VENTURE CAPITAL TAX CONCESSIONS REVIEW

KPMG Submission

KPMG Australia

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Contents

Executive Summary

Thank you for the opportunity to provide a response to the Venture Capital Tax Concessions Review (the Review). As a leading professional services firm, KPMG Australia (KPMG) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community.

KPMG strives to contribute to debate that seeks to develop a strong and prosperous economy and welcomes the opportunity to participate in the review of the Venture Capital Tax Concessions regime in Australia that includes the Early-Stage Innovation Company (ESIC), Early-Stage Venture Capital Limited Partnerships (ESVCLP frameworks) and the Australian Venture Capital Fund of Funds (AFOF).

Given these programs have not been subject to extensive review in over five years, the Review is timely and welcome to many across the sector. Improvements to the ESVCLP and VCLP regimes in 2016 have resulted in a significant increase in the number of registered ESVCLPs and the programs have provided additional venture capital.

KPMG's Venture Pulse Q2 2021 report shows the venture capital investment amounts from 2013 to 2021 and demonstrates that both the amount investment and number of deals in Australia has increased since 2016. For instance, in Q2 2016, there was $243.9 million invested in Australia, and this has grown significantly to a record $907 million in Q2 2021[1].

KPMG's response to the Consultation Paper seeks to directly respond to the consultation questions and sets out seven recommendations.

KPMG looks forward to continued engagement with Treasury and Industry Innovation and Science Australia (IISA) as a final approach to venture capital tax concessions is developed in the coming months.

Yours sincerely,

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1 https://assets.kpmg/content/dam/kpmg/xx/pdf/2021/07/venture-pulse-q2-2021.pdf

Background

About KPMG

KPMG is a global organisation of independent professional firms, providing a full range of services to organisations across a wide range of industries, governments, and not-for-profit sectors. We operate in 146 countries and territories and have more than 227,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in a digital-driven world.

Accelerating Business Growth

KPMG's Accelerating Business Growth (ABG) team is dedicated to developing integrated advice aimed at supporting the growth ambitions of our clients. We work with our clients to understand their business needs and assist in delivering holistic advice that enables them to help reach their growth potential.

Section 1: KPMG recommendations

Recommendation 1:

KPMG would welcome any further opportunity to work with the Government to review the ESIC and ESVCLP frameworks given the long history we have advising clients on program parameters and requirements.

Recommendation 2:

While potentially out of scope of the Review, KPMG recommends that the ESIC and ESVCLP thresholds are reviewed in order to ensure they are fit for purpose and that any revised thresholds are supported by modelling to ensure any increase to program cost is managed within existing budgets.

Recommendation 3:

Improvements to the mechanism for registration, such as a more streamlined approach, could make the process easier and further increase the number of these types of funds. There is also an opportunity to review terms of investments and restrictions in investor make-up and further clarity could be provided on the financial services and property development investment exclusions (e.g. to make clear technology companies such as in those sectors are not excluded investments).

Recommendation 4:

To alleviate some conservativism, it may be beneficial for the Government to issue clear guidance around the use of ESVCLPs in the context of broader economic funds (e.g. stapled or follow on funds).

Recommendation 5:

Consideration of a new Australian Innovation Company structure which seeks to monetise tax losses and attract high-net-worth-individuals into Australia's start-ups sector.

Recommendation 6:

KPMG encourages revisiting the limited partnership collective investment vehicle (CIV) announcement, as this would enhance flexibility and address a lack of familiarity with the different investment vehicles currently available.

Recommendation 7:

KPMG considers that there are several areas that could be reviewed to improve the ESVCLP program:

- The discretion to allow an investor to hold >30 percent interest in a given ESVCLP should be reviewed and ideally extended beyond superannuation funds to other large investors where the benefit will be distributed back to a broader group (thereby still meeting the policy intent to provide a broader benefit).
- ESVCLP excluded investment types could be reviewed to ensure early-stage technology companies are not excluded due to the sector they seek to service (e.g., financial services and property).
- There could be benefit in reviewing the financial thresholds to better understand if there is benefit increasing fund size or lifespan.
- Clarification on whether ESVCLPs can have 'follow on' or 'stapled' funds which may ultimately improve the efficacy of the program.

Section 2: Response to Consultation Questions

Part 1: Consultation questions

In this section we would like to draw on our expertise and experiences with clients to provide insights in response to the consultation questions.

1. Have the VCLP, ESVCLP and AFOF programs met their objective to generate additional venture capital investment, including foreign venture capital investment in Australia?

   a. If so, how and to what extent have these programs met the objective outlined above? Is there any readily available data, evidence or examples to support how these programs have incentivised additional investment?

KPMG notes that the focus of each program differs. The primary focus of the VCLP program is to attract foreign investment to the Australian venture capital sector, while the ESVCLP program is focused on encouraging early-stage investments in start-ups and expanding enterprises with a view to commercialisation of the activity. The objective of the AFOF structure is to provide diversification and flexibility for the fund and its investors.

