Australian Private Equity &
Venture Capital Association Limited

20 July 2015

Commissioner Melinda Cilento and
Commissioner Warren Mundy
Productivity Commission
GPO Box 1428
CANBERRA ACT 2601

By email: business.inquiry@pc.gov.au

Dear Commissioners,

Submission to Productivity Commission Inquiry into Business Set-up, Transfer and Closure

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to provide a submission to the Productivity Commission's Inquiry into Business Set-up, Transfer and Closure ("the Inquiry").

AVCAL represents the venture capital (VC) and private equity (PE) industry in Australia, which has a combined total of $25 billion in funds under management sourced from domestic and offshore investors, including Australian superannuation funds. VC and PE firms invest billions of dollars in a wide range of companies ranging from startups to large businesses spanning many sectors across the national economy.

VC and PE play an important role in business setups, particularly for the high-growth, innovative businesses that Australia needs to propel it to its next phase of economic growth.

There are a number of areas where we believe policy reforms could help to unblock current barriers to business setup, transfer and closure and foster greater productivity from PE and VC investment in Australian businesses. These have been the subject of ongoing discussions between AVCAL and the Government in the past few years. We believe that these issues should be considered during the course of the Commission's deliberations. The key reform areas fall into the two broad categories set out below:

1. Addressing barriers faced by startups and other private companies in accessing capital; and
2. Addressing barriers to business restructuring, by reducing the complexity and cost of external administration for businesses.

The attached submission sets out these recommendations in greater detail.

If you would like to discuss any aspect of this submission, please do not hesitate to contact me or Dr Kar Mei Tang

Yours sincerely,

Yasser El-Ansary
Chief Executive
AVCAL

AVCAL SUBMISSION

I. ADDRESSING BARRIERS FACED BY STARTUPS AND OTHER PRIVATE COMPANIES IN ACCESSING CAPITAL

Australia needs businesses that are innovative and productivity-driven. Both these characteristics are core components of the value proposition that VC and PE funds look to bring to their portfolio companies (see Deloitte Access Economics (2013) for a summary).

Currently, PE-backed businesses in Australia:[1]

- **Support more than 500,000 jobs**, making this group a larger employer than either the automotive or banking industries;
- **Contribute over 4% every year to Australia's GDP**;
- **Generate more revenue than the coal mining or general insurance industries**; and
- **Contribute significantly to the net returns of superannuation funds and other investors**, returning 12% p.a. in the 15 years to December 2014 and outperforming the ASX 300 by 5% p.a. on average. In fact, recent Rice Warner research indicates that that a diversified MySuper portfolio with an allocation to PE delivers the best median retirement balance across a range of diversified portfolios, compared to a baseline 70/30 diversified portfolio with no allocation to PE.

Although VC funds invest in higher-risk early stage companies, many Australian VC-backed companies have also gone on to become important job creators and market leaders in their respective fields. The longer term outcomes of VC funding include the following:

- **VC focuses on backing future global market leaders and drivers of growth and employment.** In the digital economy, innovative businesses with a unique value proposition cannot afford sit back and to grow their business slowly. This is where seed stage money (through angel investors and government grants), and subsequent early stage funding (through VCs or corporates, in most startups' first institutional capital raising rounds) are important in helping startups continue on their accelerated growth path. In Australia, listed VC-backed companies take an average of only 9 years from incorporation to IPO, compared to non-VC-backed companies which take an average of 18 years (Cumming and Johan (2013)).[2] For example, SEEK was founded in 1997, and in 1999 the government-seeded AMWIN fund invested $2.5m as part of the startup's first institutional fundraising. Today SEEK is a multibillion company that is the largest online jobs listings business in the world. In addition, there are many other more recent VC-backed growth stories such as SIRTeX, Pharmaxis, Nitro PDF, Shoes of Prey and Spinifex Pharmaceuticals, which was recently acquired by Novartis for $200m in one of the biggest VC exits in Australian history.
- **VC backing leads to longer term investment in innovation and commercialisation.** VC-backed companies are innovation-centric, and continue to generate new ideas and products as they grow. In Australia, VC-backed companies spend on average 200 times more on R&D per employee than other businesses. Ten of the largest VC-backed companies alone have spent $1.4b in R&D from 2005-2011. Ten of the largest VC-backed companies alone have spent $1.4b in R&D from 2005-2011: companies that reached critical mass only because of early stage support by VC and the Government. VC-backed companies that reach this critical mass also invest in high-value infrastructure and jobs to support their R&D and manufacturing operations. For instance, Cochlear's $128m global headquarters and manufacturing and R&D facility is located on the Macquarie University campus, while ResMed's 12-hectare manufacturing and R&D campus is located at Sydney's Norwest Business Park.

This is despite the fact that VC and PE funds in Australia are currently invested in only around 500 companies, which is 1% of an estimated 30,000 private investable businesses with high growth potential in Australia.

[1] Deloitte Access Economics (2013), *The Economic Contribution of Private Equity in Australia*; Cambridge Associates (December 31 2014), *Australia Private Equity and Venture Capital Index and Benchmark Statistics;* Rice Warner (2015), *Implications of MySuper asset allocations for retirement outcomes*.

[2] Cumming, Douglas J. and Johan, Sofia, Venture's Economic Impact in Australia (November 15, 2013). Journal of Technology Transfer, Forthcoming. Available at SSRN: http://ssrn.com/abstract=2354944

Some of the challenges faced by emerging high-growth businesses in accessing capital are outlined below.

