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February 25th 2011

By electronic lodgement
Review of the tax arrangements applying to collective investment vehicles
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

Dear Sirs

Discussion Paper – Review of the Tax Arrangements Applying to Collective Investment Vehicles
Submission made in regard to VCLPs on behalf of Harbert Fund Advisors (Australia) Pty Ltd

On behalf of Harbert Fund Advisors (Australia) Pty Ltd (**"Harbert Australia"**), we welcome the opportunity to provide a submission in response to the December 2010 Board of Taxation Discussion Paper entitled *Review of Tax Arrangements Applying to Collective Investment Vehicles* (**"the Discussion Paper"**).

By way of background, Harbert Australia is an Australian company that provides local advisory services to two Venture Capital Limited Partnerships that were established in 2009 to attract foreign and domestic investment capital into Australia – Harbert Australia Private Equity Fund I LP (**"HAPE I"**) and Harbert Australian Private Equity Parallel Fund I LP (**"HAPEP I"**) (together "**the VCLPs**").

These VCLPs represent the sole means by which we invest in small to medium sized growth companies, that is, companies with an enterprise value between $20-$50 million. To date we have raised approximately $40 million from predominately American individuals and invested approximately $30 million in three fast growing Australian businesses. We have plans to raise HAPE II later this year with a target size of $100-$150 million. The outcome this current tax review into VCLPs will have a direct impact on the success of our fund raising.

Based on our own first-hand experiences in establishing and maintaining VCLPs, we feel it is appropriate to provide some direct insight into the practical difficulties and inefficiencies encountered. We trust that these comments, together with our suggested solutions, will enable the VCLP rules to be improved in order that Australia can continue to attract additional foreign investment capital to stimulate our economy.

If you have any queries please do not hesitate to contact Brendan Anderson on (03) 8660 7103, Jeremy Steele on (03) 8660 7102, or Paul Abbey of PricewaterhouseCoopers on (03) 8603 6733.

Yours sincerely,

Brendan Anderson
Managing Director
Harbert Fund Advisors (Australia) Pty Ltd

1. Introduction

We understand from the Board of Taxation's Discussion Paper titled *Review of Tax Arrangements Applying to Collective Investment Vehicles* that there are policy concerns surrounding the effectiveness and competitiveness of Australia's taxation treatment of Venture Capital Limited Partnerships (VCLPs). Specifically the Board through its Discussion Paper seeks 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"

We recognise these concerns relate to whether the regime is attractive to foreign investors and this concern has guided the submissions made herein. We have also considered the introduction of a deemed capital account treatment for investors, as well as other amendments to the regime that could encourage further foreign investment into Australian VCLP's.

While our suggestions focus around creating a consistency between the current VCLP regime and its intended policy objectives, our belief is that the policy objective itself may be more effective if it was expanded to:

"attracting investment, both foreign and domestic, <u>into early stage, high risk start-up companies</u> and expanding Australian businesses" (emphasis added)

The aim being not to disadvantage potential domestic investors over foreign investors.

We previously made a submission to the Board of Taxation dated 23 June 2010 in response to the May 2010 Consultation Paper entitled *Developing an Investment Manager Regime – Improving conduit income arrangements for managed funds*. With this in mind, we provide below our observations and submissions.

2. Submissions

2.1 Investment restrictions

The following submissions are made in relation to the restrictions imposed in the VCLP regime and whether they are consistent with the policy objectives of the regime.

2.1.1 Target company requirement

A requirement for eligibility to be treated as a flow-through entity for tax purposes is that a VCLP cannot invest in companies with a value exceeding $250 million: refer to subsection 118-425(6) of the *Income Tax Assessment Act 1997* ("**ITAA 1997**"). In our view, this limitation can be quite prohibitive and can also minimize the VCLP's pool of potential target investments which in turn decreases its attractiveness to foreign and domestic investors. Such a decrease is contrary to the main policy objective of the VCLP regime being to provide incentives for non-resident investment in relatively high risk start-up and expanding businesses.

The use of the value of an entity's asset base to determine its status as a start-up or expanding business is an arbitrary measure. The value of a company's asset base does not alone indicate the riskiness of a business, and therefore, should not be used as a basis to restrict investment.

It is our submission that this restriction be removed entirely. At the very least, we submit that the following may be worth considering as secondary alternatives in the event that a complete repeal of the $250 million investment limit is not possible:

- Increase the permitted entity value to $500 million; or
- Introduce a form of indexation similar to the indexation of the Foreign Investment Review Board (**"FIRB"**) reporting thresholds. The intention being to allow the permitted entity value to increase over time.

