VCLP Reform Program and its Impact on Global Venture Capital Investment in Australia

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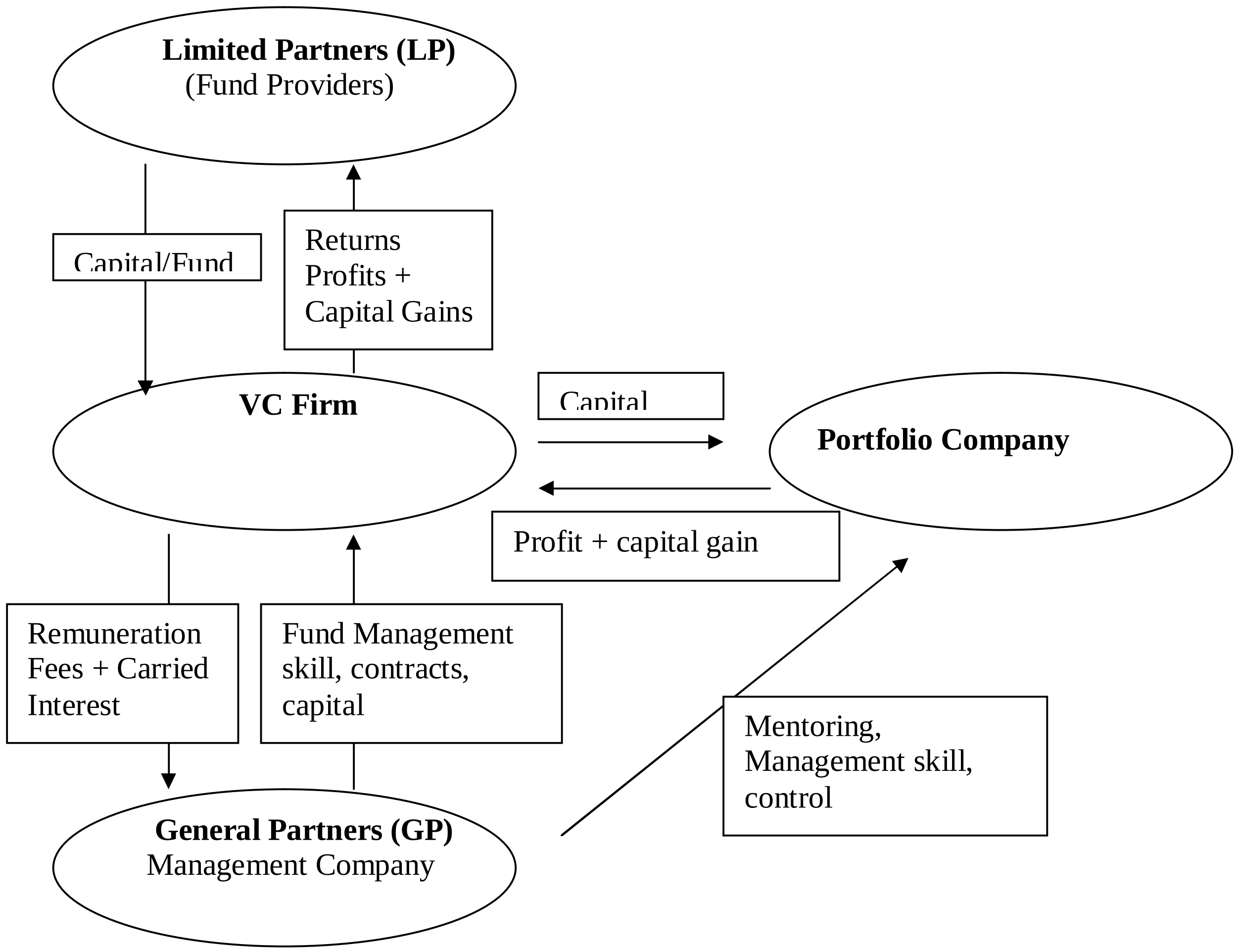
ABSTRACT

