Briefing note on key design considerations of proposed new Limited Partnership CIV

Key points

- **Australia’s current suite of collective investment vehicles (CIVs) is out of step with international practice**, necessitating complex, costly structures, and deterring foreign investment
  - Having a simple, internationally competitive CIV regime is critical to Australia’s ambition to be a regional financial services hub, which will in turn, drive significant local employment opportunities
  - Australia’s use of trusts (e.g. managed investment trusts (MITs)) is unusual internationally and deters foreign investors
  - Over the last five years (FY2013 to FY2017), around 64% of commitments to Australian private equity funds came from offshore investors, underlining the importance of having a CIV which is well-understood overseas.
- If Australia wishes to grow the funds available for investment into unlisted assets such as high growth, Australian businesses, a new limited partnership (LP) CIV must be created as soon as possible
  - LPs are the globally accepted private equity (PE) and venture capital (VC) vehicle of choice, and could transform the flow of capital into high growth Australian businesses.
- **A new LP CIV could be quickly introduced given there are only a limited number of issues** to address.
- The new LP CIV will assist the Australian managed funds industry by encouraging PE funds to set up Australian investment structures, thereby generating highly skilled investment manager jobs in Australia.
- A new LP CIV will cut red-tape by creating a more equal and competitive landscape with competing foreign funds management hubs such as Singapore, the US and the UK.

Summary of key features of commonly used international CIVs

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Tax transparent in relation to income and losses</th>
<th>Ability to prevent permanent establishment for foreign investors</th>
<th>Carried interest is on capital account/capital incentive regime</th>
<th>No undue investment restrictions/no control test</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany (Kommanditgesellschaft)</td>
<td>Yes(^1)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Ireland (Limited Partnership)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Luxembourg (SICAR)</td>
<td>Yes(^2)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>New Zealand (Limited Partnership)</td>
<td>Yes(^3)</td>
<td>Yes</td>
<td>n/a(^4)</td>
<td>Yes</td>
</tr>
<tr>
<td>Switzerland (Limited Partnership)</td>
<td>Yes</td>
<td>Yes(^5)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>UK (English &amp; Scottish Limited Partnerships)</td>
<td>Yes</td>
<td>Yes(^6)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>USA (Limited Partnership)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

---

1 Where the limited partnership is structured as a non-entrepreneurial limited partnership.
2 Where the SICAR is established as a fiscally transparent entity – an elective regime.
3 Although no specific deeming exists, this is the generally adopted position.
4 Note New Zealand does not have a capital gains tax regime.
5 This is the general position under Swiss tax law in respect of non-residents.
6 This is the general position under UK tax law except where the limited partnership conducts trade in the UK (this will generally not cover private equity funds holding shares in investee companies)
Recommended design features of an Australian LP CIV

1. Flow-through tax treatment and consistent tax treatment of PE and VC gains
   - Consistent with the MIT regime and consistent with the Board of Taxation’s recommendation, the LP CIV should have a deemed CGT treatment for its eligible investments.
   - A partnership “flow-through” treatment should be adopted, consistent with the Early Stage Venture Capital Limited Partnership (ESVCLP), Venture Capital Limited Partnership (VCLP), and AFOF rules.

2. There should be no prohibition relating to “control” of a trading company in order to retain tax transparent status
   - The current MIT control test is inconsistent with Australia’s funds management competitor jurisdictions like the US, UK and New Zealand
     - In such jurisdictions, their respective LP CIVs are not prohibited from controlling a trading company in order to maintain their tax transparent status.
     - A new Australian LP CIV that retains a control test restriction will experience limited uptake from industry and investors.
   - The current MIT control test rules are out-dated, and premised on policy concerns that have been progressively addressed by tax reforms over the last 30 years, such as the introduction of refundable imputation credits and a stronger Part IVA general anti-avoidance regime.
     - Controlled companies are taxed at the corporate tax rate
     - CIVs are widely held and typically closed-ended funds which are not being used to avoid corporate taxation
     - The control test is particularly difficult for the PE industry as it prevents the fund vehicle from taking a majority interest in an underlying company.
     - The new MIT arm’s length rule now addresses any integrity concerns associated with transactions with investees
   - ESVCLPs and VCLPs do not have a control test
   - If there are still remaining corporate tax integrity concerns, consideration should be given to a “safe harbour” exception to ensure that the control test is not breached if the only assets which the CIV has are shares in an investee company and the making of loans to investees.

Next steps

- AVCAL would welcome a dedicated discussion with Treasury to discuss the proposed new LP CIV. We note that different tax and policy considerations will be at play to those for the corporate CIV, partly given investors into PE and VC are generally institutional or sophisticated investors.
- AVCAL recommends that Treasury closely examines LP structures in other international jurisdictions so as to ensure that any new vehicle matches with global best practice.
National Innovation Fund – suggested design considerations

December 2016

**Background**

In recognition of persistent market failure, successive Commonwealth Governments have sought to support early stage companies via schemes such as the R&D tax incentive, introduction of early stage venture capital limited partnerships (ESVCLPs) and venture capital limited partnerships (VCLPs), and public-private co-investment funds (e.g. the Innovation Investment Fund (IIF) discussed below).

