EARLY STAGE VENTURE CAPITAL LIMITED PARTNERSHIPS

AN INTRODUCTION TO AUSTRALIA’S TAX-EXEMPT VENTURE CAPITAL STRUCTURE

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When it comes to structuring a new venture capital fund, it is essential to ensure fund managers choose a fund structure that:

- is best suited to their investment strategy;
- helps fast-track their capital raise program; and
- optimises fund returns for investors.

The Early Stage Venture Capital Limited Partnership (ESVCLP) structure facilitates distributions to investors that are exempt of Australian income and capital gains tax, and allows the fund manager to receive its carried interest on capital account.

In this article, we have attempted to synthesise our experience in establishing ESVCLPs for many of Australia's leading fund managers to provide an overview of the key issues for new fund managers.
LEGAL STRUCTURE
An ESVCLP is a limited partnership, which means it must have at least one General Partner and at least one Limited Partner on establishment.

The General Partner must be structured as a Venture Capital Management Partnership and is generally responsible for the management of the fund. The General Partner also has liability in respect of the fund.

The liability of Limited Partners is limited to the amount of capital committed but not contributed, provided they do not participate in the management of the business of the partnership.

The structure of each Limited Partner should be carefully considered in order to ensure returns are optimised.

FUND SIZE
In order to obtain unconditional registration, the partnership’s committed capital must be at least $10 million and not greater than $200 million.

Committed capital is the aggregate amount of capital that the Limited Partners are obliged to contribute to the partnership, which will need to be evidenced by a binding subscription agreement that incorporates the fund manager’s AML/CTF and FATCA compliance requirements.

COMMITTED CAPITAL THRESHOLD
A Limited Partner, together with its associates, must not commit more than 30% of the total committed capital of the fund unless the Limited Partner is: an authorised deposit-taking institution, a life insurance company, a public authority carrying on a life insurance business or a widely-held complying superannuation fund.

Innovation Australia also has discretion to waive the 30% cap on a case-by-case basis and has done so in the past.
**FUND TERM**

The partnership is required to remain in existence for a period not less than 5 years and not more than 15 years.

**FUND REVENUE**

Generally, the fund will have two sources of revenue; the management fee and the performance fee (or carried interest).

The management fee is typically 1.5%-2% of the committed capital, reducing over time as funds under management decrease due to write-offs and divestments. The management fee is used to fund the day-to-day operations of the fund, and is generally not a source of profit. In fact, the key challenge for smaller funds is to meet their operating costs from the management fee alone, often requiring the principals to subsidise operating costs or to consider raising a larger fund.

The performance fee that an investment team may command will vary depending upon the uniqueness of the investment proposition and the track-record of the team. Generally, the fee will be circa 20%, but may be higher where the investment opportunity is particularly compelling. The structure of the carried interest distribution provisions can materially affect the fund manager’s returns and should be carefully considered.

**CONDITIONAL & UNCONDITIONAL REGISTRATION**

Fund managers may apply for conditional registration as soon as:

- the fund structure has been established;
- the constituent documentation is in place; and
- the offer document has been finalised.

Generally, once conditional registration has been granted by Innovation Australia, the fund manager will commence its capital raising program using the conditional registration status to give investors comfort that the investment strategy being proposed is suitable for the ESVCLP program.

Typically, once a fund raises its first $10 million, it will: conduct its first close, apply for unconditional registration and commence its investment program.

**KEY STAGES OF AN ESVCLP**

The investment period of an ESVCLP generally runs for 4-5 years and is the period during which the fund manager will make all of its initial investments and form its portfolio.
After the investment period is a period of:

- making follow-on investments;
- implementing value acceleration strategies; and
- managing the portfolio assets through to exit.

Generally, the portfolio management period runs for another 4-5 years, and the fund would then begin to wind up (around the 10-year mark).

