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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

VENTURE CAPITAL BILL 2002

TAXATION LAWS AMENDMENT (VENTURE CAPITAL) BILL 2002

EXPLANATORY MEMORANDUM

(Circulated by authority of the
Treasurer, the Hon Peter Costello, MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
AAT	Administrative Appeals Tribunal
AFOF	Australian venture capital fund of funds
ATO	Australian Taxation Office
CGT	capital gains tax
Commissioner	Commissioner of Taxation
DITR	Department of Industry, Tourism, and Resources
GDP	gross domestic product
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
OECD	Organisation for Economic Co-Operation & Development
PDF Act 1992	<i>Pooled Development Funds Act 1992</i>
PDF Board	PDF Registration Board established under the <i>Pooled Development Funds Act 1992</i>
TLA(VC) Bill	Taxation Laws Amendment (Venture Capital) Bill 2002
VCLP	venture capital limited partnership
VCMP	venture capital management partnership
VC Bill	Venture Capital Bill 2002

General outline and financial impact

Venture capital tax concession

The Venture Capital Bill and the Taxation Laws Amendment (Venture Capital) Bill facilitate non-resident investment in the Australian venture capital industry by providing incentives for increased investment which will support patient equity capital investments in relatively high-risk start-up and expanding businesses that would otherwise have difficulty in attracting investment through normal commercial means. These bills amend the ITAA 1936, the ITAA 1997, and the PDF Act 1992.

The Taxation Laws Amendment (Venture Capital) Bill extends the current tax exemption, provided to certain foreign pension funds on profits from the disposal of investments in eligible venture capital businesses, to:

- all tax-exempt non-residents from Canada, France, Germany, Japan, the United Kingdom or the United States of America;
- non-resident venture capital funds of funds established and managed in Canada, France, Germany, Japan, the United Kingdom or the United States of America; and
- taxable non-residents, which are resident in Canada, Finland, France, Germany, Italy, Japan, the Netherlands (excluding the Netherlands Antilles), New Zealand, Norway, Sweden, Taiwan, the United Kingdom or the United States of America, holding less than 10% of the equity in a venture capital limited partnership.

This bill also:

- provides venture capital limited partnerships, Australian venture capital funds of funds and venture capital management partnerships with flow-through taxation treatment. This provides Australia with world's best practice investment vehicles for venture capital; and
- taxes the venture capital manager's share of gains made by a VCLP or an AFOF on the sale of eligible venture capital investments (the carried interest) as a capital gain.

The Venture Capital Bill establishes a registration process for venture capital limited partnerships, Australian venture capital funds of funds and eligible venture capital investors.

Date of effect: This measure will apply from 1 July 2002.

Proposal announced: The proposals were announced in Treasurer's Press Release No. 81 of 15 October 2001.

Financial impact: This measure has a cost to revenue of \$21 million in 2003-2004, \$25 million in 2004-2005 and \$30 million in 2005-2006.

Compliance cost impact: This measure will involve compliance costs arising from the requirement to register with the PDF Board and to report on a quarterly and annual basis. The PDF Board may also require additional information from time to time. However, these compliance costs will be minimal in comparison to the taxation benefits arising to the foreign investors.

Summary of regulation impact statement

Regulation impact on business

Impact: This measure will impact on non-resident investors, venture capital funds of funds vehicles, and venture capital fund managers. The measure will also impact on eligible Australian companies seeking venture capital investments.

The Government agencies who administer this tax concession will also be impacted by this measure, in particular the ATO, DITR, AusIndustry and Invest Australia.

Main point: This measure will increase the level of investment in the Australian venture capital industry by non-residents. It will result in greater competition and increased access to overseas expertise for start-up and expanding companies.

Chapter 1

Tax exemption for profits on venture capital investments

Outline of chapter

1.1 This chapter explains the new tax exemption on venture capital investments. In particular, it explains what conditions must be met before the tax exemption can apply, and who can access it. The detailed description of what constitutes a VCLP and an AFOF is discussed in Chapter 2.

Context of amendments

1.2 The purpose of this measure is to extend the tax exemption already provided to certain non-resident tax exempt pension funds (contained in Subdivision 118-G, and sections 26-70 and 51-55 of the ITAA 1997) to gains derived from investments in eligible venture capital companies by non-residents from certain jurisdictions.

Summary of new law

1.3 The new law provides an exemption from income tax on profits or gains on equity investments made by a VCLP in Australian companies whose assets are not more than \$250 million, to partners in the VCLP that are:

- tax-exempt residents of Canada, France, Germany, Japan, the United Kingdom or the United States of America;
- venture capital funds of funds established and managed in Canada, France, Germany, Japan, the United Kingdom or the United States of America; and

- taxable residents of Canada, Finland, France, Germany, Italy, Japan, the Netherlands (excluding the Netherlands Antilles), New Zealand, Norway, Sweden, Taiwan, the United Kingdom or the United States of America, and who hold less than 10% of the committed capital of the VCLP.

1.4 The exemption is also available to partners in an AFOF, which is a partner in a VCLP, that are:

- tax-exempt residents of Canada, France, Germany, Japan, the United Kingdom or the United States of America;
- venture capital funds of funds established and managed in Canada, France, Germany, Japan, the United Kingdom or the United States of America; and
- taxable residents of Canada, Finland, France, Germany, Italy, Japan, the Netherlands (excluding the Netherlands Antilles), New Zealand, Norway, Sweden, Taiwan, the United Kingdom or the United States of America, and who hold less than 10% of the committed capital of the AFOF.

1.5 Tax-exempt residents of the specified countries who invest directly in the Australian companies that qualify as a venture capital investment will also qualify for the exemption if they register with the PDF Board.

Detailed explanation of new law

The exemption

1.6 Eligible non-resident partners in a VCLP are exempt from tax on their share of the profit or gain made on the disposal by the VCLP of an eligible venture capital investment, so long as the investment was owned by the VCLP for at least 12 months and held at risk. Conversely, any loss on that investment is not deductible. *[Schedule 1, items 3, 4 and 6 of the TLA(VC) Bill; sections 26-68, 51-54 and 118-405 of the ITAA 1997]*

1.7 Similarly, eligible venture capital partners in an AFOF (the AFOF itself is a partner in a VCLP) are exempt from tax on their share of the profit or gain on the disposal of an eligible venture capital investment and losses or deductions are not available. The gain or loss on an eligible venture capital investment is made by a partner in an AFOF regardless of whether the venture capital investment disposed of was made by the AFOF, or a VCLP in which the AFOF is a partner. *[Schedule 1, items 3, 4 and 6 of the TLA(VC) Bill; sections 26-68, 51-54 and 118-410 of the ITAA 1997]*

Convertible notes and convertible preference shares

1.8 If a VCLP, an AFOF or an eligible foreign resident acquires a share in a venture capital investee company by converting a convertible note or a convertible preference share issued by the company, the 12 month period the share is required to be held commences from the time the partnership or foreign investor acquired the convertible note or convertible preference share. *[Schedule 1, item 6 of the TLA(VC) Bill; subsections 118-405(3), 118-410(4) and 118-415(3) of the ITAA 1997]*

Eligible venture capital partners

1.9 An eligible venture capital partner is a partner in a limited partnership where the partner is:

- a tax-exempt resident of Canada, France, Germany, Japan, the United Kingdom or the United States of America;
- a foreign venture capital fund of funds (see paragraph 1.21);
or
- an entity that is a resident of Canada, Finland, France, Germany, Italy, Japan, the Netherlands (excluding the Netherlands Antilles), New Zealand, Norway, Sweden, Taiwan, the United Kingdom or the United States of America and holds less than 10% of the partnership's committed capital.

1.10 To be an eligible venture capital partner, a foreign venture capital fund of funds, together with any connected entity, must not hold more than 30% of the partnership's committed capital. A tax-exempt resident of the specified countries can hold up to 100% of the partnership's committed capital. *[Schedule 1, item 6 of the TLA(VC) Bill; paragraphs 118-420(1)(a) and (b) of the ITAA 1997]*

1.11 An entity is a connected entity of another if one is an associate of the other within the meaning of 'associate' in section 318 of the ITAA 1936 or, if the entity is a company, another member of the same wholly-owned group. However, the association between entities that are connected entities only because of being partners in a VCLP or an AFOF is disregarded in determining whether:

- an entity is an associate of another for the purposes of the 30% limit on the amount of committed capital a partner may have in a VCLP; or

- a partner qualifies for the exemption because its interest in the VCLP or AFOF together with that of connected entities is less than 10%.

[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-420(2) of the ITAA 1997]

Committed capital

1.12 A partner's committed capital is the total amount the partner may become obliged to contribute to the partnership, including any amount to be contributed by way of debt.

1.13 This amount is the committed capital whether the partner actually contributes the amount obliged and whether any amounts paid as contributed capital are returned to the partner.

1.14 The partnership's committed capital is the sum of each partner's contributed capital. *[Schedule 1, item 6 of the TLA(VC) Bill; section 118-445 of the ITAA 1997]*

Tax-exempt non-residents

1.15 An entity is a tax-exempt non-resident if:

- the entity is not a resident of Australia and is a resident of Canada, France, Germany, Japan, the United Kingdom, the United States of America or any other country prescribed in regulations; and
- the entity's income is exempt, or is effectively exempt, from taxation in the country in which it is resident.

1.16 The existing exemption, which is limited to foreign superannuation funds, is expanded to include other tax-exempt non-resident entities such as endowment funds and foundations. These entities may invest either directly or as partners of limited partnerships. *[Schedule 1, items 6 and 23 of the TLA(VC) Bill; subsections 118-420(3) and 995(1) of the ITAA 1997]*

1.17 An entity is effectively exempt from taxation if:

- a law of that country;
- a decree, proclamation, instrument or direction (however described) issued by a competent authority in that country; or
- an administrative arrangement in that country,

has the effect that no tax, or an insignificant amount of tax, is paid on income derived by the entity. This will include entities which are required to pay tax on particular classes of income representing an insignificant portion of their total income, for example, a United States pension fund that derives some unrelated business taxable income that is subject to tax, while the remainder of their income is exempt. An entity which does not pay tax because tax is levied on a flow-through basis, or does not pay tax because of the operation of a double tax treaty, will not be regarded as exempt from tax. *[Schedule 1, item 6 of the TLA(VC) Bill; paragraph 118-420(3)(c) of the ITAA 1997]*

Foreign venture capital funds of funds

1.18 A foreign venture capital fund of funds can be:

- a limited partnership; or
- an entity which is not taxed as an entity in its country of residence, whether by operation of law or election, but the entity's income is taxed to members in accordance with their interests in the entity.

[Schedule 1, item 6 of the TLA(VC) Bill; subsections 118-420(4) and (5) of the ITAA 1997]

1.19 An entity that is a general partner of a VCLP cannot be a foreign venture capital fund of funds. *[Schedule 1, item 6 of the TLA(VC) Bill; paragraphs 118-420(4)(c) and (5)(d) of the ITAA 1997]*

1.20 A limited partnership can be a foreign venture capital fund of funds if the partnership was established in Canada, France, Germany, Japan, the United Kingdom or the United States of America. The general partner must also be a resident of one of these countries. It is possible that a limited partnership may be established in one of the specified countries and the general partner may be a resident of another specified country. *[Schedule 1, item 6 of the TLA(VC) Bill; paragraphs 118-420(4)(a) and (b) of the ITAA 1997]*

1.21 An entity that is not a limited partnership can be a foreign venture capital fund of funds if:

- it is not taxed as an entity in its country of residence but its income is taxed to members in accordance with their interests in the entity; and
- it was established in Canada, France, Germany, Japan, the United Kingdom or the United States of America and is a resident of one of those countries. The entity may be established in one of the specified countries but be a resident of another specified country.

