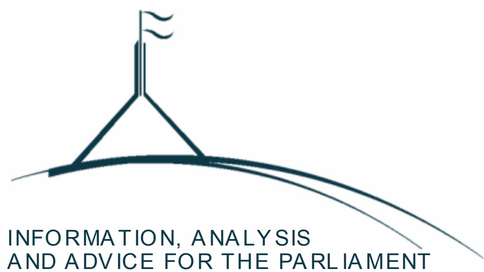

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Bills Digest
No. 168 2003–04

Tax Laws Amendment (2004 Measures No.3) Bill 2004

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No. 168 2003–04

Tax Laws Amendment (2004 Measures No.3) Bill 2004

Michael Priestley and Bernard Pulle
Economics, Commerce and Industrial Relations Section
21 June 2004

Contents

Purpose 1
Background 2
Main Provisions 2
Schedule 1 – Venture Capital 2
New holding company 4
Predominant activity test 4
Ineligible activities 5
Ongoing eligibility requirements 5
Statement regarding ongoing eligibility requirements 5
Schedule 2 – Worker entitlement funds – FBT exemption 5
Schedule 3 – Technical corrections to foreign tax credit provisions 6
Concluding comments 6
Venture capital amendments – Industry response 6
Endnotes 7

Tax Laws Amendment (2004 Measures No.3) Bill 2004

Date Introduced: 27 May 2004

House: House of Representatives

Portfolio: Treasury

Commencement: Sections 1 to 4 and Schedule 1: the day the Act receives Royal Assent.

Schedule 2: 1 April 2004.

Schedule 3: the day the Act receives Royal Assent.

Purpose

To amend:

- the *Income Tax Assessment Act 1936* (ITAA 1936) and the *Income Tax Assessment Act 1997* (ITAA 1997) to allow an investment in the holding company of a company or a group of companies to qualify for the tax exemption if it satisfies certain requirements

- the *Venture Capital Act 2002* to require the general partner of a Venture Capital Limited Partnership (VCLP) or Australian venture capital Fund-of-Funds (AFOF) and eligible venture capital investor to include a statement in the annual return as to whether the company met each ongoing eligibility requirement at all times during the financial year

- the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986) to extend the transitional arrangements for the fringe benefits tax (FBT) exemption by one year beginning on 1 April 2004 for certain contributions to worker entitlement funds, and

- the ITAA 1936 to make certain technical corrections to the provisions that allow foreign tax credits.

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Background

As there is more than one them to the amendments in the three Schedules in this Bill, the background to the various measures will be discussed in the Main Provisions section.

Main Provisions

Schedule 1 – Venture Capital

In December 2002, the Parliament enacted legislation to extend the scope of the tax exemption for venture capital investments. The object of the legislation was to improve incentives for foreign investment in the Australian venture capital industry and encourage the relocation of international venture capital managers to Australia.

The key features of the legislation were set out in Bills Digest No. 77 2002-03 and can be summarised as follows:

- flow-through tax treatment for certain types of limited partnerships, that is Venture Capital Limited Partnerships (VCLPs), Australian venture capital Fund-of-Funds (AFOFs) and Venture Capital Management Partnerships (VCMPs). This enables partners in a VCLP, AFOF and VCMP to be taxed at the partner level on gains and losses of the partnership, and brings Australia into line with international jurisdictions

- tax exemption on the share of profit or loss made on the disposal of certain investments for eligible investors. This allows certain overseas investors including tax-exempt entities such pension funds to exit from a venture capital investment without incurring a capital gains tax liability, and

- taxation of venture capital manager's carried interest as a capital gain. If the venture capital manger is an individual, and the partnership agreement under which the carried interest arises was entered into at least 12 months before the disposal, then a discount capital gain applies to tax only 50 per cent of the capital gain.

