Australian Private Equity &
Venture Capital Association Limited

1 June 2015

Mr Roger Brake
Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

Email: bettertax@treasury.gov.au

Dear Roger,

Submission in response to *Re:think* Tax discussion paper

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to respond to the tax discussion paper *'Re:think, Better tax system, better Australia'* (the discussion paper), released in March 2015.

AVCAL is the national association that represents the Private Equity (PE) and Venture Capital (VC) industry in Australia, which manages over $25 billion in funds on behalf of domestic and offshore investors. These funds supply capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies. Globally, the PE and VC industry manages more than US$3.8 trillion in assets on behalf of long-term institutional investors such as superannuation and pension funds and endowments.

There is no question that Australia's future economic prosperity will be inexorably tied to our collective capacity to bring about meaningful tax reform to modernise key aspects of our out-dated 20th century tax system. The rate of change in the way business is now conducted has highlighted the importance of moving forward with the development of a comprehensive blueprint for reform that strikes an appropriate balance between ambition and what is practicable.

The work that has been done over recent years as part of the Future Tax System review must serve as a robust platform upon which to construct a tax reform agenda for the short and medium-term. Although that review was completed almost five years ago, much of the economic and policy analysis remains current.

For the Australian PE and VC industry, the most pertinent aspects of the discussion paper relate to the need to attract more domestic and offshore investment into Australian businesses, and the importance of encouraging greater levels of entrepreneurship and innovation across our economy. Our specific comments and associated recommendations in those two key areas are set out in the attached submission.

AVCAL very much looks forward to actively participating in the *Re:Think* tax reform process over the coming months. If you would like to discuss any aspect of this submission further, or if you require any additional information to assist in your analysis of the key issues, please contact me or Dr Kar Mei Tang on 02 8243 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive

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Australian Private Equity &
Venture Capital Association Limited

Tax Discussion Paper

Submission to Treasury

June 2015

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EXECUTIVE SUMMARY

Australia is facing a range of challenges in addressing the economic needs of its population in a highly dynamic international context. Increasing globalisation, technological advances, demographic shifts, and a myriad of other changes are all impacting on how current and future governments will be able to set fiscal policy, and in turn, how they will be able to manage these challenges.

As we transition away from the resource-driven economic momentum of the last few years, finding sustainable sources of government revenue will become increasingly important. The recent volatility in commodity prices – and the consequential and immediate impact on the nation's fiscal position – highlights the enormity of this task. The tax white paper process represents a fundamental and important step in furthering the discussion around how the tax system can work effectively whilst delivering growth increases in jobs across the economy.

The 2015 Intergenerational Report highlighted that in respect of some of the nation's most pressing economic challenges, a projected slowdown in population growth is likely to be coupled with a decline in the workforce participation rate, which will in turn lead to a decline in economic growth. But the report also noted, "A well-structured tax system can assist in making Australia a more attractive place to invest, boost economic growth and create new jobs."[1]

Simple changes to headline tax rates can be an enticing short-term lever to 'band-aiding' immediate budget deficits. However, the more essential focus for the nation is to take steps towards a more stable and growing tax base over the long-term, which will come from a sustainable pickup in economic growth across the economy. For that reason, removing existing barriers to growth, as well as exploring new opportunities in new and emerging sectors of our economy, will both feature prominently in the nation's capacity to unlock new economic horizons.

Two of Australia's key economic strengths stand out from others for the PE and VC industry.

Australia has a highly educated and technologically knowledgeable workforce, and we are generally considered to be an attractive destination for inbound investment into our economy. These two strengths should form essential ingredients in structuring an effective tax reform agenda for Australia's future. They are also the two key areas that are of most importance to AVCAL's PE and VC members, who can each play a role in driving a build-up of momentum towards greater investment and entrepreneurialism across our economy.

In this paper, AVCAL has set out a range of policy issues that we believe must be addressed as part of this tax reform process. Some of the issues canvassed can and should be addressed in immediately, through relatively straightforward amendments to existing tax laws, whilst others will need to be addressed as part of a longer-term reform agenda.

The primary areas of reform that have the potential to immediately alleviate roadblocks which currently constrain major increases in PE and VC investment into Australian businesses include:

- Reform of the Venture Capital Limited Partnerships (VCLP) regime
- Streamlining business financing arrangements (debt/equity tax rules)
- Improving tax settings to encourage greater entrepreneurship and innovation
- Reforming key aspects of the state tax regimes, and
- Simplifying ownership structures and tax grouping rules.

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[1] 2015 Intergenerational Report Summary, Commonwealth of Australia, March 2015.

The key areas of reform that should be considered as part of a longer-term overhaul of Australia's tax system include:

- A more advanced and globally competitive Collective Investment Vehicle (CIV) regime
- Improving the tax rules relating to revenue/capital account to increase certainty
- Enhancing the capital gains tax discount regime for long-term investment
- Maintaining the fundamental structure of the current dividend imputation system, and
- Boosting the competitiveness of Australia's headline corporate income tax rate.

1. Removing roadblocks – Boosting investment into Australian businesses

Australia is a net importer of capital, and is reliant on offshore investment to help support the growth and expansion of our businesses, as well as the development of our domestic infrastructure capacity.

Domestic investors, particularly Australian superannuation funds, are also continually growing in economic influence and playing an increasingly important role in allocating capital not just within Australia, but also internationally. Ensuring that Australia has the right tax settings in place for both local and foreign investors will help to maintain and improve our position as an attractive investment destination in the competitive global market. Australia's geographic isolation does represent an impediment in some respects, which necessitates us doing everything possible to continue to lift our credentials as a preferred investment destination for allocators of capital in key markets across Asia, North America, Europe and the Middle East.

Looking at other jurisdictions in the developed world, it is clear that they face similar challenges. A survey of Heads of Tax of European companies, conducted by Deloitte in 2013, found that their reasons for classifying tax regimes as either 'favourable' or 'unfavourable' were consistently predicated on transparency, certainty, a well-designed tax system, and the possibility of forming sensible working relationships with tax authorities. These were all cited as key attributes that made a significant difference to their perspectives on the attractiveness of investing in each jurisdiction.