2.1.2 Bolt-on acquisitions

The investment opportunities of a VCLP are further restricted by the operation of subsection 118-425(4) ITAA 1997. This provision disallows a company in which the VCLP has invested, from investing any money in another company (i.e. "bolt-on acquisitions"), unless it is a related company. As the investments of a VCLP are restricted by section 118-425(1)(d) (refer to section 2.1.3 for further discussion on the limitations of this provision) it can not necessarily be guaranteed that a VCLP will have a controlling stake in the original company. Given this, it may be difficult to manage the prevention of bolt-on acquisitions which could result in the early exit of a VCLP from an investment. Early exit from an investment results in a VCLP not gaining the full reward available from a high risk investment. This decreases the appeal of these high risk investments, thus reducing the likelihood of investment into a VCLP. Given this, we question what policy objective this restriction is trying to achieve given the other provisions limiting VCLP investments.

We submit that this provision prohibiting acquisitions such as these are repealed. Or at the very least we submit the provision be amended to allow the investment by the existing investee company if the new target also meets the requirements in section 118-425 ITAA 1997 for eligible investments irrespective of whether the new target is a connected entity.

2.1.3 Committed capital restrictions

A requirement for eligibility to be treated as a flow-through entity for tax purposes is that a VCLP cannot invest more than 30% of its committed capital into one company, or its connected entities: refer 118-425(1)(d). 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. Therefore, this restriction becomes commercially problematic.

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. It is our view that this is adds unnecessary administration for the VCLP and limits investment opportunities in venture capital targets whom the policy is trying to support.

In addition it creates uncertainty for investors, as well as potentially limiting the investment opportunities of the VCLP because the committed capital of the partnership may not be great enough to allow it to invest in the venture capital targets it desires. Such a limitation does not align with the primary policy objective of the regime, being to increase investment in high risk businesses; therefore, we submit that the provision be repealed.

It is understood that the policy intention behind the limitation is to minimise improper use of the VCLP structure by, for example, corporations when establishing subsidiaries. However, it is our view that the provision is unnecessarily restrictive. Therefore, at the very least, we submit that the following may be worth considering as secondary alternatives in the event that a complete repeal of the provision is not possible:

- Increase the percentage to 80%; or
- Have the 30% of committed capital act as an initial investment cap. If the investment company requires further capital after the initial investment time the VCLP can participate in order to help support the continued growth in the venture capital investee company; or
- Have the limitation seek a diversity of investors rather than investments by limiting an investor's committed capital to 60% of total committed capital of the VCLP at the time of closing of the fund.

When considering this submission we ask that you take into account that some VCLP investments may prove unprofitable, and therefore, these funds could be better spent in another more profitable investment. The committed capital restriction may not allow for this transfer to occur which is not an appealing outcome for investors.

2.1.4 Conditional registration

Conditional registration creates uncertainty in the minds of potential investors when initially seeking to raise capital. Foreign investors already face multiple levels of uncertainty in applying the VCLP provisions, including uncertainty surrounding the revenue/capital distinction; the conditional registration adds another layer to this. This added uncertainty is likely to further deter foreign investors as the risk of failing to register, and as a consequence not receiving the VCLP concessions, could lead to significantly unfavourable outcomes for foreign investors. To lower the risk to foreign investors, and in turn attract them into Australian based funds, we suggest the removal of the conditional registration provision and have automatic unconditional registration.

2.2 Structural concerns

The following submission is made in relation to the concerns arising as a result of the structure of the VCLP regime.

2.2.1 Complex legal structure involving VCLP and VCMP

The rule in section 94D(3) *Income Tax Assessment Act 1936* ("**ITAA 1936**") suggests the general partner of a VCLP must be a venture capital management partnership (**"VCMP"**). As the VCMP is also a limited partnership it will also require a general partner which will likely take the form of a company. This adds an extra layer of administration within the VCLP structure compared with more conventional limited partnership structures. It is our submission that this section be repealed to simplify this convoluted structure.

2.2.2 AFSL license

One of the requirements for the creation of a VCLP is the need to obtain an Australian Financial Services License (**"AFSL"**). Under the *Corporations Act 2001* an AFSL is oriented more towards retail investors and risks. However, in our experience, the VCLPs are more focused towards wholesale investors. It is our submission that the VCLP licensing requirement be relaxed to more closely reflect the wholesale investor base rather than a retail investor base.

2.2.3 Reporting to Innovation Australia

A further administrative requirement for VCLP status is the quarterly reporting obligations to Innovation Australia. We submit that it be done on a self-assessment basis similar to income tax, and again like income tax reporting, be required only annually. At the very least, we submit fund size be a factor considered in determining how regularly reporting is required. For example:

- if the committed capital of the fund is greater than $100 million reporting be required six monthly;
- if greater than $250 million reporting be required quarterly.