In 2002, Australian Federal Government adopted the Venture Capital Limited Partnership (VCLP) legislation and formalized the establishment of Venture Capital Limited Partnerships and Australian Fund of Funds (AFOFs). These investment vehicles are preferred flow-through mechanisms that offer significant tax exemptions and ensure capital gains and losses flow straight to the end investors, rather than to the fund managers. This change brings Australian venture capital industry in line with the structures used in most other countries. Both AVCAL (Australian Venture Capital Association) and the Federal government claimed that this is a major reform package and should immediately attract many international investors, such as, foreign pension funds, fund of funds, university foundations and other endowment funds. This paper critically examines the key features of the reform package and its implications for Australian VC industry. The analyses suggest that while the reform package looks quite encouraging from outside, its actual impact seems to be significantly compromised in the details.

INTRODUCTION

Historically the venture capital (VC) industry in Australia had started with a few investment firms where the owners of the VC firm supplied the necessary funds that were invested in a number of portfolio companies. Such owner managed or self-managed VC firms are still in existent. However, with the increasing demand and supply of capital, diversity, sophistication and regulation of the financial market, technological advancement, and the involvement of institutional investors in the private equity market have resulted in the separation of the ownership and the management of the fund. Professional fund managers were hired to manage the fund investment in portfolio companies. This development is very similar to the development of joint stock companies where the ownership and management of the company is separated and an agency relationship is created. In the VC industry this agency relationship is called "partnership." In this partnership, the VC firm puts together one or more venture capital funds. These funds attract capital from external investors, which are used as venture fund to specific portfolio companies. The venture capital industry generally works on the basis of a partnership structure. This so called partnership is usually labeled as “limited partnership” where the suppliers of venture capital are called “limited partners” or LPs and the fund managers are called “general partners” or GPs. The general partners act as agents of the limited partners in investing their funds (Gifford, 1997). The general partners invest their human capital and career with an objective of creating wealth for the partnership, which are distributed to the partners. The general partners (i.e. the fund managers) receive a management fee equal to a percentage (usually 2- 3 per cent) of the capital fund under management. If successful, the general partners (i.e. the management company receives an additional percentage (usually 15 to 30 per cent) of profit from each fund. This share of profit to the general partners is called “carried interest.” The remaining share of profit belongs to the general partners. In a self managed VC firm this allocation of profit does not arise. However, the current Australian VC industry is dominantly structured along the LP/GP split (Figure 1) and the issue of share of profit (and loss) and the *carried interest* plays a critical role. This issue is more prominent in the case where a local VC firm raises funds from offshore sources. The question of taxability of trading profit/loss and capital gains/losses, and the repatriation (in/out) of profit/loss are subjected to a multitude of regulatory requirements. This apparent lack of clarity and fairness in the allocation of benefits is alleged to have been a major de-motivating factor to the foreign investors in investing funds in Australian VC market. The VCLP reform package is supposed to address these issues.

Figure 1: The Partnership structure of a Venture Capital Firm.



This paper critically examines the provisions of the VCLP reform package and assesses its impact on the possible inflow of foreign venture capital investment in Australia. The paper is arranged in four sections. The first section presents an overview of the venture capital industry, types of firms, partnership structures and mutual rights and obligations of limited partners and general partners. The second part examines the salient features of the legislative reform package. The third part examines similar legislative developments in other major countries. The final part makes a critical judgment of the impacts of the VCLP reform package in attracting foreign VC funds into Australia.