However, it is important to build flexibility into your fund documentation to facilitate extensions of the fund term in circumstances where the market is not conducive to exits or where you hold assets that require more time to realise full value.
PART TWO
MAKING ELIGIBLE VENTURE CAPITAL INVESTMENTS

Once the fund is unconditionally registered\(^1\) and you begin executing your investment program, it is important that your investment management team is able to quickly assess not just the commercial viability of an investment proposal, but whether or not the investment is permitted by the ESVCLP rules.

Contravention of the eligible investment rules potentially compromises a fund’s ESVCLP registration and therefore the attached tax concessions.

 Whilst there is no legislative definition of ‘early stage’, there are two sets of rules that determine whether an investment may be made by an ESVCLP:

1. the investment must fall within the parameters set out in your approved Investment Plan; and
2. the investment must be an eligible venture capital investment.

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INVESTMENT PLAN

In order to obtain ESVCLP registration, your Investment Plan must be approved by Innovation Australia together with the balance of the fund’s constituent documentation.

In order for the Investment Plan to be appropriate, the document will need to demonstrate a focus on early stage venture capital having regard to investment criteria such as:

1. the development stage of the entities in which the partnership proposes to invest;
2. the levels of cash flow of those entities;
3. the levels of technology of those entities;
4. the ratio of intellectual property to total assets of those entities;
5. the levels of risk and return in those entities;

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\(^1\) It is possible to begin investing before obtaining unconditional registration in some circumstances.
6. the amount of tangible assets and collateral of those entities against which borrowings may be secured;

7. the partnership’s approach to making and holding investments;

8. whether the partnership’s committed capital can only be used in relation to early stage venture capital and whether it can be transferred to other entities;

9. whether the Investment Plan is connected with other plans that if combined would lead to the partnership exceeding the maximum fund size; and

10. any additional matters specified in the guidelines published by Innovation Australia.

These factors do no limit the items that Innovation Australia can take into account in determining whether an investment plan is appropriate, but it is essential that your Investment Plan covers each of these elements.

ELIGIBLE VENTURE CAPITAL INVESTMENTS

An ESVCLP may only make investments that are eligible venture capital investments as defined in the taxation legislation. The following paragraphs provide a summary of those provisions.

ELIGIBLE ACTIVITIES

It is an ongoing requirement that an investee’s predominant activity must not be ineligible. Ineligible activities include:

- property development and land ownership;
- finance activities to the extent that they involve banking, providing capital to others, leasing, factoring and securitisation;
- insurance;
- construction (including improvements, extensions or upgrades) or acquisition of specific infrastructure facilities; and
- investments where income is derived by interest, rents, dividends, royalties or lease payments – companies that hold passive investments.

THE INVESTMENT MUST BE AT RISK

An ESVCLP’s investment documentation must not include arrangements which secure the maintenance of the value of the investment, its earnings or returns. This includes agreements, understandings or

2) Please note that currently no guidelines have been issued.
promises to this effect which are either enforceable or unenforceable at law or in equity.

There is limited guidance on what ‘at risk’ means. Therefore, ESVCLP fund managers need to carefully consider the terms of issue of any securities they enter into to ensure this rule is not contravened. The effect of this rule is to water down some of the protections that venture capital fund managers typically include in investment documentation.

PERMITTED SECURITIES & LOANS

The investment must be an acquisition of one of the following:

- shares in a company;
- options (including warrants) originally issued by a company to acquire shares in the company; and
- convertible notes that are issued by the company that are not debt interests.

A debt interest cannot be an eligible venture capital investment. However, it is possible to make a permitted loan to an investee if the partnership owns at least 10% of the total equity and total convertible debt interests of the company; the company is an eligible venture capital investment and the repayment period is not more than 6 months.

AUSTRALIAN & FOREIGN INVESTMENTS

As a general rule ESVCLPs are required to focus on Australian investments, with 80% of a fund’s committed capital required to be allocated to initial investments that meet the Australian nexus test.

Up to 20% of the fund’s committed capital may be invested directly in foreign entities.