- **Startups do not fit the investment profiles of traditional sources of capital.** Startups typically lack tangible assets, steady revenues and credit records. For these reasons, traditional sources of financing such as banks and the capital markets are not readily accessible to them. They tend to be funded from a mixture of personal funds, friends and family, government grants and angel funding at the seed stage (usually below $1-2m), and often receive their first institutional funding from VCs at the Series A stage and beyond. Corporate buyers and larger international VCs may come in at Series B or C funding rounds once the startup has proven itself and the investment is 'de-risked' to some extent. While some startups can self-fund in the early stages through bootstrapping (using personal finances/revenues/trade credit), this strategy can only take the business so far before it will need to access larger amounts of expansion capital.
- **High-impact ventures can also be very time- and capital-intensive.** Commercialisation activity, particularly in certain areas of the manufacturing, life sciences and energy sectors, can take a long time and require a high degree of capital commitment from the outset. Biotech startups, for example, can often take 10 to 15 years to bring a new product to the market, costing an average of US$1.2b for a new drug and US$92m for a novel medical device.[3] The high risk and long investment periods discourage early-stage investment by corporates and public markets, making VC one of the few viable sources of funding available for such investments. VCs help mitigate the investment risk by pooling capital into diversified portfolios, and applying their sectoral expertise to make targeted investments in treatments and devices that can be used to cure diseases and treat public healthcare needs.

These inherent challenges mean that Australia needs effective ways to channel private investment into the kinds of innovative, high-potential businesses that will drive future productivity and economic growth. VC and PE represent an important potential source of capital for such businesses.

However, the drying up of funds available for investment has seen little to no growth in the number of companies receiving VC and PE investment over the years. The number of companies receiving VC investments has remained flat at around 80 to 90 p.a. over the last 10 years, with a significant proportion constituting follow-on investments rather than new investments (Figure 1).[4] In the case of PE investments, the number of investee companies has been steadily declining over the years (Figure 2).

Figure 1: VC investments in Australia

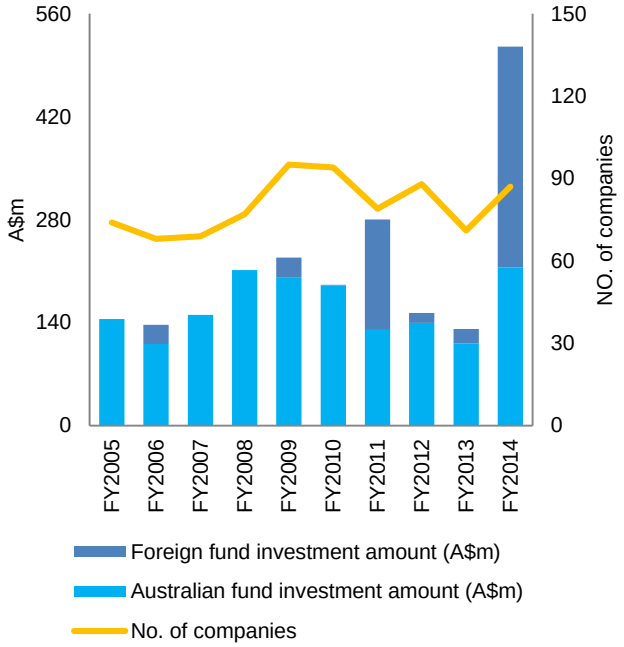
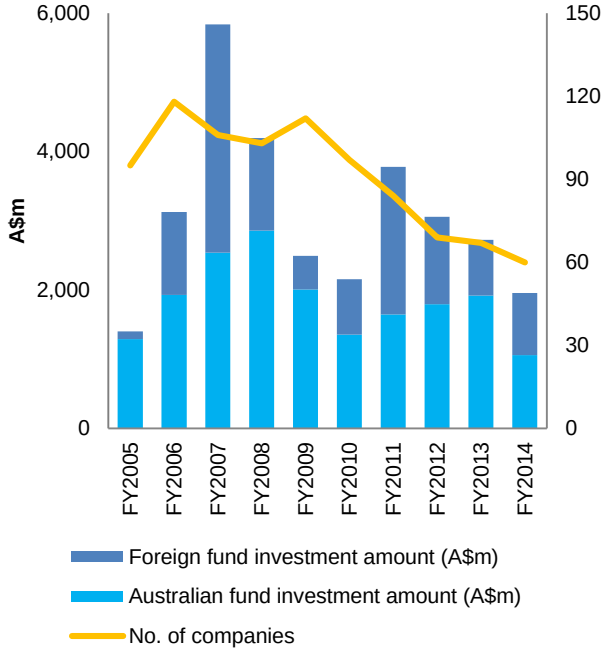


Figure 2: PE investments in Australia



Source: AVCAL

[3] National Venture Capital Associaation (2013), *Patient Capital 3.0*; Makower, Josh, et al. (2010), *FDA Impact on U.S. Technology Innovation*.
[4] Although the amount of VC funding going to Australian companies rose in FY2014, a large part of this increase was attributable to a single investment by US-based Insight Venture Partners' US$250m (A$266m) investment in Campaign Monitor, a Sydney-based email marketing campaign developer. This was the largest ever single VC investment in an Australian technology company.

With the recent increase in activity among angel investors, accelerators, incubators, and smaller VC funds (managing $50m and below), greater growth is being seen in the seed and other early stage rounds, compared to later stage rounds. It can be seen that VC investment activity in Australian startups has skewed slightly towards the smaller sub-$2m investment rounds in the last five years compared to the five years prior, while VC participation in $10m to $20m investment rounds has declined (Figure 3 and Figure **4**).

