Early Stage Venture Capital Limited Partnerships

A tax-free structure for early stage venture capital investments

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As the effects of the global financial crisis begin to subside, and smart money is once again beginning to look for a home, new fund managers need creative value differentiators to ensure the most successful capital raising campaign.

One method is to explore alternate methods of fund structuring that maximise returns for investors.

The Early Stage Venture Capital Limited Partnership (**ESVCLP**) program is aimed at stimulating Australia's early stage venture capital sector by allowing generous tax concessions for funds meeting the registration and investment criteria set out in the legislation.

What is an ESVCLP?

An ESVCLP is a venture capital fund, structured as a limited partnership and registered with Innovation Australia.

Limited partnerships are the preferred structure for venture capital investors internationally because of the flexibility of the 'flow-through' taxation position and the limited liability of investors.

Tax benefits of ESVCLPs

An ESVCLP will have flow-through tax treatment – that is, the ESVCLP will not be taxed at the partnership level. In addition, income distributions and capital gains earned as a result of investment in an ESVCLP will be exempt from tax in Australia in the hands of both domestic and foreign partners.

The tax-free treatment is a significant legislative incentive which has the potential to both considerably increase a fund's internal rate of return and assist it to attract a wider pool of investors.

Tax losses by ESVCLPs, however, will not flow through to nor be deductible by partners.

What does 'early stage' mean?

An ESVCLP must have a focus on early stage investment.

The legislation does not define 'early stage', however it does provide that ESVCLPs may invest in entities whose gross assets are up to $50 million at the time of the first investment. This relatively high threshold would typically include expansion stage investments.

In determining the extent to which an investment plan focuses on early stage venture capital, Innovation Australia will have regard to a number of key indicators including:

1. the stage of development of the proposed investee entities
2. the level of technology in the entity
3. the proportions of intellectual property to total assets of the entity
4. the levels of risk and return of the entity
5. the amount of tangible assets and collateral against which borrowings may be secured by the entity
6. the partnership's investment hold strategy
7. whether or not the investment plan is connected with any other investment plans which would result in the partnership exceeding the financial investment limitations set out in the Act.

It is important to ensure the partnership deed and the investment plan address not only the specific regulatory requirements of the legislation, but also have regard to the policy which underlies the legislation and the areas of discretion Innovation Australia has over the registration process.

What it takes to achieve ESVCLP registration

There are a number of legislative requirements which determine both the financial structure of ESVCLP investments and the nature of the investee entities. Among those requirements are:

1. ESVCLPs may only invest in entities whose pre-dominant activity consists of eligible activities. Activities which are not eligible include property development, land ownership, banking, providing capital to others, leasing, factoring, securitisation, insurance, construction, acquisition of infrastructure or related facilities and making investments directed at deriving income in the nature of interest, rents, dividends, royalties or lease payments.
2. The size of the ESVCLP fund must be between $10 million and $100 million.

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3 No single partner's interest in an ESVCLP may exceed 30% of the total committed capital, subject to exceptions which include superannuation funds.

In addition, ESVCLPs are required to lodge quarterly and annual reports with Innovation Australia.

What types of securities can an ESVCLP acquire?

In making an investment an ESVCLP may acquire the following kinds of securities:

1 shares in a company

2 units in a unit trust

3 options (including warrants)

4 convertible notes, provided they are not debt interests.

It is noteworthy that Pooled Development Funds were not permitted to acquire convertible notes or units in a unit trust. ESVCLPs now have these investment options.

Commonly venture capital funds will make their first investment in an investee entity by way of convertible note. Acquiring a convertible note minimises the risk associated with early stage investments by giving the investor the opportunity to conduct further due diligence on the entity to determine whether or not it wishes to convert the note into equity securities. At the same time, the investor retains an entitlement to receive the fixed or floating interest rate as well as an option to have its investment repaid on maturity of the note.

Also, an ESVCLP may make a loan to a proposed investee entity whether or not it holds an existing security in that entity provided the loan is repaid within six (6) months. This gives an ESVCLP the option to make its initial investment by way of pure debt rather than by convertible note.

How much can an ESVCLP invest in one group?

The total amount an ESVCLP invests in interests (including debt and equity interests) of an entity and any associate or other member of the same wholly owned group of that entity must not exceed 30% of the total committed capital of the ESVCLP.

The divestiture rule

ESVCLPs cannot hold investments in an investee entity whose gross assets together with the assets of an associate of, or a member of the same wholly owned group as, the investee entity exceeds $250 million.

Once this limit is exceeded, the partnership must dispose of the investment within 6 months of the end of the partnership's income year in which the limit was exceeded. Innovation Australia may extend the divestiture period by an additional 3 months on request of the general partner.

Investments in entities which exceed the $250 million threshold but demonstrate the potential for significant additional growth may be transferred to a related purchase structure.

Conclusion

The ESVCLP investment vehicle gives new fund managers the opportunity to substantially differentiate a new managed venture capital fund.

The vehicle brings the Australian venture capital industry one step closer to having a world-class venture capital investment vehicle. The ESVCLP model compares favourably with the Pooled Development Fund model and represents a compelling proposition for investors of funds prepared to focus on early stage investment opportunities with high growth potential in eligible activities.

As the market familiarises itself with the benefits of the new structure, the ESVCLP is likely to become the preferred vehicle for venture capital investment in Australia.

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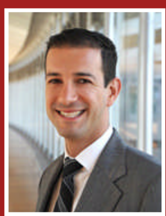

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