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CAPITAL MARKET INCENTIVES

Venture capital tax relief

Recommendation
19.1 Targeted tax relief for venture capital investment

Capital gains tax exemption

(a) That, from the date of announcement, non-resident tax exempt pension funds from certain jurisdictions (or limited partnerships of such funds) be allowed an explicit exemption from income tax on gains derived from the disposal of investments in new equity in eligible venture capital projects.

Scope of exemption

(b) That the exemption be restricted to:

- **(i) exempt pension funds from the United States, the United Kingdom, Japan, Germany, France and Canada — from the date of announcement;**
- **(ii) other countries' pension funds provided those countries exempt only bona fide pension funds — on or after the date of effect specified in amending legislation;**
- **(iii) investments which are at risk and held by the investor for a period of not less than 12 months; and**
- **(iv) investments in an eligible venture capital project — defined as one where the receiving entity:**
  - **has gross assets not exceeding $50 million (including the new investment); and**
  - **does not engage in property development as its primary activity.**

General provision

A Platform for Consultation (page 298) raised the issue of targeted capital gains tax (CGT) relief for venture capital investment. Submissions to the Review argued that there is a shortage of venture capital funding in Australia and that the current CGT regime is an impediment to the development of this market.

The Review accepts the argument that to stimulate venture capital funding from both domestic and non-resident sources it is necessary to make the CGT regime more competitive. The Review also accepts the argument that capital from international investors would not only have a direct effect but would be a catalyst for development of the domestic venture capital market if the presence of experienced foreign investors spills over into an enhanced local capacity for assessing and undertaking high risk investments.

Submissions have pointed to a class of non-resident investors that would invest in venture capital projects in Australia, were it not for the current CGT regime. Foreign tax-exempt entities, for example US pension funds, are hindered because they face no tax on investments at home and many other countries but there is considerable doubt within the investment community about their liability for Australian taxation.

This measure, together with scrip-for-scrip rollover relief (Recommendation 19.3), should significantly improve the climate for encouraging new ventures, particularly those of an innovative nature, to become established in Australia.

Application

The Review's recommendation that tax-exempt pension funds from certain jurisdictions be granted an explicit tax exemption on income (including capital gains) derived from the disposal of investments in new equity in eligible venture capital projects is intended to place their taxation status beyond doubt. One concern among potential investors, currently, is that they may be deemed to have a local establishment, which, under existing current law, would expose them to tax. The Review's recommendation will apply regardless of whether the investor has a permanent establishment in Australia. It will also ensure that, for example, just as an Australian superannuation fund is not taxed in the US on capital gains made in the US, US pension funds will similarly enjoy comparable treatment on capital gains derived from venture capital investments in Australia.

In order to maximise the catchment for potential venture capital while guarding against possible avoidance activity, the Review recommends that the relief on capital gains be available to funds resident in any 'approved' jurisdiction. The main criterion for approval is that the exemption of pension funds in the foreign jurisdiction should be available only to bona fide retirement pension funds. To obviate unnecessary delay in commencement of the scheme, the measure will apply from announcement to exempt pension funds from the US, the UK, Japan, Germany, France and Canada. The list of eligible countries will then be expanded with date of effect specified in amending legislation subject to the criterion mentioned above. The six specific countries listed have tax systems which are closely comparable with Australia's.

Since the foreign jurisdictions that qualify will be unclear until draft legislation is available, the Review recommends that this measure apply only from a date to be announced — that date could be announced when the exposure legislation is available or at the time the amending legislation is introduced.

Partnerships of exempt foreign pension funds from the approved jurisdictions, even if all the partners are not resident in the same jurisdiction, will also qualify for concessional capital gains treatment. It is not intended that the relief be extended to combinations of pension funds where any of the funds involved are not tax exempt in their home jurisdiction. It will also be necessary for non-resident pension funds to demonstrate that they are indeed tax exempt in their home jurisdiction.

To target the capital gains relief effectively, the Review considers that the benefits of the concession should accrue to those investors who bear the risk of investing in venture capital projects. Where an investor is able to enter into an arrangement whereby its investment is protected or guaranteed in some manner, it is likely that the investment would have taken place in the absence of any concession. In this case the application of the concession would just act to raise the returns to the investor rather than encourage investment that would not otherwise have taken place. Accordingly, the Review has limited the application of the concession to those investors who bear the risk of their investments. The details of how this measure will target investors who are bearing risk on their investments in venture capital projects will be included in the draft legislation.

It has also been argued that venture capital projects require 'patient' capital in order to facilitate the transfer of management and other skills to such start ups. To facilitate this, the investment will need to be held for not less than 12 months in order to qualify for the concession. This balances the competing interests of encouraging patient capital for venture capital projects and providing flexibility for investors to revise their holdings.

