lack of a proper bare PE Partnership structure. It is not what the VCLP legislation was intended for.

2. The Government should see that the R&D Tax credit bill (stuck in Senate) is passed ASAP. This is potentially one of the most powerful ways of stimulating the early stage knowledge driven companies that should become a backbone of the Australian economy in future years.