[Schedule 1, item 6 of the TLA(VC) Bill; paragraphs 118-420(5)(a) to (c) of the ITAA 1997]

Taxable non-residents

1.22 An entity other than a tax-exempt non-resident or a foreign venture capital fund of funds, may also qualify as an eligible venture capital partner, if:

- the partner is a resident of a specified country (see paragraph 1.23); and
- the committed capital of the partner and any connected entities (except entities that are connected only because of being partners in the same VCLP or AFOF) must be less than 10% of the partnership's committed capital.

[Schedule 1, item 6 of the TLA(VC) Bill; paragraph 118-420(1)(c) of the ITAA 1997]

1.23 The partner must be a resident of one of the following countries:

- Canada;
- Finland;
- France;
- Germany;
- Italy;
- Japan;

- the Netherlands (excluding the Netherlands Antilles);
- New Zealand;
- Norway;
- Sweden;
- the United Kingdom;
- the United States of America; or
- any other foreign country prescribed by regulation.

[Schedule 1, item 6 of the TLA(VC) Bill; paragraph 118-420(6)(a) of the ITAA 1997]

1.24 However, a partner who holds less than 10% of the committed capital of a VCLP or AFOF is not an eligible venture capital partner if it is:

- a general partner of a VCLP; or
- a tax-exempt non-resident or a foreign venture capital fund of funds.

[Schedule 1, item 6 of the TLA(VC) Bill; paragraph 118-420(6)(b) of the ITAA 1997]

1.25 A trust cannot be an eligible venture capital partner if an Australian resident:

- is or is likely to become presently entitled to a share of the income of the trust for the purposes of Division 6 of Part 111 of the ITAA 1936; or
- has or is likely to have an individual interest in a share of the income of the trust for the purposes of Division 5 of Part 111 of the ITAA 1936.

The Australian resident may be presently entitled to, or have an individual interest in the income of the trust, either directly or indirectly through one or more interposed partnerships or trusts. *[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118 420(7) of the ITAA 1997]*

Direct investment – eligible venture capital investors

1.26 It is not necessary to invest in a VCLP or an AFOF to access the capital gains tax concession. A tax-exempt non-resident who is a resident of Canada, France, Germany, Japan, the United Kingdom or the United States of America, and is registered by the PDF Board as an eligible venture capital investor, can also make a direct eligible venture capital investment which qualifies for the tax exemption. [*Schedule 1, item 6 of the TLA(VC) Bill; section 118-415 of the ITAA 1997*]

1.27 The registration requirements for an eligible venture capital investor are discussed in Chapter 5.

Chapter 2

Venture capital limited partnerships

Outline of chapter

2.1 This chapter explains the taxation treatment of VCLPs, AFOFs and VCMPs. Although these partnerships are limited partnerships, they will be treated as ordinary partnerships for Australian tax purposes. Treating these entities as ordinary partnerships allows the income, profits, gains and losses of the partnership to flow-through to partners who are then taxed according to their respective tax status. The chapter also explains the requirements a VCLP or an AFOF must satisfy for it to be treated as an ordinary partnership for Australian tax purposes.

Context of amendments

2.2 Limited partnerships are the preferred vehicle for venture capital investments internationally. Venture capital investors typically invest in venture capital projects through intermediaries such as limited partnerships or funds of funds to diversify their portfolio of venture capital assets in the most cost efficient manner and to access specialist venture capital management.

Summary of new law

2.3 The new law establishes 3 new limited partnerships, VCLPs, AFOFs and VCMPs, and provides for their tax treatment as ordinary partnerships. Partners in these partnerships will be taxed on their share of the income, profits, gains and losses of the partnership according to the partner's tax status. This flow through treatment for VCLPs and AFOFs will be conditional on each of the partnerships being registered by the PDF Board as a VCLP or AFOF. The partnership will cease to be a VCLP or AFOF if its registration is revoked by the PDF Board. There is no registration process for VCMPs.

2.4 As a VCLP, an AFOF or a VCMP is a limited partnership, loss limitation rules will limit the deduction allowable to limited partners for partnership losses to the extent of the partner's exposure to the loss.

Detailed explanation of new law

Venture capital limited partnerships

2.5 A limited partnership is a VCLP at a particular time if the PDF Board registers it as a VCLP and the registration is in force.
[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-405(2) of the ITAA 1997]

2.6 A limited partnership may be registered as a VCLP if:

- it is formed under a law of any Australian State or Territory or under a law of Canada, France, Germany, Japan, United Kingdom, United States or any part of those countries;
- its partnership agreement specifies that the partnership is to remain in existence for at least 5 years but not more than 15 years;
- it only carries on activities which are related to the making of eligible venture capital investments;
- its committed capital is at least \$20 million;
- its only investments are eligible venture capital investments;
- the only debt interests held by it are permitted loans (see paragraph 5.15); and
- the general partner has notified the PDF Board that the VCLP has sufficient funds to begin its investment program.

[Part 2, sections 9-1 and 13-1 of the VC Bill]

2.7 Every general partner must be a resident of one of those countries but not necessarily a resident of the country in which the partnership was formed.

Australian venture capital funds of funds

2.8 A limited partnership is an AFOF at a particular time if the PDF Board registers it as an AFOF and the registration is in force. *[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-410(3) of the ITAA 1997]*

- 2.9 A limited partnership may be registered as an AFOF if:
- it is formed in Australia;
 - every general partner is resident in Australia;
 - its partnership agreement specifies that the partnership is to remain in existence for at least 5 years but not more than 20 years;
 - it only carries on activities which are related to the making of eligible venture capital investments;
 - its only investments are investments in a VCLP or eligible venture capital investments in a company in which a VCLP (in which the AFOF is a partner) already holds an investment;
 - the only debt interests held by it are permitted loans (see paragraph 5.15); and
 - the general partner has notified the PDF Board that the AFOF has sufficient funds to begin its investment program.

[Part 2, sections 9-5 and 13-5 of the VC Bill]

Venture capital management partnership

2.10 A limited partnership that is a general partner of a VCLP or an AFOF and only carries on activities related to being a general partner is a VCMP. The partnership ceases to be a VCMP if any of these circumstances change. *[Schedule 2, item 16, subsection 94D(3) of the ITAA 1936]*

2.11 A partner in a limited partnership is a general partner if the partner's liability is not limited. *[Schedule 2, item 2, subsection 6(1) of the ITAA 1936]*

Taxation of VCLPs, AFOFs and VCMPs

2.12 Under the existing law, limited partnerships come within the definition of corporate limited partnerships in section 94D of the ITAA 1936, and are taxed as if they were companies (Division 5A). The bill amends section 94D to provide that a VCLP, an AFOF or a VCMP cannot be a corporate limited partnership. VCLPs, AFOFs and VCMPs will therefore be treated as ordinary partnerships for taxation purposes. *[Schedule 2, item 16 of the TLA(VC) Bill; subsection 94D(2) of the ITAA 1936]*

2.13 Section 92 of the ITAA 1936 provides for the calculation of the net income or a partnership loss of a partner in an (ordinary) partnership. Each partner is assessable on its share of net income and a deduction is allowable to each partner for its share of any partnership loss.

2.14 In the absence of any exemption, each partner's share of the net income derived by a VCLP, an AFOF or a VCMP will be included in the partner's assessable income under subsection 92(1). If the partner is a resident of Australia, the partner will be assessable on the whole of its share of the net income or, in the case of a non-resident partner, the partner will be assessable on its share of the net income of the partnership that is attributable to Australian sources.

Loss limitation

2.15 If a VCLP, an AFOF or a VCMP makes a partnership loss, the deduction allowable to a limited partner in respect of that loss cannot exceed the amount of the partner's financial exposure to the loss. This amount is calculated by deducting the following from the amount of capital contributed by the limited partner:

- the amount of contributed capital the partnership has repaid to the partner;
- the total of all deductions allowed to the partner for partnership losses incurred in previous income years; and
- the amount of any debt of the partner that is secured by the partner's interest in the VCLP or the AFOF.

[Schedule 2, item 13 of the TLA(VC) Bill; subsection 92(2AA) of the ITAA 1936]

Example 2.1

A partner contributes \$100,000 to a VCLP. The partner finances the contribution with \$20,000 of its own and a loan of \$80,000 secured by the partner's interest in the VCLP. The lender values the partner's

interest in the VCLP (or AFOF) at \$70,000 so the partner provides an asset, such as shares, valued at \$10,000 as security. The partner's amount worked out under the method statement is:

Partner's contribution	\$100,000
Less: Contribution Repaid	nil
Deductions allowed for previous losses	nil
Debt secured by interest in VCLP	<u>\$70,000</u>
Amount	\$30,000

The partner's share of the partnership loss for the 2002-2003 year of income is \$40,000. The deduction allowable to the partner is reduced to \$30,000

2.16 Deductions may be allowable in later years of income for partnership losses that were not allowable to the partner in the income year it was incurred because of the new subsection 92(2AA). The amount of the deduction not allowed in the year of income in which the loss was incurred is referred to as the 'outstanding subsection 92(2AA) amount'. *[Schedule 2, item 14 of the TLA(VC) Bill; subsection 92A(1) of the ITAA 1936]*

2.17 A limited partner has an outstanding subsection 92(2AA) amount if:

- the deduction otherwise allowable for a partnership loss in a previous year of income was reduced under subsection 92(2AA); and
- the amount of partnership loss deductions that was not allowable to the partner in a previous year or years of income because of subsection 92(2AA) exceeds the deductions for these losses that have been allowed in later years of income.

[Schedule 2, item 14 of the TLA(VC) Bill; subsection 92A(2) of the ITAA 1936]

Example 2.2

Following on from the previous example, in the 2003-2004 year of income the partner's share of the partnership loss incurred for that year is \$5,000. During that year the partner contributed further capital of \$20,000 which was financed from the partner's funds. There has been no change in the amount of the debt or the value of the security provided.

Amount worked out using the method statement in subsection 92(2A):

Partner's contribution	\$120,000
Less: Contribution Repaid	nil
Deductions allowed for previous losses	\$30,000
Debt secured by interest in partnership	<u>\$70,000</u>
Amount	\$20,000
Subtract: partner's share of partnership loss for the year	\$5,000
Step 1 amount	\$15,000
Outstanding subsection 92(2AA) amount	\$10,000

As the amount worked out under step 1 is greater than the outstanding subsection 92(2AA) amount, the amount of the deduction allowable to the partner for previous years losses is the outstanding subsection 92(2AA) amount (\$10,000).

If the partner's additional contribution during the 2003-2004 income year was only \$10,000, the deduction allowable to the partner for previous years losses would be:

Amount worked out using the method statement in subsection 92(2A):

Partner's contribution	\$110,000
Less: Contribution Repaid	nil
Deductions allowed for previous losses	\$30,000
Debt secured by interest in VCLP	<u>\$70,000</u>
Amount	\$10,000
Subtract: partner's share of partnership loss for the year	\$5,000
Step 1 amount	\$5,000
Outstanding subsection 92(2AA) amount	\$10,000

As the amount worked out under step 1 is less than the outstanding subsection 92(2AA) amount, the amount of the deduction allowable to the partner for previous years losses is the amount worked out under step 1 (\$5,000).

2.18 Division 36 of the ITAA 1936 provides for the deduction of tax losses incurred in previous years of income. The loss represented by a partner's outstanding subsection 92(2AA) amount will not be able to form part of a partner's tax loss that would be deductible under Division 36. These section 92(2AA) losses are deductible only where the conditions in new subsection 92A(1) are met. [*Schedule 2, item 14 of the TLA(VC) Bill; subsection 92A(3) of the ITAA 1936*]

2.19 These loss limitation rules are necessary to protect the integrity of the measure. Without these rules limited partners would be able to claim deductions for losses to which they were not exposed. Other jurisdictions, including Canada, New Zealand, the United Kingdom and the United States of America, also have rules to limit the pass through of losses to limited partners.