While international VCs have been more active in Australia in recent years, their investments in Australian startups tend to occur at the later stage funding rounds of $20m+. These investments tend to be relatively intermittent and "lumpy" compared to the investment activity of local funds focusing primarily on Australian investments, and are predominantly targeted at later-stage ICT businesses (Figure 5 and Figure **6**). The thinning of funding capacity available domestically at progressively larger round sizes is illustrated by the fact that only one new large later-stage Australian VC fund (of $200m) has been raised in the last four years.

Figure 3: % of total companies funded by VC, categorised by deal value FY05-09

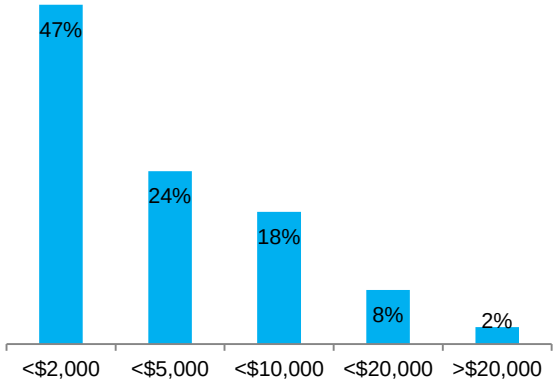


Figure 4: % of all companies funded by VC, categorised by deal value FY10-14

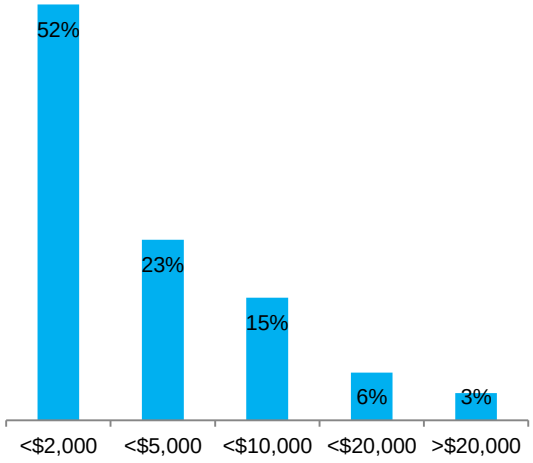


Figure 5: Australian VC investments

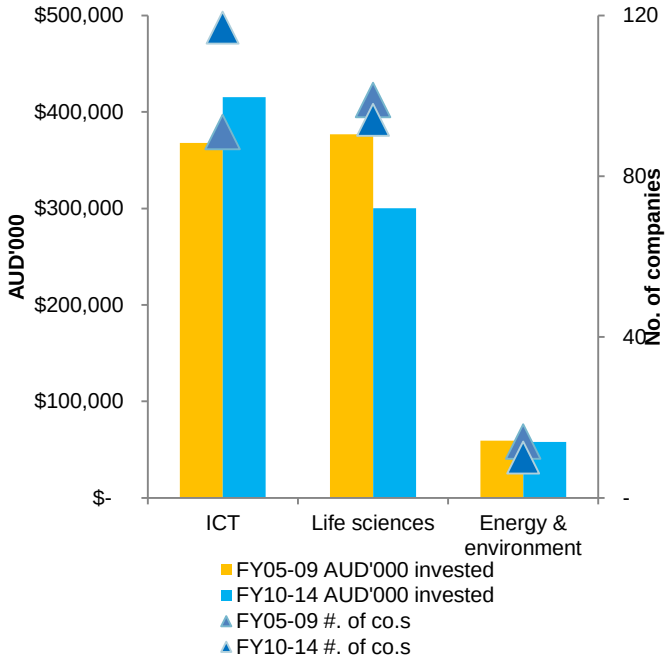
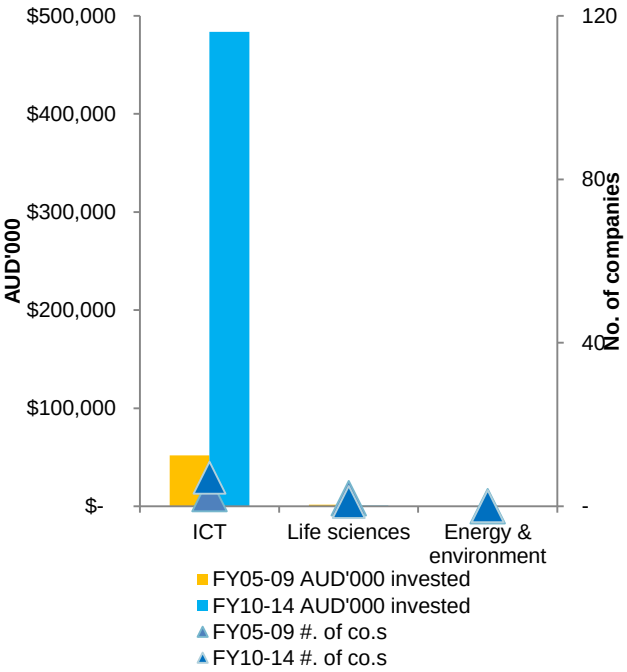