Conversely, respondents viewed negatively those jurisdictions that exhibited policy uncertainty, continual and unpredictable legislative change, or "tax authorities who are unable or unwilling to find solutions to tax issues created by commercially motivated transactions."[2]

Tax certainty is also strongly linked with expectations of future economic performance. In a survey of 3,300 US business leaders by KPMG, a third of respondents felt that more tax certainty for both business and individuals would have the greatest impact on the economy, which exceeded the number of respondents citing the European bank crisis (24%) and the Chinese economy (13%).[3] [4]

Tax uncertainty constrains the flow of funds coming into a jurisdiction because investors cannot properly assess whether the opportunity fits their risk-return profile, and this can lead to wider reputational damage for that country.

Australia is a competitive international destination for investment. It was the eighth largest recipient for inbound foreign direct investment in the world for 2011-2013, having a global market share greater than many major developed and developing economies including Canada, the UK, Germany, India, France, Italy, South Korea and Japan.[5]

Like many other sectors of the domestic economy, Australia's PE and VC industry is reliant on both domestic and overseas investment to provide the capital needed to support the over 500 companies backed by the industry.

Figure 1 shows the sources of PE and VC fundraising over the ten years to 30 June 2014. From FY2005 to FY2009, domestic investors contributed just over half of all fundraising, but in the subsequent five years that number fell to 43%, demonstrating the growing importance of offshore investors to the domestic PE and VC industry.

The chart also shows the decline in overall fundraising since the global financial crisis. This is a result of both domestic and international investors contributing less to PE and VC funds in Australia, notwithstanding the fact that the aggregate funds under management within the domestic superannuation system has grown significantly over the same period.

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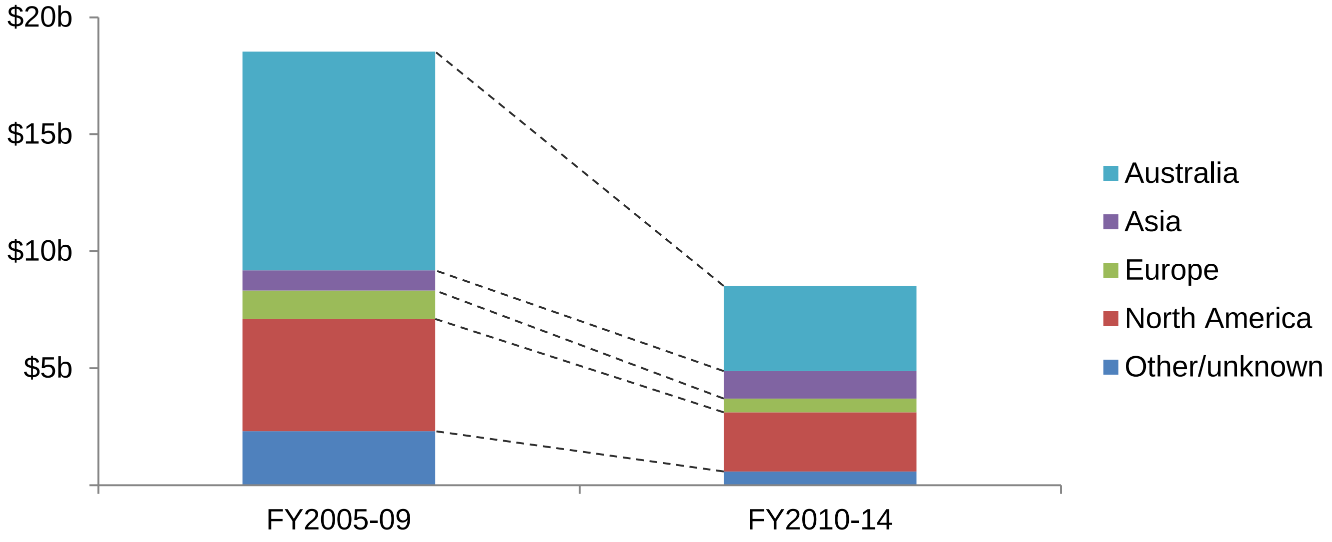
[2] European Tax Survey: The benefits of stability, Deloitte, 2013.
[3] KPMG Survey: Many Business Executives Believe More Tax Certainty Would Help Drive US Economic Recovery, KPMG LLP, January 2013.
[4] Australia: Tax uncertainty hurts the economy, Jonathon Leek, Corrs Chambers Westgarth, June 2013.
[5] Inward FDI Performance: How Australia compares, Austrade, May 2015.

Figure 1: Australian PE and VC fundraising by source, FY2005-2014



Source: AVCAL.

The need for greater business investment in Australia has been well documented over recent years. Alongside the demographic shifts that are taking place there is an obvious and growing need for business founders (who have worked tirelessly to start and develop strong Australian businesses in a variety of industry sectors) to identify appropriate succession planning strategies. In many cases, those succession planning strategies will necessitate an injection of external equity capital, and at present, those with the capacity to meet that demand and provide that capital are limited. Clearly, the PE and VC industry presents one of the nation's best channels through which to address this economic challenge.

AVCAL estimates that some 30,000 Australian businesses fall into the category of being an 'investable pool' of businesses that can benefit in some way from PE and VC investment. Reversing the current trend of declining fundraising is vital to ensuring that the sector can continue to invest in the growth and expansion of Australian businesses that are in desperate need of the capital, skills and experience that come from PE and VC investment.

In AVCAL's view, part of the solution to addressing this unmet need in the market lies with the capacity of the tax system to deliver a simple and cohesive framework for investors and fund managers. Put simply, the design of our tax system should not act as a handbrake on the capacity of Australian businesses to attract equity capital investment from sources such as PE and VC.

Developing a deep pool of investors into Australian PE and VC funds requires careful consideration of the relative competitiveness of our economy internationally, especially in respect of our capacity to attract investment into domestic businesses and major projects.

For many years, the Australian tax regime for funds management has been singled out as below world-class standards. Numerous reviews and inquiries have consistently concluded that a stronger and more globally competitive tax system for funds management is essential to lifting the overall economy.

A number of the issues raised in this submission go directly to the issue of taking steps to create best-in-practice investment vehicles for Australian fund managers.

Fund managers typically use collective investment vehicles (CIVs) to raise their funds. The most commonly used vehicles used by PE and VC fund managers in Australia are the venture capital limited partnerships (VCLPs) and managed investment trusts (MITs).

However, specific flaws in both of these vehicles place key parts of Australia's funds management industry at a significant competitive disadvantage. The most concerning issue, however, is not that the industry is saddled with an uncompetitive and outdated framework. It is the fact that the changes required to address the problems have been identified and supported by governments and expert advisers, and still has been no action taken to improve the rules; highly competitive economies operating in a global marketplace for capital cannot afford to ignore immediate and simple adjustments to policy in this way.