Capital gains

2.20 Capital gains made on assets held by a VCLP, an AFOF or a VCMP will be taxable to a partner in the same way as interests on assets held by an ordinary partnership. For example, as the CGT provisions are the primary code for taxing gains and losses made by superannuation funds, approved deposit funds and pooled superannuation trusts (section 304 of the ITAA 1936), gains flowing to any of these entities as a limited partner in a VCLP or AFOF will be taxed as capital gains.

2.21 Any capital gain or loss on the realisation of assets held by the VCLP or AFOF, including the carried interest distributed by a VCMP, will be taxed according to the partner's tax status. Thus, individuals who are partners in a VCMP will qualify for the CGT discount on the carried interest if they satisfy the other requirements for the discount.

Change of entity status

2.22 Where a limited partnership becomes or ceases to be a VCLP, an AFOF or a VCMP during an income year (but not on the first or last day of the income year) the following periods will be treated as a separate income year:

- the period from the beginning of the income year to the day before the partnership becomes a VCLP, an AFOF or a VCMP;
- the period from the day the partnership became a VCLP, an AFOF or a VCMP to the end of the income year, or the day the partnership ceased to be a VCLP, an AFOF or a VCMP, if earlier; and

- the period from the day before the partnership ceased to be a VCLP, an AFOF or a VCMP to the end of the income year.

[Schedule 2, item 12 of the TLA(VC) Bill; section 18A of the ITAA 1936]

2.23 Amendments to various provisions of the ITAA 1936 and ITAA 1997 are necessary to deal with the creation of separate income years for periods in an income year when a partnership's status as a VCLP, an AFOF or a VCMP changed. The following provisions are amended to deal with these separate income years:

- the definition of 'year of income' in the ITAA 1936 to include as a year of income the separate income years created in an income year in which the partnership became or ceased to be a VCLP, an AFOF or a VCMP *[Schedule 2, item 8 of the TLA(VC) Bill; paragraph 6(1)(b) of the ITAA 1936]*;
- provide that the separate income years created will be included in references to an year of income in the ITAA 1936 *[Schedule 2, item 9 of the TLA(VC) Bill; subsection 6(2) of the ITAA 1936]*;
- provide that references to accounting period adopted in lieu of a year of income includes the separate years of income created because of a change in the partnership's status *[Schedule 2, item 10 of the TLA(VC) Bill; subsection 6(2AA) of the ITAA 1936]*;
- exclude partnerships whose status changes as a result of becoming or ceasing to be a VCLP, an AFOF or a VCMP during a year of income from being required to seek the leave of the Commissioner to adopt a different accounting period as a year of income *[Schedule 2, item 11 of the TLA(VC) Bill; subsection 18(1) of the ITAA 1936]*;
- provide that each separate accounting period of an income year that is a separate income year because of a change in the partnership's status is the income year for which income tax is worked out *[Schedule 2, item 18 of the TLA(VC) Bill; paragraph 4-10(2)(b) of the ITAA 1997]*; and
- provide that if an entity has an accounting period that is not the same as the financial year, the accounting period is an income year. The will allow the different accounting periods created because of a change in the partnership's status during a financial year to be separate income years *[Schedule 2, item 20 of the TLA(VC) Bill; paragraph 9-5(2)(b) of the ITAA 1997]*

2.24 Amendments have also been made to the notes to relevant sections to include references to the separate income years created

because of a change in the partnership's status. *[Schedule 2, items 19 and 21 of the TLA(VC) Bill; subsections 4-10(2)(note) and subsection 9-5(2)(note) of the ITAA 1997]*

2.25 The definition of 'income year' in subsection 995(1) of the ITAA 1997 is amended to include as an 'income year' the separate accounting periods created in an income year in which the partnership became or ceased to be a VCLP, an AFOF or a VCMP. *[Schedule 2, item 24 of the TLA(VC) Bill; subsection 995-1(1) of the ITAA 1997]*

2.26 A new note has been added at the end of the definition of 'income year' in subsection 995(1) of the ITAA 1997. This note refers to the separate accounting periods created in an income year in which the partnership became or ceased to be a VCLP, an AFOF or a VCMP that are treated as separate income years. *[Schedule 2, item 25 of the TLA(VC) Bill; subsection 995-1(1)(note) of the ITAA 1997]*

Losses

2.27 If a limited partnership that becomes a VCLP, an AFOF or a VCMP incurred a tax loss before it became a VCLP, an AFOF or a VCMP, the tax loss is not deductible to the VCLP, AFOF or VCMP. *[Schedule 2, item 23 of the TLA(VC) Bill; section 195-65 of the ITAA 1997]*

2.28 However, if a limited partnership ceases to be a VCLP, an AFOF or a VCMP, any tax loss that occurred before the partnership became a VCLP, AFOF or VCMP will qualify for deduction under Division 36 as a tax loss of the partnership. *[Schedule 2, item 23 of the TLA(VC) Bill; section 195-70 of the ITAA 1997]*

2.29 The special rule that restricts a limited partnership with a tax loss that has become a VCLP, an AFOF or a VCMP from deducting that loss while it is a VCLP, an AFOF or a VCMP will be included in the list of special rules about tax losses. *[Schedule 2, item 22 of the TLA(VC) Bill; section 36-25 of the ITAA 1997]*

2.30 As mentioned above, where the status of a VCLP, an AFOF or a VCMP changes during an income year, the partnership will have at least two income years. These income years will be less than 12 months. Thus, each of the income years will be shorter than the standard income year under which income tax is worked out. This shorter period may result in income tax being worked out, in some circumstances, on an inappropriate basis. In these cases, the Commissioner will have power to make a determination modifying the operation of a provision to take into account the fact that the particular accounting period is shorter than 12 months. *[Schedule 2, item 23 of the TLA(VC) Bill; subsection 195-75(1) of the ITAA 1997]*

2.31 The determination can only be made to modify the operation of a particular provision to take into account the fact that the partnership's accounting period is shorter than 12 months. *[Schedule 2, item 23 of the TLA(VC) Bill; subsection 195-75(2) of the ITAA 1997]*

2.32 Any determinations made will be disallowable instruments for the purposes of section 46A of the *Acts Interpretation Act 1901*. *[Schedule 2, item 23 of the TLA(VC) Bill; subsection 195-75(3) of the ITAA 1997]*

Chapter 3

Venture capital investee companies

Outline of chapter

3.1 This chapter explains what is required for a venture capital investment to attract the tax concession (an eligible venture capital investment) and the requirements an investee company must satisfy to receive eligible venture capital investments.

Context of amendments

3.2 VCLPs make eligible venture capital investments by acquiring shares or options in unlisted Australian companies, the foreign holding company of such companies, or listed Australian companies that the VCLP delists within 12 months. Tax-exempt non-residents of certain countries, foreign venture capital funds established in those countries, and taxable non-residents of other specified countries (who hold less than 10% of the committed capital of the VCLP), who are partners in a VCLP, may qualify for an exemption from income tax on any profits or gains the VCLP makes on the realisation of shares in the Australian company or foreign holding company.

3.3 If an AFOF is a partner in a VCLP, the AFOF may acquire shares directly in these Australian companies or their foreign holding company if the VCLP in which it is a partner has made an eligible venture capital investment in the company.

3.4 Tax-exempt non-residents of certain countries who invest directly in these Australian companies or their foreign holding company may also qualify for an income tax exemption on the profits or gains on realisation.

Summary of new law

3.5 An eligible venture capital investment must satisfy a number of requirements:

- the venture capital investee company must meet the size restriction in respect of its assets and the amount of investment it is seeking (see paragraph 3.19);
- the venture capital investee company must be an Australian resident with 50% or more of its employees and assets situated in Australia or the foreign holding company of such a company, provided the foreign parent is resident in a specified country and it does not carry on any business other than to support the primary activity of the venture capital investee company; and
- the venture capital investee company's primary activity must not be a specified ineligible activity.

Detailed explanation of new law

Eligible venture capital investments

3.6 To qualify for the tax concession the investment must be an eligible venture capital investment.

3.7 The investment must be at risk, in that the VCLP, AFOF, or the investor in the case of direct investments, must bear the risk of owning the shares or options. *[Schedule 1, item 6 of the TLA(VC) Bill; paragraph 118-425(1)(a)]*

3.8 For an investment to be at risk the VCLP, AFOF, or the investor, must have no arrangement either before or after the share is acquired as to:

- maintaining the value of the share; or
- maintaining the amount of earnings made from owning it.

For example, a put option arrangement designed to maintain the value of the shares to the owner of the shares would not be 'at risk'. *[Schedule 1, item 6 of the TLA(VC) Bill; section 118-430]*

3.9 The investment must be shares or options (including warrants) in a venture capital investee company. *[Schedule 1, item 6 of the TLA(VC) Bill; paragraph 118-425(1)(b)]*

3.10 If the investment is made by a VCLP or an AFOF, its interest, together with any connected entities, in the venture capital investee company must not be more than 30% of the VCLP's or AFOF's committed capital. *[Schedule 1, item 6 of the TLA(VC) Bill; paragraph 118-425(1)(d)]*

3.11 A loan, including convertible notes, cannot be an eligible venture capital investment. There are also limitations on the amount of a loan a VCLP or an AFOF may make to a venture capital investee company in which it has made an eligible venture capital investment. This is considered in more detail in Chapter 5.

Location

3.12 At the time the investment is made the investee company must be an Australian resident. Further, if it is the first investment made in the company by the investor, the company must also:

- have more than 50% of the persons engaged by the company at that time to perform services, actually performing those services primarily in Australia; and
- have more than 50% of its assets (determined by value) situated in Australia,

for a period of at least 12 months from the date of the initial investment.

3.13 The value of an asset of the company is that shown on the last audited accounts prepared for the company for a period ending less than 18 months before that time. If there are no audited accounts, then an audited statement prepared in accordance with Australian Accounting Standards that shows the value of the assets at a time no longer than 12 months before that time will be required. *[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-425(10)]*

3.14 However, the general partner of a VCLP or an AFOF may apply to the PDF Board for a reduction in the 12 month period in appropriate circumstances. Similarly, a general partner may apply to the PDF Board to waive the requirement to comply with either or both the requirements relating to performance of services or the siting of assets in Australia. *[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-425(2)]*

Activities of the company

3.15 The company must not have any of the following as its primary activity:

- property development or land ownership;
- finance – to the extent that it is banking, providing capital to others, leasing, factoring, securitisation;
- insurance;
- the construction or acquisition of infrastructure activities; or
- investments that generate interest, rents, dividends, royalties or lease payments.

[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-425(3)]

3.16 A company that engages in any of the above activities that is ancillary and incidental to the primary activity (which is not one of those mentioned) will not be carrying on an excluded primary activity. For example, a company may acquire land and construct a factory for the purpose of the primary activity of manufacturing semi-conductors. The company would not be regarded as being in the business of property development in this instance. *[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-425(3)]*

3.17 The company's primary activity should be able to be determined from its day to day activities and its business plan even if the company engages in a number of activities, some of which may be excluded primary activities. The primary activity is not necessarily determined from the value of assets or the revenue generated by an activity.