Improvements to venture capital tax concessions in 2016 were aimed at building on the momentum in venture capital investment in Australia at the time by making the programs more internationally competitive and to attract greater levels of venture capital investment. The changes included the introduction of the 10 percent tax offset of limited partners (LPs) and an increased maximum fund size for ESVLPs. The introduction of the Early Stage Investor Tax Incentive, modelled on the UK Seed Enterprise Investment Scheme (SEIS), also helped incentivise earlier stage investments.

KPMG's *Venture Pulse Q2 2021* report shows the venture capital investment amounts from 2013 to 2021 and demonstrates that both the amount investment and number of deals in Australia has increased since 2016.

For instance, in Q2 2016, there was $243.9 million invested in Australia, and this has grown significantly to a record $907 million in Q2 2021 [2]. The changes in 2016 also resulted in a significant increase in the number of registered ESVCLPs, which have increased from approximately 12, to the current 84 registered and 34 conditionally registered ESVCLPs.

This is a significant increase and whilst some of the investment within those funds may have gone to the same early-stage companies without the changes, it would be fair to say the additional tax incentives introduced since 2016 have helped. While the ESVCLP program has gained a significant number of registrations, we note that there are currently only 10 registered AFOFs and just one conditionally registered AFOF [3], indicating that this particular program may not be achieving its intended objectives.

b. If the objective has not been met, what are the key challenges or barriers that impact on the programs' ability to meet the above stated objective?

While there has been a substantial increase in the level of venture capital investment in Australia, including a considerable number of ESVCLP registrations, there are some challenges that could be addressed. Improvements to the mechanism for registration, such as a more streamlined approach, could make the process easier and further increase the number of these types of funds, especially when it comes to encouraging greater participation in ESVCLPs by larger investors.

There is also an opportunity to review some of the restrictions in terms of investments and restrictions in investor make-up (for example when the discretion to allow an investor to have more than 30 percent should be applied).

Further, clarity on the intended application of the financial services and property development investment exclusions is advised (e.g. to clarify that these exclusions are not intended to prevent investment into early stage technology companies that service those sectors). At present there are also opportunities to increase incentives especially for superannuation funds.

2. Have the VCLP, ESVCLP and AFOF programs met their objective to develop venture capital management skills and experience in the Australian venture capital sector?

a. If so, how and to what extent have these programs met the objective outlined above? Is there any readily available data, evidence or examples to support your views?

KPMG considers that the objective of developing capital management skills and experience across the venture capital sector has been achieved to some extent when compared to the investment patterns that existed in 2015. The VCLP and ESVCLP programs have certainly increased the number of funds and to a lesser extent, number of fund managers. However, many of the funds are run by the same management teams and although this is slowly changing, there could be scope for government to introduce measures that seek to increase diversity in the skillsets of management teams going forward.

[2] https://assets.kpmg/content/dam/kpmg/xx/pdf/2021/07/venture-pulse-q2-2021.pdf

[3] https://business.gov.au/grants-and-programs/australian-venture-capital-fund-of-funds/list-of-australian-venture-capital-fund-of-funds

b. If the objective has not been met, what are the key challenges or barriers that impact on the programs' ability to meet the above stated objective?

In 2016, the Government enhanced the concessional treatment of the ESVCLP program to target this concession towards ventures at the early stages of the lifecycle of a developing start-up. The objective of the ESVCLP and the other programs in scope of this review were to: 1) increase levels of venture capital investment in Australia, and 2) enhance the development of skills and experience of venture capital fund managers. These changes were also intended to encourage and support innovation, risk-taking, and an entrepreneurial culture in Australia.

To ensure the original objectives of the program are met, it would be beneficial to see mechanisms that make entry easier and more diversified, however this would of course need to be balanced against good management and ensuring management teams have the right skillsets.

3. Has the ESVCLP program provided additional venture capital for early-stage start-up and expanding businesses?

a. If so, what has been the impact?

As per the response to question 1a, improvements in 2016 have resulted in a significant increase in the number of registered ESVCLPs and the program has provided additional venture capital. However, it is necessary to recognise that some of the funding would have been invested into the same early-stage start-ups regardless of the program changes.

b. If not, what have been the barriers and challenges of the ESVCLP program that limit targeting investment in early-stage businesses?

There are several barriers and challenges that could be considered when reviewing the ESVCLP program. It would be beneficial to review the restrictions around FinTech and property development and provide greater clarification around excluded investments, i.e. where the investment is a technology product, it shouldn't be subject to this exclusion. Additional challenges include excluded investment sectors, inflexible investment plans, having the same management teams and largely limiting >30 percent discretion to super funds (should consider listed entities or others where benefit is widely distributed).