1.1 VENTURE CAPITAL LIMITED PARTNERSHIP REFORM

1.1.1 Critical need for tax certainty

The VCLP regime was introduced in 2002 to provide Australia with a "world's best practice investment vehicle for venture capital" with the expectation of increasing international investment in the sector. The announcements at the time recognised that a simple limited partnership vehicle that enabled tax transparent treatment for fund investors was required if Australian fund managers were to efficiently compete with their international peers.

The government commissioned a Board of Taxation review in 2011 to examine the VCLP regime in Australia. The report produced by the Board noted that in order to facilitate increased investment in venture capital businesses in Australia, a deemed capital account treatment should apply to eligible domestic partners on gains or profits made by a VCLP on the disposal of eligible investments. This would reduce uncertainty in the tax treatment of domestic limited partners, which the Board (citing the Ralph Report) acknowledged as an important source of funding for venture capital in Australia.

However, given the original policy intent of the VCLP regime to differentiate between investments in startup and expansion-stage businesses with more established enterprises, the review was not asked to examine whether potential reforms could be made to broaden the application of the VCLP regime to enable wider use in Australia's PE industry.

In AVCAL's view, the substantial changes to the business and economic landscape in Australia since 2002 and the lack of foreign investment generated by the current regime suggest that the original policy objectives of the regime should be revisited. Specifically, the policy objectives should be broadened beyond providing a tax transparent limited partnership regime for a range of VC investments and investors, which would enable a wider range of Australian businesses and investors to benefit from PE investment.

There is currently an inconsistency in the tax rules that apply to different classes of domestic investors in VCLPs. As the legislation stands now, foreign investors in these vehicles have a high level of tax certainty, but a similar level of certainty does not currently exist for all domestic investors.

This uncertainty is also discouraging potential new investment through PE and VC funds that would utilise VCLPs. This unnecessarily exacerbates the already challenging climate for attracting new private investment. In the three years from 2012-14, there were only five new VCLPs formed. This was half the number formed in the preceding three years (ten funds), which in turn was half the number raised in 2006-08 (20 funds).[6]

[6] AusIndustry data.

In preparing this submission, AVCAL has consulted with members to ensure the submission appropriately highlights the significance of the current difficulties faced by Australian-based PE and VC fund managers in the area of the VCLP tax regime. Based on a broad consultation programme, there is clear and compelling evidence that Australian fund managers with broad investor bases are typically forced to operate at least five CIVs per fund in order to facilitate PE or VC activities within the currently available CIV regimes. This would generally include the following:

1. A VCLP used to house certain foreign investment on deals that satisfy the eligibility requirements;

2. An alternative vehicle (commonly either a trust or offshore limited partnership) to house the foreign investment in transactions that don't qualify for eligible investments in a VCLP;

3. A trust to house local MIT investors;

4. A trust to house sovereign investors (who demand separate vehicles in Australia in order to get certainty in an uncertain environment); and

5. A trust to house other investors (both domestic and foreign).

Based on industry feedback, the use of at least five vehicles per fund is a conservative estimate and many fund managers have even more entities as a result of larger investors requiring their investment to be 'ring fenced' in separate vehicles to avoid being impacted by the tax uncertainty that arises as a result of being pooled with other investors.

It is important to note that such parallel fund structures are entirely unique to the Australian market, and give rise to significant administrative and compliance burdens for Australian fund managers. The below table summarises the typical PE and VC fund structures utilised in Australia and in other key jurisdictions offshore, which illustrates the unnecessary level of complexity which exists in Australia at the moment:

Table 1: Typical PE and VC main fund structures utilised in selected jurisdictions

Australia	**New Zealand**	**UK**	**US**	**HK**	**Singapore**
1 VCLP 4 unit trusts	1 Limited Partnership	1 Limited Partnership	1 Limited Partnership	1 Offshore Limited Partnership	1 Offshore Limited Partnership 1 Exempt Singapore company

The issues for PE and VC fund managers arise both at the time of fundraising and through ongoing compliance. In this regard the unnecessary complexity has both a direct and indirect negative impact on Australian fundraising activities.

The direct impact is realised in the following ways:

- Australian fund managers offering unusual and complicated structures are less appealing to offshore investors with mobile capital which can make a material difference in how they balance capital allocations;

- Significant time and money being expended by fund managers attempting to familiarise offshore investors with Australian CIVs in which their investment would be housed and managed;

- Significant costs are incurred establishing and administering parallel fund structures.

Troublingly, Australian PE fund managers are now encountering circumstances where offshore investors are deciding not to invest in a VCLP fund, by virtue of the fact that Australian investors are refusing to invest in a VCLP (because of the uncertainty of tax outcomes from the existing VCLP regime) which in turn reinforces investor suspicion regarding the effectiveness and security of the vehicle.

The compliance burden of administering these separate vehicles also erodes the net investment returns that Australian fund managers are able to offer potential investors and in one instance, this erosion over the life of a fund was estimated to be 15% of the gain returned to investors.

The following example illustrates the compliance burden faced by Australian PE and VC fund managers:

- Based on conservative estimates, the additional setup costs associated with structuring around the current deficiencies are approximately $150,000 to $200,000 for each PE or VC fund which is established;

- The conservative additional annual compliance costs for one fund are $80,000, taking into account unit pricing, auditing, Australian and offshore tax obligations, company secretarial, custodian services and other regulatory reporting obligations;