Eligibility

The Review has deliberately sought to establish broad criteria for determining eligible projects. The aim is to identify broad criteria that encompass higher risk venture capital projects without the need for government to predetermine the exact nature of the projects. Property development investments are excluded because they would not fall under even a broad definition of the term 'innovation'. A similar exclusion applies in the United Kingdom's Enterprise Investment Scheme for similar reasons to those motivating the Review's recommendation.

A limit of $50 million on the gross assets of the firms receiving the investment will ensure that the relief is targeted to firms that may face difficulties in raising significant new capital. It will not function to limit the size of the investor's total portfolio of such investments. And there would be no limit on the total capital gain in respect of which the investor will be able to gain relief.

Pooled Development Funds

Domestic investors are also an important potential source of venture capital funding. The Review notes that the Pooled Development Fund (PDF) program is designed to provide an incentive for local investment in venture capital projects (see Attachment A to this section). The Review considers that the PDF program offers an appropriate mechanism to encourage investment in venture capital by domestic investors and has noted the changes to the program announced by the Government in the 1999-2000 Budget to enhance its attractiveness as a vehicle for venture capital investment.

Representations to the Review have suggested that the PDF scheme can be difficult to access. The main concerns were the requirement for the PDF to invest in new equity and the 30 per cent limitation on individual holdings in a PDF (although superannuation funds, including non-resident pension funds, will be able to own 100 per cent of a PDF following the changes announced in the Budget). While these issues are beyond the scope of the Review, the Government may wish to consider whether a relaxation of these requirements may be useful in stimulating further domestic venture capital investment.

Recommendation
19.2 Effectiveness review for venture capital relief

Review after five years

(a) That the effectiveness of the concession proposed in Recommendation 19.1 be reviewed five years after its introduction.

Investors to supply annual information

(b) That to facilitate the review, investors be required:

(i) to register with, and provide information to, the Pooled Development Fund (PDF) Board when the investment is made; and

(ii) to provide an annual return indicating, for example, the amount invested and any distributions made.

The Review has been convinced that Australia stands to benefit from stimulating the venture capital market. However, the proof will be in the effectiveness of this scheme. Accordingly, it is proposed that a review take place five years after commencement. Investors wishing to benefit from concessional treatment will be required to register with and provide information to the PDF Board at the commencement of their investment and in annual returns in order to provide a factual basis for the review. In particular, the recommended review should examine whether there has been a net addition to total investment in venture capital and whether changes should be made to the list of jurisdictions covered.

The provision of information by the investor is not meant to be onerous and should not require the investor to provide any more information than it would collect in the normal course of business. Requisite information would include the amount of the investment and the amount returned to investors by way of distributions and return of capital.

Scrip-for-scrip rollover relief

Recommendation
19.3 Rollover relief for takeovers

Takeovers to be by widely held entities

(a) That, commencing from the date of announcement, optional rollover relief from taxation of capital gains be provided for exchanges of membership interests in companies or fixed trusts in takeovers involving at least one widely held entity.

Criteria governing entities and members

(b) That the rollover relief apply for takeovers where the acquiring entity acquires or increases its holding to at least 80 per cent of the voting interests in another entity through a takeover scheme.

(c) That the rollover relief not apply to non-residents unless:

(i) they hold membership interests in resident entities; and

(ii) where a previous liability for tax on capital gains existed, the replacement membership interest would also be liable for tax on capital gains.

Treatment of pre-CGT interests

(d) That for membership interests qualifying under paragraphs (a), (b) and (c) and acquired in exchange for a membership interest acquired pre-CGT:

(i) the replacement membership interest not attract capital gains exempt status; and

(ii) the acquisition value of the replacement membership interest:

- **be its market value at the time that the membership interest is acquired; and**
- **become its initial tax value.**

A number of submissions to the Review suggested that the current CGT arrangements are an impediment to corporate acquisition activity in Australia. It was argued that under the current CGT regime, entities may be forced to pay a premium when making an acquisition to induce equity holders with potential CGT liabilities to accept the offer. This may act as an impediment to transactions that would otherwise be economically viable. The absence of rollover relief also raises equity concerns because the interest holders in the target entity face a CGT event while those in the acquiring entity do not, even though as a result of the transaction they hold interests in the same entity. As a consequence, the decision about which entity is the acquiring entity becomes important to interest holders.

The Review has also noted that the Parliamentary Joint Committee on Corporations and Securities, in its report on the *Corporate Law Economic Reform Program Bill 1998 (CLERP Bill)* recommended the introduction of scrip-for-scrip rollover relief. This recommendation was in response to evidence presented to the committee during its public hearings.