In addition, fund managers tend to be very conservative due to legacy AusIndustry guidance around the programs not being part of a broader economic fund. To alleviate some of this conservativism it may be beneficial for the Commonwealth to issue clear guidance around the explanation of ESVCLPs in the context of broader economic funds.

Finally, it would be beneficial to revisit restrictions around investor interests and investment restrictions.

4. Has the VCLP program incentivised foreign investors into Australia's venture capital sector?

The VCLP program is predominately utilised by private equity managers (growth funds and buyout funds) rather than venture capital funds. The investors into VCLPs are typically foreign investors and super funds, driven in part by the nature of the VCLP tax concessions. Given the Australian private equity industry is more developed than the Australian venture capital industry, there is more capital committed to VCLPs than ESVCLPs.

5. To what extent do the programs achieve the broader program objectives as outlined in explanatory memoranda, to:

a. foster a shift towards a culture of innovation and entrepreneurial risk-taking?

The Venture Capital Tax Concessions programs partially fostered a shift towards innovation and entrepreneurial risk-taking, although it is important to recognise that other levers, such as changes to Employee Share Schemes (ESSs), bankruptcy and other laws have also had an impact. Thus, investor tax incentives, coupled with other mechanisms to incentivise innovation and qualified risk taking have had an impact and seen an increase in venture capital investment in Australia.

Further, changes in global markets and Australia's relative stability have made Australia a more attractive market for foreign venture capital. Ensuring our innovation and investor tax incentives (along with other incentive programs) are globally competitive and stable will, over the medium and longer term, continue to attract capital and foster a culture of innovation and entrepreneurial risk taking.

b. provide Australia with a world's best practice investment vehicle for venture capital?

The current tax concessions make the risk versus after-tax reward analysis more attractive for the investor. However, other than the investor tax offset, they do not provide a benefit until the investment becomes profitable or is disposed of.

A powerful method of creating further incentive to invest in early-stage companies may be to reduce the immediate cash risks to the investor.

One way of doing this is to allow the investor to immediately benefit from the tax losses of the company invested in.

In KPMG's December 2020 submission to the Senate Select Committee on Financial Technology and Regulatory Technology [4], we proposed the establishment of an Australian Innovation Company model.

This proposal seeks to put cash into the innovation sector, by allowing the transfer, for full consideration, of a portion of tax losses arising from salary expenditure incurred by an 'innovation company'. The ability to do this would be linked to the subscription of equity.

The proposal has the following advantages:

1. The concession follows a hard-nosed commercial decision to invest, rather than government seeking to pick winners.
2. The concession is likely to attract High Net Worth Individuals who are in a better position to both absorb the risk and to provide additional skills and guidance to the innovation company.
3. The concession is linked to salary expenditure paid to Australian resident taxpayers and thus provides a level of safeguard against leakage of revenue.

Key features are as follows:

1. The transferable tax loss is limited to a percentage (say 70 percent) of salary expenditure.
2. The transferor and the transferee must be companies.
3. Full consideration (non-assessable/non-deductible) is to be paid for the loss.
4. An equity investment of a multiple of the loss (say 4 times) must be made for 2 years.
5. An eligible start-up would need to be defined. It could be broad or narrow.
6. A maximum transferable loss could be set (say $5m).

[4] https://home.kpmg/au/en/home/insights/2021/01/fintech-regtech-kpmg-submission-to-senate-select-committee.html

Example

Tax loss attributable to salaries (top slice approach)	**100,000**
Transferable salary tax loss percentage	70%
Tax loss transferred	70,000
Company tax rate (say for simplicity)	30.0%
Value of tax loss transferred	21,000
Minimum Investment Multiple for tax loss transfer	4.0
Minimum investment	84,000
Minimum investment period	2 years
Years over which tax loss can be utilised by Investor	1 year
Average tax rate on $100,000 salary cost	27.0%

Further details are in our response to the Committee's question on notice, please refer to the appendix.

Additionally, the government could look to include a control test which would make the programs look and feel like a management investment trust. There could be a need for a new type of fund that could be flexible enough to raise domestic funds.

Finally, KPMG would encourage revisiting the limited partnership collective investment vehicle (CIV) announcement, as this would enhance flexibility and address a lack of familiarity with the different investment vehicles currently available.

c. make finance more readily available and cheaper for high-risk expanding businesses?

There are a range of measures that could make finance more readily available and cheaper for high-risk expanding businesses. Firstly, it would be beneficial to expand the whitelist of investors that are able to apply the >30 percent discretion. We also refer to the response above which explains that allowing investors to immediately benefit from the tax losses of the company invested in would reduce the immediate cash risks to the investor and encourage investment in early-stage companies. Increasing the tax offsets available to high-risk industries from 10 to 20 percent could also incentivise investment.

