



Tax Breaks for Venture Capital

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The Tax Laws Amendment (2007 Measures No.2) Bill 2007 (**Bill**) was introduced into the Australian Parliament on 29 March 2007. Amongst other amendments, the Bill contains reforms to the venture capital regime by relaxing the eligibility requirements for concessional tax treatment for foreign residents investing in venture capital limited partnerships (**VCLPs**), as well as providing tax concessions for Australian residents and foreign residents investing through a new investment vehicle called an early stage venture capital limited partnership (**ESVCLP**).

The introduction of the ESVCLP investment vehicle and enhancement of the operation of the existing VCLP regime contained in the Bill was part of a package of measures announced in the 2006/07 Federal Budget aimed at encouraging domestic and foreign investments in the venture capital sector of the private equity market.

The reforms will apply to the 2007/08 and later income years.

Enhancement of the VCLP regime

Under the existing VCLP regime, eligible foreign resident partners from certain countries are exempt from tax on their share of the profit or gain made on the VCLP's disposal of an eligible venture capital investment. The limited partnership is treated as an ordinary partnership rather than a corporate limited partnership (which is taxed as a company).

As a result of the amendments, the operation of the VCLP regime is to be enhanced by removing or relaxing a number of restrictions. These changes:

- remove restrictions on the country of residence of limited partners;
- reduce the required minimum capital required for registration as a VCLP from \$20 million to \$10 million;

- allow investments to be made through the acquisition of convertible notes (that are equity for tax purposes) and investments in unit trusts;
- allow auditors to be appointed at the end of the financial year in which an investment is made; and
- allow up to 20% of a VCLP's committed capital to be invested in companies and unit trusts that do not satisfy the residency requirements.

Structure of the new ESVCLP regime

The Bill also provides taxation concessions for Australian residents and foreign residents investing in early stage venture capital activities through the new ESVCLP investment vehicle.

ESVCLPs will provide "flow-through" tax treatment and partners in an ESVCLP will enjoy tax exemption on their share of the income and gains derived from eligible early stage venture capital investments. The tax exemption applies to limited partners that are Australian residents or a foreign resident of any country, as well as a general partner that is either an Australian resident or a resident of a country with which Australia has a double tax agreement. The new ESVCLP regime replaces the Pooled Development Fund (PDF) regime which was

subject to tax (at concessional rates) although investors in PDFs were exempt from tax.

A venture capital general partner's share of the gains made in a VCLP on the sale of the eligible venture capital investments, i.e. the carried interest, is taxed as a capital gain and may benefit from the CGT discount. The tax treatment of the carried interest will also extend to a general partner in an ESVCLP under the new regime.

Concluding remarks

In view of the fact that only 15 VCLPs have been registered since this regime commenced in 2002, one might wonder whether the easing of a number of restrictions, while welcome, will necessarily enhance the attractiveness of a VCLP structure. This is particularly the case in light of reforms that took effect in December 2006 and which significantly reduce the impact of capital gains tax on foreign investors.

The introduction of the new ESVCLP vehicle will benefit both Australian and foreign investors and is a vehicle that should be considered for investments in venture capital which meets the parameters of the regime.

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