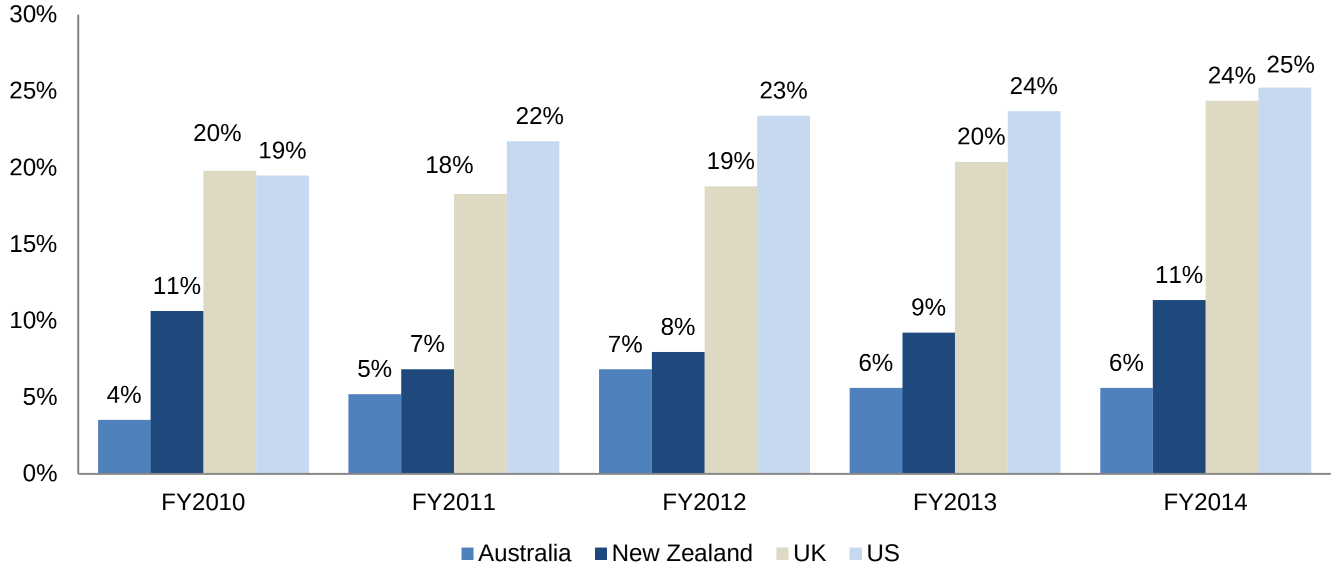
- A typical life span for each generation of fund is around 10 years. The additional set-up and compliance costs per fund can therefore be estimated to be approximately $1 million per manager.

- Taking into account the number of Australian VC and PE fund managers in this position, and the fact most funds have multiple generations of funds running in parallel with ongoing compliance obligations, the incremental compliance cost to Australian managers could conservatively be estimated to be in the tens of millions of dollars.

These expenses are significant, particularly for small and medium-sized fund managers, and provide a disincentive for them to raise funds offshore. The impact of this is that less international capital will be attracted into Australia. The expenses also fuel ongoing debate between the PE and VC industry and Australian superannuation fund managers who are increasingly focussed on the level of fees associated with their investment. Reduced PE and VC compliance costs may also therefore help reverse the trend of Australian superannuation funding heading offshore. The other point to consider is the administrative cost, savings on the part of the government and ATO in managing the setup and compliance of these duplicate entities.

1.1.2 Extending the current investment thresholds in the VCLP regime

Figure 2: Number of PE transactions as a percentage of all M&A deals



Sources: S&P Capital IQ, AVCAL analysis.

Figure 2 shows the number of PE deals as a proportion of total M&A activity across a number of regions. The proportion in Australia has historically been far below other developed markets, such as the UK and the US. Extending the VCLP regime to enable its wider use in the broader PE and VC sector would stimulate activity in the local PE and VC market by attracting increased levels of both domestic and international mobile capital. The extended Australian economic benefit of this is that the increased capital managed in Australia will act as a mechanism to drive investment in Australian companies which are competing for capital with international peers.

In this regard, the proposed measures should target three key areas of reform to the existing VCLP regime:

1. Amendments to remove roadblocks to mobile Australian capital being invested locally rather than offshore (by providing certainty in relation to accessing CGT treatment and CIV transparency);

2. Amendments to attract mobile offshore capital to Australia (by removing the need for parallel fund structures and offering offshore investors the ability to invest via a best practice investment vehicle); and

3. Amendments to facilitate wider use of the VCLP by Australian based PE and VC managers (by removing restrictions on eligible investment criteria originally intended to limit the scope of the regime to early stage businesses).

Many of the arguments put forward in relation to VCLP reforms are consistent with previous submissions lodged over the course of the last five years, including AVCAL's most recent submission in December 2014 as part of the "Cutting Red Tape" initiative, and also in 2009 in the context of the Managed Investment Trust reform consultations.

1.2..BUSINESS FINANCING ARRANGEMENTS – DEBT/EQUITY RULES

1.2.1 Debt and equity tax rules

The debt and equity tax rules have become a key foundational component of Australia's income tax system since their implementation in 2001. Over the years various reviews have been carried out in relation to this area of tax law, including most notably the 2003 review by the ATO's National Tax Liaison Group Finance and Investment Subcommittee and the 2014 review by the Board of Tax.

Ensuring that the rules provide the greatest level of long-term certainty for taxpayers must always be a key principle in formulating tax rules governing business financing arrangements. For the PE and VC industry, long-term certainty is a critical element of fostering and encouraging investment decisions across the Australian economy, because for many PE and VC firms the investment horizon can typically range from around three to seven years, on average. The reclassification of certain instruments as either debt or equity throughout this investment horizon can present significant challenges for investors that have made their original allocation decisions on the basis of key assumptions around taxation.

AVCAL is very supportive of the current debt and equity tax regime, because the existing rules play an important role in maintaining the integrity of the overall Australian tax system. In addition, AVCAL supports the Board of Taxation's recent findings in relation to the debt and equity rules; in particular, the proposals to provide clarification regarding related scheme provisions and the application of section 974-80. This clarification will provide PE and VC firms with greater certainty in relation to various aspects of the debt and equity tax rules in circumstances where investee companies issue both debt and equity instruments to the fund.

1.2.2 Thin capitalisation regime

The thin capitalisation regime aims to limit the capacity of multinational firms to move profits out of Australia by assigning an excessive amount of debt to their Australian operations. Australian subsidiaries can apply one of a number of thresholds under the rules, including the 'safe harbour' limit, the 'arm's length' debt limit and (for outward investors) a worldwide gearing ratio limit. Different safe harbour limits apply to 'general entities', non-bank financial entities and banks.

However, a series of changes to thin capitalisation rules over the past few years have given rise to tax uncertainty, and are negatively impacting on the viability of some investment structures employed by global investors, including international PE funds.

Some of the issues arising from these recent changes relate to the impact on:

- undermining the economics of existing investments;
- affecting bid values on future investments; and
- the introduction of additional costs where existing investments may need to be restructured to either bring them into line with the new safe harbour limits, or use the arm's length debt test. However, both options carry potentially significant costs and can have further flow-on consequences, for example the triggering of foreign exchange gains or losses.

AVCAL has put forward the case to the Board of Taxation and Treasury to reduce the compliance cost and improve tax certainty associated with the existing arm's length debt test. Reforms in this area would go a long way to lifting Australia's relative competitive position against other jurisdictions in this key area of the tax system.