OVERVIEW OF THE VENTURE CAPITAL INDUSTRY

Types of VC Firms and Partnership Structures

Most mainstream VC firms are organized as limited partnerships in which the VC firm serves as the general partner. The most common type of VC firm is an independent firm that has no affiliation with any other financial institution. These are called, 'private independent firms". VC firms may also be affiliates or subsidiaries of a commercial bank, investment bank or insurance company and may make investment on behalf of the parent firm's clients or on behalf of outside investors. Examples of such VC firms are, Deutsche Bank Capital Partners, Macquarie Direct Investments, Colonial First State Private Equity, AMP Global Investors Private Equity, and Westpac Private Equity etc. Subsidiaries of some industrial companies may also act as VC firms investing on behalf of its parent company. Other organizations may include government sponsored investment programs that help start-up companies either through the state, local or federal government programs. AusIndustry is an example of such VC type.

The VC firm usually organizes its partnership as a pooled fund. This is a fund made up of the general partner and the limited partners, typically organized as "fixed" life partnerships, usually having a life of ten years. Each fund is capitalized by commitments of capital from the LPs. Once the partnership has reached its target size the partnership is closed to new investment or even existing investors so that the firm has a fixed capital pool from which to invest.

Like a mutual fund, a VC firm may run more than one fund at a time. A VC firm may raise another fund after closing the first fund in order to continue to continue to invest in companies and to provide investment opportunities fro existing and new investors. It is quite common to see a VC firm raise a number of funds consecutively over ten to fifteen years. Each fund is managed separately and may have its own LP and GP. The investment strategy of these funds may be similar or very different to other funds in the firm. The firm may have one fund with a specialized focus, and another with a different focus and yet another with a broadly diversified portfolio. It depends on the degree of specialization and/or diversity of the VC firm.

Fund raising and capital Calls

The process of seeking funds from investors is typically called "fund raising". The commitments of funds are collected from the investors during the formation of the fund. The VC firm will distribute a prospectus to potential investors with a target fund size. It may take weeks and months to raise the required capital.

Making investments in portfolio companies requires the VC firm start “calling” its LPs to satisfy their commitments. The VC firm may collect or “call” the needed investment from the LPs in a series of installments commonly known as “capital calls”. These calls are also popularly known as “takedowns” or “paid-in capital”.

Fund of Funds (FOFs)

A fund of fund is a partnership organized to invest in other partnerships. This structure provides the LP with added diversification and the ability to invest smaller amounts into a variety of funds. Investment decision takes considerable investment knowledge, courage and time on the part of the LPs. Many LPs may have neither the resources nor the expertise to invest and manage many funds. In such cases, they might hire investment advisors as the ‘gatekeepers” or invest in fund of funds which provide added diversity and protection.

Disbursements and Exits

The actual investment of funds by a VC firm into investee companies is called ‘disbursements”. The company may receive the promised capital in one or more rounds of financing. The VC firm may make these disbursements alone or co-invest with other VC firms forming a syndicate. Such syndication provides more capital resources and each VC firms brings some competitive advantage to the investment. The VC firms provide capital and management expertise and usually also take a seat on the board of the company to make sure that the investment has the best chance of being successful.

Depending on the investment focus, risk profile, liquidity position and strategy of the VC firm, it may normally seek to exit the portfolio company within 3 to 5 years of initial investment. While the initial public offering (IPO) may be the most glamorous and heralded type of exit for the VC and the owners of the company, most successful exits of venture investments occur through a merger or acquisition of the company by its original founders or by another company.

BACKGROUND OF THE VCLP REFORM PROGRAM IN AUSTRALIA

The Australian Venture Capital Association (AVCAL) and other leading VC firms in Australia have long been claiming that a major obstacle in attracting foreign venture capital investment to Australia is the treatment of limited partnerships as companies for Australian tax purposes. The requirement to pay tax on gains derived from VC investment in Australia has been a major disincentive for many international investors from investing in Australia. Gains from similar reciprocal investment in their countries would be exempt from tax in their countries. It is believed to have significantly reduced the global funds available for financing start-up and expanding companies, particularly in the biotech and technology industries in Australia. The only tax concession for venture capital investments was an income and capital gains tax exemption for direct investments in designated companies and fixed trusts by foreign pension funds from a limited number of specified countries.

