



# Australian Private Equity & Venture Capital Association Limited

1 February 2019

Budget Policy Division  
Department of the Treasury  
Langton Crescent  
PARKES ACT 2600

## **Pre-Budget Submission for 2019-20**

The Australian Private Equity and Venture Capital Association Limited (AVCAL) is pleased to contribute its budget policy recommendations to the Government as part of the formulation of the 2019-20 Federal Budget. At this time of economic transition, it is all the more important that Australia has in place the right policy settings to support the next wave of investment and innovation-driven growth.

AVCAL represents the private equity (PE) and venture capital (VC) industry in Australia, which has a combined total of around \$26 billion in funds under management on behalf of domestic and overseas investors including Australian and offshore superannuation and pension funds, sovereign wealth funds, and family offices. VC and PE firms invest billions of dollars in early stage and established businesses spanning across almost every sector of our national economy. In the financial year ending 30 June 2018 alone, PE and VC invested around \$4.1 billion into Australian businesses.

An April 2018 study by Deloitte Access Economics provides some deeper insights into the economic contribution of PE, including:

- In FY2016, PE-backed businesses contributed \$43 billion in total value added to the Australian economy – equal to 2.6% of Australian GDP;
- PE-backed businesses supported 327,000 FTE jobs (172,000 directly, and 155,000 indirectly);
- In FY2016, PE-backed businesses added almost 20,000 FTE jobs, accounting for 11% of total Australian employment growth in FY2016;
- PE-backed businesses typically delivered annual revenue growth of 20%, while boosting the size of their workforce by 24%;
- More than 85% of PE-backed businesses introduced some type of process or product innovation in FY2016, far greater than the average profile of non-PE backed businesses.

AVCAL believes that one of the most fundamental challenges currently facing Australia is building and future-proofing a sustainable and growing economy. It is therefore important that this is recognised and tackled through cohesive and well-designed government policies, including measures taken through the Federal Budget.

Industry as a whole also has a role to play in informing and engaging with the Government on such important issues. This includes the private capital investment industry, which invests in a wide range of Australian companies, be they early stage tech startups or long-established agricultural or manufacturing businesses. In particular, our PE and VC fund manager members seek to invest in high-growth companies that use that invested capital to expand their workforce, increase sales growth and invest in highly innovative and market-leading research and development.

Policy recommendations aimed at enabling these scale-up businesses to succeed and become internationally competitive are the primary subject of this submission. These should be complemented by a new set of innovation-focused policy initiatives that can have a significant impact on Australia's broader economic transition, including creating the next crop of global businesses out of Australia and driving a new wave of highly skilled, well-paid jobs. This would follow on from a number of successful initiatives introduced by the Federal Government as part of the National Innovation and Science Agenda (NISA) such as new tax incentives for early stage investors; important reforms to the venture capital investment framework; and the creation of a Biomedical Translation Fund aimed at commercialising promising health and medical research.

The policy recommendations outlined below are focused on a number of areas including: the introduction of a new limited partnership collective investment framework and reforms to rules around existing investment vehicles; Government co-investment programs aimed at boosting investment into high growth Australian businesses; and the research and development tax incentive. Ensuring that Australia has an internationally competitive policy environment is crucial if we are to continue to enjoy an enviable record of economic growth and capitalise on the technological changes we are seeing globally.

If you would like to discuss any aspect of this submission further, please do not hesitate to contact either me or Kosta Sinelnikov, AVCAL's Head of Policy & Research, on 02 8243 7000.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Yasser El-Ansary', with a horizontal line underneath.

**Yasser El-Ansary**  
Chief Executive

# AVCAL Pre-Budget Submission 2019-20



## EXECUTIVE SUMMARY

Despite our high standard of living, Australia still has much work to do to transition our economy into a more knowledge-based high value-add market. The latest available rankings of economic complexity, developed by Harvard University's Center for International Development, ranked Australia 86th globally – the lowest ranked of all developed economies and lower than many developing countries. Since 1996, when Australia was ranked 57th globally for economic complexity, we have dropped 29 places, which shows that we need to do much more if we want to build and future-proof a sustainable and growing economy that can attract talent and capital from international markets.