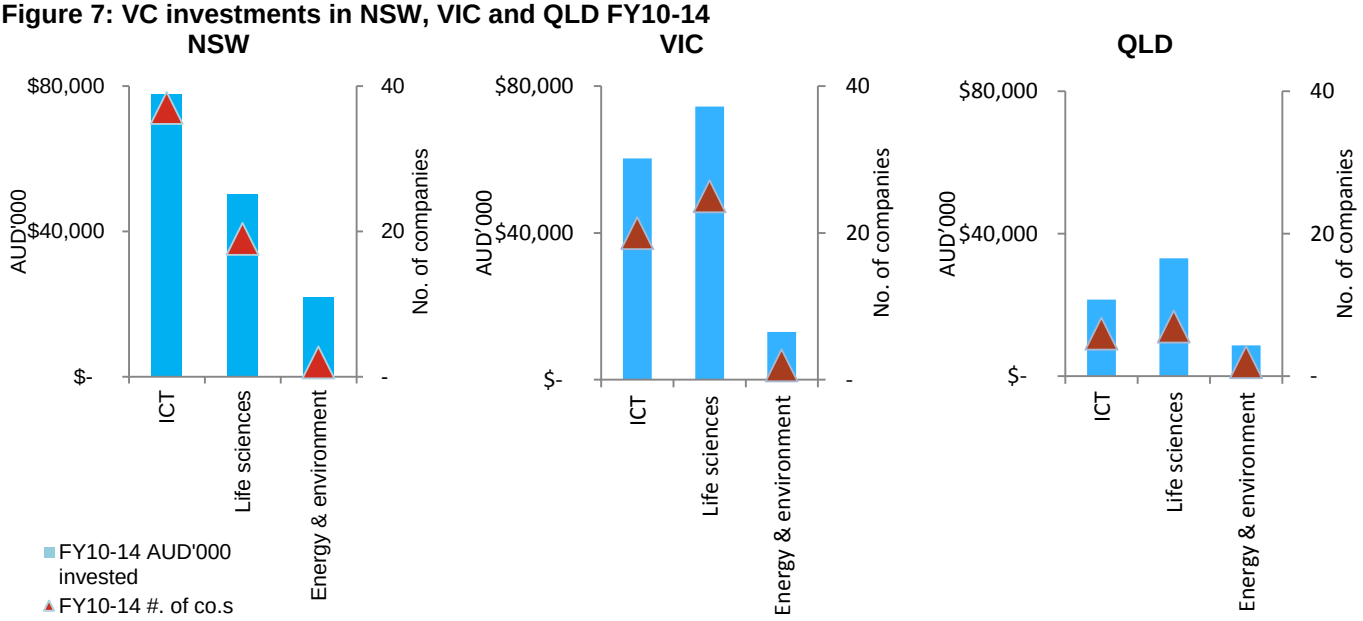
Figure 6: Foreign VC investments



Source: AVCAL

Geographically, VC investments tend to be concentrated in urban centres, while PE investments are more widely dispersed across both urban and regional areas. New South Wales has historically accounted for a slightly larger share of VC investment in the Information & Communications Technology (ICT) sector, followed by the Life Sciences sector, while this pattern is reversed for Victoria and Queensland.

Figure 7: VC investments in NSW, VIC and QLD FY10-14



Source: AVCAL

There are a number of areas where AVCAL believes that policy reforms can be effectively targeted to help to catalyse economic growth from business investment via PE and VC funds.

These issues have been the subject of ongoing discussions between AVCAL and the Government in the past few years. We believe that these policy recommendations should be considered during the course of the Commission's deliberations.

Recommendation 1: Introduce a dedicated translational innovation programme with a long-term focus

One core element of the innovation system that has historically been significantly underdeveloped in the Australian innovation system is the "D" in R&D.

In previous years the Commonwealth has spent around $9 billion annually supporting research and innovation, but with a heavy emphasis on research and industry assistance. Less than 1.5% of this budget has been dedicated to research translation into commercial outcomes. Given this disproportionate emphasis, the relatively poor commercialisation rates from otherwise-valuable publicly-funded research in Australia are not surprising.

Programmes such as the Innovation Investment Fund (IIF) were originally introduced to address this need to bridge the gap between the science lab and the market. Third party evidence shows that the public benefits from support through the IIF are clear.

However, the National Commission of Audit's report in May 2014 included the IIF as a "sector-specific grant" under a range of "industry-specific research programmes" (chapter 10.2) that it recommended should be abolished. It is important to note that this is an incorrect characterisation of the programme as it is neither sector-specific nor a research programme. Importantly, it is not a grant or a "handout", but a private-public co-investment programme (with proceeds returned to the Government).

Government co-investment is typically very important at this stage of financing, as a lever and incentive for private investors to share the risk of investing in early, untested high-risk ventures. In addition, as the Financial System Inquiry's interim report noted, "Australia's venture capital and private equity markets are small, and there are barriers to generating significant investor interest".

This market failure can be ascribed to a combination of factors including the onset of the global financial crisis, the withdrawal of superannuation funds from investing in VC, and the intermittent and insufficient distribution of the funds in subsequent rounds of the IIF programme over recent years. These factors have led to a "stop-start" approach (with a bias towards more *'stop'* than *'start'*) to financing Australian start-ups over the years, and the inability of local VCs to scale up to meaningfully participate in later-stage investment rounds in tandem with their investees' rapid growth.

With the abolishment of the IIF and Commercialisation Australia programmes announced in the 2014-15 Federal Budget (replaced with a smaller, more generalist Entrepreneur Infrastructure Programme), this already-small proportion of Government support for commercialisation has gone steadily backwards since 2007, at a time when other countries are boosting public funding for innovation support.