The Australian Venture Capital Association Limited (AVCAL) estimates that the new tax changes will attract an additional $1 billion in foreign venture capital investment into Australia over the next five years.[1] In 2002, Australia attracted 24 per cent of private equity invested in the Asia-Pacific region.[2]

The first Australian managed VCLPs under the new tax changes were granted conditional registration by the Pool Development Funds (PDF) Board in May 2003.[3] The conditional registrations totalled $575 million in new venture capital:

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Name of Fund	Capital Sought	Investment Stage
Macquarie Investment Partners IV, LP	$300 million	Expansion and later
Starfish Technology Fund I, LP	$80 - $100 million	Technology
Deutsche Private Equity Fund II, LP	$175 million	Expansion and later

The first foreign managed limited partnership, in this case an AFOF, was registered with PDF Board in 2004 and the amount invested is reported to be close to $250 million. However, the market has drawn attention to structural and administrative hurdles preventing overseas managed funds from seeking registration:

> The VCLP regime, whilst offering significant tax benefits, has not to date proved to be attractive to foreign managed funds due to the complexity of the rules on the one hand, and the lack of market experience by those administering the regime on the other. The potential for Australian taxation of foreign manager's carry has also acted as a disincentive to registration. Accordingly, while registration offers certainty that qualifying investments will not be subjected to Australian capital gains tax, structural and administrative hurdles have to date prevented funds from seeking registration.[4]

The tax exemptions were originally only granted to certain eligible non-residents on the gains made on eligible venture capital investments. The amendments in **Schedule 1** extend the tax exemption to eligible investments made in a holding company of a corporate group as announced by the Minister for Revenue and Assistant Treasurer in Press Release No. C027/04 of 6 May 2004.

The rationale for the extension of the tax exemption is given in the Explanatory Memorandum to the Bill:

> 1.7 The existing law provides than an eligible venture capital investment can only be made into a company whose total assets, together with those of any connected entities, are valued at not more than $250 million immediately before the investment is made. The effect of this test (the permitted entity value test) is that where a company is being disposed of by a corporate group or institution whose assets are valued at more than $250 million, the investment is not eligible for the exemption. This is the case even if the company will not be connected to the group after the investment has been made and the value of its assets, together with that of the entities that will continue to be connected after the investment is made, will not be more than $250 million.
>
> 1.8 The amendments will allow an eligible investment to be made into a company if the value of its assets and those of its connected entities, but excluding entities that will not be connected after the investment is made, is not more than $250 million. Integrity rules will ensure that treating each investee company as an independent entity will not allow otherwise ineligible investments in companies that

are members of a large corporate group to qualify for the exemption by splitting into smaller entities.[5]

The amendments in the Bill impose numerous conditions to obtain the favourable tax treatment including the 'predominant activity' test that will be determined by the Pool Development Funds (PDF) Board. The amendments also impose reporting obligations in respect of the ongoing eligibility requirements for an eligible venture capital investment. The amendments will take effect from 1 July 2002, the date the venture capital tax changes came into operation (**Part 3** of **Schedule 1**).

The amendments to the *Venture Capital Act 2002* will require the general partner of a venture capital investment and eligible investor to include, among other things, in reports to the PDF Board, a statement as to whether the company met each ongoing requirement at all times during the financial year.

The significant amendments in **Schedule 1** are considered below.

New holding company

Subdivision 118-F of the ITAA 1997 deals with the capital gains exemptions for venture capital and section 118-425 provides a meaning of venture capital investment.

Proposed subsection 118-425 (11) to be inserted into section 118-425 of the ITAA 1997 by item **11** of **Schedule 1** provides that an acquisition of shares or options by a VCLP, AFOF or eligible investor in a company that is formed solely for the purpose of investing in another company, including the holding company of a group, will be an eligible venture capital investment if:

- within 6 months of the investment being made the holding company uses the money to acquire shares or options in the other company, or to pay administrative expenses associated with the investment in the other company, or provides loans to the other company, and
- the company in which the new holding company invests meets the requirements to be an eligible venture capital investment within that 6 month period and after the end of that period.

Predominant activity test

Item 7 of **Schedule 1** repeals subsection 118-425(3) which deals with primary activity and substitutes **proposed subsection 118-425(3)** which provides a predominant activity test.

Proposed subsection 118-425(3) provides that a company satisfies the predominant activity test if it satisfies at least 2 of the following requirements:

- more than 75 per cent of its assets are used primarily in activities that are not ineligible activities
- more than 75 percent of its employees are engaged primarily in activities that are not ineligible activities
- more than 75 per cent of its total assessable income is derived from activities that are not ineligible activities.