Policy recommendations aimed at enabling 'scale-up' businesses to succeed and become internationally competitive are the primary subject of this submission. These recommendations should be complemented by a new set of innovation-focused policy initiatives that can have a significant impact on Australia's broader economic transition, including creating the next crop of global businesses out of Australia and driving a new wave of highly skilled, well-paid jobs. This would follow on from a number of successful initiatives introduced by the Federal Government as part of the National Innovation and Science Agenda (NISA) in December 2015, such as new tax incentives for early stage investors; important reforms to the venture capital investment framework; and the creation of a Biomedical Translation Fund aimed at commercialising promising health and medical research.

The NISA was an important and welcome step change to the Government's approach to the innovation ecosystem. A new set of innovation policy measures would build on that approach and help to support the strong pipeline of capital available for investment into innovative Australian businesses, where more than \$4 billion of VC fundraising has been recorded since the start of 2016.

Beyond early stage companies, it is critical that scaling-up Australian businesses receive the capital they need to expand, hire more employees and compete globally. It is these 'scale-ups' that can be the catalyst for the next wave of national economic growth. In order to achieve this goal, important tax reforms will be necessary. In particular, the introduction of a world best practice limited partnership collective investment vehicle would assist the flow of capital from PE and VC into these businesses. This would enable significantly higher levels of private investment into Australian businesses, leading to the flow-on effects of increased employment opportunities, revenue growth and economic output. As research has shown, private capital investment can be a significant driver of employment growth.

This submission sets out our recommendations on the priority measures we believe should be undertaken in the 2019-20 Budget so as to address key roadblocks constraining private capital investment into Australian businesses. These recommendations are summarised below:

1. **New limited partnership vehicle** – that any new structure should draw on international best practice, including by not importing an MIT-style 'control test' (see part 1 below);
2. **Reforms to Early Stage Venture Capital Limited Partnerships and Venture Capital Limited Partnerships** – that a further package of reforms be introduced (see part 2 below);
3. **Government equity co-investment** – introduction of new programs to attract greater public-private investment into high growth Australian companies (see part 3 below);
4. **Research & development tax incentive** – that the Government be flexible in its approach to changes to the R&D Tax Incentive depending on the outcome of the parliamentary approval process for the relevant legislation (see part 4 below);
5. **Portfolio holdings disclosure** – that the Government promptly legislate the proposed reforms, and that any new regime apply no sooner than 31 December 2019 (see part 5 below);
6. **Thin capitalisation rules** – that the Government provide certainty to the sector regarding the current rules, and that any future changes operate prospectively and with due regard to the potential impact on investment (see part 6 below);
7. **Education funding and visa pathways for skilled migration** – that the Government address the current talent gap that exists for many high-growth companies by investing both in education and opening up pathways for skilled migrants (see part 7 below).

Further detail on these recommendations are outlined below.

## 1 *New limited partnership collective investment vehicle*

AVCAL welcomed the Treasurer's commitment in the May 2016 budget to introduce a new limited partnership (LP) collective investment vehicle on or after 1 July 2018. Currently, Australia's existing suite of collective investment vehicles (CIVs) is out of step with international practice, necessitating complex structures and constraining foreign investment. Having a simple, internationally competitive CIV regime is critical to Australia's ambition to be a regional financial services hub which will, in turn, drive significant local employment opportunities.

In particular, Australia's use of trusts (e.g. managed investment trusts (MITs)) is uncommon internationally and deters foreign investors. Noting that over the last five years, around 64% of commitments to Australian PE came from offshore investors, it is critical that Australia's CIVs are well-understood overseas.

Accordingly, it is important that a flow-through, internationally best practice LP – the globally accepted PE and VC vehicle of choice – be introduced as soon as possible, keeping in mind that the original introduction date of 1 July 2018 has not been met. Supporting the broader policy objectives of the NISA, such a vehicle could transform the flow of capital into high growth Australian businesses, helping to facilitate Australia's transition to a knowledge-driven economy.