This measure will encourage start-up and innovative enterprises to remain in Australia. Often entrepreneurs receive the reward for their investment when the venture reaches the initial public offer (IPO) stage. However, under the current CGT arrangements, if the IPO were to proceed as a scrip-for-scrip transaction the entrepreneur would face a CGT liability even though there may be no cash payment. This may act as an incentive for some embryonic businesses to relocate to other jurisdictions to Australia's detriment. It may also impact on the availability of funding for these activities domestically as there would be fewer local success stories to attract the interest of investors. This issue may become more significant as the trend continues towards the globalisation of economic activity and the growing importance of knowledge-based industries.

With rollover relief, the membership interests of resident taxpayers will retain their original tax value and the resident member will not be required to pay tax on capital gains at the time of the takeover. Tax would be deferred until the ultimate disposal of these interests with the original tax value used to calculate the tax payable.

Scope of rollover relief

A Platform for Consultation (page 297) raised the issue of whether rollover relief should be limited to publicly listed companies. In recognition of the efficiency gains involved, the Review considers it appropriate to allow rollover relief where at least one of the entities is widely held regardless of whether they are listed or unlisted. Rollover relief will also be applied in relation to fixed trusts (including unit trusts) — either as target or acquiring entities or both.

Rollover relief will be restricted to takeovers where one of the companies or fixed trusts is widely held. This will limit potential valuation problems and avoidance that might arise from transactions between companies and fixed trusts that are not widely-held. An entity will qualify as widely held where it has at least 300 members and no grouping of 20 or fewer members owning 75 per cent or more of the interests of the entity (see Recommendation 6.21).

Non-resident holders of membership interests will be able to obtain rollover relief for takeovers involving an exchange of membership interests subject to two conditions:

- if the non-resident member holds 10 per cent or more of the voting interests in the original public Australian entity but after the takeover holds less than 10 per cent of the acquiring entity, the new equity holding will remain an asset on which a non-resident is liable to pay tax on capital gains on disposal; and
- if the non-resident is to receive an interest in a non-resident entity, the exchange will be a taxable event if disposal of the original interest would otherwise have been a taxable event.

Submissions were received indicating that rollover relief should be afforded to widely held entities, including unit trusts and superannuation funds, where they wish to merge and improve their overall efficiency. Such amalgamation would involve a merging of the underlying assets of the entities; rollover of cost bases at the underlying asset level would be needed to make the entire transformation of the two entities free from tax on capital gain consequences. Though the Review can see some merit in allowing a special asset-level rollover for such entities as it may facilitate rationalisation of entities where a takeover has occurred, it might create an area of inconsistent treatment of asset cost bases and losses upon consolidation. Accordingly, the Review has confined its recommendation to rollover at the membership interest level. The treatment of cost bases for assets would fall within the general regime for consolidation of entity groups proposed in Section 15.

Impact

The Review considers that rollover relief with takeovers will enhance the functioning of, and value creation by, the corporate sector in Australia. The

Review also expects that the capital gains taxation base will be increased by this measure with asset values benefiting from a more efficient allocation of capital and an increased rate of realisations induced by the extra takeover activity.

This measure should be implemented from the date of announcement as a delayed implementation is likely to cause entities to defer acquisitions. Such a hiatus in corporate and other restructuring would be detrimental to efficiency.

Pre-CGT assets

The Review does not propose that the CGT exempt status of pre-CGT equity interests be preserved in an equity exchange. The Review's intention is to alleviate the cash flow problems of individuals and to free up the capital market. Under arrangements that currently apply to successful takeovers, the tax free status of pre-CGT assets is lost; the Review sees no reason to change this outcome.

Application of rollover relief

Rollover relief will apply only to the exchange of equity for equity in a qualifying takeover. Cash or other property received as a part of a takeover will be subject to tax on capital gains. This does not preclude an entity making a takeover bid in terms of cash and scrip. Such an offer could be where the member is able to elect to take an exchange of equity for part of their membership interest and a cash payment for the remainder. Offers in the form of a fixed proportion of scrip and cash for an equity interest will also be included. In these cases the cash received will be subject to tax on capital gains, and appropriate modifications will be made to the tax value of the members' interests. The Review believes that this will provide substantial flexibility for entities to structure their takeover bids.

Where the acquisition is through the exercise of the compulsory acquisition powers contained in the *Corporations Law* in consequence of a takeover scheme, scrip-for-scrip rollover relief will apply to those equity holders who have their interests compulsorily acquired.

Recommendation
19.4 Rollover relief for business demergers or deconsolidations

Demerger not to produce taxing event

(a) That, where a widely held entity splits its operations into one or more new entities and issues membership interests in these entities to the original members in the same nature and proportion as their original membership interest:

(i) there be no tax consequences for the members; and

(ii) the tax value of the membership interest be spread across the new and old interests.