Investment in other entities

3.18 A venture capital investee company cannot invest any part of an eligible investment in any other entity unless the other entity is connected with the company and meets the residency, primary activity, size, auditor and listing requirements of a venture capital investee company. The company cannot use any part of the investment in a trustee capacity. However, any investment the investee company makes by way of a deposit with authorised deposit-taking institution such as a bank, is disregarded. *[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-425(4)]*

Value of the venture capital investee company

3.19 The value of the assets of the company and any connected entity must not exceed \$250 million immediately before an investment is made. This amount is referred to as the *permitted entity value*. [Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-425(6)]

3.20 The *permitted entity value* is the sum of:

- the total value of the entity's assets; and
- the total value of the assets of other connected entities to the extent they are not included in the first entity's assets.

[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-440(1)]

3.21 The value of assets (both current and non-current) is that shown on the last audited accounts prepared for the company for a period ending less than 18 months before that time. If there are no audited accounts, then an audited statement prepared in accordance with Australian Accounting Standards that shows the value of the assets at a time no longer than 12 months before that time will be required. [Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-440(2)]

Listing

3.22 At the time the investment is made the company's shares should not be listed on an Australian or a foreign stock exchange. If the shares are listed, the investment can be an eligible venture capital investment if the company is delisted within 12 months of the initial investment.

[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-425(7)]

Scrip for scrip investments

3.23 Where shares in another company are acquired in exchange for shares that at the time of disposal were an eligible venture capital investment (i.e. a scrip for scrip exchange), the replacement shares will be treated as an eligible venture capital investment even if the company does not satisfy the requirements. However, if the company in which the replacement shares are held does not actually satisfy the requirements for a venture capital investee company, any shares acquired from a further scrip for scrip sale will not be treated as an eligible venture capital investment. [Schedule 1, item 6 of the TLA(VC) Bill; paragraphs 118-425(8)(a) and (b)]

3.24 The replacement shares acquired under a scrip for scrip sale will only qualify as an eligible venture capital investment if the investor, that is, VCLP, AFOF or eligible venture capital investor, disposes of *all* of its shares in the original investee company in return for shares in one other company. *[Schedule 1, item 6 of the TLA(VC) Bill; paragraph 118-425(8)(c)]*

Non-resident holding companies

3.25 A non-resident company that meets the value and listing requirements (see paragraphs 3.19 and 3.22) may be treated as a venture capital investee company if the company:

- is a resident of Canada, France, Germany, Japan, the United Kingdom, the United States of America, or any other country prescribed by regulation;
- beneficially owns all the shares in an Australian resident company that satisfies the requirements for an eligible venture capital investment; and
- does not carry on any business other than to support the primary activity of the Australian company.

[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-435(1)]

3.26 If a non-resident holding company is treated as meeting the requirements of a venture capital investee company, and the Australian subsidiary ceases to be an Australian resident within 12 months of the initial eligible venture capital investment being made in the company:

- eligible venture capital investments already made in the company cease to be eligible for the exemption; and
- any further investments made in the company will not be eligible for the exemption.

[Schedule 1, item 6 of the TLA(VC) Bill; subsection 118-435(2)]

Chapter 4

Venture capital managers

Outline of chapter

4.1 This chapter explains the taxation treatment of a venture capital manager's share of the gains made by a VCLP or an AFOF on the sale of eligible venture capital investments. The venture capital manager's share of these gains, known as the carried interest, is taxed as a capital gain.

Context of amendments

4.2 The expansion of the venture capital industry is a critical element in realising the innovation potential in *Backing Australia's Ability*. Venture capital managers inject hands-on expertise to increase significantly the success and growth of investee companies. Active management of these companies distinguishes the venture capital industry from the passive funds management industry. Treating the carried interest of venture capital managers as a capital gain is consistent with the way that interest is taxed in the United Kingdom and the United States. It should encourage leading international venture capital managers to locate in Australia and facilitate the development of the venture capital industry.

Summary of new law

4.3 An individual venture capital manager's entitlement to a payment of carried interest is a new CGT event, CGT event K9. The manager makes a capital gain at the time an entitlement to receive a payment arises. The capital gain is a discount capital gain if the carried interest arises under a partnership agreement that was entered into at least 12 months before the CGT event happened and the other requirements for the discount are met.

Detailed explanation of new law

What is the carried interest

4.4 A carried interest is a partner's entitlement to a distribution from a VCLP, an AFOF or a VCMP that is contingent on profits being attained for the limited partners of the VCLP or AFOF. A carried interest can be held by:

- a general partner of a VCLP or an AFOF; or
- a limited partner of a VCMP that is a general partner of a VCLP or AFOF.

These partners are referred to as 'venture capital managers' throughout this explanatory memorandum. *[Schedule 3, items 5 and 16 of the TLA(VC) Bill; subsections 104-255(4) and (5) and subsection 995-1(1)]*

4.5 The carried interest does not include any entitlement the partner may have to a management or similar fee from the VCLP, AFOF or VCMP. *[Schedule 3, item 5 of the TLA(VC) Bill; paragraph 104-255(6)(a)]*

4.6 A general partner may acquire an equity interest in a VCLP or AFOF by undertaking to commit capital to the partnership. The carried interest does not include any interest of the general partner that is attributable to that equity interest. *[Schedule 3, item 5 of the TLA(VC) Bill; paragraph 104-255(6)(b)]*

Taxation of the carried interest

4.7 When a venture capital manager becomes entitled to receive a payment of carried interest CGT event K9 happens and the manager makes a capital gain. This entitlement may be held directly, when the manager is the general partner in a VCLP or an AFOF or a limited partner in a VCMP, or indirectly, when the manager holds the interest in the VCLP, AFOF or VCMP through a trust or similar flow-through entity.

4.8 When the level of profits specified in the partnership agreement have been attained for the limited partners of a VCLP or AFOF and the venture capital managers become entitled to a payment of carried interest, the event that creates the entitlement in the sale of an eligible venture capital investment by a VCLP or an AFOF. As a VCLP or an AFOF is a partnership, any capital gains or losses made on the partnership's CGT assets are made by the partners individually and each partner's entitlement is calculated according to the relevant partnership agreement (section 106-5). The effect of the carried interest entitlements being treated as capital

gains made by venture capital managers is that these amounts are not taken into account in calculating the net income of the VCLP or AFOF under section 92 of the ITAA 1936. *[Schedule 3, items 4 and 5 of the TLA(VC) Bill; section 104-5 and subsection 104-255(1)]*

4.9 The time at which the CGT event happens is the time the venture capital manager becomes entitled to receive the payment. Typically, the entitlement will arise at the same time as the VCLP or AFOF sells the eligible venture capital investment and allocates the proceeds according to the partner's interests in the partnership.

4.10 If a manager holds an interest as a limited partner in a VCMP through a trust, the trust would become entitled to the payment at the time the VCMP allocates the capital gain made by the VCLP or AFOF. If the individual venture capital manager is presently entitled to a share of the net income of the trust, the capital gains character of the carried interest included in a distribution flows to the manager and the time of the event is the time the trust became entitled to the payment of carried interest. *[Schedule 3, item 5 of the TLA(VC) Bill; subsection 104-255(2)]*

4.11 The amount of the capital gain is the amount the manager is entitled to receive or the market value of any property received in lieu of payment. A venture capital manager cannot make a capital loss on a carried interest. *[Schedule 3, item 5 of the TLA(VC) Bill; subsection 104-255(3)]*

4.12 The term 'payment' in relation to 'entitled to receive a payment of carried interest' includes:

- a payment that is attributable to the carried interest;
- giving property to satisfy a carried interest; or
- giving property to satisfy an entitlement that is attributable to a carried interest, such as an entitlement arising from an indirect interest in a general partner of a VCLP or AFOF or in a limited partner of a VCLP.

[Schedule 3, item 5 and 17 of the TLA(VC) Bill; subsections 104-255(7) and 995-1(1)]

Carried interest taxed as a capital gain

4.13 Where an amount is both a capital gain and income, the amount is generally taxed as income (section 118-20). However, an entitlement to receive a payment of carried interest that is CGT event K9 is taxed as a capital gain. The carried interest is not ordinary income of the venture capital manager and is statutory income only to the extent that it is a capital gain. Likewise, a deduction is not allowable to a VCLP, an AFOF or a VCMP for a carried interest payment.

4.14 To achieve this outcome the following provisions of the income tax law that could apply to treat a payment of carried interest as income, will not apply:

- the ordinary income and deduction provisions of the income tax law (sections 6-5 and 8-1 of the ITAA 1997);
- provisions relating to profit-making undertakings or plans (sections 15-15 and 25-40 of the ITAA 1997 and sections 25A and 52 of the ITAA 1936); and
- the statutory income provisions (section 6-10 of the ITAA 1997) except section 102-5 of the ITAA 1997 which includes net capital gains in assessable income.

[Schedule 3, items 2, 3 and 13 of the TLA(VC) Bill; sections 10-5, 12-5 and 118-21]

Discount capital gains

4.15 In working out whether a capital gain is a discount capital gain the cost base of the CGT asset is required to be taken into account (sections 115-5 and 115-20). A cost base cannot be taken into account in working out the capital gain made from CGT event K9 in relation to a carried interest because a carried interest does not have a cost base. The requirement to take the cost base into account does not apply when calculating the capital gain arising from a carried interest. *[Schedule 3, items 6 and 7 of the TLA(VC) Bill; section 110-10 and subsection 115-20(3)]*

4.16 For a capital gain to be a discount capital gain the CGT event must happen to a CGT asset that was acquired at least 12 months previously. This requirement does not apply to a carried interest entitlement that is CGT event K9. A carried interest entitlement can be a discount capital gain if the partnership agreement under which it arises was entered into at least 12 months before the CGT event. *[Schedule 3, item 8 of the TLA(VC) Bill; subsection 115-25(2A)]*

Capital proceeds

4.17 In working out a capital gain from a CGT event the capital proceeds are taken into account. The capital proceeds are the total of the amount received or the market value of any property received in respect of the event (section 116-20). In certain circumstances, such as if there are no capital proceeds or the proceeds cannot be valued, the person is taken to have received the market value of the CGT asset that is the subject of the event (subsection 116-30(1)). Some CGT events are expressly excluded from being subject to this rule (subsection 116-30(3)).

4.18 Special rules setting out the capital proceeds for certain CGT events are set out in section 116-20(2). The capital proceeds for CGT event K9, entitlement to receive a payment of a carried interest, is specified to be the amount of the payment to the extent that it is a payment of carried interest. *[Schedule 3, items 9 and 10 of the TLA(VC) Bill; subsection 116-20(2)]*

4.19 There are 5 modifications that can be made to the general rules about capital proceeds for particular CGT events (section 116-10). The CGT events for which the general rules have been modified are set out in section 116-25. Modifications 2, 3 and 4, the apportionment rule, the non-receipt rule and the repaid rule, apply to CGT event K9. *[Schedule 3, item 11 of the TLA(VC) Bill; section 116-25]*

4.20 The apportionment rule (section 116-40 – modification 2) will be relevant if a payment received includes an amount that is attributable to another CGT event or some other amount due. For example, a venture capital manager may receive a payment that includes the manager's share of a distribution from an equity interest the VCMP holds in the VCLP and a payment of carried interest.

4.21 The non-receipt rule (section 116-45 – modification 3) will be relevant if an entitlement to a carried interest that arose in a particular year was unlikely to be paid because of events occurring after that time. For example, a carried interest entitlement may not be paid because the VCLP became insolvent.

4.22 The repaid rule (section 116-50 – modification 4) will be relevant if a venture capital manager is required to repay an amount of carried interest paid in an earlier income year. For example, a VCLP may incur losses on its venture capital investments in later years and be required to repay carried interest entitlements that were paid on the basis of profits made in earlier years.

Ceasing to be entitled to a carried interest

4.23 If a venture capital manager ceases to be entitled to receive a payment of carried interest from a VCLP, AFOF or VCMP, CGT events A1 or C2 may apply. The market value substitution rule (modification 1) can apply to these CGT events. Broadly stated, the market value substitution rule replaces a taxpayer's actual capital proceeds, if any, with the market value of the asset that is no longer owned if:

- no capital proceeds are received; or
- the capital proceeds received in a non-arm's length transaction are either less or more than the asset's value.