It is worth emphasising that if certain features of Australia's MIT regime are imported into a new LP structure, especially the 'control' test, then the new vehicle's utility will be compromised, severely limiting its ability to act as a catalyst for greater investment into promising businesses. Drawing on international best practice, including from Australia's fund management competitors, AVCAL's recommended LP design features are attached to this submission as **Appendix A**. As Treasury will note in the document, a 'control test' or similar investment restriction is not a feature of comparable overseas LP vehicles.

Further, adopting the LP design features proposed in Appendix A would be consistent with the recommendation of the Johnson Report ("Australia as a Financial Centre") as it would ensure that foreign investors in Australian-managed PE funds are, for tax purposes, treated the same as if the investments were made directly by the non-resident without the use of any Australian intermediary.

**AVCAL Recommendation 1: That the Government re-commit to the introduction of a limited partnership vehicle from 1 July 2019 and commence work on it as a matter of priority.**

**AVCAL Recommendation 2: That the design of any new limited partnership vehicle should draw on international best practice, including by avoiding an unnecessary 'control test'.**

## 2 *Reforms to venture capital limited partnerships*

The changes to early stage venture capital limited partnerships (ESVCLPs) and venture capital limited partnerships (VCLPs) which were made effective 1 July 2016 were strongly supported by the PE and VC industry. However, given the speed with which they were introduced, there remain a number of areas where amendments and/or clarifications regarding these investment vehicles are necessary.

One important issue is the need to ensure that no regulatory handbrakes are placed on the early stage investment pipeline. This has become particularly crucial because of a set of investment plan guidelines that have been formulated by Innovation & Science Australia and released by AusIndustry in the second half of 2018. These guidelines set out criteria that a VC fund manager would need to abide by in order for their ESVCLP fund to be approved.

The guidelines state that ESVCLPs should be investing into companies that meet a very narrow definition of being 'early stage':

*As a general rule, a business will be viewed as 'early stage' if:*

- *it was incorporated seven or fewer years ago*
- *its average revenue over the past two years is less than \$3 million.*

While AVCAL understands that the criteria are not intended to be definitive rules which would prevent companies that do not meet the conditions from being deemed 'early stage', we nonetheless believe that they are overly restrictive and not in line with our understanding of the policy intent of the ESVCLP regime. A strict application of the criteria would lead to inappropriate outcomes whereby companies aren't able to receive funding even though by any commonly held industry definition they would be considered early stage companies. It may also impact negatively on prior investments made through any ESVCLP fund structure.

This is a particularly poignant example of where unnecessary regulations are hampering the ability of professional fund managers to make investments into a critical part of the economy. They are also creating uncertainty where none had existed before, as the venture capital industry had taken the NISA package as a strong signal that the Government was seeking more capital to flow into innovative businesses at all stages of growth.

In addition there are a set of complementary reforms, outlined below, which would further enhance the regime and deliver on the policy objective of increasing funding of promising, early stage Australian companies. Some key suggested areas for reform that cover the ESVCLP and/or VCLP programs include:

