



25 February 2011

The Board of Taxation  
The Treasury  
Langton Crescent  
CANBERRA ACT 2600

Dear Sir/Madam,

**Submission on the Review of Tax Arrangements for Collective Investment Vehicles**

Please find the attached a submission from OneVentures with our feedback on the Board of Taxations "Review of Tax Arrangements for Collective Investment Vehicles" paper of December 2010. Our main recommendations centre on the following points:-

1. **the 20% cap on offshore investment should not apply to investee companies which are redomiciled offshore but continue to commercialise Australian based R&D with the cap of 20% remaining only for non-Australian related investments in a Fund**
2. **investors should be allowed to claim fees and capital losses in an ESVCLP due to the generally lengthy time it takes for any gains to be realized (often over 7 years in venture funds) while keeping the tax free status on gains. This should be retrospectively applied.**
3. **The Fund should be able to continue investing when the investee company is listed. Ie a Fund needs to be able to do follow-on funding rounds whether the company is listed or unlisted to protect its investment.**
4. **The tax treatment of manager carry should be in keeping with the VCLP or ESVCLP tax treatment due to the hands on nature of the investment and the value created by the manager in building capital and asset value within investees.**
5. **The Fund should be able to invest in a hold-co which moves capital into an operational company is necessary. Many of our investees hold their Intellectual Property in a holding company and VCs prefer to invest in the company with the main asset (generally that with the IP).**
6. **The tax office should reduce the list or redefine ineligible activities. We have had investments which appear to fall into the ineligible activities category eg a web business providing pay day loans. It is unclear to us why they are ineligible for funding yet are legitimate early stage business creating jobs.**

Yours sincerely,

Dr Michelle Deaker  
Managing Partner

# **OneVentures Submission on the Review of Tax Arrangements Applying to Collective Investment Vehicles**

## **Introduction**

OneVentures is a venture capital fund manager based in Sydney and Brisbane. OneVentures currently manages the \$40 million OneVentures Innovation Fund which is an ESVCLP structure and is an IIF Licensed fund under Round 2 Tranche 3 of the Commonwealth Government's IIF Scheme administered by AusIndustry.

As a stakeholder managing Australian venture capital funds using structures provided under the Venture Capital Act 2002, OneVentures welcomes the Tax Board's initiative to review the tax arrangements applying to Collective Investment Vehicles. The Principals at OneVentures have many years of venture funds management experience both here in Australia and in the United States and Europe. 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. There is room however for some flexibility in the restrictions as addressed in the following questions.

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

At the moment it is not possible to have a parallel trust structure alongside an ESVCLP due to regulations prohibiting this. We think this is restrictive on an investment manager and there should be a way to effectively allow for this so long as the minimum funds of \$10million or more is allocated to the ESVCLP.

The primary reason to employ a parallel trust structure is to allow the manager to place investor capital into investee portfolio companies that find themselves ineligible for support from either a VCLP or ESVCLP. This occurs in two cases:

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- 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 or ESVCLP 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 or ESVCLP. 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.

**Recommendation: the restriction on VCLP or ESVCLPs investing in portfolio companies that have subsequently become 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 and the market opportunity is considered greater. Australia has to realize 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. The drawback with the VCLP and ESVCLP restrictions is that there is an artificial cap on the amount of capital that can be invested outside of Australia (20%). It should also be pointed out that the cap does not restrict some capital going offshore for investments with no Australian connection. It is likely this latter point was to allow some ineligible investments by the manager based on geography. 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.

**It is our recommendation that either**

- 1. the 20% cap on offshore investment does not apply to investee companies which are redomiciled offshore but continue to commercialise Australian based R&D; and the cap of 20% remains for non-Australian related investments in a Fund; OR**
- 2. the cap is increased from 20% to 50%. The rationale behind the 50% figure is that it is the case that almost all companies will redomicile if in the early stage venture market even though they may still offer significant jobs in Australia. The Fund generally keeps 50% of funds for follow-on funding for any one investee company. It is anticipated that a large portion of such follow on funding will be required to support international expansion.**

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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.”*

In venture capital investing, the investor takes on losses well in advance of any capital return. It generally takes investors up to 7 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). What the government needs to be doing is stimulating an area of the economy which does lead to the most significant area of job growth and help support the investors in creating this and many more tax payers. As is recognized large companies generally statistically cut jobs to drive business efficiencies whereas it is the small business end of the market where true jobs growth happens.

Additionally, 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.

**Recommendation: In an ESVCLP which targets early stage opportunities, investors should be able to claim tax losses while keeping the status of tax free on income and capital account. In the worst case, the tax losses claimed are later offset against future gains should these occur. This should be retrospectively applied as there are only a handful of ESVCLPs currently who all face this issue with their investors.**

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?”*

We are unclear why the government needs a cap and forces divestment on the Fund for any asset that has exceeded \$250million. While we would be delighted if this happened, 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 time of first investment (ie below \$50million 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 due to a restriction could have a very negative impact on outcome for the Fund and investors.

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**Recommendations:**

**The upper asset value test be either removed or raised to \$500 million.**

**The lower asset value test be lifted for VCLPs to \$100m to allow better utilization of this investment vehicle for expansion and early buyout transactions in private equity.**

**The lower asset value test be maintained at \$50m for ESVCLPs.**

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 should also be noted that offshore investors still need to claim tax in their own jurisdiction when investing in Australian ESVCLP. The ESVCLP still needs to carry some “deemed capital account” stamp that is recognized in other global tax jurisdictions.

**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. In many cases and certainly in venture capital, these incentives generally only happen on realizations and these may take 7 to 10 years to materialize, so attractive tax treatment is valid. It should also be noted that the investments are very actively managed and the value creation is growth in asset value. The manager actively contributes to capital growth versus the usual “passive funds management industry” and the difference should be treated accordingly.

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?”*

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## **Final general comments**

1. In order for Australian private equity (as distinct from venture capital) to be internationally competitive in it's 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.
3. Venture capital funds require the ability to invest in a hold-co which moves capital into an operational company is necessary. Many of our investees hold their Intellectual Property in a holding company and VCs prefer to invest in the company with the main asset (generally that with the IP).
4. The definition of ineligible activities should be reduced or removed. We have had investments which fall into the ineligible activities category eg a web business providing pay day loans. It is unclear to us why they are ineligible for our funding yet a legitimate early stage business creating jobs.

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