Australia currently lags behind global averages in terms of its VC activity. VC investments represent, on average, 0.03% of GDP internationally, but in Australia it only constitutes 0.02% of GDP. Countries such as Israel (0.4%) and US (0.17%) greatly exceed the OECD average by a significant margin.[5]

The fundraising statistics, compiled by AVCAL across the industry, demonstrate the urgency of addressing this funding gap: total VC funds raised in Australia in the five years from FY2010 to FY2014 amounted to only 57% of the amount raised in the preceding five years (Figure 1). Of the new VC funds raised in the last five years, most would not have been able to be raised without Government co-investment. Similarly, the Government's own Australian Innovation System Report shows that VC availability has deteriorated steadily since 2006.[6]

Figure 8: Sources of VC funds raised FY05-09 vs FY10-14, by type of investor

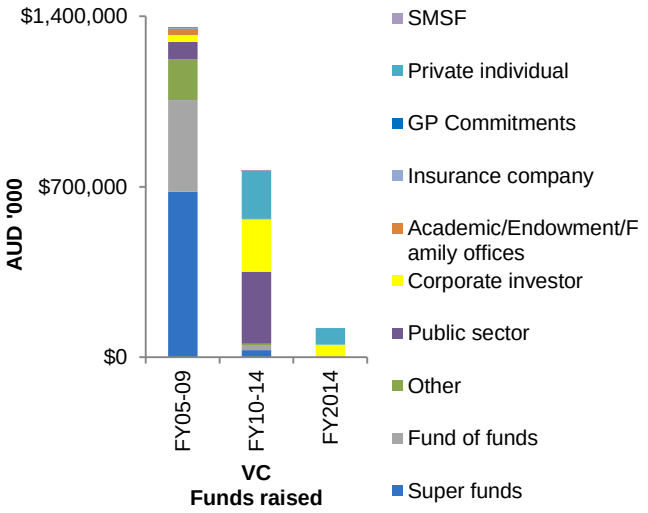
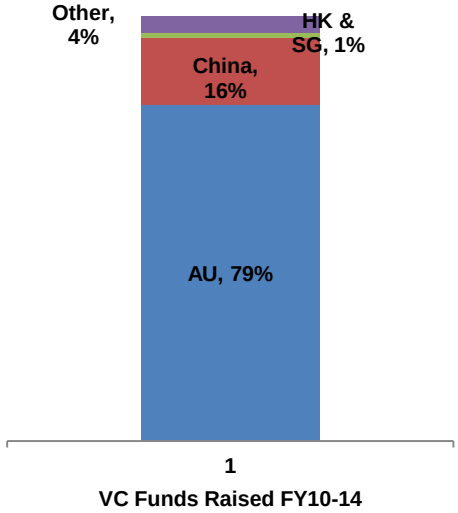


Figure 9: Sources of VC funds raised FY10-14, by country of investor



Source: AVCAL

There are both structural and cyclical factors behind the difficulty in attracting sufficient funding allocation into VC and PE. Notwithstanding those factors, AVCAL believes that there is the significant gap in productive capital

[5] OECD, 2012 data.
[6] Department of Industry, *Australian Innovation System Report,* 2013.

investment into Australian startups will only continue to grow if steps to arrest the decline in funding are not addressed.

The Government's Significant Investor Visa (SIV) reforms and Medical Research Future Fund (MRFF) are steps in the right direction. The Government's recently-concluded Review into Boosting the Commercial Returns from Research is also welcome.

It should be noted however that all around the world, countries are adopting as an integral part of their commercialisation policies something that is currently largely absent in Australia: a publicly-funded venture co-investment programme.

Globally, traditional institutional investors have been gradually but inexorably pulling back from supplying the high-risk capital needed to back new ventures. Although corporate venture funds, high net worth individuals and successful entrepreneurs have stepped in to take their place to some extent, this has largely not been sufficient to address the overall funding gap.

The Productivity Commission's draft report cites research which indicates that US VC industry, despite its relative maturity, faces similar difficulties to Australia where fund returns are highly skewed, and consequently the industry as a whole faces significant challenges in attracting sufficient private capital to invest in startups.

The US Government has responded quickly to this market failure. The US – as has other markets – has recognised the strategic need to supplement VC funding to nurture and retain the startups they see as unique economic value creators. In 2011, recognising that even in a country as rich in VC as the US, many startups still lacked access to capital, President Obama's Startup America initiative set up a $1b Early Stage Innovation Fund to co-invest in promising startups alongside VC funds.

In fact, in most developed markets other than Australia, public and private sector VC co-investment programmes investment are a core part of national economic policy. These programmes are recognised as a particularly powerful lever in attracting both local and international institutional investors into early stage ventures.

Table 1: Government-backed VC investment programmes in Developed Markets

Country	Public venture investment programme	Country	Public venture investment programme
US	Startup America $1b Early Stage Innovation Fund (2011)	Netherlands	Dutch Venture Initiative(2012)
UK	UK Innovation Investment Fund (2009)	Sweden	Various state-owned VC funds such as Inlandsinnovation AB, Industrifonden and Sjatte AP-fonden
New Zealand	NZ Venture Investment Fund (2002)	Canada	Venture Capital Action Plan (2013), Northleaf Venture Catalyst Fund (2014)
Germany	ERP EUR 1bn Fund (2004), INVEST-Subsidy for VC (2014)	Denmark	Dansk Vækstkapital, Vækstfonden

Source: AVCAL

Other than the US, countries that have introduced these initiatives include New Zealand, the UK, Canada, the Netherlands, Germany, Denmark, Sweden, Singapore and Israel.[7] This is because VC is -- given the high-risk nature of its investments – still one of the most efficient models for funding startups. Research by Harvard Professor Josh Lerner demonstrates that a dollar of VC investment is, on average, 3-4x more effective in stimulating productive innovation in the manufacturing industry than a dollar of traditional corporate R&D.

The public-private co-investment model works not just internationally but also in Australia. The South Australian BioSA model has shown that for every $1 of public funds BioSA has invested in early stage tech companies, these companies on average achieved $10 in further investment or revenue from sales.