1. Amending the tax treatment of ESVCLP gains above the \$250m threshold – currently, there is legislation before the Senate that imposes a cap on the extent to which tax concessions are available to ESVCLPs disposing of investments made once an investee company's value exceeds the \$250 million threshold (*Treasury Laws Amendment (2018 Measures No. 2) Bill 2018*). AVCAL recommends that the Government amend the legislation such that after reaching the \$250m threshold, domestic investors in ESVCLPs derive gains on capital gains tax account (consistent with the approach taken for early stage innovation company investments), while foreign investors are deemed to be tax-exempt, which is consistent with the general CGT exemption for non-residents and the approach taken by the VCLP regime;
2. Calculation of the 20% concession for offshore investments – the current wording of the legislation (section 118.425 (12A), *Income Tax Assessment Act 1997*) suggests that before making an offshore investment, the manager must determine whether, *at that point in time*, other offshore investments (including earlier investments in the same company) in the portfolio are worth more than 20% of the ESVCLP/VCLP's committed capital – i.e. the fund manager must re-value all the investments in the portfolio before making further investments. If the first foreign portfolio company has performed well, leading to a high valuation, future investments will not be able to be made in other foreign companies or even 'follow-on' investments in the first foreign portfolio company. In our view, a simpler, more manageable approach would be to clarify that the 20% offshore investment rule should apply at all times to the *originally* invested capital amount rather than the evolving, changeable value of the fund over the course of its life-time.
3. Equal tax treatment of all domestic investors in VCLPs – currently, domestic super funds and most foreign investors clearly attract deemed capital account treatment for gains or profits made by a VCLP on the disposal of eligible investments. This should be clarified via legislation to always extend to all other investors in VCLPs also (primarily domestic investors including high net wealth individuals, corporates, family offices and endowment funds) so as to reduce the complexity of investment structures, attract new investors into the sector, and provide certainty to the market. Following strong stakeholder consensus, we note that the 2011 Board of Taxation review recommended the Government amend the law to allow deemed capital account treatment for eligible domestic investors on gains or profits made by a VCLP on disposal of eligible investments.
4. Allowing corporates to access the ESVCLP program – currently, no investor may contribute more than 30% of the partnership's committed capital unless Innovation & Science Australia's Innovation Investment Committee approves otherwise. However, there is an exemption from this requirement for banks, life insurance companies and widely-held complying superannuation funds. We understand that there are a number of large, listed Australian corporates, from a diverse range of sectors, which are currently considering creating their own corporate venture capital (CVC) arms as a means of driving innovation and gaining strategic insights from the early stage sector. However, the vehicle of choice for Australian venture investing – the ESVCLP – is not available to them, and we understand that the Committee has been unwilling to grant a waiver from the 30% requirement. Accordingly, we recommend the Government review this restriction so as to encourage corporate Australia to play a greater role in early stage investing. Globally, CVC is an important part of the overall venture ecosystem, participating in 20% of all venture deals completed in H1 2017, according to the CB Insights Global CVC report.

5. Expediting the Foreign Investment Review Board (FIRB) business exemption certificate approval process for ESVCLPs and VCLPs – currently, domestic funds that have raised capital from certain offshore investors (e.g. public pension funds or sovereign wealth funds) are able to undergo a pre-approval process to be exempt from the standard FIRB approval process when investments are made out of that fund. This pre-approval process can still be lengthy and impede the deployment of capital into Australian companies. AVCAL recommends that funds raised through an ESVCLP or VCLP structure that would currently fall within the scope of these FIRB processes should be exempt. These fund structures are already overseen and administered by other government bodies such as AusIndustry and the Australian Taxation Office from the initial fundraising stage right through to when the funds are divested. They also go through a rigorous application process with Innovation & Science Australia in order to be registered. We believe that this oversight framework is sufficient to maintaining a high level of integrity and compliance with all relevant legal and tax rules. Excluding these funds from FIRB processes would help to reduce red tape for the fund managers that are investing into and supporting Australia's high growth companies, and allow for more capital to flow into the early stage and high growth sectors of the economy.

**AVCAL Recommendation 3: that the Government address unnecessary regulations that are hampering and creating uncertainty for greater levels of investment into early stage and venture capital-backed businesses.**

**AVCAL Recommendation 4: As part of the Federal Budget, if not earlier, that the Government introduce a package of ESVCLP and VCLP reforms with a view to enhancing the overall efficacy of the venture capital regulatory regime.**

### **3 Government equity co-investment programs**

AVCAL's research report, *The Venture Capital Effect*, published in June 2017, outlined the potential for VC to transform the Australian economy, drawing on international experience. In particular, the United States stands as an example of a country where VC has had a profound economic impact. October 2015 research from Stanford University and the University of British Columbia showed that, in the US, since 1974, 42% of new public companies had received VC backing. Those companies employed over 3 million people and accounted for 63% of the public market capitalisation of new public companies over that period (approx. US\$4.4 trillion), as well as 38% of total employees. Significantly, VC-backed firms made up 85% of the total R&D expenditure of post-1974 public companies.