Limited Liability Partnership Vehicle

Limited Partnerships (LPs) or Limited Liability Partnerships (LLPs) are the most commonly used international investment structure for venture capital investment. Partners (i.e. investors) in the limited partnerships have limited liability. It is limited to the amount invested in the partnership, in the same way if they had invested in a company or a unit trust. Typically the general partner (who is subject to unlimited liability) will hold the assets of the partnership effectively on trust for the limited partners. In 2001 the AVCAL made a submission to the Federal Government recommending the adoption of the Limited partnership as the appropriate vehicle for venture capital investments in Australia and also made certain key recommendations about the taxation treatment of the LP structure. In November 2002, the Federal Government introduced legislation in the parliament which is supposed to remove a tax impediment faced by international investors wishing to invest in Australian companies and should pave the way for the establishment of Venture capital Limited partnerships (VCLPs) and Australian Venture Capital Fund of Funds (AFOFs). Both investment vehicles will be flow through for tax purposes, meaning that capital gains and losses will flow straight through to end investors. Such limited partnership structures are the investment vehicles of choice in all major venture capital industries worldwide.

The legislation is in two parts: The Venture Capital Act 2002 (the VC Act) and the taxation laws amendment (venture capital) act 2002 (tax Act). These two bills received royal assent in 19 December 2002. These acts will apply retrospectively from July 2002. This legislative change brings Australian venture capital industry into line with most other countries, making it much easier for international investors to know where they stand. This should be attractive to many kinds of international investors such as pension funds, funds of funds, foundations and endowment funds. These entities are now considered to be exempt from capital gains tax on their investments in Australian VCLPs, provided the investors are resident in a “designated country”. The list of designated countries currently include the US, UK, Japan, Germany, France and Canada.

Tax Treatment of VCLPs and AFOFs

An “eligible” VCLP will constitute a tax flow through vehicle, meaning that the structure itself will not attract tax. Rather, the tax consequences arising out of the activity of the VCLP will pass through and fall upon the partners in the VCLP. The current tax rules that deem a limited liability partnership to be taxed as a company will no longer apply to a VCLP. Hence investors will be treated in the same way as partners in a normal partnership. The investors (LPs) will have to account for their proportionate share of any profits or losses, including capital gains and losses, arising from the VCLP. This should be contrasted with a unit trust, which while allowing a flow through of income does not provide a flow through of losses to investors. Instead of losses being trapped in the investment vehicle, those losses will be available to the investors in a VCLP for tax offsets when they are realized by the VCLP.

Tax Concessions

The new legislation retains the existing exemption for certain foreign pension funds in its current form. In addition, the new rules allow certain non-resident investors tax exemptions for profits and gains from disposals (directly, or through VCLPs) of *eligible venture capital investments (EVCI).* The new rules, however, allow flow through tax treatment to limited partnerships that qualify as either:

- Venture capital limited partnerships (VCLPs), or
- Australian venture capital fund of funds (AFOFs), or
- Venture capital management partnerships (VCMPs)

The legislation also provides restrictive definitions of these investment vehicles, which will be discussed later in the paper.

The new rules also allow that the carried interest of the managers in a VCLP, AFOF or VCMP is treated as capital gains rather than a revenue income, or as fringe benefit. This measure is intended to align the interest of the managers with those of the investors.

Scrip for Scrip Exemption

The tax Act recognizes that an exit from an EVCI may be by means of scrip consideration and provides that, in certain circumstances, shares acquired in consideration for the transfer of an EVCI (consisting of shares) will also be treated as EVCI. Any gain from the subsequent disposal of shares acquired in the scrip-for-scrip exchange would itself be exempt from tax for relevant investors, even though the company, in which those chares are held, does not, itself, satisfy the requirements for being an investee company. This would apply only once to the first scrip-for scrip transaction in relation to a particular investment.

