

**A STRUCTURAL ANALYSIS OF
AUSTRALIA'S
VENTURE CAPITAL TAX EXPENDITURE
PROGRAMS**

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Outline

- Presentation will examine the legal structures and tax concessions used in Australia to encourage venture capital (“VC”) investment
 - Focus on the operation of Australia’s Pooled Development Funds (“PDF”) program
 - Also briefly discuss the role of the Venture Capital Limited Partnership (“VCLP”) program

PDF Program

- PDF program:
 - Heavily regulated scheme established under the PDF Act (1992)
 - Designed to encourage VC investment in Australian SMEs
 - Operates as a “tax expenditure program”
- PDF Program creates investment vehicles known as “PDFs”:
 - PDFs are companies registered with the PDF Board
 - PDFs pool investors’ funds to make VC investments in SMEs
 - PDFs must operate subject to strict investment restrictions
 - Australia’s largest PDF is an ASX listed company which has a market capitalisation of around \$200m

PDF restrictions

Investors

Must generally not own > 30% of shares in PDF
Must only make equity investments in PDF

PDF

Must carry on the business of making and holding PDF investments
Must only make eligible “SME investments” and “unregulated investments”
Must believe SME will use capital for establishing or expanding eligible business
Must not generally invest > 30% of shareholders funds in any particular SME
Must invest 65% of raised capital in SME investments within 5 years
Must make minimum 10% investment in each SME

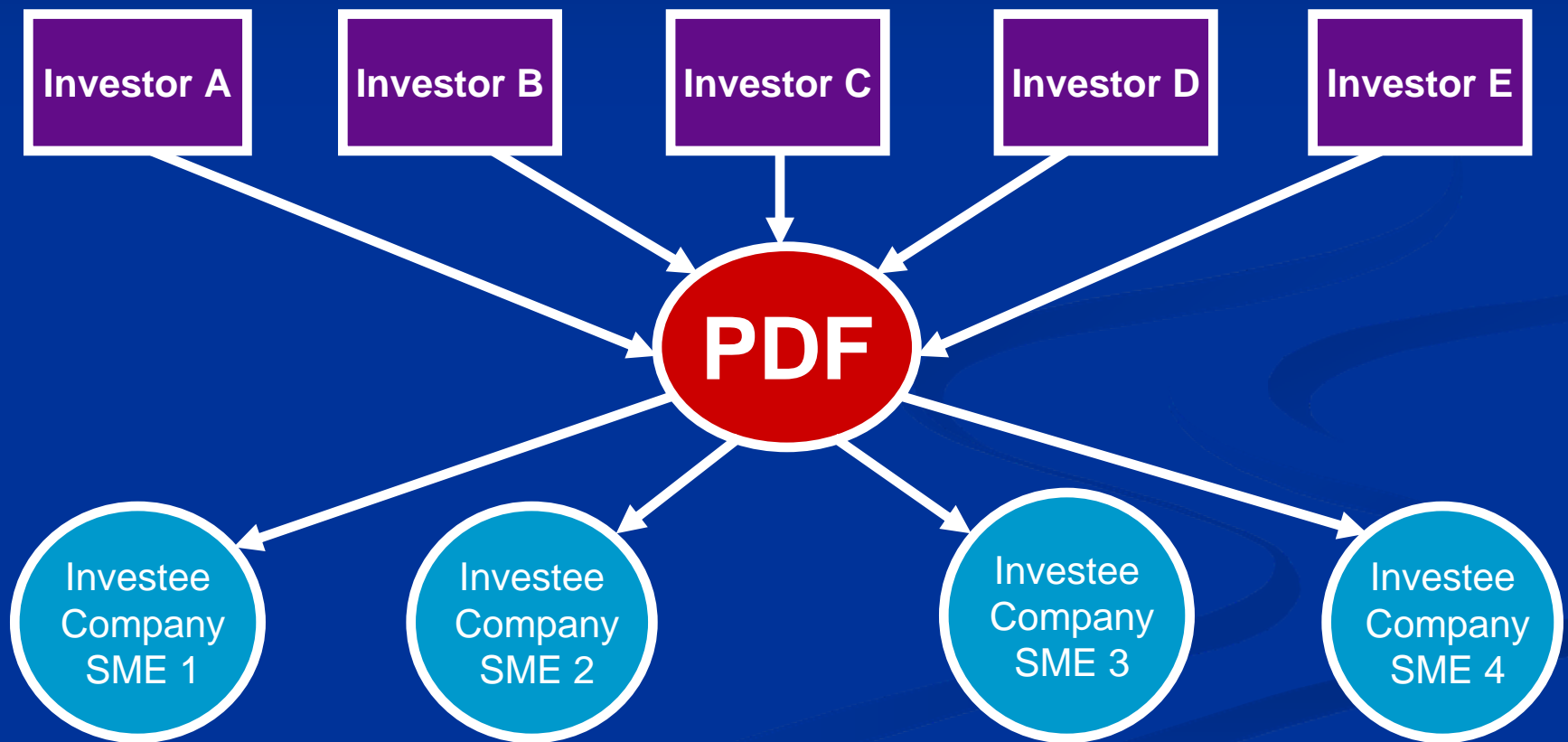
SME investments

SME’s assets must not exceed \$50m
SME’s primary activity must not be retail sales
or land development