This would result in reduced compliance costs, and in turn increased return, for VCLP investors especially for smaller funds. It would also reduce government costs associated with the regime.

2.3 Revenue/capital distinction

As a result of the release by the Australian Taxation Office (**"ATO"**) of two draft taxation determinations, TD 2009/D17 and TD 2009/D18, foreign investors into Australia are currently faced with increased uncertainty as to whether their investment gains will be treated as revenue or capital for Australian income tax purposes. In the context of Australian funds established as Managed Investment Trusts (**"MITs"**), the introduction of *Tax Laws Amendment (2010 Measures No. 1) Act 2010* has eliminated this uncertainty in the form of an irrevocable election being available to the taxpayer. More specifically, if made, the election allows all gains and losses on the disposal of a share, a non-share equity interest, a unit in a unit trust, land, or an interest in any of the aforementioned to be captured on capital account.

Currently, this election is only available for an entity which is an MIT as defined in section 12-400 of the *Taxation Administration Act 1953* (**"TAA 1953"**). Therefore, these concessions do not currently extend to VCLPs and their foreign investors.

As you would be aware, CGT event K9 found in the ITAA 1997 provides (concessionary) CGT treatment in respect of carried interest derived via an eligible VCLP. It is extremely incongruous that the current VCLP rules do not also provide CGT treatment for the other investors. This inconsistency is further emphasised when compared with the CGT election that can be made available to MIT investors as mentioned above.

We submit that Treasury consider amending the VCLP rules to also include an MIT-style capital gains tax (**"CGT"**) election for eligible VCLP investors. This would create consistency between the two regimes and create certainty for (foreign) investors, potentially resulting in increased foreign investment into Australia into a fund vehicle (limited partnership) which is familiar to most non-residents. By way of suggestions only, we have provided suggested wording in Appendix A. This new provision would apply to venture capital limited partnerships as defined in section 118-405(2) ITAA 1997.

We also submit that the inconsistency of treatment between MITs and VCLPs is no longer as relevant from a policy perspective. Whilst the MIT rules also have restrictions that would prevent a CGT election for MIT investors (where the MIT directly "controls" an active trading business), such restrictions are not relevant for VCLPs on the basis that the VCLP would typically invest in shares in target/investee companies or units in target/investee unit trusts rather than the VCLP carry on an active trading business in its own right. In any event, the VCLP rules contain greater investment restrictions which appear to be more stringent than the MIT eligibility concessions.

It is should also be noted that the lack of clarity on the revenue/capital distinction also creates uncertainty for potential domestic investors. This once again creates an unfair and inefficient outcome for domestic investors over foreign ones.

3. Conclusion

It was our intention through this submission to outline issues we have encountered as an Australian company that provides local management and advisory services to two Venture Capital Limited Partnerships. In summary, it is our submission that the VCLP provisions are convoluted legislation which do not appeal to their intended users and have not adequately satisfied their main objective of attracting foreign investment into Australia. We hope that this submission will assist in your review and provide practical solutions to the issues discussed.

Appendix A – CGT election suggested wording

(1) The modifications in subsection (2) apply if:

*(a) a *CGT event happens at a time involving a *CGT asset; and*

*(b) the CGT asset is owned at that time by an entity that is a *venture capital limited partnership in relation to the income year in which the time occurs; and*

*(c) the CGT event happens because the venture capital management partnership in its capacity as general partner of the venture capital limited partnership *disposes of, ceases to own or otherwise realises the asset; and*

(d) the asset is covered by subsection (3); and

(e) a choice under subsection (4) covering the entity is in force for the income year in which the time occurs.

*(2) These provisions do not apply to the *CGT event:*

*(a) sections 6-5 (about *ordinary income), 8-1 (about amounts you can deduct), and 15-15 and 25-40 (about profit-making undertakings or plans);*

(b) sections 25A and 52 of the Income Tax Assessment Act 1936 (about profit-making undertakings or schemes);

(c) section 118-20 (about reducing capital gains if amount otherwise assessable);

(d) Division 70 and section 118-25 (about trading stock).

(3) (a) An asset is covered by this section if it is any of the following:

*(i) a *share in a company (including a share in a foreign hybrid company);*

*(ii) a *non-share equity interest in a company;*

(iii) a unit in a unit trust;

(iv) land (including an interest in land);

*(v) a right or option to *acquire or *dispose of an asset of a kind mentioned in paragraph (a), (b), (c) or (d).*

(b) However, the asset is not covered by this subsection of it is any of the following:

*(i) a *Division 230 financial arrangement;*

*(ii) a *debt interest.*

*(4) (a) The *venture capital limited partner of a venture capital limited partnership may make a choice under this section that covers the venture capital limited partnership.*

*(b) The choice must be made in the *approved form.*

(c) The choice, once made, cannot be revoked.