A more unified strategy could support business growth, where venture capital would play a role in a broader suite of measures. We also note that within the current venture capital programs, it would be beneficial to introduce a clear framework to help businesses understand what investment vehicles and programs are available to them.

KPMG considers that the proliferation of FinTechs has done more to make finance more readily available to high-risk expanding businesses than venture capital programs. Furthermore, special targeted programs from state and federal governments, such as the Victorian Government's R&D cash flow loans and the Federal Clean Energy Finance Corporation have contributed to making finance more readily available.

d. improve funding for promising projects across the economy and in industries beyond the technology sector?

KPMG does not believe that venture capital tax incentives should be utilised to direct funding towards specific industries or projects. By nature, tax incentives tend to be industry agnostic, and therefore may not be the best mechanism to improve funding for specific projects or industries. KPMG suggests that this may be best left to other programs such as the proposed patent box regime and organisations like ARENA.

Additionally, implementing an overall strategy on how to support innovation and ventures in a particular sector is key to improving funding, for example, the Australian Government's Modern Manufacturing Strategy and as part of that, funding provided under the Modern Manufacturing Initiative (MMI). The Strategy is a whole-of-government approach to help Australian manufacturing scale-up, become more competitive and resilient [5].

6. Have there been any spillover benefits, costs or unintended consequences associated with the programs?

We believe the benefits of the programs are the intended benefits, including diversification of fund managers, more funds being invested into early-stage companies, and greater number of registrations, this is especially so for the ESVCLP program. In relation to costs, while it is not cheap to set up an ESVCLP, this does not appear to be impacting the number of registrations, which has grown significantly since 2016.

We note that the restrictions related to financial services and property development is heading off some investment and has constrained the market in terms of what they can invest in. The industry is currently cautious and is looking at thresholds and understanding where there is an overlap between two programs.

7. Are there any other matters within the scope of the ToR that should be considered in this Review?

KPMG has recently contributed to two White Papers by the Australian Information Industry Association (AIIA). The first, Building Australia's Digital Future in a Post-COVID World [6], which made several recommendations that have subsequently been supported by government, and most recently Growing Globally Competitive Industries [7], which contains several further recommendations around supporting innovation from ideation through to successful commercialisation.

These recommendations include urging the Federal Government to undertake a comprehensive review of how Australia supports innovation including how the government can focus immediate efforts on supporting and enabling industries of strategic importance; encouraging government to work with industry and research organisations to foster innovation; introducing a software development tax incentive and extending the patent box regime to patents relating to all sectors of strategic importance.

[5] https://www.industry.gov.au/data-and-publications/make-it-happen-the-australian-governments-modern-manufacturing-strategy/our-modern-manufacturing-strategy

[6] https://aiia.com.au/wp-content/uploads/2021/03/Building-Australias-Digital-Future-in-a-Post-COVID-World-AIIA-Whitepaper-2020-2.pdf

[7] https://aiia.com.au/wp-content/uploads/2021/08/AIIA-Growing-Globally-Competitive-Industries.pdf

Further to the above, KPMG considers there are a number of potential improvement areas that could be considered for the ESVCLP program.

1 The discretion to allow an investor to hold >30 percent interest in a given ESVCLP should be reviewed and guidance provided. The Innovation and Science Australia Information Paper issued in May 2018 is helpful [8], however it is focused on superannuation funds. There would be greater benefit in guidance that applies more broadly to industry; e.g. whether and in what circumstances the discretion might apply to other widely held entities such as listed companies.The MIT white list entities could be used as guidance [9].

2 ESVCLP excluded investment types could be reviewed to ensure certain investment vehicles aren't unnecessarily excluded. The recent FinTech investment amendment was welcome but could be expanded – for instance where an ineligible activity such as property development or infrastructure facilities (see s.118-425(13, ITAA 1997) is ancillary to a permitted activity such as developing a cleantech innovation. Arguably this is already the case, but it would be useful if Industry Innovation and Science Australia considered publishing similar materials to the Fintech - private finding application guidance [10] for other industries and sectors.

3 There could be benefit in reviewing the financial thresholds to better understand if there is benefit increasing fund size or fund lifespan.

4 Clarification on whether ESVCLPs can have 'follow on' or 'stapled' funds which may ultimately improve the efficacy of the program.

[8] https://www.business.gov.au/-/media/grants-and-programs/esvclp/early-stage-venture-capital-limited-partnerships-info-paper-exercise-of-discretion-pdf.ashx?sc_lang=en&hash=0C5C887DD8014D96634F1ECD7539A25C
[9] http://classic.austlii.edu.au/au/legis/cth/consol_act/itaa1997240/s275.20.html

[10] https://www.business.gov.au/-/media/grants-and-programs/vc/fintech-application-guidance-pdf.ashx?sc_lang=en&hash=06630D5E23BD9361D0783C9845468B32

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