4.24 If the venture capital manager does not receive any capital proceeds on ceasing to be entitled to a carried interest, the manager will not be treated as having received capital proceeds equal to the market value of the interest. *[Schedule 3, item 12 of the TLA(VC) Bill; subsection 116-30(5)]*

Non-resident managers

4.25 The carried interest entitlement of a venture capital manager that is a non-resident of Australia for taxation purposes is a capital gain if the capital proceeds are regarded as being derived from an Australian source. The capital proceeds will be regarded as having an Australian source if they would have had an Australian source if the receipt was ordinary income of the recipient. *[Schedule 3, item 15 of the TLA(VC) Bill; subsection 136-15(3)]*

Fringe benefits

4.26 An individual venture capital manager may become entitled to a carried interest in circumstances related to their employment. The carried interest payment is expressly excluded from being a 'fringe benefit' within the definition in section 136 of the FBTAA 1986 where:

- the manager becomes entitled to receive a payment of a carried interest; or
- the manager is granted or acquires a carried interest or an entitlement to a carried interest.

[Schedule 3, item 1 of the TLA(VC) Bill; paragraphs 136(1)(ma) and (mb) of the FBTAA 1936]

Chapter 5

Registration

Outline of chapter

- 5.1 This chapter explains:
- how an entity may register as a VCLP or an AFOF;
 - the obligations of the entity whilst registered;
 - the circumstances in which the registration may be revoked by the PDF Board; and
 - how eligible venture capital investors may register their venture capital investments and their obligations once they are registered.
- 5.2 The legislation relating to registration is contained in the Venture Capital Bill 2002.

Context of amendments

- 5.3 The registration rules ensure that the Government can both monitor compliance with the tax concession and assess the impact of the tax concession.

Summary of new law

- 5.4 Partners in a VCLP or an AFOF and direct investors can only qualify for the tax exemption on profits and gains made on the disposal of venture capital investments if the partnership or the investor is registered with the PDF Board.
- 5.5 The general partner of a limited partnership may apply to the PDF Board for registration as a VCLP or an AFOF, as appropriate. A limited partnership cannot be registered as both a VCLP and an AFOF.

5.6 Once a limited partnership is registered as a VCLP or an AFOF, the general partner must give the PDF Board:

- a quarterly return within 1 month of the end of a quarter;
- an annual return within 3 months of the end of the financial year; and
- any further information the PDF Board requires.

5.7 The PDF Board may revoke the registration of the limited partnership if it:

- fails to satisfy registration requirements;
- fails to provide an annual or quarterly return or other required information;
- does not divest an ineligible investment;
- makes an application for revocation of registration; or
- makes more than one ineligible investment within 12 months.

5.8 Before it revokes registration the PDF Board will invite the general partner to make written submissions about the particular matter. In the case of a partnership not meeting a registration requirement, the PDF Board will allow the partnership a period to meet the requirement. The length of the period depends on whether the requirement not being met is an 'investment' or 'other' registration requirement. For an investment registration the PDF Board will determine a reasonable period which must not be longer than 6 months. The period allowed to meet an 'other' requirement will be 60 days which may be extended by no more than 60 days.

5.9 An eligible venture capital investor must register within 30 days of making its first venture capital investment to qualify for the tax exemption. The investor must provide an annual return on a similar basis as VCLPs and AFOFs. The registration may be revoked for failing to lodge an annual return or on application by the investor.

Detailed explanation of new law

Registration of VCLPs and AFOFs

5.10 A limited partnership seeking the venture capital tax concession must apply to the PDF Board for registration as a VCLP or an AFOF. An application by a general partner of a limited partnership for registration as a VCLP or an AFOF must include a statement by the general partner that the partnership meets the registration requirements of a VCLP or an AFOF as the case may be.

5.11 The general partner of the limited partnership seeking registration must make the application. This is because in a limited partnership it is the general partner that is responsible for the day to day operations of the partnership.

5.12 Different registration requirements apply to VCLPs and AFOFs because of their different roles in the venture capital concession. In each case a distinction is made between ‘investment’ registration requirements and ‘other’ registration requirements. This is because the time the PDF Board may allow a VCLP or AFOF to remedy a breach of an ‘investment’ requirement is longer than that allowed to remedy a breach of an ‘other’ requirement before revoking the registration (see below).

Registration requirements – VCLPs

5.13 The ‘other’ registration requirements of a VCLP are that:

- the VCLP is established in Australia, Canada, France, Germany, Japan, United Kingdom and the United States of America, or other foreign country that may be prescribed in the regulations. No other countries are listed for prescription at this time;
- the general partners are residents of one of the countries specified above. If there is more than one general partner, each must be a resident of the specified country;
- the partnership agreement specifies that the partnership is to remain in existence for not less than 5 years and not more than 15 years; and
- the partnership’s committed capital is at least \$20 million.

[Part 2, paragraphs 9-1(1)(a), (b), (c) and (e) of the VC Bill]

- 5.14 The investment registration requirements of a VCLP are that:
- the partnership does not hold an investment that is not an ‘eligible venture capital investment’ or an investment that would be an eligible venture capital investment if the company had met the residency, location and size requirements (see Chapter 3);
 - the partnership will only carry on activities that are related to making venture capital investments that are eligible for the exemption or would be if they met the residency, location and size requirements; and
 - every debt interest (such as a loan) the partnership holds is a ‘permitted loan’ (see next paragraph).

[Part 2, paragraphs 9-1(1)(d), (f) and (g) and subsection 5-1(2) of the VC Bill]

Permitted loan

5.15 A permitted loan is a loan made by a VCLP or an AFOF to a venture capital investee company (see Chapter 3 for more information on venture capital investee companies). The conditions applying to the loan vary according to whether the VCLP or the AFOF holds an eligible venture capital investment in the company.

5.16 If the VCLP or AFOF does not hold an eligible venture capital investment in the company the loan must be repaid within 6 months of being made (unless the PDF Board extends the period). A general partner of a VCLP or AFOF may apply to the PDF Board in the approved form for a longer term. The PDF Board may allow a longer period if it is satisfied that there are exceptional circumstances and the extended period is no longer than is reasonably necessary. *[Part 2, paragraphs 9-10(1)(b) and subsections 9-10(2) and (3) of the VC Bill]*

5.17 However, there is no time limit on a loan to a company if the partnership holds equity interests, and specified debt interests, in that company, and those interests are at least 10% of the company’s total equity interests, and specified debt interests. Only debt interests which can be converted to equity interests (e.g. convertible notes that confer a right to acquire shares in the company) are included in the specified debt interests. *[Part 2, paragraph 9-10(1)(a) of the VC Bill]*

Registration requirements – AFOFs

- 5.18 The ‘other’ registration requirements of an AFOF are that:
- the AFOF is established under the law of a State or Territory;
 - all general partners (if more than one) are residents of Australia;
 - the partnership agreement specifies that the partnership is to remain in existence for not less than 5 years and not more than 20 years; and
 - the partnership will only carry on activities that are related to making venture capital investments that are eligible for the exemption, or that are related to investing in a VCLP.

[Part 2, paragraphs 9-5(1)(a) to (c) of the VC Bill]

- 5.19 The investment registration requirements of an AFOF are:
- it may only make investments in VCLPs and direct investments in a company that a VCLP in which the AFOF is a partner has made an investment; and
 - it will only carry on activities that are related to making venture capital investments that are eligible for the exemption or would be if they met the residency, location and size requirements;
 - every debt interest (such as a loan) the partnership holds is a ‘permitted loan’ (see paragraph 5.15).

[Part 2, paragraphs 9-5(1)(d) to (f) and subsection 5-5(2) of the VC Bill]

Application for registration

5.20 A general partner of a limited partnership may apply for registration of the partnership as a VCLP or an AFOF, as the case may be, in the form approved by the PDF Board. This will allow the PDF Board to request the application to be in writing or to be lodged electronically if appropriate. *[Part 2, subsection 11-1(1) of the VC Bill]*

Information to be included in an application

5.21 An application by a general partner of a limited partnership must include the following information:

- the name, residency status and relevant qualifications and experience of each general partner;
- the name, address and residency status of each limited partner;
- the address of the general partner's registered office;
- the address of the registered office of the VCLP or AFOF;
- the business address of the VCLP or AFOF;
- a copy of the partnership agreement (see below for details of the information the agreement must contain);
- the documents that were issued inviting investment in the partnership, for example, a private placement offer;
- the amount of each partner's committed capital in the VCLP or AFOF;
- if applicable, details of the facts that qualify any non-resident partner to be tax exempt in the partner's country of residence;
- if the application is an application for registration as a VCLP, a statement by the general partner as to whether the partnership meets the registration requirements of a VCLP; and
- if the application is an application for registration as an AFOF, a statement by the general partner as to whether the partnership meets the registration requirements of an AFOF.

[Part 2, subsection 11-1(2) of the VC Bill]

Partnership agreement

5.22 The partnership agreement must:

- require the partners to contribute their committed capital as and when required under the agreement;

- prohibit the addition of new partners to the partnership except as provided for in the agreement;
- prohibit increases in the partnership's committed capital except as provided in the agreement;
- confer on the general partner the right to require partners to contribute their committed capital to the partnership; and
- include a plan which outlines the partnership's future intended investment activities.

[Part 2, paragraph 11-5(2)(f) of the VC Bill]

Further information requirements

5.23 If the PDF Board decides that specified information is to be provided in an application for registration as a VCLP or an AFOF it will make a resolution to that effect. The determination will be in writing and signed by the Chairman of the PDF Board. This will enable the PDF Board to require any information it considers necessary to decide whether to register a partnership as a VCLP or an AFOF. *[Part 2, subsection 11-5(1) of the VC Bill]*

5.24 Any determinations made will be disallowable instruments for the purposes of section 46A of the Acts Interpretation Act 1901. *[Part 2, subsection 11-5(2) of the VC Bill]*

5.25 If the PDF Board requires further information to decide a particular application for registration as a VCLP or an AFOF, the PDF Board may ask the general partner to provide the required information. *[Part 2, section 11-10 of the VC Bill]*

Period within which an application is to be decided

5.26 The PDF Board is required to make a decision within 60 days of the application being lodged. However, the PDF Board has a discretion to extend the period for deciding an application by up to 60 days but only if written notice is given to the general partner. The PDF Board must decide the application within the extended period. *[Part 2, section 11-15 of the VC Bill]*

Registration by the PDF Board

5.27 The PDF Board must register a partnership as a VCLP or an AFOF if an application was made and the application provides all the information required and any additional information required by the PDF Board. However the PDF Board will not register the partnership as a VCLP or an AFOF if it is satisfied that the applicant does not meet the

registration requirements or the partnership has had a previous registration revoked. *[Part 2, subsections 13-1(1) and (2) of the VC Bill]*

5.28 The PDF Board is obliged to notify the general partner of the limited partnership as soon as practical once a decision has been made. *[Part 2, subsection 13-1(3) of the VC Bill]*

5.29 The PDF Board cannot register a limited partnership as both a VCLP and an AFOF. *[Part 2, subsection 13-1(4) of the VC Bill]*

Conditional registration

5.30 The PDF Board has a discretion to conditionally register a partnership as a VCLP or an AFOF if the application does not meet all the information requirements. However the PDF Board will not conditionally register the partnership as a VCLP or an AFOF if the PDF Board is satisfied that the applicant would not meet the registration requirements before the conditional registration period lapses or the partnership has had a previous registration revoked. *[Part 2, subsections 13-5(1) and (2) of the VC Bill]*

5.31 Conditional registration does not mean the partnership is registered as a VCLP or an AFOF but it will enable the general partner to issue a prospectus to attract investors prior to obtaining final registration. *[Part 2, subsection 13-5(3) of the VC Bill]*

5.32 It is important to note that conditional registration does not guarantee that the applicant will be ultimately approved as being a VCLP or an AFOF. *[Part 2, subsection 13-5(4) of the VC Bill]*

5.33 If a partnership is not registered as a VCLP or an AFOF within 24 months of being granted conditional registration, the conditional registration lapses. *[Part 2, subsection 13-10(2) of the VC Bill]*

Date of effect of registration

5.34 If conditional registration has not been granted, registration comes into effect on the day registration was granted. If conditional registration has been granted, registration comes into force on:

- the day the partnership was established if the partnership has only carried on activities related to becoming registered as a VCLP or an AFOF; or
- if this is not the case, the day conditional registration was granted.