Additional Exemption for Certain “Direct Investment”

Capital gains and profits from disposals of direct investments in EVCI (as discussed above) by “eligible venture capital investors” are exempt from Australian tax. To qualify as an eligible VC investor, an entity must:

- Be registered as such with the PDF (Pooled Development Fund) Board; and
- Be a *tax-exempt non-resident*

Tax exempt non-residents” are foreign residents of Canada, France, Germany, Japan, the United Kingdom and the United States (the so called *specified countries*), or any other country prescribed by the regulations whose income is exempt, or effectively exempt, from taxation in the entity’s country of residence.

Taxation of Carried Interest as Capital gains

A *carried interest* is an entitlement of a general partner to the distribution from a VCLP or AFOF to the extent that the distribution is contingent upon the attainment of profits for the LPs in that entity. A carried interest of a VCMP will depend on the attainment of profits for the LPs of the

VCLP or AFOF in which the VCMP is the general partner (manager). Under the new rules the amount of carried interests are taxed as capital gains, are not treated as income and are specifically excluded from the fringe benefit tax regime. This is deemed to be a major benefit for Australian resident general partners (managers)

Distribution of profits in respect of a general partner's ordinary equity interest in a partnership and any ongoing management or similar fees (not dependent on the attainment of profits) are, however, excluded from the definition of "carried interest".

Tax Treatment of Losses

Eligible non-resident investors are exempt from paying any Australian tax on profits and gains from disposals or other realizations of "eligible venture capital investment" made directly, or through a VCLP or AFOF, and naturally they are not entitled to claim deductions for their shares of losses made from such disposals made from such disposals or realizations.

Summary of Tax Exemption Principles

1. Tax exemption only applies to profits/gains from realization of investments. Such exemptions do not apply to dividends, interests or other income.
2. The exemption applies in three separate situations:
   - To certain foreign investors in a VCLP
   - To certain foreign investors in an AFOF
   - To certain foreign direct investors
3. Exemptions not applicable to domestic investors
4. Exemptions only available to "eligible VC partner" for a VCLP or AFOF and for direct investment to "eligible VC investor" who is a registered tax exempt non-resident.
5. The VCLP must have met registration requirements (discussed later) both at the time investment is made and sold. For an AFOF, both the VCLP and AFOF must satisfy registration requirements.
6. Exemption only applies if investment is held for a minimum of 12 months.

ELIGIBLE VENTURE CAPITAL INVESTMENTS (EVCI)

The new tax exemptions only apply to profits and gains arising from the disposal or realizations of *eligible venture capital investments (EVCI)*. The following conditions and tests must be satisfied to qualify to be an EVCI:

1. The investment must be "at risk", that is, it cannot have a mechanism that maintains a floor value or ensure profits from the investment.

2. The investment must be in a company. The form of investment is limited to shares, options or warrants (provided the shares and options do not constitute a "debt interests" for tax purposes)

3. The investee company must satisfy “Australian nexus test”. The nexus test requires:
    - The company must be an Australian resident;
    - At the time of the investment, and for 12 months afterwards, it must have more that 50% of its employees working in Australia; and
    - More than 50% of its assets by value are located in Australia.

4. Investee company must satisfy ***activity test***. Investee company cannot carry on excluded activities. Excluded activities are:
    - Property development, construction or the acquisition of infrastructure activities;
    - Banking, leasing, factoring and securitization;
    - Insurance;
    - Making investments to derive passive income, such as, interest, rent, dividends etc.

5. Investee company not to invest in other companies. The company must not invest in any other entity unless the other entity is a connected entity of the investee company, which also satisfies the criteria for an eligible venture capital investment.

6. The investee company must have a registered auditor.

7. The value of the investee company must not exceed AUD 250 million. The gross assets of the company and any connected entity immediately before a proposed investment must not exceed AUD250 million. The asset value will be that shown in the company’s last audited accounts, which must be for a period ending less than 18 months before the time of the proposed investment, or if there are no such audited accounts, an audited statement no more than 12 months old.