Fundamentally, Australia needs a stable, consistent and comprehensive approach in building up its commercialisation ecosystem, not just in the medical science industry but also to capitalise on the wealth of research it generates in other areas such as information technology, clean technology and other advanced technologies.

AVCAL recommends the introduction of a new dedicated $500m translational innovation funding programme, building on the learnings from the IIF programme, as a key component of our innovation policy agenda that would be most likely to deliver the most meaningful long-term impact.

In terms of budget impact, the administered capital provided through the translational innovation fund should have little to no impact on the Government's fiscal balance. The Government receives an equity share in these investments and has the opportunity to participate in any returns from the funds invested.

This investment, from a Federal perspective, is small when juxtaposed against the vital role it would play in stimulating private investment in Australian-grown innovation, and the long-term benefits of jumpstarting the creation of a vibrant local innovation system.

Recommendation 2: Ensure the Medical Research Future Fund's (MRFF) mandate includes a translational medical innovation fund

AVCAL welcomes the Government's commitment to establishing the MRFF. For the fund to meet its objectives, it is strongly recommended that a meaningful allocation from the fund be invested into commercialisation activity through a translational medical innovation fund that builds on the experience and successes of Australia's medical commercialisation activities.

The evidence shows clearly that professional VC backing, and the management expertise and commercialisation experience that VC managers bring to their investments, is vital for Australian medical research to progress beyond the laboratory. For example:

- One in four ASX-listed healthcare companies have received VC backing before;
- Of the top 50 healthcare and biotech stocks on the ASX, one-third have been VC-backed before;
- Australian VC-backed biotech companies punch above their weight, despite significant underfunding for commercialisation activity in this sector.[8] Medical innovations successfully brought to global markets with the help of VC backing include the ReCell spray-on skin for burns victims, the groundbreaking L-Dex lymphedema diagnostic device for cancer patients, and Picato, the world's first effective topical treatment for actinic keratosis (sunspots); and
- Most major global pharmaceutical companies get only a single drug approved by the US FDA in a given year. But of the 39 new medicines approved in 2012, two came from Australian VC portfolios: Picato (as mentioned above) and Synribo, a new treatment for chronic myelogenous leukemia.

[7] Examples include the UK Government's Future Fifty17 program; Startup America;18 the Singapore Government's $14b commitment to the National Framework for Innovation and Enterprise including the Early Stage Venture Fund Scheme; Israel's Yozma programme and Sweden's national network of 43 startup incubators, 12 seed investment funds and 33 science parks that have been incubating over 950 highgrowth technology companies per annum for the last 20 years. These programs focus on the small number of companies with the highest growth potential rather than broad support for traditional new businesses and SMEs. https://www.qld.gov.au/dsitia/assets/documents/startup-ecosystem-mapping-report.pdf

[8] See Exhibit 6.4 in *The Final Report of the Strategic Review of Health and Medical Research* (2013), Department of Health and Ageing.

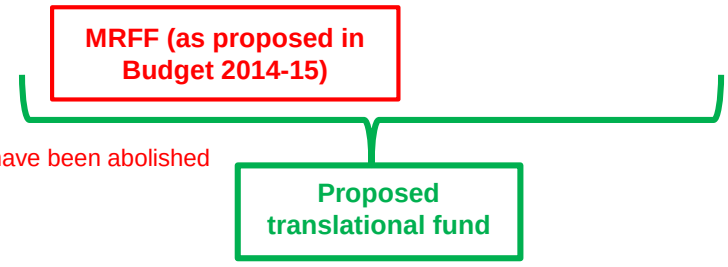
In highlighting the important role of medical research, the Government has reinforced the central role that the MRFF could play in helping to identify cures and treatments for ailments and conditions that have a significant social and economic impact across our community.

It should be noted that research breakthroughs alone are not enough to create new cures for cancer or diseases such as Alzheimer's. To bring a product from the science lab to the end-user requires both translation activity (creating practical applications from basic research) and commercialisation (bringing the product to market).

These valuable activities are currently undertaken only to a very limited extent under the auspices of agencies such as the National Health and Medical Research Council (NHMRC), which focuses primarily on research grant funding. And at present, new funding for the translation and commercialisation activities needed to link *upstream* research with *downstream* users is (almost) non-existent.

Funding stages for the commercialisation of medical research into end products and services is represented below:

Commercialisation funding stages	**Pre-clinical**	**Early clinical**	**Late clinical**
	'Valley of Death #1'	*'Valley of Death #2'*	
Example	Research has identified potential new product via lab research, initial animal models, etc.	Research has discovered a molecule as drug candidate, evidenced by animal studies.	'In man' clinical trials already through phases I and II (pilot), and addressable market scoped as commercially significant.
Funding required	• No funding for further lab or animal trials available from grants, but too early for biotech, venture capital or industry investment. • Grants of up to ~$250k to fund early research and commercialisation • Investment of $200k–$1m per project over 2 to 3 years.	• Funding for phases I and II (pilot) clinical trials to collect data that can support proposals to venture capital, biotechs and industry. • Requires up to ~$10m per project over 5 years.	• Funding through phases II (well controlled) and III global clinical trials. • Requires ~$15–$500m over 5+ years.
Current funding sources	**Grant Schemes:** • NHMRC Development Grants • Commercialisation Australia • ARC Linkage Projects scheme **Commercial Investment:** • Discretionary MRI and university reserves • Pre-VC sources (e.g. angels) • MRCF • Biopharma/other	• Innovation Investment Fund • MRCF and other private sector biotech fund managers • Small cap public biotechs	• Innovation Investment Fund • MRCF and other private sector biotech fund managers • Small cap public biotechs • CSL and other large pharma (Note: All above source actively, but MRCF and other private sector biotechs underfunded)



*Funding sources in red have been abolished

Sources: AVCAL, Australian Government Department of Health and Ageing, *Strategic Review of Health and Medical Research*, Consultation Paper Summary, October 2012.