5.35 Thus, if a VCLP or an AFOF has not carried on any unrelated activities before being granted conditional registration it will be treated as an ordinary partnership for tax purposes from its establishment. Registration continues to be in force until it is revoked by the PDF Board. *[Part 2, section 13-10 of the VC Bill]*

Obligations while registered

Annual return

5.36 The PDF Board requires an annual return from the general partner of a VCLP or an AFOF within 3 months of the end of each financial year. If the annual return is not received within this time period, then it may be grounds for the PDF Board to revoke the registration of the VCLP. *[Part 2, section 15-1 of the VC Bill]*

5.37 The annual return must be in writing and contain the following information:

- the name and address of each limited partner and its residency status, and if the residency status changed during the year, the details of the changes;
- if a partner is claiming to be tax exempt in the country of residence, the details of the facts that qualify the partner to be tax exempt;
- details of:
 - each partner's committed capital; and
 - any acquisition or disposal of a partner's equity interest in the partnership during the year, including any consideration given or received for the acquisition or disposal;
- details of any variation made to the partnership agreement during the year;
- details of:
 - investments the partnership made during that year;
 - investments the partnership holds at the end of the year; and

- any investments disposed of during the year including any profits or losses made on the disposal; and
- a statement from the general partner that the partnership met the registration requirements of a VCLP or an AFOF, as the case may be, throughout the financial year.

[Part 2, section 11-1 of the VC Bill]

Further information in returns

5.38 If the PDF Board decides that specified information is to be provided in an annual return it will make a resolution to that effect. The determination will be in writing and signed by the Chairman of the PDF Board. *[Part 2, subsection 15-5(1) of the VC Bill]*

5.39 Any determinations made will be disallowable instruments for the purposes of section 46A of the *Acts Interpretation Act 1901*. *[Part 2, subsection 15-5(2) of the VC Bill]*

Quarterly returns

5.40 The general partner of a VCLP or an AFOF must give the PDF Board a return within 1 month of the end of each quarter (a quarter for these purposes is a 3 month period ending on 31 March, 30 June, 30 September or 31 December). The return must include details of all investments made and disposed of during the quarter and show the profit or loss on disposal and how it was calculated. *[Part 2, section 15-10 of the VC Bill]*

5.41 If the VCLP or AFOF fails to notify the PDF Board about these investments then registration may be revoked.

Revocation of registration

5.42 If the registration of a partnership as a VCLP or an AFOF is revoked the partnership ceases to be taxed as an ordinary partnership. From the time its registration is revoked the partnership will be taxed as a company and will not be able to be registered again as a VCLP or an AFOF. Eligible partners in a VCLP will not qualify for the tax exemption on any profits or gains made on the disposal of eligible venture capital investments.

5.43 Given the serious consequences for a limited partnership that loses its registration as a VCLP or an AFOF, the PDF Board will not revoke a partnership's registration until it has notified the general partner of the matters that may result in registration being revoked and given the

partnership time to remedy the breaches and to make submissions on the matter. The PDF Board may allow longer period for remedying breaches of an investment requirement than for an 'other' requirement as more time may be required.

Revocation for not meeting investment registration requirements

5.44 The PDF Board has the power to revoke the registration of an eligible VCLP or AFOF if the PDF Board has reason to believe that the VCLP or AFOF does not meet the investment registration requirements (see paragraphs 5.14 and 5.19).

5.45 However before exercising this power, the PDF Board must give the general partner of the partnership notice that if the requirements are not satisfied at the end of a specified period, registration will be revoked. *[Part 2, subsection 17-1(1) of the VC Bill]*

5.46 The PDF Board must give the partnership a reasonable period of time (but not more than 6 months) to rectify the concerns the PDF Board may have concerning the investment registration requirements. *[Part 2, subsection 17-1(2) of the VC Bill]*

5.47 The notice given to the general partner referred to in paragraph 5.45 must:

- state the matters the PDF Board considers may be grounds for revocation of registration;
- state the period within which the investment registration requirements must be complied with; and
- advise the general partner that it can make written submissions to the PDF Board about matters raised in the notice.

[Part 2, subsection 17-1(3) of the VC Bill]

5.48 The general partner may make submissions to the PDF Board about the matters in the notice. *[Part 2, subsection 17-1(4) of the VC Bill]*

5.49 The PDF Board will revoke the registration of the VCLP or the AFOF if they are satisfied that after a reasonable period of time, the partnership does not meet the investment registration requirements of a VCLP or an AFOF. *[Part 2, subsection 17-1(5) of the VC Bill]*

Revoking registration for not meeting other registration requirements

5.50 The PDF Board has the power to revoke the registration of an eligible VCLP or AFOF if the PDF Board has reason to believe that the VCLP or AFOF does not meet other registration requirements, that is registration requirements that are not investment registration requirements (see paragraphs 5.13 and 5.18). *[Part 2, subsection 17-5(1) of the VC Bill]*

5.51 Before exercising this power, the PDF Board must notify the general partner of the partnership that it will revoke registration if these requirements are not satisfied within 60 days. *[Part 2, subsection 17-5(1) of the VC Bill]*

5.52 The notice given to the general partner must:

- state the grounds the PDF Board feels may be grounds for revocation of registration;
- state that the general partner can apply for an extension of the 60 day period within which the requirements must be satisfied; and
- advise the general partner that it can make written submissions to the PDF Board about matters raised in the notice within the 60 day period or the extended period.

[Part 2, subsection 17-5(2) of the VC Bill]

5.53 The general partner may apply for an extension of the 60 day period. *[Part 2, subsection 17-5(3) of the VC Bill]*

5.54 The PDF Board also may extend the 60 day period if it is satisfied the partnership is making reasonable progress towards meeting the requirements and that the requirements are likely to be met within the extended period. *[Part 2, subsection 17-5(4) of the VC Bill]*

5.55 The general partner can make submissions to the PDF Board about the matters of concern during the 60 day period or, if the PDF Board has extended the period, during the extended period. *[Part 2, subsection 17-5(5) of the VC Bill]*

5.56 The PDF Board will revoke the registration of the VCLP or the AFOF if, after considering any submissions, it is satisfied that at the end of the 60 day period or the extended period, the partnership does not meet

the other registration requirements of a VCLP or an AFOF. *[Part 2, subsection 17-5(5) of the VC Bill]*

Revocation at the discretion of the PDF Board

5.57 A VCLP or AFOF may have its registration revoked if it:

- failed to lodge an annual return;
- failed to lodge a quarterly return;
- failed to provide information the PDF Board has requested;
or
- received more than 1 notice from the PDF Board within a 12 month period for breaching the registration requirement that the partnership must only hold eligible venture capital investments (an AFOF may, of course, hold an investment in a VCLP without breaching this requirement).

[Part 2, subsection 17-10(1) of the VC Bill]

5.58 However, the PDF Board must not revoke the registration of a VCLP or an AFOF unless it has given the general partner 28 days to make submissions about the failure to provide the required return or notification and considered any submissions made. *[Part 2, subsection 17-10(2) of the VC Bill]*

Notice of revocation

5.59 If the PDF Board decides to revoke a partnership's registration it must notify the general partner and set out the reasons for deciding to revoke. *[Part 2, subsection 17-15(1) of the VC Bill]*

5.60 The revocation takes effect from the day the PDF Board decides to revoke registration. The partnership ceases to be a VCLP or an AFOF and will be taxed as a company from that day. *[Part 2, subsection 17-15(2) of the VC Bill]*

Revocation on application by a partnership

5.61 A partnership may apply to have its registration revoked by requesting the PDF Board in writing to revoke its registration. *[Part 2, subsection 17-20(1) of the VC Bill]*

5.62 On receiving the application for revocation by the partnership, the PDF Board must take steps to comply with the request as soon as practical. *[Part 2, subsection 17-20(2) of the VC Bill]*

5.63 The revocation takes effect on the day the notice is given to the general partner. *[Part 2, subsection 17-20(3) of the VC Bill]*

Registration of eligible venture capital investors

5.64 A direct investor entity will qualify for the tax exemption on profits and gains made on the disposal of venture capital investments if the investor is registered with the PDF Board as an eligible venture capital investor.

5.65 The entity may apply to the PDF Board for registration within 30 days after it makes its first eligible venture capital investment. *[Part 3, subsections 21-5(1) and (2) of the VC Bill]*

5.66 An application by an investor must be in writing and include the following information:

- the residency status of the applicant;
- details of the applicant's tax exempt status in its country of residence and details of the facts that qualify the applicant as a tax-exempt non-resident;
- the address of the applicant's registered office;
- the details of the first venture capital investee company in which the applicant has invested (or proposes to invest) and the industry in which it operates; and
- the amount of the investment and the date on which it was or is to be made, and details of other investments that are not venture capital investments that the entity holds in the company.

[Part 3, subsection 21-5(3) of the VC Bill]

5.67 The PDF Board must register the applicant if it is satisfied that all information has been provided. *[Part 3, subsection 21-5(4) of the VC Bill]*

5.68 If the PDF Board registers the applicant, the PDF Board must notify the applicant within 60 days after the application was made. *[Part 3, subsection 21-5(5) of the VC Bill]*

Period within which the application is decided

5.69 The PDF Board is required to make a decision within 60 days of the application being lodged. However, the PDF Board has a discretion to extend the period (by up to 60 days) in which to decide the application but only if written notice is given to the applicant. The PDF Board must then decide the application within the extended period. *[Part 3, section 21-10 of the VC Bill]*

Date of effect of registration

5.70 If the PDF Board approves the registration of the investor as an eligible capital investor, the registration comes into effect on the day on which the first venture capital investment is made in the venture capital company. *[Part 3, subsection 21-15(1) of the VC Bill]*

5.71 The registration will be in force until it is revoked by the PDF Board. *[Part 3, subsection 21-15(2) of the VC Bill]*

Annual return

5.72 Each eligible investor must give the PDF Board an annual return within 3 months of the end of each financial year. If the annual return is not received within this time period, then it may be grounds for the PDF Board to revoke the registration of the eligible investor.

5.73 The annual return must contain the following information:

- the investor's residency status as at the end of the financial year;
- the address of the investor's registered office;
- details of the facts that qualify the investor to be tax exempt in its country of residence;
- details of eligible venture capital investments made during the year, disposed of during the year, held at the end of the year and any profits or losses incurred on the disposal of the investments; and
- the industries to which these investments relate.