AVCAL also does not see a compelling case for further changes to be made to the thin capitalisation safe harbour limits. The changes recently implemented with regard to tightening the safe harbour rules effectively amounted to the introduction of retrospective tax laws, because they did provide any transitional relief for existing debt arrangements that were the subject of multi-year agreements entered into between parties acting on a commercial basis.

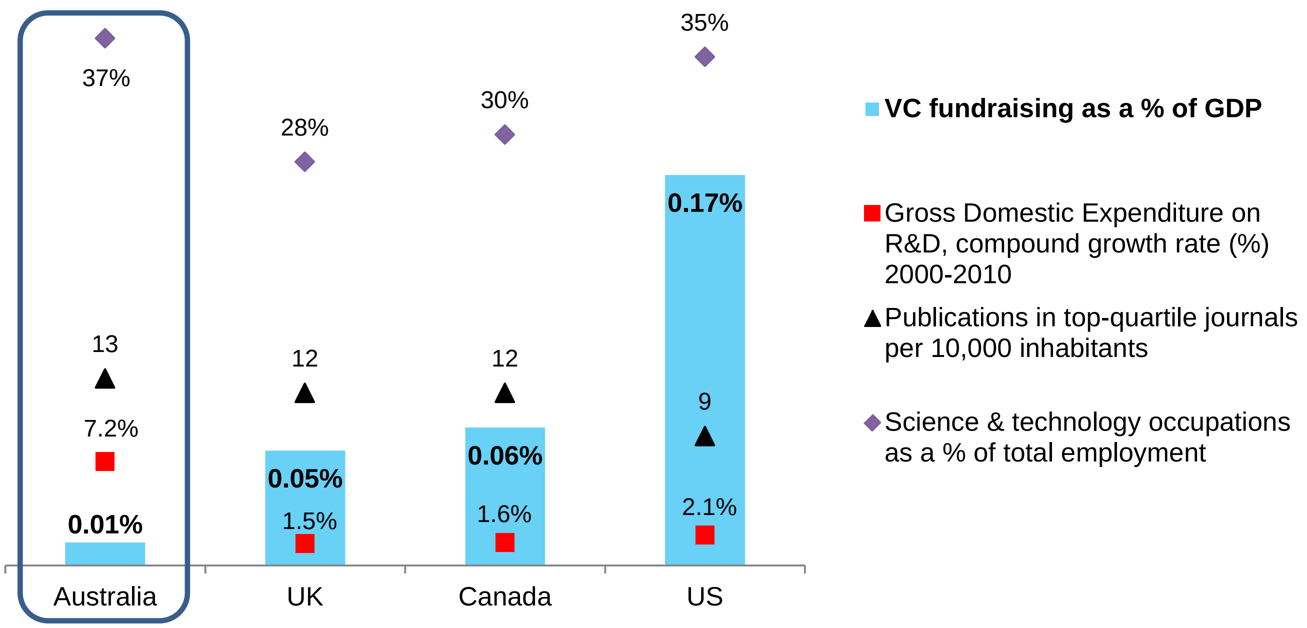
The changes to the debt deduction rules resulted in taxpayers that had entered into binding agreements not being entitled to claim deductions for costs that under the rules which were in place at the time of investment, they were able to. This change was contrary to a long-standing principle of tax policy making in Australia that appropriate transitional arrangements are implemented as part of the introduction of any tax changes that diminish the position of taxpayers. These changes directly impact the rate of return of existing Australian investments by PE funds and give rise to Australia's international standing as a stable and predictable investment location.

1.3 TAX SETTINGS TO FOSTER GREATER LEVELS OF ENTREPRENEURSHIP AND INNOVATION

The Commonwealth Scientific and Industrial Research Organisation (CSIRO) has cited the imperative for greater innovation in Australia as an emerging 'megatrend' – a deep-set trajectory for economic and social change over the coming 20 years.

Australia punches above its weight in a number of innovation metrics. Australia's research output is substantial, and its research and innovation indicators are highly competitive compared to other advanced economies (see Figure 2). Some of the notable examples of Australian innovation delivering world-class technology include 802.11a WiFi technology, the human papillomavirus vaccine Gardasil, spray-on skin ReCell for burns victims, the technology behind Google Maps, and the bionic ear by Cochlear.

Figure 3: VC fundraising vs research and innovation metrics



Sources: Austrade, WEF, AVCAL analysis.

However, the capacity of Australia's industry to invest in the commercialisation of this research is far smaller than in other countries such as the UK, the US, and Canada.

VC fundraising in the UK and Canada is five to six times higher as a proportion of GDP than it is in Australia. In Israel, the equivalent metric is approximately 30 times as much as Australia's. Our VC industry is currently still only investing in a fraction of the opportunities afforded by Australia's substantial pipeline of research and innovation. What this tells us is that there is substantial scope for increased investment and returns from further commercialising research outcomes.

Part of the solution to the challenge of attracting more capital is to ensure that the tax system delivers the greatest possible level of certainty for investors, as outlined in our recommendations regarding VCLP reform and further below on the establishment of a more internationally-competitive collective investment vehicle regime. The tax reform process should also consider creating a world-class tax system for early-stage innovative companies through two key channels:

- allowing for the quarterly refund of R&D credits for eligible early-stage high innovation businesses (which is vital to improving the cash-flow pressures that many of those businesses face), and
- reforms to the taxation of employee share schemes.

Further detail in relation to these measures is set out below.

1.3.1 R&D tax incentive

Australia's business expenditure on R&D (BERD) as a percentage of GDP was at 1.24% in 2011-12, declining from a peak of 1.38% in 2008-09. This was markedly lower than the OECD's average of 1.59% for 2011-12.[7] In other words, we are falling further behind in developing our R&D capabilities and consequently further from becoming a leading 'knowledge nation'.

Improved R&D tax settings can play a vital role in encouraging high-growth, highly innovative businesses to establish and grow their R&D bases in Australia.

Early stage companies involved in developing new technologies often face cash-flow constraints because they require significant cash outlays in the early stages of the product life cycle. Currently, these companies can access a 43.5% refundable tax offset on expenditure related to eligible research and development (R&D). The R&D tax regime has had a very significant positive impact in supporting domestic businesses investing in innovation, as well as attracting businesses from offshore to relocate their R&D activities to Australia.