The National Innovation & Science Agenda (NISA), announced in December 2015, outlined a range of additional policy measures designed to further support the early stage ecosystem. We believe, given time, these reforms will be transformative for the sector.

In our view, the next phase of Australia’s innovation reforms – NISA 2.0 - must focus on supporting Australian ‘scale-ups’: those businesses that have graduated from the initial start-up phase with a proven product and market opportunity which now need further capital (often $5m-20m) and expertise to hire staff, drive sales growth and invest more in R&D. Currently, a lack of institutional funding (e.g. from super funds) at this vital stage pushes maturing, innovative Australian companies abroad. Ensuring these companies receive support has economy-wide implications, including Australia’s ability to drive future productivity and employment growth.

Over the last five financial years (FY12-16), only 25% of venture-capital backed companies received later/expansion stage funding, down from 29% of venture-capital backed companies in FY07-11.

A National Innovation Fund can play an important role in this next phase of innovation reform. Outlined below is some background on the previous IIF, followed by suggested design features for the proposed National Innovation Fund.

**Innovation Investment Fund**

The most significant public-private fund implemented by Commonwealth Governments was the sector-agnostic Innovation Investment Fund (IIF) announced in 1997. The IIF had several key features including:

- Matched dollar for dollar public-private commitments;
- A competitive bid process whereby fund managers sought to obtain a license to manage IIF capital;
- Unequal distribution of profits above a hurdle rate of investment return: 90% (private investors) vs 10% (Government investor).

We note that the IIF was abolished in 2014 despite strong opposition from industry stakeholders, including AVCAL, and multiple independent reviews which concluded that the IIF had been successful in channelling greater investment into early stage companies and had helped develop the domestic venture capital sector. Success stories from the IIF program include:
• **AMWIN** fund: one of the first funds licensed under the IIF. Since its commencement in 1998, AMWIN provided investors with a 1,047% internal rate of return, with international independent research firm Preqin rating it the top performing venture fund in the world.¹

• **SEEK**, which returned 6.5 times AMWIN Innovation Fund's original investment in 1999 which was part of the company's first institutional capital raising. Today, SEEK's market capitalisation is around $5.4bn and it is one of the world's most successful jobs-listing companies.

• **Pharmaxis**, a GBS Venture Partners IIF investment. Pharmaxis is an Australian pharmaceutical research company with a portfolio including two respiratory products (Bronchitol and Aridol) in various world markets and a research pipeline focused on areas of high unmet clinical need. Pharmaxis is working towards approval of its cystic fibrosis drug Bronchitol in the United States (having already been marketed in Australian and Europe) and is already selling its Aridol lung function test in Europe, Asia and Australia. In parallel, Pharmaxis is developing a pipeline of drug candidates for the treatment of inflammatory and fibrotic diseases. Pharmaxis manufacturers and exports their approved products from a purpose-built facility in Sydney.

We note that the administered capital provided under the IIF led to the acquisition of a financial asset for the Government, with no impact on the underlying fiscal balance of the federal budget. In return for the IIF funding, the Government received an equity share in the investments made. Returns from the Government's investment were then recycled into the existing revolving fund, and re-committed to future VC funds. The IIF therefore represent an example of successful Government-private sector collaboration, offering commercial returns for all investors.

**Suggested design features of a National Innovation Fund**

As venture capital and private equity funds are committed for an average 10-year term and returns do not generally start flowing until later stages of the fund’s life, a long-term approach is necessary. Considering the lessons learned from the IIF, and the recently launched Biomedical Translation Fund model, we would suggest the following design features for a National Innovation Fund:

- In order for it to have a meaningful impact on the market, and the development of scale-up businesses, the Fund should have a minimum Government commitment of $500m over two years (with returns reinvested);
- Sector-agnostic fund with matching capital commitments from private investors and the Government;
- A competitive bid process whereby fund managers seek to obtain a license to manage capital (a Fund undertaking individual company investments would be costly to administer, pose due diligence challenges and would be inconsistent with the diversified portfolio approach of venture capital funds);
- Unequal distribution of profits above a hurdle rate of investment return between private and public investors (e.g. 90/10 under the IIF, 60/40 under the BTF);
- An equity financing model offers greater flexibility for companies than debt, while strongly aligning interests between companies and their investors;
- The Fund should make investments into venture capital funds operating at different stages of the company life-cycle, noting that there are particular difficulties in conducting domestic investment rounds of over $5m;
- Investments should be permitted in both private and public companies as there are many smaller public companies which would benefit from venture capital investment.

**Next steps**

AVCAL welcomes feedback from the Government on the suggested design features outlined above. We would also be happy to facilitate an industry roundtable with our members to discuss the National Innovation Fund proposal in more detail.

---

¹ AusIndustry, **AMWIN Innovation Fund rated as world's best VC fund**, Customer Story, Jan 2014.