As at 30 June 2018, the five largest public companies by market capitalisation were all VC-backed: Apple, Google, Microsoft, Amazon and Facebook. This statistic alone should serve as a reminder of the importance of this sector to the entire economy.

As highlighted most recently in the Australian Innovation System report 2017, published by the Department of Industry, Innovation and Science, there remains much room to grow the local VC sector, and to boost investment into high growth companies. Based on OECD data, Australian VC investment as a proportion of GDP continues to rank significantly below other OECD countries at 0.013% of GDP, compared to an OECD average of 0.054%.

Although the Australian VC sector has enjoyed a resurgence over recent years, with more than \$4 billion of VC fundraising being recorded since the start of 2016, there remains much ground to make up.

Accordingly, AVCAL recommends that renewed consideration be given to government equity co-investment programs, modelled on the \$500m Biomedical Translation Fund (BTF). The BTF is a prime example of federal government funding operating to attract private capital into a sector of the economy which otherwise would not attract adequate investment. Already, the money that was raised is beginning to be deployed into ground-breaking life sciences companies such as Saluda Medical, Certa Therapeutics, Aravax, and ProTA Therapeutics. Importantly, the government is not trying to pick winners at the individual company level but rather back proven funds that can raise matching capital from the private sector.

Globally, there is a renewed commitment by many governments to become innovation leaders, in recognition of the profound technological change sweeping the world, and the challenges and opportunities which that offers.

For example, in November 2017 HM Treasury published its final report into financing growth in innovative firms. The review had been commissioned by the UK government in order to understand why some of Britain's highest potential startups can struggle to scale-up because of a lack of finance. Many of the issues discussed in the UK review are similar to those faced by Australian companies, including the need to boost institutional investment into PE and VC, and some of the constraints that can hold back such investment.

Despite having a VC sector that is almost twice the relative size of Australia's, the UK has recognised the importance of further developing an innovation-driven economy and has committed substantial additional funding to achieve it – developing an action plan that will unlock £20 billion of patient capital investment into innovative firms over ten years, on the back of the above report's findings. Since its Autumn (November) 2017 Budget, the UK government has launched a number of initiatives in order to deliver its 10-year action plan to unlock over £20 billion to finance growth in high-growth innovative firms, including:

- launching British Patient Capital, which has been given resources of £2.5 billion to invest in innovative firms, in June 2018;
- extending the Enterprise Investment Schemes and Venture Capital Trusts to support innovative knowledge-intensive companies;
- launching the Managed Funds program, a fund of funds seeded with £500 million by the British Business Bank, in May 2018;
- investing in first-time and emerging fund managers through the British Business Bank's Enterprise Capital Funds;
- backing overseas investment in UK venture capital through the Department of International Trade, securing £240 million of investment this financial year; and
- launching the National Security Strategic Investment Fund in September 2018 with up to £85 million to invest in advanced technologies that contribute to national security.

Clearly, an important part of the UK innovation policy mix is significant investment into equity co-investment programs. Accordingly, the Government should look to formulate a package of measures which, though they may involve some budgetary cost in the short-term, must be viewed as an important long-term investment in Australia's future.

With the recent establishment of the BTF, as well as examples of government-backed funds from overseas, the Government now has a blueprint for launching similar schemes (and extending existing programs) which couple government funding and private capital and direct it towards specific areas of need.

**Appendix B** to this submission is an AVCAL briefing note which provides a skeleton outline of how a "National Innovation Fund" might operate (in response to the August 2016 announcement by the former Minister for Industry, Innovation and Science, The Hon Greg Hunt MP, that such a fund would be explored with industry).

