Funds Management & Financial Services Alert

Tax reforms to boost investment in venture capital vehicles

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Recent announcements

The Federal Government has announced that it will support all the proposals made by the Board of Taxation (**Board**) in its recent review of the Venture Capital Limited Partnership (**VCLP**) and Early Stage Venture Capital Limited Partnership (**ESVCLP**) regimes (together the '**VC Regimes**'). It is hoped that the changes to be implemented will provide a significant boost to these relatively under-used investment vehicles.

What are the VC Regimes?

The VCLP and ESVCLP regimes were established in 2002 and 2007 respectively. The policy objectives of the VC Regimes were two-fold:

- to increase domestic and off-shore investment in entities seeking to commercialise innovative Australian research; and
- to provide an internationally-accepted investment vehicle for venture capital, leading to the development of skills and experience for Australian venture capital managers.

The VC Regimes provide special tax treatments for those who invest through them. They receive the benefit of flow-through taxation and eligible foreign investors are exempt from income tax on profits or gains derived from the sale of eligible investments by them.

According to the submissions made to the Board, the levels of investment in VCLPs, and particularly ESVCLPs, are very low. The Board estimates approximately $1.6 billion has been invested by VCLPs since they were introduced in 2002 and a paltry $5.5 million by ESVCLPs. It seems the ESVCLP regime has been particularly beset by problems since it was introduced in 2007. Firstly, the GFC hit shortly after its introduction, but in addition, the regime required the states and territories to each pass amendments to their partnership legislation to allow ESVCLPS to be established and this was not achieved until 2009.

What were the Board's recommendations?

To increase investment in the VCLP Regime, the Board made the following recommendations to improve the operation of each regime:

- For VCLPs:
  - Any gains or losses made by a VCLP on the disposal of an eligible venture capital investment held for 12 months which flow through to partners should be deemed to be on capital account for eligible domestic partners.
  - Eligible domestic investors should be defined consistently with eligible foreign partners.
  - An Australian managed investment trust (**MIT**) should be able to invest as a limited partner in a VCLP and retain its MIT status and tax concessions.
  - The restriction for foreign venture capital 'fund of funds' should be removed provided the fund is widely held.
- For ESVCLPs:
  - An investee entity should have greater flexibility to invest in other complementary ventures, provided the investee entity acquires a controlling stake in the other entity and the other entity is otherwise an eligible investment.
  - The holding company exception should be modified to allow an ESVCLP to invest in a holding company which has existing interests in multiple subsidiaries, as long as those subsidiaries satisfy the eligible venture capital investment requirements.

- Innovation Australia should have discretion to allow ESVCLPs to exceed the 20 per cent foreign investment cap provided the investment has a material national benefit (as associated with the commercialisation of Australian research and development).
- An Australian MIT should be able to invest as a limited partner in an ESVCLP and retain its MIT status and tax concessions.
- Where a limited partner in an ESVCLP is a trust (that is not taxed as a corporate), the investors in that trust should not be prevented from accessing the special tax treatment accorded under the ESVCLP regime.

Other important announcements

At the time the Federal Government announced it was supporting the Board's proposals about the changes to the operation of the VC Regimes, it also announced the other significant reforms to the regulation of the venture capital industry as follows:

- Lowering the minimum investment capital required for entry into the ESVCLP program from $10 million to $5 million to facilitate increased funding from 'angel' investors.
- Administering the VCLP and ESVCLP programs as a single regime to provide clearer entry for investors and managers wishing to use these investment vehicles.
- Phasing out the Pooled Development Fund program over a number of years.

Impact of the proposed changes

The adoption of the above proposed changes by the Government to the taxation of VCLPs may lead to an increase in investments through VCLPs in Australian private equity fund structures. The proposed changes are intended (amongst other things) to partially equalise the taxation benefits currently provided to MITs so that there may ultimately be no taxation difference for most investors electing to invest in either a MIT or a VCLP.

Some of the other proposed changes, such as permitting a MIT to invest as a limited partner in a VCLP and retain its MIT status and tax treatment (which was previously denied by the Commissioner), should also increase VCLP investment and may open a significant source of capital for VCLPs given the rise of investment in MITs since 2010.

Fund managers will continue to prefer to include VCLPs in fund structures as the general partner of a VCLP is entitled to claim its carried interest in the fund on capital rather than revenue account. This is contrary to MITs, where the manager's carried interest is taxed on revenue account. Many non-resident investors will also continue to prefer investing in VCLPs rather than MITs as unitised trust structures are not commonly used in other jurisdictions and contain concepts foreign to many offshore investors.

It is therefore likely that most venture capital and private equity fund structures will continue to comprise, or at least initially offer participation in, a VCLP and a MIT. However, there may no longer be a need to quarantine specific investors in specific vehicles or separate investors into different investment 'streams' as a result of the proposed changes.

However, with increasing pressure on fund managers to decrease fund costs and increase fund administration efficiency, managers may elect to proceed with a VCLP as the only initial investment vehicle and, where necessary, staple a MIT to the structure where the fund intends to make investments which are ineligible for a VCLP. Other fund managers, particularly those offering interests solely to resident investors, may prefer to continue with a MIT as the sole investment vehicle of the fund given the more significant investment restrictions placed on VCLPs, which are set to continue.

If you would like any further information about the proposed changes or you would like to discuss the taxation benefits of investing through the VC Regimes, then please contact George Hodson.

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