Australia has the resources and capability to effectively convert research into high-quality products through the translation and commercialisation process. It is for this reason that we must ensure that the economic benefits which can arise from investing in the whole spectrum of medical research activity are realised in Australia, rather than in other jurisdictions. A massive opportunity exists to take advantage of the research infrastructure that was built in in the past, and realise the *development* aspect of R&D.

Australia's capacity to compete for the 'best and brightest' talent from around the world, and our future economic prosperity, will very much depend on our ability to take deliberate and decisive steps in relation to key areas of policy such as this.

There are some standout examples from around the world that are instructive in considering how Australia can best meet the commercialisation challenge. These include:

- The Wellcome Trust, a UK-based charitable foundation that funds biomedical research, has total assets of £17.3b (A$31.2b) and is extensively invested in the translation and commercialisation of medical research by:
  - Investing 7.8% of total assets into VC, including £200m in its dedicated healthcare-focused fund, Syncona Partners, as well as allocations to external healthcare fund managers.
  - Funding for basic research and translation/commercialisation, the latter being done through a number of schemes, including a targeted Translation Fund, and the Health Innovation Challenge Fund (parallel funding provided by the UK Department of Health).
- The Howard Hughes Medical Institute, the largest private supporter of academic biomedical research in the US, has a US$16.9b (A$18.3b) endowment which also invests in life sciences and biotech VC funds.
- The US-based Mayo Clinic, a medical research and practice group with investments valued at over US$5b, has a dedicated VC fund that seeks to bridge the gap between research discoveries and the marketplace.

In our view, the translational medical innovation fund should start immediately with an initial amount of at least 10% of the MRFF starting balance (estimated to be at $1b), with a view to reviewing this quantum as the fund grows and federal budgetary conditions improve. This amounts to only $100m p.a., which is likely to be offset to some extent by the annual earnings from the original $1b endowment balance.

The formation of the fund without further delay would help to minimise the gap in translational funding arising from the abolishment of the Commercialisation Australia and IIF programmes.

Government funds would be matched by the private sector, and should be invested and managed by independent professional venture managers with expertise in translation and commercialisation, rather than by a specific Government agency.

The fund should allow investment in all stages of the research and translation cycle, including subsequent (later) rounds. This would especially help mitigate the current gap seen in later stage venture funding, and reduce the likelihood of promising research failing to succeed or achieve its full potential due to lack of funding later on. Allocating funds to both basic research and translation/commercialisation would allow the MRFF to realise its full potential in alleviating the rising level of healthcare and related costs for future governments in Australia over coming decades.

It is important to note that capital provided by government would only be called three to four years after the call on private investor capital, as recommended by the McKeon Review in the design of its proposed Translational Biotech Fund. It is our understanding that there would be no impact on the underlying fiscal balance of the federal budget because the capital outlay would be treated as a financial asset rather than an expense. As recommended by the McKeon Review, the fund should be governed by an investment advisory board, with board members to be appointed by the investors and to include government representatives. The investment advisory board would be able to run a tender process to select the best manager(s) for the fund.

AVCAL recommends that the MRFF should allocate a meaningful amount to a dedicated medical translational fund which should:

- Start immediately with a minimum allocation of $100m funded from the initial $1b endowment of the MRFF, rather than the dividend stream
- Incorporate a 'matching' of government funds by the private sector
- Government funds can be called on only after private funds have been fully drawn down
- Focus on all stages of translation and commercialisation of medical research, and
- Be invested and managed by professional venture managers, with manager selection based on merit.

Recommendation 3: Consistent tax treatment for investors in VCLPs

The Venture Capital Limited Partnership (VCLP) regime was introduced to enable venture funds to be structured as limited partnerships that can facilitate the pooling of capital into equity investments in risky startup and expanding Australian companies.

Currently, VCLPs provide clear and consistent tax treatment for most foreign investors (as they benefit from a full tax exemption for any investment gains) and complying superannuation funds (which benefit from statutory capital account treatment). However, domestic investors in a VCLP (other than complying superannuation funds) and certain foreign resident investors which are not "eligible venture capital partners" may have gains from VC investments taxed on revenue account.

This creates two classes of domestic and foreign investors that are potentially subject to different tax outcomes, creating unnecessary uncertainty and complexity for investors. Such an outcome is inconsistent with the original policy objectives of the VCLP regime.

This has consequently discouraged Australian investors from using VCLPs in favour of managed investment trusts (MITs), forcing fund managers to use an array of different vehicles to provide tax certainty for different types of investors.

This absence of tax certainty critically undermines the policy objective underlying the VCLP regime. This consequently affects the ability of Australian PE and VC funds to effectively access an important segment of potential investors to direct more productive investment in high-growth potential businesses in Australia.

The compelling case for changes to be made to bring about greater certainty for all investors was identified and supported by the Board of Taxation in their June 2011 report to the Government.

This uncertainty in respect of the VCLP tax outcome will also represent a possible handbrake on the effectiveness of the Government's recently announced changes to the Significant Investor Visa (SIV) regime. Under the new SIV framework, which came into effect from 1 July 2015, applicants will be required to invest at least 10% of the minimum investment requirement into ESVCLP and/or VCLP funds. Visa applicants who transition to domestic investor status over the term of their investment in a VCLP will not have certainty at the outset on how their VCLP investment proceeds will be taxed.