There is also currently a lack of capability and investment capacity to support new ventures and innovative businesses located in regional and rural areas of Australia, despite the fact that regional Australia contributes one third of our national output and is home to 8.8 million people. Away from large population centres such as Sydney and Melbourne, there is a huge potential for a mix of public and private funding to build businesses and generate job opportunities in rural and regional areas. Stimulating economic growth in these areas of Australia could provide a catalyst for much-needed revitalisation of many regional communities.

To this end, AVCAL believes that the Government should explore the establishment of a Regional Innovation Fund. This fund would be a vehicle to stimulate and support the establishment and growth of startups, new businesses and industry sectors – such as agritech – in regional and rural areas of Australia. Similar to the BTF, professional fund managers would be eligible to manage the fund and invest it in the most promising companies and technologies. These areas should be given the same opportunities and resources to benefit and be a part of technology-driven changes within the economic landscape.

This fund could be modelled on, and sit alongside, similar initiatives launched by state governments or by Regional Development Australia. Such initiatives include:

- Regional Growth Fund, which allocates \$272.2 million in funding to a range of transformational regional infrastructure projects;



- Regional Jobs and Investment Packages, with \$222.3 million of funding to support the Government's commitment to stimulate economic growth in Australian regions;
- Regional Growth Fund in New South Wales, which is investing an additional \$1.6 billion in regional infrastructure to support growing regional centres, activate local economies and improve services; and
- The Regional Jobs and Infrastructure Fund, which is the Victorian Government's overarching regional development package.

The Government's recent announcement of an Australian Business Growth Fund, modelled on similar initiatives in the UK and Canada, is a welcome development. It demonstrates that relatively minor changes to certain regulations (in this case changes to the treatment of banks' equity holdings for regulatory capital purposes) can open up big opportunities for more private capital investment. The Australian Business Securitisation Fund is likewise a good way of encouraging higher levels of business lending into the SME market which otherwise would have been untapped.

AVCAL believes that such a pragmatic policy approach, coupled with strong industry consultation, could be effective in unlocking new sources of capital that invest into SMEs and high growth businesses more generally.

**AVCAL Recommendation 5: that the Government give renewed consideration to equity co-investment programs, as well as regulatory changes that unlock private sources of capital, in order to boost investment into high growth Australian companies.**

**AVCAL Recommendation 6: that the Government look specifically to establish a Regional Innovation Fund to support the establishment and growth of startups, new businesses and industry sectors – such as agritech – to catalyse economic growth in regional and rural areas of Australia.**

#### **4** *Research and development tax incentive*

The R&D Tax Incentive is a critical element of the innovation and tax system which ensures that valuable R&D expenditure is carried out by Australian companies, and that those offshore companies that undertake R&D in Australia (such as clinical trials) continue to do so. In an era of mobile capital, and global competition, it is essential that Australia's policy settings continue to attract rather than deter R&D expenditure. Competitive policy settings are particularly important for Australia given our natural disadvantages include a small domestic market, and relative geographic isolation (e.g. compared with Singapore or the UK which are significant R&D hubs).

The R&D scheme must remain its bedrock given it is critical to the growth and functioning of many innovative Australian businesses. The scheme is well-understood, and recognised as Australia's most important innovation policy lever. At a time of economic transition, it is vital that policies such as the R&D scheme remain stable and continue to support long-term investment decision-making.

Following on from the Fraser-Ferris-Finkel review of the R&D Tax Incentive scheme, the Government announced changes to the program in the 2018-19 Federal Budget, including an annual cap on the refundable component of the scheme of \$4 million. Those changes are yet to be legislated, having gone for review to the Senate Economics Legislation Committee, which is due to report back by 11 February 2019.

It is still uncertain whether the legislation will be passed through the Parliament before the end of the Autumn sitting period. Given this uncertainty, we believe that the Government should be flexible in its approach to these changes depending on the outcome of the parliamentary approval process.