Ineligible activities

As mentioned above one of the requirements in proposed subsection 118-525(3) is that more than 75 per cent of the activities of the company or group must not relate to ineligible activities. **Proposed subsection 118-425 (13)** lists these ineligible activities which include property development or land ownership, finance, insurance, construction and investments generating interest, dividends, royalties or lease payments.

Ongoing eligibility requirements

The amendments to the ITAA 1997 contained in **Part 1** of **Schedule 1** of the Bill impose a number of ongoing eligibility requirements for an investment to be eligible for the tax exemption. These ongoing requirements are the predominant activity test **(proposed subsection 118-425(3))**, the restriction on investing in other companies **(**subsection 118-425(4)**)**, the company's auditors to be registered **(proposed subsection 118-425(5))**, and the requirement of a company into which a holding company was formed to invest to meet the eligibility requirements **(proposed paragraph 118-425(11) (d))**.

Statement regarding ongoing eligibility requirements

Amendments proposed to the *Venture Capital Act 2002* in Part 2 of **Schedule 1** will require information relating to ongoing eligibility requirements to be included in reports to PDF Board. This will include a statement in the annual return as to whether the company met each ongoing eligibility requirement at all times during the financial year.

Schedule 2 – Worker entitlement funds – FBT exemption

Worker entitlement funds are funds which provide for employee entitlements such as leave payments or payments when an employee ceases employment. From 1 April 2003, certain contributions to approved worker entitlement funds are exempt from FBT under section 58PA of the FBTAA 1986. The exemption was designed to ensure that these

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contributions are not taxed twice, once as a fringe benefit when paid into the fund and again as income when paid out of the fund.

As a transitional arrangement, the FBT exemption also applied to certain contributions made to existing worker entitlement funds during the FBT year beginning on 1 April 2003. A fund is an existing worker entitlement fund if it accepted contributions during the FBT year beginning on 1 April 2002 for the purposes of meeting obligations in relation to leave payments or payments when an employee ceases employment.

On 1 April 2004 the Minister for Revenue and Assistant Treasurer announced in Press Release No. C019/04 that employers will have until 31 March 2005 to comply with the FBT exemption for payments made into worker entitlement funds. The Minister added that the one year extension to transitional arrangements is intended to address concerns that the emerging interpretation of the law would deny many employers access to the FBT exemption.

Item 2 of **Schedule 2** extends the FBT exemption to contributions made to an existing worker entitlement fund or an approved worker entitlement fund during the FBT year beginning on 1 April 2003 or 1 April 2004.

Schedule 3 – Technical corrections to foreign tax credit provisions

Division 18 of the ITAA 1936 deals with credits in respect of foreign tax. **Schedule 3** to the bill contains minor amendments to sections 160AFCD and 160 AFCJ of Division 18 to ensure that provisions for allowing foreign tax credits to arise in particular circumstances will continue to operate properly following changes to the foreign tax credit provisions that were made as a result of the Timor Sea Treaty.

Concluding comments

Venture capital amendments – Industry response

The Australian venture capital industry is supportive of the amendments in the Bill to extend the tax exemption. The Chief Executive of AVCAL has stated that the Bill represents the culmination of 18 months negotiation with the Commonwealth Government to encourage new foreign venture capital investment and to further develop the venture capital industry.[6]

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Endnotes

1 Australian Venture Capital Journal, 'Parliament Passes VCLP Bills', February 2003 Year 12 No 117, p. 15.

2 See Axiss Australia, *Venture Capital and Private Equity in Australia*, Data File Series 2004.

3 See Australian Venture Capital Association Limited, Press Release, 'Venture Capital Limited Partnerships off to a flying start', 8 May 2003.

4 Australian Venture Capital Journal, 'Offshore investor comes in with Australian Venture Capital Fund of Funds', May 2004 Year 13 No 131, p. 15.

5 *Explanatory Memorandum*, Tax Laws Amendment (2004 Measures No. 3) Bill 2004, p. 6.

6 Australian Venture Capital Association Limited, News Letter, 27 May 2004.

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