AVCAL recommends that changes be made to ensure that all investors in VCLPs have legislative certainty that the returns generated on investments are taxed on capital account, thereby aligning the tax outcome for VCLPs with other CIV regimes here in Australia and globally. To the best of our understanding, AVCAL does not believe that the implementation of these reforms would carry a significant revenue cost to the federal budget position.[9]

A consistent and clearly defined VCLP tax regime will support the broader innovation agenda by encouraging private domestic investors to invest in unlisted Australian startups and SMEs with high growth potential. Removing the current inconsistency in the law to give investors the certainty they need will help harness more private capital to go to Australian businesses.

Innovative businesses need the kind of stable capital provided by investors with the expertise and medium- to long-term outlook necessary for this asset class. By providing them with this kind of stability Australian businesses will have sufficient runway to innovate and adapt to global markets. This should ultimately lead to greater employment growth across industry sectors that will give Australia the competitive edge in the future.

[9] Any perceived risk to the revenue associated with AVCAL's recommendations should be more than offset by increased taxation receipts from bigger and more profitable portfolio companies, and more productive workforces. The assessment of the Deputy Governor of the RBA, Mr Battellino, noted in the Senate Report on the review of private equity in 2007, was that: "[the] conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base."

Recommendation 4: Introduce R&D quarterly tax credits for early stage companies

Early stage companies involved in developing new technologies often face cash-flow constraints because they require significant cash outlays in the early stages of the product life cycle.

Currently, these companies can access a 45% rebate on expenditure related to eligible research and development (R&D). The R&D tax regime has had a very significant positive impact in supporting domestic businesses investing in innovation. It is also an important incentive for offshore investors to put money into Australian companies, and in attracting businesses from offshore to re-locate their R&D operations to Australia. This plays an important role in helping businesses to source adequate levels of capital investment in the knowledge that the regime will deliver long-term certainty to businesses that commit large allocations towards R&D activities.

In some cases, however, accessing the support that can be delivered by the existing R&D regime can effectively be delayed by up to 16 months, as businesses are typically required to wait until the point in time that they lodge their income tax return for the financial year, and then wait a further four months to secure the R&D rebate that they may be eligible for.

In a practical sense, companies seeking to commercialise patents can miss out on the opportunity to derive premium earnings and returns on investment during the exclusive earning period for new patents.

AVCAL recommends a move to quarterly R&D tax credits to alleviate some of the cash-flow constraints that these companies face. The businesses that would gain the most out of this change are small, research-intensive enterprises with annual turnover under $20 million. These businesses typically have limited access to capital, but the R&D tax credit has been one measure that has been widely supported by those small businesses that invest heavily in R&D activities.

The fiscal impact on the federal budget would appear to relate mostly to timing differences, and concerns regarding over or underpayment of credits can be addressed in much the same way as for quarterly GST or PAYG income tax payments. While there is a perceived risk in relation to the difficulty of clawing back overpayment of credit due to the risk profile of these early stage companies, integrity rules similar to those used for the GST and income tax can be put in place to mitigate the risk. More generally, the risk profile of these companies is not dissimilar to many other SMEs, which are a vital part of the Australian business landscape.

In a global marketplace for capital and R&D investment, it is critically important to position Australia as an innovative 21st century economy and a ‘knowledge nation’. Australia must continue to improve its policy settings in the R&D area, to ensure that we can continue to compete with other jurisdictions around the world.

AVCAL does not believe that there is a significant fiscal cost associated with the introduction of these reforms to the R&D tax credit regime, but there will almost certainly be a very real and positive impact on the working capital of small innovative companies in Australia.

I. ADDRESSING BARRIERS TO BUSINESS RESTRUCTURING, BY REDUCING THE COMPLEXITY AND COST OF EXTERNAL ADMINISTRATION FOR BUSINESSES

Recommendation 5: Reduce the complexity and cost of external administration for businesses

A well-functioning external administration regime facilitates the efficient recycling of capital, and therefore contributes to the efficiency with which funds are allocated across the economy. It also protects creditors’ rights, which promotes confidence in broader credit provision.

AVCAL welcomes the Productivity Commission’s work in seeking policy solutions to reduce the complexity and cost of external administration for businesses. AVCAL is of the view that this Inquiry should consider aspects of the Chapter 11 regime that are intended to help maximise the chances of the business continuing as a going concern. This recognises the fundamental principle that it can be more economically efficient for a business to be sold as a going concern, or at least allowed time to reorganise and cancel some of its debts, rather than if the business's assets were to be forcibly sold off individually under voluntary administration.

One example of an aspect of the US Chapter 11 regime that should be considered, for example, is the US prohibition against the termination of supply agreements when the only grounds for termination are that the company is entering Chapter 11, even if the company is able to pay those suppliers as long as it remains a going concern. The Corporations Act has no such protection for the business, which makes the business more vulnerable to contract terminations that hasten severe financial hardship or collapse.

AVCAL supports Draft Recommendation 15.2 for an appropriate 'safe harbour' provision to allow companies and their directors to explore restructuring options without liability for insolvent trading.

AVCAL also supports Draft Recommendation 15.4 whereby *ipso facto* clauses that allow termination of contracts solely due to an insolvency event are unenforceable if a business comes under the control of an administrator or receiver, or if the company is utilising the safe harbor arrangements. These provisions would help meet the broader objective of allowing distressed companies to have more options in turning around their operations in a cost-effective and less disruptive manner.