If the legislation that covers the R&D Tax Incentive changes isn't passed through the Parliament, then these changes should be deferred. At that stage, further thought should be given to whether any measures to amend or reduce the cost of the scheme should be progressed.

If the legislation is passed and given Royal Assent, then no further changes to the R&D tax scheme should be undertaken.

We believe that any legislative changes should also take effect from 1 July 2019, rather than the previously announced 1 July 2018 start date. This would allow for a practical transition period for those affected by the

changes. It would be highly detrimental to the local innovation ecosystem and Australia's standing as an ideal place for R&D trials if R&D work that otherwise would have gone ahead in Australia has been driven offshore as a result of the recent uncertainty around the future of the scheme.

Finally, it is our view that in the interests of certainty and the principle that policy should generally be prospective in nature, that companies that have already received notification from AusIndustry as to their eligibility for the R&D incentive for multi-year R&D programs would not be affected by the introduction of a refundable component cap (i.e. that they would be subject to "grandfathered" treatment). Failing that, any transitional arrangements should pay due consideration to the impact they would have on investments that have already been made by companies, in good faith, on the basis of then current policy settings.

**AVCAL Recommendation 7: that the Government be flexible in its approach to changes to the R&D Tax Incentive depending on the outcome of the parliamentary approval process for the relevant legislation.**

**AVCAL Recommendation 8: that the changes to R&D should take effect from 1 July 2019 if the legislation is passed, and that the Government commit to 'grandfathered' treatment of multi-year R&D programs previously notified to AusIndustry.**

## **5** *Portfolio holdings disclosure*

AVCAL notes that in September 2017 the Government introduced draft portfolio holdings disclosure legislation which largely replicated the bill put forward prior to the 2016 federal election (which itself lapsed as a result of the proroguing of the 44<sup>th</sup> Parliament). We understand that the draft legislation is currently before the Senate but there is a risk that the small number of parliamentary sitting days scheduled for the early part of 2019 would preclude the bill from being legislated prior to the next federal election.

Given the significance of these reforms to the superannuation and broader funds management sector, and in the interests of business certainty, AVCAL seeks confirmation that it is the Government's intention that the proposed reforms be legislated as soon as possible in 2019. As noted previously, AVCAL has welcomed the Government's commitment to introduce a regulatory framework that seeks to strike the appropriate balance between transparency and usability. Accordingly, we are pleased that a 5% exemption for commercially sensitive investments remains in the draft bill. This is particularly important for PE and VC investments as it limits the potential damage to the investment returns of super funds investing in the asset class due to commercially sensitive information being revealed.

We look forward to further consultation with Treasury and regulators on aspects of the proposed regime that will be dealt with in the regulations, especially how any materiality threshold might operate.

With respect to the commencement of the new regime, we note that the draft legislation states that its date of effect would be 31 December 2018. Given the passage of time, AVCAL recommends that any new portfolio holdings regime should have a deferred implementation date of no earlier than 31 December 2019, in order to allow adequate time for further consultation with the sector on detailed regulations and to allow a reasonable transition period.

Pressing ahead with an implementation date of any earlier than 31 December 2019 could cause significant compliance costs given the compressed timeframe in which funds would have to adjust to the new requirements. This would also come at the same time as the superannuation sector is grappling with the implementation of another complex piece of reform, *ASIC Regulatory Guide 97: Disclosing fees and costs in PDSs and periodic statements*, which itself is subject to an ASIC consultation process, and may change further.

**AVCAL Recommendation 9: That the Government legislate its new portfolio holdings disclosure regime as soon as possible, and that the implementation of any such regime take effect on or after 31 December 2019.**

## 6 *Thin capitalisation rules*

The thin capitalisation regime aims to limit the capacity of multinational firms to move profits out of Australia by assigning an excessive amount of debt to their Australian operations. Australian subsidiaries can apply one of a number of thresholds under the rules, including the 'safe harbour' limit, the 'arm's length' debt limit and a worldwide gearing ratio limit. Different safe harbour limits apply to 'general entities', non-bank financial entities and banks.