The regime plays an important role in helping businesses to source adequate levels of capital investment in the knowledge that the regime will deliver long-term certainty to businesses that will often commit large allocations towards R&D activities. Stability and certainty in relation to the operation of the R&D system is therefore a fundamental driver of realising the policy objectives of the regime.

In some cases, however, accessing the support that can be delivered by the existing R&D regime can effectively be delayed by up to 16 months, as businesses are typically required to wait until the point in time that they lodge their income tax return for the financial year, and then wait a further four months to secure the R&D rebate that they may be eligible for. In a practical sense, companies seeking to commercialise patents can miss out on the opportunity to derive premium earnings and returns on investment during the exclusive earning period for new patents.

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[7] Australian Key Innovation Indicators, Department of Industry, September 2014.

AVCAL recommends that changes be made to the R&D regime to allow access to quarterly credits for small, research-intensive enterprises with annual turnover under $20 million. Further support for this reform can be found in recent recommendations made by the Financial System Inquiry and the Board of Taxation, which have both pointed to the economic merits of such a move.

1.3.2 ESS and related tax measures

AVCAL is very supportive of the proposed reforms which are currently before Parliament in relation to the employee share schemes (ESS) tax rules for startups. These reforms will significantly improve the ability of Australian enterprises to compete for and retain global talent internationally.

A broader-based adoption of ESS across the Australian startup community will require a carefully calibrated alignment between the right policy settings and the right legislative design. On the whole, we believe that the legislation currently before Parliament achieves many of those outcomes. There are, however, some important practical issues which we have raised in previous discussions, which will likely remain potential roadblocks to the more widespread adoption of ESS by startups across the economy.

There are two aspects of the proposed regime in particular which we recommend should be addressed to ensure that the reforms meet their policy objective. The first requires a minor but important adjustment to the proposed new laws to allow for the sale or disposal of employee interests within three years without punitive taxation implications.

The second relates to the ATO's current work in providing standard documentation for startups introducing ESS. Alongside the introduction of standardised documentation, there must be modifications made to ASIC's existing administration practices in relation to the disclosure, hawking and licensing rules contained in the Corporations Act. These changes are necessary so that startups are not required to make confidential financial accounts information public in order to simply be able to offer ESS to their employees. One of the primary concerns with making such confidential information public is the potentially harmful implications for those startups that wish to negotiate future capital raising rounds with new investors.

1.4 REFORM OF STATE TAXES

1.4.1 Harmonisation of payroll tax administration across states

Businesses that operate in multiple states and territories, including those businesses invested in by PE and VC funds, are required to deal with different rules for payroll tax and workers' compensation in each jurisdiction. The rules on declared wages, contractors and workers compensation differ across each jurisdiction, notwithstanding the fact that the core policy principles embedded within each system are the same.

Geographical expansion can therefore have a multiplier effect on tax compliance costs for small businesses. These costs can accumulate to become extremely burdensome. Take for example the following illustrations:

- Payroll tax returns are required to be lodged monthly. A small business that has operations across the country can lodge up to eight returns each month, which translates into 96 returns per year; and

- Workers' compensation declared wages returns are required to be lodged annually. As a result, a business can lodge up to eight different returns yearly to comply with the different state requirements.

AVCAL believes that further harmonisation of payroll tax administration across States and Territories is an issue that should be addressed in the very short-term. A more harmonised tax system in this area, with a retained capacity for each state to compete on the basis of headline rates, would significantly reduce the complexity and the onerous compliance burden that is imposed on small business looking to expand outside their home states, and increase efficiency in the tax system overall.

1.4.2 Reform of state-based stamp duty system

The current state based stamp duty system, in particular landholder duty, is an inefficient tax and in some instances acts as an impediment to encouraging PE investment. Three specific examples of how this frustrates and adds unnecessarily to the cost of normal investment operations are set out below.

Significant transaction cost borne over a short period of time.

The *Re:think* discussion paper states that “stamp duties on conveyances add to the costs of buying and selling property and can discourage businesses from undertaking productivity enhancing purchases of existing land and capital. The outcome can be retention of land for relatively unproductive purposes.”

In AVCAL’s view, landholder duties, given the relatively low thresholds and inconsistent application between each jurisdiction, also discourages PE investment into businesses where landholder duties will be triggered. Because typical ownership periods range from three to seven years, a PE investor must assess this issue up-front and weigh the cost implications against forecast growth over the three to seven year period. The relatively high landholder duty costs act as a handbrake on potential new equity capital investment in certain circumstances where an investment may otherwise make commercial and economic sense.

Onerous group reconstruction relief provisions

Sometimes PE funds need to transfer existing investments between related and affiliated funds to facilitate syndication and co-investment activities. The current landholder reconstruction relief rules do not provide sufficient flexibility to enable such transfers to freely occur between related funds. This inhibits investment structure flexibility and can result in multiple instances of duty costs being incurred on the same investment.

Uncertainty concerning the definition of a “landholder”

Although landholder duty is typically charged based on the value of certain assets held by a ‘landholder’, the definition of ‘land holdings’ can be interpreted on a very different basis by some jurisdictions. If a potential investee company has lease holdings on which significant improvements have been made, the investee may be deemed a ‘landholder’ for duty purposes.

In some jurisdictions, where leasehold improvements are sufficient to cause an investee company to be classified as a ‘landholder’ for duty purposes, duty would be payable not just on these assets but on the full value of their property, plant and equipment holdings. This sort of outcome seems inconsistent with original policy objectives, and almost certainly places the investee company at a competitive disadvantage when seeking to attract PE investment.

1.4.3 Ownership structures and tax grouping rules

Many of the tax rules relating to ownership structures, such as change of control or grouping rules, are written based on typical corporate group structures. These rules present difficulties for PE and VC funds as certain technical interpretations can result in anomalous tax outcomes for PE and VC backed investee companies. Two such examples are set out below.

Payroll taxes

The grouping rules relevant for the purposes of establishing the tax-free threshold are problematic for PE and VC funds as some state revenue offices may interpret this to mean that investee companies are not entitled to the tax-free threshold on the basis that they are members of a wider payroll tax group, with the wider group including other investee companies in which the PE or VC fund has invested. Investee companies are not 'grouped' with each other for other tax purposes such as income tax, duty or GST and it would be unusual for grouping to take place in these circumstances.