[Part 3, section 21-20 of the VC Bill]

Revocation of registration

5.74 The PDF Board may revoke an eligible investor's registration if it fails to lodge an annual return. *[Part 3, subsection 21-25(1) of the VC Bill]*

5.75 As soon as the PDF Board has revoked the registration of an eligible investor it must give the investor a notice which advises of the revocation and sets out the PDF Board's reasons for deciding to revoke. *[Part 3, subsection 21-25(2) of the VC Bill]*

5.76 However, the PDF Board must not revoke the registration of an eligible investor unless it has given the investor 14 days to make written submissions to the PDF Board about the failure to provide the required return or notification, and considered any submissions made. *[Part 2, subsection 21-25(3) of the VC Bill]*

Revocation on application

5.77 An eligible investor may make a written request to the PDF Board to revoke its registration. *[Part 2, subsection 21-25(3) of the VC Bill]*

5.78 The PDF Board must take steps to comply with the request to revoke the registration as soon as practical. *[Part 2, subsection 17-20(2) of the VC Bill]*

5.79 The revocation takes effect on the day notice is given to the investor. *[Part 2, subsection 21-25(3) of the VC Bill]*

Determinations by the PDF Board – certain investments

- 5.80 A general partner may apply to the PDF Board to:
- shorten the 12 month period an investee company is required to meet residency and location requirements; or
 - waive the requirement to comply with either or both the requirements relating to performance of services or the situating of assets in Australia (see paragraph 3.12).

Determination to shorten 12 month period

5.81 A venture capital investee company is required to be an Australian resident at the time a venture capital investment is made in the company and to continue to be an Australian resident for a period of 12 months. Further, if it is the first investment made in the company by the investor, the company must also:

- have more than 50% of the persons engaged by the company at that time to perform services, actually performing those services primarily in Australia; and

- have more than 50% of its assets (determined by value) situated in Australia,

for a period of at least 12 months from the date of the initial investment.

5.82 The general partner of a VCLP or an AFOF that holds an investment may apply to the PDF Board, in an approved form, for a determination reducing the 12 month period during which these requirements are to be satisfied. *[Part 4, subsection 25-5(1) and (2) of the VC Bill]*

5.83 The PDF Board may make principles it will apply in considering whether to make a determination. These principles will be a disallowable instrument for the purposes of section 46A of the *Acts Interpretation Act 1901*. In making a determination the PDF Board will apply principles contained in that statement. *[Part 4, subsections 25-5(3), (4) and (7) of the VC Bill]*

5.84 If the PDF Board decides to determine a period shorter than 12 months the PDF Board will notify the VCLP or AFOF as soon as practicable after making that decision. *[Part 4, subsection 25-5(5) of the VC Bill]*

5.85 If the PDF Board refuses to make a determination to shorten the 12 month period, it must notify the general partner and set out the reasons for its refusal. *[Part 4, subsection 25-5(6) of the VC Bill]*

Determination that the location of assets and/or employees not apply

5.86 In relation to the requirement that the company:

- have more than 50% of the persons engaged by the company at that time to perform services, actually performing those services primarily in Australia; and
- have more than 50% of its assets (determined by value) situated in Australia,

the general partner of a VCLP or an AFOF that holds an investment may apply to the PDF Board, in an approved form, for a determination that either or both of these requirements not apply. *[Part 4, subsections 25-10(1) and (2) of the VC Bill]*

5.87 The PDF Board may make principles it will apply in considering whether to make a determination. These principles will be a disallowable instrument for the purposes of section 46A of the *Acts Interpretation Act 1901*. In making a determination the PDF Board will apply principles contained in that statement. *[Part 4, subsection 25-10(3), (4) and (7) of the VC Bill]*

5.88 If the PDF Board decides to waive either or both of these requirements, the PDF Board will notify the VCLP or an AFOF as soon as

practicable after making that decision. *[Part 4, subsection 25-10(5) of the VC Bill]*

5.89 If the PDF Board refuses to make a determination that a requirement not apply, it must notify the general partner and set out the reasons for its refusal. *[Part 4, subsection 25-10(6) of the VC Bill]*

Consequential amendments

Amendments to the ITAA 1997

5.90 The Taxation Laws Amendment (Venture Capital) Bill 2002 inserts a definition of the terms ***form approved by the PDF Board*** and ***permitted loan*** into the ITAA 1997. Both these terms are defined to have the same meaning as in the Venture Capital Bill 2002. *[Schedule 4, items 1 and 2 of the TLA(VC) Bill; subsection 995-1(1) of the ITAA 1997]*

Amendment to the Pooled Development Funds Act 1992

5.91 An AFOF is defined to mean an Australian venture capital fund of funds and to have the same meaning as in subsection 118-410(3) of the ITAA 1997 (see paragraph 2.8). *[Schedule 4, item 3 of the TLA(VC) Bill; subsection 4(1) of the PDF Act 1992]*

5.92 The term ***limited partnership*** is defined to have the same meaning as in the ITAA 1997. *[Schedule 4, item 4 of the TLA(VC) Bill; subsection 4(1) of the PDF Act 1992]*

5.93 A VCLP is defined to mean an venture capital limited partnership and to have the same meaning as in subsection 118-405(2) of the ITAA 1997 (see paragraph 2.5). *[Schedule 4, item 5 of the TLA(VC) Bill; subsection 4(1) of the PDF Act 1992]*

5.94 The functions of the PDF Board are set out in section 6 of the PDF Act 1992. Section 6 is amended to add the following functions:

- registering limited partnerships as VCLPs or AFOFs;
- registering entities as eligible venture capital investors;
- making determinations relating to the location requirements of a venture capital company (see paragraph 5.83 and 5.87); and
- giving information it obtains relating to the registration of VCLPs, AFOFs and eligible venture capital investors to the Commissioner for the purpose of implementing and administering the taxation law.

[Schedule 4, item 6 of the TLA(VC) Bill; subsection 6(3) of the PDF Act 1992]

5.95 The secrecy provision is amended to allow members of the PDF Board and its staff and consultants to disclose information for the purposes of the Venture Capital Bill 2002. *[Schedule 4, item 7 of the TLA(VC) Bill; paragraph 71(1)(d) of the PDF Act 1992]*

5.96 The definition of *tax law* for the purposes of the secrecy provision in subsection 71(5) includes the Venture Capital Bill 2002. *[Schedule 4, item 7 of the TLA(VC) Bill; subsection 71(5) of the PDF Act 1992]*

5.97 The PDF Board cannot delegate to a member of the PDF Board its power to:

- register limited partnerships as VCLPs or AFOFs or revoke their registration under Part 3 of the Venture Capital Bill 2002;
- register entities as eligible venture capital investors or revoke registration under Part 3 of the Venture Capital Bill 2002;
- make determinations under Part 4 of the Venture Capital Bill 2002.

[Schedule 4, item 9 of the TLA(VC) Bill; paragraphs 72(1)(c) to (e) of the PDF Act 1992]

5.98 The PDF Board cannot delegate to a committee of 2 or more of its members its power to:

- register limited partnerships as VCLPs or AFOFs or revoke their registration under Part 3 of the Venture Capital Bill 2002;
- register entities as eligible venture capital investors or revoke registration under Part 3 of the Venture Capital Bill 2002;
- make determinations under Part 4 of the Venture Capital Bill 2002.

[Schedule 4, item 10 of the TLA(VC) Bill; paragraphs 73(1)(c) to (e) of the PDF Act 1992]

5.99 The PDF Board's power to:

- register limited partnerships as VCLPs or AFOFs or revoke their registration under Part 3 of the Venture Capital Bill 2002;
- register entities as eligible venture capital investors or revoke registration under Part 3 of the Venture Capital Bill 2002; or

- make determinations under Part 4 of the Venture Capital Bill 2002,

cannot be performed by a member, or exercised in writing signed by a member, pursuant to a resolution of the PDF Board. *[Schedule 4, item 11 of the TLA(VC) Bill; paragraphs 74(2)(c) to (e) of the PDF Act 1992]*

Miscellaneous

Annual report

5.100 The PDF Board must prepare and give the Minister a report of its operations as soon as practical after the end of a financial year. *[Part 6, subsection 33-1(1) of the VC Bill]*

5.101 The report must include:

- a list of partnerships that were registered as VCLPs or AFOFs at the end of the financial year;
- a list of partnerships that became registered as VCLPs or AFOFs during the financial year; and
- a list of partnerships whose registrations as VCLPs or AFOF were revoked during the year.

[Part 6, subsection 33-1(2) of the VC Bill]

5.102 The report must also include the following information relating to eligible venture capital investors:

- a list of entities that were registered at the end of the financial year;
- a list of entities whose registrations were revoked during the financial year; and
- a list of entities whose registrations were revoked during the financial year.

[Part 6, subsection 33-1(3) of the VC Bill]

Form approved by the PDF Board

5.103 A notice or application is in the form approved by the PDF Board if it:

- is in the form approved for the particular kind of application;
- contains a declaration signed by the person required to sign the form;
- contains the information the form requires and any further information, statement or document the PDF Board requires; and
- is given in the form the PDF Board requires which may be electronically.

[Part 6, subsection 35-5(2) of the VC Bill]

5.104 The bill provides that the Governor-General may make regulations prescribing matters that are required or permitted to be prescribed or are necessary or convenient to be prescribed for carrying out or giving effect to the bill. *[Part 6, subsection 33-10 of the VC Bill]*

Chapter 6

Review of decisions

Outline of chapter

6.1 This chapter explains the method and process for reviewing decisions made by the PDF Board relating to the registration of VCLPs and AFOFs.

Summary of new law

6.2 A person affected by a decision made by the PDF Board has the right to seek an internal review of the decision and, if dissatisfied with that review, may apply to the AAT for a review of the confirmed or varied decision. *[Part 5 of the VC Bill]*

Detailed explanation of new law

Reviewable decisions

- 6.3 The following decisions are reviewable:
- a decision made under subsection 5-10(3) to allow a period longer than 6 months for the repayment of a short-term loan permitted under paragraph 5-10(1)(b) *[Part 5, paragraph 29-1(a) of the VC Bill]*;
 - a decision made under section 9-1 to refuse to register a limited partnership as a VCLP or an AFOF *[Part 5, paragraph 29-1(b) of the VC Bill]*;
 - a decision made under section 9-5 to refuse to register conditionally a limited partnership as a VCLP or an AFOF *[Part 5, paragraph 29-1(c) of the VC Bill]*;

- a decision made under section 13-1, 13-5 or 13-10 to revoke a registration for not meeting investment registration requirements or other registration requirements, for failing to comply with requirements to lodge returns and provide certain information, or for consistent breaches of investment requirements [*Part 5, paragraph 29-1(d) of the VC Bill*];
- a decision made under subsection 13-1(2) to determine a period within which an investment registration requirement must be met [*Part 5, paragraph 29-1(e) of the VC Bill*];
- a decision made under section 17-1 to refuse to register an entity as an eligible venture capital investor [*Part 5, paragraph 29-1(f) of the VC Bill*];
- a decision made under section 17-20 to revoke an entity's registration for failing to lodge an annual return [*Part 5, paragraph 29-1(g) of the VC Bill*];
- a decision made under section 19-1 to determine a period shorter than 12 months during which residency, employee and asset requirements for a venture capital investee company are to be met, or a decision refusing to make a determination [*Part 5, paragraph 29-1(h) of the VC Bill*]; and
- a decision made under section 19-5 refusing to waive a requirement that a venture capital investee company locate its employees and assets in Australia [*Part 5, paragraph 29-1(i) of the VC Bill*].