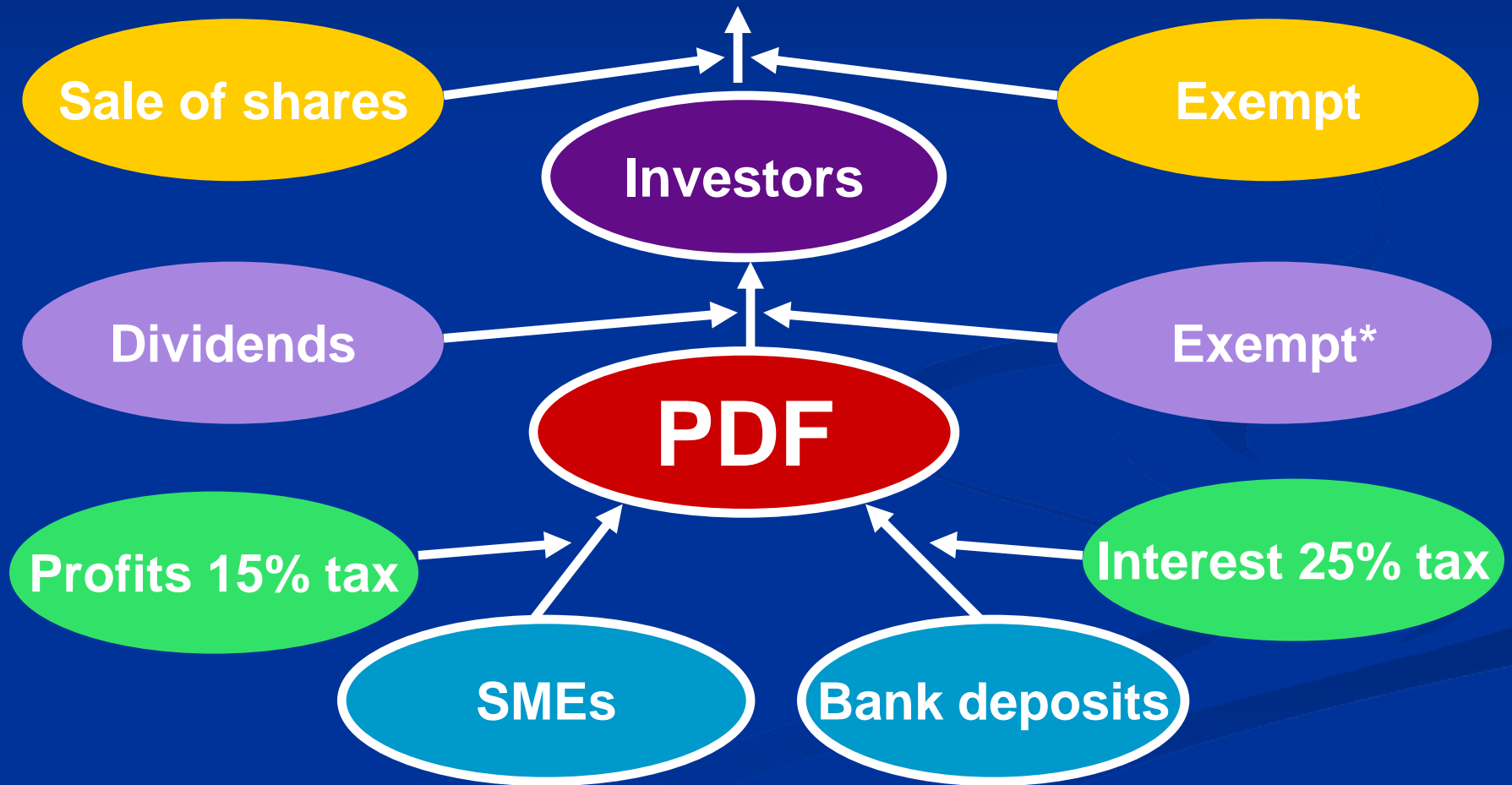
Unregulated Investments

Consists of only approved
investments (eg bank deposits)

Typical PDF Investment Structure



Concessional taxation treatment



Statistics

■ PDF Registrations

- 107 PDFs registered as at 30 June 2004
- 126 PDFs registered as at 30 June 2001 (peak)

■ Capital raised by PDFs

- 766m total capital raised as at 30 June 2004
- Between 30 June 2001 and 30 June 2004 PDFs raised between \$48m to \$51m each year (compares with 148m and 144m at its peak in previous two years)

■ Investment in SMEs by PDFs

- \$635m cumulative amount invested as at 30 June 2004 invested in 482 SMEs
- 79% of investments under \$1m
- Almost 80% of investments in SMEs valued under \$5m (57% of investments in SMEs valued under \$1m)

Observations

- PDF program still generally poorly understood
- Interest in PDF program surged a few years ago following PDF Act changes (eg allowing share buy backs), but has since slowed down
- PDF program operates subject to significant restrictions – not suitable in all cases involving VC investment
- The PDF program does not provide “up-front” tax concessions like the former MIC program
- The tax concessions require success of underlying investments
- The cost of the PDF concessions are recouped by the government through the growth in the PDF’s underlying investments in SMEs
- The PDF program has added risks for investors because they are unable to claim losses and (generally) deductions for financing costs
- The PDF program is targeted at Australian investors and operates alongside separate venture capital concessions for foreign investors (VCLP scheme introduced in 2002)

VCLP Program

- **Flow through taxation** – Program creates 3 new kinds of limited partnerships which are taxed on a flow-through basis under Div 5 (rather than as companies under Div 5A):
 - VCLPs, AFOFs and VCMPs
- **Tax exemptions** – “Eligible venture capital partners” and “eligible venture capital investors” are exempt from tax on gains and losses made from “eligible venture capital investments” that have been held for at least 12 months
- **CGT treatment of venture capital managers** - Venture capital managers taxed under “CGT event K9” (rather than general tax rules) on their “carried interest” component (potential for CGT discount to apply)