For example, it would be unusual for two businesses operating wholly independently to be able to transact GST-free with each other because they have the same financial sponsor. In a PE context, all investee companies are operated wholly independently from one another, with their own management teams and employees. There is no administrative overlap and they not have access to each other's books and records. The only cross-over between investee companies relates to board representatives nominated by the PE sponsor. Whilst the investee entities share a common financial sponsor (the PE fund), such ownership structures do not typically lead to grouping outcomes for either tax or accounting purposes.

The anomalous outcome for payroll tax purposes is something which should be corrected as a matter of priority.

Where a single CIV is used for all investments in the fund's portfolio, inadvertent consequences such as this payroll tax grouping issue may arise. Given the size of some investee companies, losing the ability to rely on the tax-free threshold for payroll tax represents a material ongoing cost to the business, which impedes the ability of those businesses to invest those funds in the creation of new employment opportunities within the business.

Continuity of ownership testing

Australia has a series of loss integrity rules which govern the utilisation of prior year tax losses. Broadly, a company is required to maintain continuity of ownership of over 50% from the beginning of the loss year to the end of the income year in which it proposes to utilise that carried forward loss (the 'continuity of ownership test' ('COT')). "Ownership" of the loss company is traced through interposed entities to the ultimate individual shareholders.

Where the COT is failed, the loss may still be utilised if the loss company has maintained the same business from the time of the change in ownership to the end of the income year of utilisation.

Administratively, tracing ownership through widely held PE funds to ultimate beneficial shareholders is challenging, if not practically impossible for the management team of investee companies. Because of this, it is often not possible to conclude whether the COT rules are breached for any given relevant income year.

A more administratively simple regime should be put in place to allow for concessional COT tracing rules to be applied for portfolio business owned by widely held funds.

2. Long-term reforms for a more competitive Australian economy

2.1 COLLECTIVE INVESTMENT VEHICLE (CIV) REFORM

The global market for PE and VC capital raising is large and highly competitive.

Almost half a trillion US dollars was raised globally in 2014, down slightly from the 2013 total of US$528b.[8] But in Australia, only US$607m was raised in 2013, or just over 0.1% of the global total. This stands in stark contrast to Australia's relative position insofar as its share of global GDP (1.9%)[9], global commercial services exports (1.12%)[10] and the third largest pool of funds under management in the world.[11]

The amount of offshore capital raised by Australia PE and VC funds has also fallen over the last few years. From FY2005 to FY2009, $6.9b was raised from known offshore investors, compared to the $4.3b raised in FY2010 to FY2014 – a decline of 38%.

One of the main factors affecting the attractiveness of the local market and the ability of Australian fund managers to raise capital relates to the taxation arrangements of CIVs.

The imperative of developing a best-in-practice CIV regime in Australia was raised in the 2009 Johnson report (*Australia as a Financial Centre – Building on our Strengths*). In this report, it was noted that there was a lack of an appropriate CIV in Australia which was familiar and recognised by potential offshore investors, particularly in the Asia-Pacific region.

In this respect, it was observed that the tax regime of investment vehicles in Australia, which provides for tax transparent treatment of unit trust structures and limited partnerships in very narrow cases (such as through VCLPs), was inadequate for the purposes of facilitating the growth and international expansion of Australia's funds management industry.

The report observed that this limitation in our tax system architecture contributes to the widespread use of offshore investment vehicles by Australian fund managers, which results in the loss of new Australian employment opportunities in the fund administration, financial and custody service industries. Given the already strong relative position of our financial service sector as a share of our overall economy, continuing to build on our strengths to create new employment and growth market opportunities in these areas is something that should be of major concern to our national economy.

Introducing a separate regime that provides for a new tax transparent CIV that is recognisable and familiar to domestic and offshore resident investors will serve as a better solution that can either replace, or run in parallel with, the reforms we recommended earlier in relation to the VCLP regime. This new CIV should have many of the recommended features described previously in relation to VCLPs.

It is also important to highlight that due to the ATO's views on capital and revenue characterisation, made public via TD 2010/21, a simple transparent limited partnership that does not provide for 'bright-line' capital account treatment will not ameliorate the uncertainty faced by potential offshore investors and certain domestic investors.

The compliance costs that Australia's current CIV regime imposes on PE and VC fund raising activity (as discussed in section 1.1) are problematic and economically inefficient. These costs highlight the fact that simplifying the CIV regime in Australia would likely be a tax accretive measure on the basis that it would improve the efficiency of

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[8] Global Private Equity Report 2015, Bain & Co., February 2015.
[9] *Why Australia* Benchmark Report 2015, Austrade, January 2015.
[10] World Trade Organization statistics, September 2014.
[11] *Why Australia* Benchmark Report 2015, Austrade, January 2015.

domestic fund managers whereas the tax collected from investors would be neutral (i.e. the current complexity does not increase tax collected from investors, it just creates a net compliance cost burden).

2.2 REVENUE/CAPITAL ACCOUNT CHARACTERISATION

The revenue/capital account characterisation is a feature of many tax jurisdictions in the developed world.

This distinction is important for investors (including domestic and foreign entities) because it can have a significant and material impact on investment outcomes when determining the net returns and viability of certain investment options in the market. Uncertainty around whether or not an investment return will be classified on revenue or capital account could lead to decisions being made to not invest an amount of capital in a venture which would otherwise satisfy other commercial and economic hurdles.

PE and VC funds typically hold an investment from three to seven years, which would automatically position them for capital account treatment in jurisdictions like the US and the UK. Other tax relief measures, such as the UK's Entrepreneurs' Relief policy, can provide further reductions in the tax applicable on capital gains.[12]

AVCAL is supportive of Australia's current policy settings in respect of the different tax outcomes which derive from revenue gains versus capital gains. Tax concessions provided in connection with capital account investments provide incentives for patient long-term investment, which is suited to the development of a major stable and growing economic investment base for the nation.

However, further reform in this area is required in order to provide certainty to PE and VC funds in respect of the availability of capital account treatment on certain gains and losses. In AVCAL's consultations with both domestic and offshore members, attention has been drawn towards a preference for a 'bright line' test to be embedded in the tax laws to remove ambiguity and uncertainty which currently pervades key aspects of the revenue/capital issue.

As an example, the US Federal Income Tax legislation provides for discounted capital gains tax rates to apply uniformly once a 12-month holding period has been satisfied. A 12-month holding period is also consistent with Australia's capital gains tax legislation which provides for certain exemptions once the 12-month holding period is satisfied.