8. No listing. The investee company must be unlisted at the time of the investment by the LP (or, if it is listed, it must de-list within 12 months of the investment)

9. Total amount invested in an investee should not exceed 30% of total committed capital of the LP. Where the investor is a VCLP or AFOF, its interests (both debt and equity) in that investee company (and in any connected entities of the investee company) must be less than 30% of the LP’s committed capital.

QUALIFYING CRITERIA FOR VCLPS

A limited partnership may apply to the PDF (Pooled Development Fund) Board for registration as a VCLP if it satisfies certain qualifying criteria. They are:

- The LP must be formed in Australia or in a ***designated country***;
- Each of its GPs must be a resident of Australia or a designated country;
- The partnership must have a minimum life of at least five years and a maximum life of no more than 15 years;
- The partnership must have a minimum committed capital of at least AUD20 million; and

- The partnership's only activities must be investing in EVCIs, which cannot be debt interests.

QUALIFYING CRITERIA FOR AFOFS

A limited partnership may apply to the PDF Board for registration as an AFOF if it meets certain qualifying criteria. They are:

- The partnership must be formed under the law of an Australian state or territory;
- Each general partner must be a resident of Australia;
- The partnership must have a minimum life of at least five years and a maximum life of no more than 20 years;
- The partnership's only activities must be investment in VCLPs or EVCI in which a VCLP (where the AFOF is a partner) also holds an investment; and
- The AFOF investment must not be a loan interests unless they are *permitted loans* (as defined in the ACT).

DEFINITION OF *ELIGIBLE VENTURE CAPITAL PARTNERS*

Eligible venture capital partners are:

- Tax exempt non-residents from the designated countries (DCs);
- Foreign venture capital *fund of funds* (FOFs) that established in a designated country and whose general partners all reside in designated countries, which need not be the country of establishment, provided that each foreign venture capital fund of funds and its connected entities do not hold more than 30% of the committed capital of a VCLP or AFOF; and
- Taxable residents of a designated country (DC), and of Finland, Italy, the Netherlands, New Zealand, Norway, Sweden or Taiwan who holds less than 10% of the committed capital of a VCLP or AFOF, provided they are not general partners of a VCLP and do not fall within one of the above definitions of *eligible venture capital partners.*

VENTURE CAPITAL MANAGEMENT PARTNERSHIPS (VCMPS)

A VCMP is a limited partnership that is a general partner (i.e. Manager) of either a VCLP or an AFOF, and only carries on activities that are required of a general partner. There is no registration requirement for VCMPs.

VCMPs are taxed as flow-through entities in the same way as VCLPs and AFOFs. Share of distributions to limited partners in a VCMP, which is contingent upon attainment of profit for the LPs in a VCLP or AFOF which is managed by the VCMP, are taxed as "carried interests" (discussed below).

COMPULSORY REGISTRATION REQUIREMENTS OF VCLPS AND AFOFS

In order to qualify for any tax exemption a VCLP or an AFOF must be registered with the PDF (Pooled Development Fund) Board. The PDF Board is charged with the administration and monitoring of the registration process of the VC vehicles.

Applications for registration as a VCLP or AFOF must be made by the general partner of a limited partnership and must include specific information set out in the (2002) VC Act. The partnership agreement itself, along with any offer documents, must be lodges with the PDF Board. In addition, the GP is required to provide a statement as to whether or not the limited partnership complies with the conditions of registration as a VCLP or AFOF, including those relating to the residency requirements of the individual partners. The application and statement must supply:

- Name, residency status, qualifications and experience of each GP
- Name, address and residency status of each LP
- Registered office or business address of each GP
- Business address of the limited partnership
- Copy of partnership agreement
- Any documents inviting investments from LPs
- Amount of each partner's committed capital
- Details of tax exemptions in country of residence
- Statement by the GP whether registration requirements are met
- Any further information as the PDF Board requires

The partnership agreement must cover details of the following:

- Contribution of committed capital
- Rules for addition of new partners
- Rules for increases in committed capital
- Details of investment plan

The PDF Board must decide the application within 60 days. The Board must register the VCLP/AFOF if all requirements are fulfilled. The PDF Board may refuse registration if requirements are not met, or any previous registration was revoked. Registration comes into force when granted. In certain cases a conditional registration for up to 24 months is allowed.