Tax values for pre- and post-CGT interests

(b) That in the case of:

(i) an initial pre-CGT membership interest — the tax value be the market value of the new equity interests immediately after their acquisition; and

(ii) post-CGT membership interests — the tax value of the new membership interest be determined by apportioning the old tax value across the new membership interest in proportion to the market value of the new membership interest.

Date of effect

(c) That this measure be implemented with the same date of effect as the entity tax regime and related measures proposed by the Review.

The Review considers that where an entity undertakes a reorganisation of its operations, leaving members in the same economic position as they were immediately before the reorganisation, there should be no taxing event. This includes reorganisations in which the original entity continues to exist. Under current tax arrangements, members in an entity that reorganises its activities, splitting them into a number of separate entities, may face a range of tax consequences. For example, equity holders may face CGT and/or income tax depending on the way in which the business undertakes its reorganisation. This acts as an impediment to entities restructuring their operations and may therefore lead to a reduction in the overall efficiency of the economy. The provision of relief will enable widely held entities to restructure their operations with a minimum of difficulty for members. It would be more difficult for valuations to be determined for entities that are not widely held.

The Review also recognises that this will require a significant change in the application of the law. As such, this change will be introduced at the same time that the entity tax regime is implemented.

Recommendation
19.5 Effectiveness review for scrip-for-scrip relief

That the effectiveness of the concessions proposed in Recommendations 19.3 and 19.4 be reviewed after about five years of operation.

It is claimed that the concessions will facilitate realignment of businesses and improve economic efficiency. The Review is recommending accordingly but it also believes that their impact should be evaluated after a period of operation to assess whether the deferral of tax involved is justified. Accordingly, the Review considers that the effectiveness of these concessions should be examined after about five years of operation.

Attachment A

Pooled Development Funds (PDFs)

Objectives

The PDF program was introduced in 1992 to develop the market for patient equity capital, including venture capital, for small to medium-sized enterprises (SMEs). A PDF is a private company established under the *Pooled Development Funds Act 1992* that raises capital from investors and invests this capital in SMEs. Companies seeking to become PDFs are required to register with the PDF Board and provide the Board with annual returns on the status of their investments. The Board comprises five members from the private sector with experience in finance, commerce and marketing.

Concessional tax treatment

To provide an incentive for investors, PDFs are taxed at 15 per cent on the SME component of their investment income and at 25 per cent on the unregulated investment component. PDF dividends are exempt from income tax and dividend withholding tax and any capital gains made by investors in selling their shares in the PDF are exempt from CGT. Also, any tax-preferred income received by a PDF retains its character when it is passed through to PDF shareholders.

While PDF dividends are tax exempt, the PDF shareholder may elect to have any franked dividends taxed as if they were not PDF dividends. Even though PDFs are only taxed at 15 per cent on their SME component, they are able to frank dividends at the company tax rate. Where the shareholder elects to have the PDF dividends taxed, the dividend imputation system applies and investors, such as superannuation funds, with tax rates less than the company rate are able to use the resulting excess franking credits to offset other income. Thus, with some exceptions, domestic superannuation funds are able to achieve an effective tax rate of 6.25 per cent with a 36 per cent company tax rate (or 7.5 per cent with a 30 per cent company tax rate) on income from investments that is taxed at 15 per cent in the PDF.

What PDFs can invest in

PDFs can invest in SMEs with total assets of less than $50 million whose primary activities are not retail operations or property development. A PDF is not allowed to invest in another PDF. A PDF is able to invest in an SME for the following purposes:

- to establish an eligible business, either alone or with another party or parties;
- to increase substantially the production capacity or the supply capacity of an established eligible business; and
- to expand existing markets substantially, or develop new markets for goods and services of established eligible businesses.

Normally, investment by the PDF must be at least 10 per cent of the total capital of the investee's business although the PDF Board is able to approve investments of less than 10 per cent. The investment must be in newly issued ordinary shares or other kinds of newly issued shares approved by the Board. The PDF Board has the discretion to approve the purchase of pre-owned shares. A PDF is not permitted to invest more than 30 per cent of its capital in any one investee company without prior approval of the Board.

In the 1999-2000 Budget the Government announced changes to the PDF program to make it more attractive. These changes include allowing a complying superannuation fund, including a non-resident pension fund and limited partnerships of such funds, to own 100 per cent of a PDF and enabling a PDF to buy back shares from investors and to return capital. PDFs will also be able to merge and make loans to equity investors.

Summary of PDF operations

There are now 60 registered PDFs that have raised over $270 million in capital, $155 million of which has been invested in 147 SMEs. In 1997-98 PDFs raised $115 million in new capital, the largest amount of capital raised in any year since the inception of the PDF program in 1992.