Additionally, offshore investors have expressed the following concerns regarding Australia's existing revenue/capital rules:

- The revenue/capital distinction is not precisely defined in Australian tax law which in many cases creates uncertainty for long-term commercial planning;

- The ATO's interpretation of the existing tax law (which indicates a tendency towards classifying gains derived in a typical PE context as revenue instead of capital) is entirely inconsistent with global norms in this area, and makes Australia less attractive by international standards;

- Where gains are classified as being on revenue account, it is necessary to consider the anti-avoidance laws contained in Part IVA, in what would otherwise be typical global investment structure. The scope of Part IVA is broad, which when coupled with the ATO's determinations on offshore PE, compounds the level of uncertainty in respect of commercial outcome planning, including with respect to the ability to rely on international income tax treaties between Australia and its major global trading partners.

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[12] Technical Factsheet 164: Entrepreneurs' Relief, ACCA, December 2010.

In addition to these points, it is important to highlight (as is discussed earlier in this submission) that the uncertainty surrounding the revenue/capital characterisation in Australia means that a simple transparent limited partnership that does not provide certainty on capital treatment will not adequately ameliorate the existing levels of uncertainty faced by would-be offshore investors and certain domestic investors.

The government should therefore take steps to bring about greater certainty in relation to the revenue/capital distinction, either via elective treatment for relevant CIVs or via a 'bright line' test that is similar to other jurisdictions with which Australia typically competes for global capital.

2.3 CAPITAL GAINS TAX REGIME AND DISCOUNT

The CGT framework is a key feature of our tax system and the CGT discount has played a vitally important role in promoting longer-term holding of investment assets since being adopted as a result of the *Ralph Review of Business Taxation* in 1999. Anecdotally, the CGT discount has also played a role in both attracting and retaining the best people working in Australia, in addition to incentivising investors and high net worth individuals to either stay in Australia or move here from abroad. The participation of individuals with those attributes in our economy helps to boost our entrepreneurial capacity and maintains a dynamic and flexible skills base than might otherwise be the case.

A well-designed CGT regime can play an important role in building the resilience of our economy which enables businesses to allocate capital efficiently for long-term purposes.

AVCAL is very supportive of the current CGT discount regime. Given that Australia's tax rates are relatively high compared with our regional competitors, the CGT discount regime is an important ingredient in incentivising individuals to remain residents of Australia for tax purposes.

Removing the CGT discount would, in some cases, be tantamount to an increase in the personal income tax rate for residents. It is clear from recent examples in Europe that increasing personal tax rates, in the context of a highly competitive market for skills and intellectual property, can directly result in labour and investors relocating to other jurisdictions that offer more favourable tax regimes.

For example, following the increase in effective personal income tax rates for high income earners in the UK in 2010, there was a spike in the number of emigrants from the UK to other jurisdictions (based on an Office for National Statistics survey).[13] In this respect, a report from the UK Home Office found that a significant proportion of the professionals emigrating from the UK during this time were choosing to move to countries with lower marginal tax rates.[14]

To support the conclusions being drawn, the rate of emigration from the UK subsequently decreased during the fourth quarter of 2012, which coincided with the announcement of a reduction in the personal tax rate as part of the 2012 UK Government budget. These fluctuations in the emigration rate (particularly with respect to high income earners) have been shown by various surveys to be linked to the effective personal taxation rate of the UK. For example, the 2012 Skandia Millionaire Monitor survey found that high taxation was the main reason for high income earners leaving the UK.[15]

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[13] Migration Statistics Quarterly Report, Office for National Statistics, February 2012.
[14] The Exchequer effect of the 50 per cent additional rate of income tax, HM Revenue & Customs, March 2012.
[15] Skandia Millionaire Monitor – Edition 1, Skandia, October 2011.

2.4 DIVIDEND IMPUTATION SYSTEM

The Australian PE and VC industry is very supportive of the current dividend imputation system. The imputation system serves as an added incentive for investment capital to flow from Australian individuals and superannuation funds into local entities, rather than offshore.

In AVCAL's view, the existence of the dividend imputation system is in no apparent way impeding the deployment of capital offshore by Australian investors or Australian businesses. There is a risk that placing restrictions or new limitations on the dividend imputation regime, specifically the ability to pay franked dividends to Australian investors, may amplify the challenges already being faced in relation to the capacity of Australian PE and VC funds to raise larger allocations of capital from domestic sources.

2.5 CORPORATE TAX RATE

Australia's current corporate tax rate of 30% (with some exceptions) is relatively high compared to the average statutory rate across the Asia-Pacific region of 23.5%, and the average OECD statutory rate of 25%. Australia's corporate tax revenue as a share of GDP was the second highest among OECD countries.[16]

These competitiveness factors, alongside the increasing internationalisation of business activities and capital, pose a risk to the stability of future government revenues through the corporate income tax system.

Ensuring that Australia continues to improve its relative competitive position will undoubtedly require a reduction in our current headline corporate income tax rate over the coming years. Moving to a lower rate that is more in keeping with our immediate peers should be taken to be a clear tax reform objective for the medium-term, which can be signalled and planned through a step-down approach which is rolled out over a period of perhaps five years.

In our view, the comments made in the *Re:think* discussion paper in respect of the corporate tax rate are well developed, and highlight the competing objectives of balancing measured reductions to the corporate income tax rate against increases to the overall level of investment:

> *Reducing Australia's corporate tax rate would increase Australia's appeal as a place to do business. It would encourage higher levels of investment in Australia and lead to capital deepening, which promotes growth in productivity, innovation, employment and wages. In the near term, lower taxes would provide an increased incentive for non-residents to invest in Australia. In the long run, increased investment would benefit all Australians (page 78).*
>
> *Company income tax drives a wedge between the before-tax rate of return and after-tax rate of return. Firms would have to offer a higher rate of return in order to attract their investment. This reduces the demand for investment, because there are fewer investment opportunities available that generate the required higher rate of return. Hence, the total amount of investment in the economy is less than would be in the absence of a company tax (illustration on page 80).*

These observations are relevant to both domestic and offshore PE and VC investors who as a matter of course constantly assess the commercial merits of deploying capital in an Australian investee business, or an offshore business.

[16] The Future of Tax: Australia's current tax system, Business Council of Australia, March 2015.

The need for ever-increasing productivity gains and growth is a core element of the value proposition that is typically synonymous with PE investment. These productivity gains, which create increases in value and new employment growth opportunities for the market, are partially eroded by a higher corporate income tax rate that directly impacts on the after-tax return available to shareholders.