Obligations to remain registered

The VCLP or AFOF must supply certain periodic documents to satisfy the PDF Board that the registration be maintained. They are:

- Annual return by 30 September each year updating application details and outlining investment activity
- Quarterly returns within 1 month of end of each quarter specifying the investment activities of the partnership

Registration as Eligible Venture Capital Investors

Applications for registration as an eligible venture capital investor must be made within 30 days of contract to acquire first eligible investment. The application must include:

- Residency and details of tax exemption status
- Address of registered office
- Details of investee company and amount invested
- Details of non-eligible investment

Eligible venture capital investors are also required to supply annual returns to the PDF Board to remain registered.

ASSESSMENT

According to an economic analysis prepared for AVCAL by Econtech, the reforms should attract an additional $1 billion of foreign capital over the next 5 years, and should add $350 million to Australia's GDP (AVCAL, 2003). Many experts in the VC industry do not, however, share such optimism. The foreign fund managers and investors attending the AVCAL annual conference in 2002 and 2003 do not seem to be impressed with the package. They believe while the reform package is a step in the right direction, it is too complicated and it offers too little to attract large volumes of foreign capital. An analysis of the tax exemption requirements suggests that the package is indeed too cautious and too complicated. The critical features of the package are listed below:

1. The tax concessions apply only to investors from a restricted number of countries (only six).
2. The venture funds will also face increased running costs to qualify for the concessions, as they must seek registration and must meet ongoing reporting obligations to the PDF Board, in order to qualify for the concessions.
3. Too much emphasis is placed upon the residential status of the investor(s). In the modern era of mixed nationalities and multiple residencies it is likely to create more confusion.
4. The "Australian nexus test" as outlined under the criteria for eligible venture capital investment (section 4.0) is too restrictive
5. There are obvious signs that the government is denying access to certain key sectors of the economy to foreign venture capital investors. The *activity test* of the EVCI quarantines property development, construction, infrastructure, banking, leasing, insurance and financial services from the list of eligible investments.
6. The maximum level of participation by a foreign venture capital partner is set at 30%. This guarantees full control by the Australian partners. Global investors usually do not respond favorably to such nationalistic and restrictive requirements.

CONCLUSION

One unintended consequence of the proposed changes has been that many existing managers deferred fund raising, which is reflected in the relatively low level of capital raised by Australian venture capital funds in 2002. Firms raised approximately $700 million from local and international investors on the year to June 2002, compared to $1.2 billion in 2000-01 and $1.4 billion in 1999-2000 (AVCAL, 2003, p. 1). The Australian venture capital industry, particularly the AVCAL had placed too much emphasis on the adoption of the VCLP reform package by the government. AVCAL has cited the example of the British case. It claims that the British government adopted similar measures in 1987, and the UK has since seen a huge capital flow and the creation of a dynamic and vibrant private equity industry (AVCAL, 2003. p. 1). However, the foreign delegates attending the AVCAL annual conferences repeatedly mentioned that polishing the legislation here and there will not bring about a radical change in the flow of capital in Australia. It has to address more fundamental economic issues, such as, market size, investment culture, role of institutional investors, labor market reform, suitable exit opportunities and attitude towards risk by local VC partners are more significant. For the last few years, shortage of funds has not been the most critical issue for the VC industry in Australia. It is rather the lack of attractive investment opportunities that resulted in a huge overhang of surplus funds not only in Australia but more so in the US and the UK. It appears that the drive towards the VCLP agenda is more to satisfy its constituency and to gain a sense of achievement by its political leadership than to actually boost the VC industry in Australia.

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