Notification of right of review

6.4 When notifying a person of a reviewable decision, the PDF Board must include a statement advising the person who made the relevant application of their right to request a review of the decision. However, a failure to provide the statement does not affect the validity of the decision. [*Part 5, section 29-5 of the VC Bill*]

Internal review of decisions

6.5 A person who is dissatisfied with a reviewable decision may request the PDF Board to reconsider the decision. The request must be made within 21 days of receiving the decision, although the PDF Board may extend the period. The request must set out the person's reasons for seeking a review. [*Part 5, subsections 29-10(1) to (3) of the VC Bill*]

6.6 On receipt of the request, the PDF Board must reconsider the decision and confirm, revoke or vary the decision. The PDF Board has 60 days to review the decision after receiving the request. If the PDF Board fails to confirm, revoke or vary the decision then it will be taken to have confirmed the decision. *[Part 5, subsections 29-10(4) and (5) of the VC Bill]*

6.7 Upon reviewing the decision, the PDF Board must give the person a written notice that advises:

- the confirmation, variation or revocation of the decision;
- the reasons for the confirmation, variation or revocation; and
- the person of their right to apply to the AAT for a review of the decision if the decision is confirmed or varied.

6.8 Failure to advise the person of the matters in paragraph 6.7 does not affect the validity of the decision. *[Part 5, subsections 29-10(6) and (7) of the VC Bill]*

6.9 If in conducting an internal review of a decision the PDF Board revokes a decision and replaces it with a new decision, the PDF Board is taken to have varied but not revoked the decision under review. *[Part 5, subsection 29-10(8) of the VC Bill]*

Review of decisions by AAT

6.10 A person who is affected by a reviewable decision of the PDF Board may apply to the AAT for a review of that decision which the PDF Board has confirmed or varied. The application can only be made by the person affected by the decision. *[Part 5, section 29-15 of the VC Bill]*

Chapter 7

Regulation impact statement

Background

7.1 Economic growth and job creation increasingly depend on successful innovation, meaning that the results of research and development must be effectively translated into commercial outcomes. Access to finance is a key factor in this process of innovation. While Australia is noted for its strong research capabilities, it has been less successful in attracting the necessary venture capital to commercialise this research.

7.2 Various submissions made to the Review of Business Taxation highlighted this market failure, indicating that there was a shortage of venture capital funding in Australia because the CGT regime that existed at the time acted as an impediment to the development of this market. The Review of Business Taxation accepted the argument that in order to stimulate venture capital funding from both domestic and non-resident sources it is necessary to make the CGT regime more competitive.

7.3 Many foreign tax-exempt entities, such as United States pension funds, the most dominant source of venture capital investment globally, would not invest in Australia as they are liable for tax on these investments, whereas they face no tax in their home jurisdiction or many other countries.

7.4 Compared with other countries, Australia's venture capital market is still relatively under-developed, especially for early stage investment. In terms of venture capital investment as a percentage of GDP, Australia ranked 13th out of 20 leading countries in 1999 accounting for 0.16% GDP¹. The Australian Bureau of Statistics conducted a survey of the activity in the Australian venture capital industry in 2000-2001. Investors had committed \$5.7 billion at the end of the year, in 806 investee companies.

7.5 In order to promote the development of the Australian venture capital market to overcome the perceived shortage of venture capital

¹ OECD: The Internationalisation of Venture Capital in OECD Countries: Implications for Measurement and Policy, Grunseli Baygan and Michael Freudenberg.

funding, the Review of Business Taxation recommended a targeted CGT concession to promote foreign investment in the Australian venture capital market. To achieve this objective the Review of Business Taxation recommended an explicit income tax exemption on gains from the disposal of eligible venture capital investments for tax exempt pension funds from certain jurisdictions (or limited partnerships of such pension funds). The Review of Business Taxation noted that there would not only be a direct effect on non-resident investment in the domestic venture capital market but also an indirect effect if the presence of more experienced venture capital investors spills over into an enhanced local capacity for assessing and undertaking high risk investments.

7.6 The Government accepted the recommendations of the Review of Business Taxation and in September 1999 introduced a CGT concession targeted to non-resident investment in venture capital. This measure has had limited success with only \$10.7 million of investment being made under the concession.

Policy objective

7.7 On 15 October 2001, the Government announced that it would extend venture capital tax concessions to all tax-exempt non-residents from Canada, France, Germany, Japan, the United Kingdom and the United States. By extending venture capital tax concessions, the Government aims to:

- facilitate the development of the venture capital industry by increasing the level of investment; and
- support patient equity capital investments in start-up and expanding businesses which would otherwise have difficulty in attracting investment.

Policy approach

7.8 These objectives will be achieved by:

- providing flow through taxation treatment to limited partnerships that are VCLPs, AFOFs and VCMPs;
- allowing an income tax exemption for profits and gains arising from the disposal or realisation of investments in eligible venture capital businesses to:

- tax-exempt entities that are residents of Canada, France, Germany, Japan, the United Kingdom and the United States, whether the investment is made directly, or as limited partner in a VCLP or an AFOF;
 - non-resident venture capital fund of funds with flow through taxation status established and managed in Canada, France, Germany, Japan, the United Kingdom and the United States, provided the fund is a limited partner in a VCLP or an AFOF; and
 - taxable residents of Canada, France, Germany, Japan, the United Kingdom, the United States, Finland, Italy, the Netherlands (excluding the Netherlands Antilles), New Zealand, Norway, Sweden or Taiwan who are limited partners in a VCLP or an AFOF and hold less than 10% of the committed capital of the partnership; and
- taxing the venture capital manager’s share of gains made by a VCLP or an AFOF on the sale of eligible venture capital investments (the carried interest) as capital gains.

Implementation options

7.9 This measure could be administered by either the ATO or jointly by the ATO, the DITR and AusIndustry (PDF Board). The disadvantage of the ATO solely implementing the measure is the lack of expert knowledge about the venture capital industry. The ATO does not have the expertise to market and promote the measure. The preferred option is for joint implementation by the 2 organisations, whereby the roles undertaken by each agency are commensurate with their legislative responsibilities.

7.10 The PDF Board will administer the registration of VCLPs and AFOFs. VCMPs will not be registered. The general partner of a limited partnership seeking registration as a VCLP or an AFOF will be required to provide certain information when registering; however, it will not be necessary for the PDF Board to check the veracity of the information. The PDF Board will be responsible for providing advice to VCLPs and AFOFs to assist in their registration. Following registration, the general partner will be required to furnish quarterly and annual returns to the PDF Board. Depending upon the happening of certain events, the PDF Board may require a general partner to provide other information.

7.11 If a VCLP or an AFOF breaches a registration requirement or fails to lodge annual or quarterly returns or provide other required information, the PDF Board may revoke its registration. However, before registration is revoked the partnership will be notified of the nature of the breach and granted time to comply. The time the PDF Board will allow to remedy a breach of a requirement or obligation will depend on the nature of the requirement or obligation. For example, a VCLP or AFOF will be allowed up to 6 months to remedy a breach of a requirement relating to its investments. In all cases a general partner will be notified of any breach and granted time in which to make submissions on the matter.

7.12 Information the PDF Board collects in the course of registering and monitoring the activities of VCLPs and AFOFs will be provided to the ATO for the purposes of administering the taxation concession and will be used to report to Government on the usage of the concession.

7.13 The ATO will administer the taxation concession. VCLPs, AFOFs and VCMPs will be subject to self-assessment which places the responsibility for complying with the taxation laws on the taxpayer. The ATO will be responsible for providing advice to VCLPs, AFOFs and VCMPs to assist them to meet their taxation obligations. The ATO will undertake compliance enforcement on a risk assessment basis. This will involve targeted testing for compliance with the eligibility requirements, that is the eligibility criteria for VCLPs and AFOFs and investments. In conducting compliance enforcement, the ATO will independently verify the information provided in the registration process, on the quarterly and annual return forms, and from any other information the general partner provides to the PDF Board.

Assessment of impacts

Impact group identification

7.14 This measure will impact on:

- tax-exempt venture capital investors resident in Canada, France, Germany, Japan, the United Kingdom and the United States;
- venture capital fund of funds vehicles resident in Canada, France, Germany, Japan, the United Kingdom and the United States;

- taxable residents of Canada, France, Germany, Japan, Finland, the United Kingdom, the United States, Italy, the Netherlands (excluding the Netherlands Antilles), New Zealand, Norway, Sweden or Taiwan who are limited partners in a VCLP or an AFOF and hold less than 10% of the committed capital of the partnership; and
- individual venture capital managers.

7.15 The measure will also impact on eligible Australian businesses seeking venture capital investments from the above mentioned investors. The investments must satisfy the following criteria for the concession:

- the investment must be in an unlisted Australian company or a listed Australian company which is in the process of delisting and the delisting takes place within 12 months of the initial investment;
- the investment can only be by way of shares or options. (Subject to certain limitations, a VCLP or an AFOF may make loans, including convertible notes, to the company);
- an initial investment must be in a company with total assets of less than \$250 million;
- the investment must be in a company that is resident in Australia and, at the time the initial investment is made, have the majority of employees and assets in Australia; and
- the company must not have as its primary activity: property development or land ownership, finance (to the extent that it is banking, providing capital to others, leasing, factoring, securitisation), insurance, construction or acquisition of infrastructure facilities, or making investments.

7.16 The measure will impact on individual venture capital managers who receive their share of the carried interest through a general partner of a VCLP or an AFOF that is a limited partnership. The effect of treating VCMPs as ordinary partnerships for taxation purposes and recharacterising the carried interest as a capital gain is that individual managers may be entitled access to the CGT discount on the carried interest.

7.17 The Government will also be affected by this measure, in particular the ATO, DITR and Invest Australia.

Analysis of costs / benefits

7.18 By jointly administering the measure, the specialist skills of the ATO and DITR will be utilised. The PDF Board has skills and knowledge relevant to industry and the promotion of venture capital investment; while the ATO has taxation law expertise and experience with compliance activities.

7.19 Joint administration will enable certain administrative functions to be carried out more effectively than if one organisation had sole responsibility. These administrative functions include:

- monitoring and reporting to Government on the impact and effectiveness of the concession;
- monitoring and enforcing compliance; and
- providing advice to investors and businesses.

7.20 Joint administration ensures a balance between the objectives of encouraging venture capital investment and maintaining the integrity of the concession.

Administration costs

7.21 The ATO will incur additional administrative costs of \$600,000 per annum in the first year of operation of the measure, with an increase to \$760,000 per annum in later years to support projected compliance activity in relation to established funds.

7.22 The DITR will incur additional administrative costs of an average of \$435,000 per annum.

Compliance costs

7.23 The new measure will involve compliance costs for VCLPs and AFOFs arising from the requirement to register with the PDF Board and to report on a quarterly and annual basis. The PDF Board may require additional information from time to time.

7.24 This reporting will require the maintenance of records of entities' investment portfolios and also details of partnership membership.

7.25 These requirements are central to the operation of the measure in that they will provide the information necessary for the ongoing monitoring of the concession and also provide the material required by the PDF Board to report to Government.

7.26 The nature of the measure is such that the compliance costs are minimal in terms of the potential overall tax benefits arising to investors.

7.27 There will be no impact on compliance costs for small business.

Revenue costs

7.28 This measure has a cost to revenue of \$21 million in 2003-2004, \$25 million in 2004-2005 and \$30 million in 2005-2006.

Benefits

7.29 This measure will have an impact on the Australian economy by increasing the level of investment in the Australian venture capital market by non-residents. It will result in greater competition. It will also increase access to overseas expertise for start-up and expanding companies by providing VCLPs, AFOFs and VCMPs with flow-through tax treatment in accordance with internationally recognised best practice for venture capital.

Consultation

7.30 The Australian Venture Capital Association Limited and some venture capital investors have been consulted in the development of this measure, and the development and drafting of the legislation.

7.31 Consultations have taken place at both the Ministerial and the departmental levels with Australian Venture Capital Association Limited on the development of the measure and the drafting of the legislation.

7.32 Consultation with industry will continue during the implementation process.

Conclusion and recommended option

7.33 This measure will be jointly implemented and administered by the ATO and DITR because of the specialist skills held by these organisations. These skills will provide flexibility in delivering the product while ensuring the integrity of the measure is maintained.

