

Venturing beyond Australia

Time to catch up with global measures

By Brett Eagle
Thu 28 Jul 2011

Australia needs to catch up with global venture capital policies and structures, Eagle Corporate Advisers' Brett Eagle says.



Venturing beyond Australia is a concept most of us readily embrace. In fact we love it, and we are good at it.

Australians are perceived in many circles as adept at functioning within other cultures, comfortable travelling to remote corners and for extended periods of time; true in social settings as well as in business.

So why do we mess it up when it comes to private equity and venture capital (VC)?

We restrict the ability of companies in VC portfolios to expand overseas.

We set up a domestic environment that is unfriendly to international capital, unnecessarily complex and uncertain.

Foremost among the barriers we have created in the VC environment is tax uncertainty. Are gains realised from the sale of companies in the portfolio for capital account or revenue? The answer is: it depends, a lot.

We should also not underestimate the negative impact caused by other, more fundamental matters.

VC needs to be understood in the context of the overall investment cycle.

This includes setting up fund structures, capital drawdown mechanics, financing needs of portfolio companies, exit strategies and ultimately return of funds to investors.

Each element depends not just on tax regulations, but also on basic corporate governance, transaction processes and other matters.

Australia is missing a number of these fundamental building blocks that make the investment cycle work as efficiently as it does in other jurisdictions.

There is no full equivalent, for example, of the generic tax 'flow-through' entity structures - limited partnerships (LP) and limited liability companies (LLC), for example - so familiar in international settings.

The LP and LLC structures are not typically regimes of taxation authorities, but rather set up for much more general application. They are administered in parallel to rules and processes for corporations.

This creates an invaluable separation of tax treatment for various investment structures and corporate governance, including equivalent mechanics surrounding decision-making, management and operations. Why should the former create confusion for the latter?

The United States offers even more flexibility with its 'check the box' election process and other regimes (for example, S corporation election, now seldom used) where most entities, corporate or otherwise, can elect to be treated on a taxable or tax flow-through basis.

Elections can also be made for offshore business entities. This is common practice for offshore fund structures. It avoids any confusion about how an offshore entity should be perceived by US tax authorities.

In 2002, Australia did set up the Venture Capital Limited Partnerships (VCLP) program and, commencing with the 2007/08 income year, the Early Stage Venture Capital Limited Partnerships (ESVCLP) program.

Both programs contain restrictive provisions around eligible venture capital investments and ineligible activities of the companies in VC portfolios.

The rules are complex and their exact application often the subject of counterparty debate in any given transaction. Fund managers have struggled to work entirely within these regimes and nearly all have set up companion fund structures to provide the needed assurances and flexibility.

There are currently 36 registered VCLPs (and five conditionally registered) and four ESVCLPs (and five conditionally registered).

It is understood nearly all VCLP funds have been established with a companion trust structure (historically, the standard entity for Australian VC funds) or other similar additional structures.

Operating multiple structures is nothing new in the fund environment, frequently including parallel funds or master-feeder structures. However, these are primarily driven by the needs of separate classes of investors (typically domestic versus offshore, tax-exempt investors).

In Australia, the companion structures are needed because the VCLP and ESVCLP programs themselves are too restrictive.

Even Australian corporate law is missing key fundamental processes so common in other jurisdictions.

We have no equivalent, for example, to the merger alternative for completing business reorganisations.

Our corporate processes around schemes of arrangement are cumbersome and costly for many transactions that should be routine.

Even at the simplest level of basic governance, Australia has thrown up hurdles to efficiency.

Requiring all shareholders to sign a written circular for resolutions passed without a meeting, for example, may seem a minor issue, but in practice it frequently creates frustration and complexity in a transaction.

By comparison, US corporations are able to sign written resolutions with the same majority as would be required at a meeting.

A recent comment to the writer of this article by professional advisers in Switzerland illustrates the perception of many in the international community - Australia has some basic processes that just appear draconian (stated in connection with other basic processes, not shareholder written circulars).

The fact is the VC market in Australia is small.

With less exposure to transactions comes a less developed body of best practices among lawyers, tax, accounting and other advisers supporting the industry.

An advanced body of best practices creates efficiency by standardising transaction processes, documentation and expectations among entrepreneurs, investors, executive management and other key stakeholders.

We need to reach out to international opportunities. We need to be better at attracting foreign capital as well as maximising expansion opportunities of companies in VC portfolios.

To be sure, fund managers in Australia are perceived in many circles as highly talented and as sophisticated as any in the world. We have every ability to build up Australia as an international centre for funds management.

We now need to play catch-up with policies and structures that currently present barriers to this objective.

Brett Eagle is chief executive of Eagle Corporate Advisers.