Follow on investments may be made in Australian entities that subsequently relocate overseas.

LISTED INVESTMENTS

An investment cannot be made in a company that is listed, either in Australia or on a foreign stock exchange, unless the partnership already owned an investment in that company before it was listed.

COMMITTED CAPITAL LIMITS

The ESVCLP rules provide for portfolio diversification by limiting the percentage of the partnership’s total committed capital; an ESVCLP may invest in a company and its connected entities to 30%. This avoids ESVCLPs being established to invest in one business.
REGISTERED AUDITOR
There is an ongoing requirement that at the end of (and at all times after the end of) the income year in which an investment is made, an investee company has an auditor that is registered in Australia; or, if the company is not an Australian resident, registered in that jurisdiction.

PERMITTED ENTITY VALUE
The value of the company cannot exceed $50 million immediately before a proposed investment is made. The total value of the entity’s assets includes the assets of connected entities.

The valuation of an asset or an investment can be determined by the last audited accounts provided that they are not older than 18 months. Alternatively, if there are no audited accounts, a statement that is prepared in accordance with the accounting standards and has been audited by the company’s auditor can be used provided it is not older than 12 months.

INVESTMENT THROUGH HOLDING COMPANIES AND IN OTHER ENTITIES
The company that an ESVCLP has invested in generally cannot invest in another entity unless it is connected with the company and the other entity satisfies a number of key requirements for eligible venture capital investments listed above. If an investee is looking to expand through acquisitions, it generally will need to take a controlling interest in order for the investment to be eligible.

PRE-OWNED INVESTMENTS
The ESVCLP program is designed to drive the injection of new patient capital into eligible businesses. Therefore, an ESVCLP generally cannot acquire a pre-owned investment except in limited circumstances.

An investment is pre-owned if it was issued or allotted to an entity other than the entity that owns the investment, unless that previous owner was an underwriter, sub-underwriter or a person who held the investment (for the purposes of offering it for sale) immediately before being acquired by the entity that now owns the investment.
PART THREE
ESVCLP APPLICATIONS

In order to apply for registration as an ESVCLP, each of the partnerships in the structure must be registered with the relevant State government body and all of the fund’s constituent documentation and its investor documents must be complete.

When assessing applications for ESVCLP registration, Innovation Australia will consider (amongst other matters):

- whether the fund’s proposed management team have the experience and qualifications necessary to execute their investment thesis;
- the extent to which the Investment Plan adequately focuses on early stage venture capital;
- whether or not the fund’s constituent documentation adequately addresses the key aspects of ESVCLP legislation and policy; and
- whether the management team has an achievable capital raising plan in place.

Applications are generally required to be submitted 6 weeks before the scheduled Innovation Australia Board meeting date.
Steven is a former PwC partner and corporate lawyer specialising in: Venture Capital and Private Equity, M&A, Alternative Finance and the commercialisation of technology. He holds a Masters of Law from the University of Sydney and is the Managing Director of Maarban Consulting.

Steven has written a number of articles on, and is regularly called upon to give specialist advice in relation to, tax-free fund structures including ESVCLPs & VCLPs, crowdfunding strategies and other alternative finance models. While at PwC, Steven led PwC's annual national venture capital market briefing titled ‘The Future of Venture Capital’ with leading Australian and international fund managers.

Steven’s past clients include: NAB Ventures, Australia Post Ventures, IQ Group, Artesian Venture Partners & the Artesian Fund of Funds, Teaminvest Private Equity, BridgeLane Capital & Tank Stream Ventures Fund, Apex Capital Partners & Apex Financial Services Fund, VentureCrowd & VentureCrowd Property, Sydney Angels Sidecar Fund, BlueChilli Venture Fund, iAccelerate Venture Fund and the Slingshot Venture Fund.

FOR MORE INFORMATION ON ESTABLISHING A VENTURE CAPITAL OR PRIVATE EQUITY FUND, PLEASE CONTACT:

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