Specifically, the Board of Taxation carefully considered a number of submissions as part of its review of the arm's length debt test, with its final report provided to the Government in December 2014 (publicly released in June 2015). To date, no Government response has been issued despite stakeholders and industry generally welcoming the recommended changes.

AVCAL had put forward the case to the Board of Taxation and Treasury to reduce the compliance cost and improve tax certainty associated with the existing arm's length debt test. Reforms in this area would go a long way to lifting Australia's relative competitive position against other jurisdictions in this key area of the tax system.

Accordingly, in the interests of business certainty, we encourage the Government to clarify its intention with respect to the recommendations made by the Board of Taxation as part of its review of the thin capitalisation arm's length debt test. AVCAL would support reforms aimed at reducing compliance costs and increasing certainty for business.

Further, AVCAL does not see a compelling case for further changes to be made to the thin capitalisation safe harbour limits. The changes implemented in recent years with regard to tightening the safe harbour rules effectively amounted to the introduction of retrospective tax laws, because they did not provide any transitional relief for existing debt arrangements that were the subject of multi-year agreements entered into between parties acting on a commercial basis.

The changes to the debt deduction rules resulted in taxpayers that had entered into binding agreements not being entitled to claim deductions for costs that, under the rules which were in place at the time of investment, they were able to. This change was contrary to a long-standing principle of tax policy making in Australia that appropriate transitional arrangements are implemented as part of the introduction of any tax changes that diminish the position of taxpayers. These changes directly impact the rate of return of existing Australian investments by PE funds and compromise Australia's international standing as a stable and predictable investment location.

**AVCAL Recommendation 10: following the Board of Taxation's 2014 review, that the Government clarify its intention with respect to current thin capitalisation rules, and that no further changes be made that would operate retrospectively or deter future investment.**

## 7 *Education funding and visa pathways for skilled migration*

Startups and scale-ups that are seeking to accelerate their growth can only do so by tapping into a deep pool of talent, both locally or globally. These businesses often find it challenging to recruit highly skilled employees that have the necessary experience and technical know-how to make the business a truly global success.

AVCAL would urge the Government to address the current talent gap that exists for many high-growth companies by investing both in education and opening up pathways for skilled migrants.

A world-class innovation ecosystem needs to be encompassed by a world-class education system. The nature of work itself is evolving, driven by technological transformation. A leading education system should encompass teaching skills that aren't traditionally taught in schools and universities, such as entrepreneurship, and provide the infrastructure to effectively deliver student outcomes starting from primary through to the tertiary phase of education. Current labour shortages in the early stage ecosystem could be addressed by funding institutions (e.g. universities, vocational colleges) that can develop and deliver courses for tertiary students aimed at fostering entrepreneurship and teaching digital STEM skills.

The teaching of STEM skills should also be embedded and encouraged from primary schooling through to tertiary education. This would help to equip school students with the skills necessary for them enter the workforce on the strongest footing.

The second part of addressing the current talent gap is through skilled migration pathways in order to attract talent from overseas. Australia is a net importer of not only capital but talent. Skilled migration has been a key component of Australia's migration system, playing an important role in generating economic growth for a number of decades.

Recent changes to the 457 visa program for skilled migrants has reduced the flow of talent to Australian companies, particularly in the tech sector. One way of attracting talent from overseas is by introducing a talent visa program targeting entrepreneurs and other highly skilled professionals such as engineers, technology experts and scientists. This would boost the pool of talent available to startups and scale-ups and complement the changes to education funding that are recommended above.

**AVCAL recommendation 11: that the Government address current labour shortages by funding institutions that can develop and deliver courses for tertiary students aimed at fostering entrepreneurship and teaching digital STEM skills. The teaching of STEM skills should be embedded from primary schooling through to tertiary education.**

**AVCAL recommendation 12: that the Government introduce a talent visa program targeting entrepreneurs and other highly skilled professionals such as engineers, technology experts and scientists from overseas to boost the pool of talent available to startups and scale-ups.**