Australian Private Equity &
Venture Capital Association Limited

5 November 2018

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Email: economics.sen@aph.gov.au

Dear Sir/Madam,

Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 [Provisions]

Thank you for giving the Australian Private Equity and Venture Capital Association Limited (AVCAL) an opportunity to contribute its views to the Senate Economics Legislation Committee in relation to its inquiry into the provisions of the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* (the Bill), initiated in October 2018.

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 almost every sector of our national economy.

Our submission focuses on two different aspects of this piece of legislation: Section 1 deals with changes to the Research and Development Tax Incentive (Schedules 1 to 3 of the Bill); and section 2 with the widening of the definition of 'significant global entities' (Schedule 7 of the Bill).

1. R&D Tax Incentive measures

VC funds typically provide capital for startups and early stage companies that are looking to build and bring to market innovative products, or develop novel solutions to old problems. These new companies are often cash-poor in the early phase of their lifecycle and must rely on a number of funding sources to get them to their next stage of growth, from which they can make significant contributions to economic and employment growth.

A particularly vital source for these companies to remain viable is the refundable component of the Research and Development (R&D) Tax Incentive program.

This part of our submission is focused on providing views and comments in relation to changes to the refundable component of the R&D Tax Incentive scheme.

1.1 Recent changes to the refundable component of the R&D Tax Incentive

The 2018-19 Budget confirmed that the Government would proceed with implementing a series of changes to Australia's R&D tax program from July 2018 which were broadly consistent with key elements of the Innovation & Science Australia 2030 Strategic Plan. AVCAL believes that the introduction of a new annual cap of $4m for businesses eligible to access the refundable R&D tax program strikes a well-considered and appropriate balance between managing the growing costs of the R&D program, while preserving the need to ensure that critical, high-value R&D continues to be carried out in Australia.

The changes to the R&D tax program also include measures to introduce a new disclosure regime which requires the Commissioner of Taxation to publish commercially sensitive information on the level of R&D activity within individual taxpaying businesses. Whilst we agree that a certain level of transparency should be maintained within such a critical industry program, it is essential that the new disclosure regime does not expose individual businesses to significant commercial harm.

1.2 The importance and scope of the clinical trial carve-out

AVCAL believes that the proposed carve-out for clinical trials is an important step and is consistent with the points that we have raised in prior submissions regarding proposed changes to the R&D Tax Incentive. It ensures that R&D activities that require large amounts of investment over a number of years, but with potentially substantial payoffs in the form of new medical treatments and therapies, continue to be pursued, and is important both commercially and for the benefit of our communities.

Furthermore, we believe that all activities and expenses incurred as a result of conducting clinical trials should be deemed eligible for the carve-out, and urge that any uncertainty in determining eligible activities be clarified through further guidance.

The explanatory memorandum to the Bill states:

> *The clinical trial exemption only applies for the purposes of the R&D tax offset if an R&D entity has registered an activity as both an R&D activity and an activity that forms part of a clinical trial. Similarly, the exemption only applies to expenditure on clinical trials if the expenditure is on R&D activities registered with ISA.*

It is our understanding that the scope of the clinical trial carve-out would include both core R&D activities as well as supporting activities. Examples of activities that should be covered by the carve-out include: manufacturing a drug for clinical trial use, database setup and other preparatory work, internal staff time (such as senior management time within a highly research-intensive biotech company), statistical analysis, costs associated with external clinical and regulatory advisors, and report writing. AVCAL believes that these activities should be included as they are essential for the execution of clinical trials.

1.3 Retrospectivity

We are concerned about the retrospective nature of the changes, especially given that commercial R&D programs typically are multi-year investments. We believe that for R&D programs and activities that have already gained approval but are to be carried out over a number of years, grandfathering arrangements should be applied that exclude them from the $4m refund cap.

We also recommend that the revised rules are implemented from 1 July 2019, in order to give companies that use the scheme time to adjust to the new rules and amend their planned R&D programs accordingly.

1.4 The definition of 'clinical trial'

AVCAL's previous submission in response to the exposure draft legislation and Department of Treasury consultation paper on the R&D Tax Incentive amendments highlighted our concern that the proposed definition of a 'clinical trial' (based on that of the Therapeutic Goods Administration) was too biased towards pharmaceutical products. We also believe that the proposed definition was too outdated in that it did not allow for the inclusion of other areas of healthcare R&D that may have substantial impacts on healthcare and human health in the future. These may include such fields as cell and gene therapies, genomic analyses, diagnostic technologies, and psychological, behavioural, or educational interventions.

While the definition proposed in the Bill specifically says that an intervention includes "a medicine, vaccine, treatment, diagnostic procedure or medical device", it still potentially limits the application of the definition to the above fields by specifying that:

> *[A clinical trial should have] the aim of achieving at least one of the following:*
>
> - *The discovery, or verification, of clinical, pharmacological or other pharmacodynamic effects;*
> - *the identification of adverse reactions or adverse effects;*
> - *the study of absorption, distribution, metabolism or excretion.*

Further, the definition as currently contained in the Bill will conceivably exclude trials which seek to make innovation advancements to the overall healthcare system and that may generate increasingly important outcomes of economic benefit to the healthcare system.

Comparing other definitions of 'clinical trial' used by other jurisdictions and organisations would be worthwhile in determining a more feasible and forward-looking definition.

In the US, the Food and Drug Administration does not set out a specific definition for a clinical trial. However, a definition is provided on the ClinicalTrials.gov database,[1] which is a resource provided by the U.S. National Library of Medicine. It gives a broader definition for what a clinical trial (otherwise called an 'interventional study') is:

> *A type of clinical study in which participants are assigned to groups that receive one or more intervention/treatment (or no intervention) so that researchers can evaluate the effects of the interventions on biomedical or health-related outcomes. The assignments are determined by the study's protocol. Participants may receive diagnostic, therapeutic, or other types of interventions.*

This definition is less prescriptive than the Bill's definition in terms of the range of outcomes that a clinical trial aims to evaluate by referring to biomedical and health-related outcomes.

The World Health Organisation's definition[2] also uses a more encompassing description of interventions:

> *For the purposes of registration, a clinical trial is any research study that prospectively assigns human participants or groups of humans to one or more health-related interventions to evaluate the effects on health outcomes.*

[1] https://clinicaltrials.gov/ct2/about-studies/glossary

[2] http://www.who.int/topics/clinical_trials/en/

Interventions include but are not restricted to drugs, cells and other biological products, surgical procedures, radiological procedures, devices, behavioural treatments, process-of-care changes, preventive care, etc. (emphasis added)

It also speaks of 'health outcomes', which broadens the range of objectives of a clinical trial. This could again be broadened out further to include economic benefits driven by health outcomes and overall healthcare system outcomes. It would also need to be combined with the inclusion of pharmacological, pharmacodynamic and pharmacokinetic (absorption, distribution, metabolism, excretion) objectives to fully encompass the range of clinical trial activity.

One definition that we believe may better encapsulate the range of activities that should be included is proposed below. Rather than abandoning the definition set out in the Bill, we believe the Committee should recommend that it be broadened out to include a greater range of activities and interventions that are studied, as well as the range of outcomes that are assessed:

A clinical trial is any research study that assigns human participants or groups of humans to one or more health-related interventions to evaluate the effects on:

- *health or health-related outcomes;*
- *the discovery, or verification, of clinical, pharmacological or other pharmacodynamic effects;*
- *the identification of adverse reactions or adverse effects; or*
- *the study of absorption, distribution, metabolism or excretion.*

Interventions include but are not restricted to drugs, cells and other biological products, surgical procedures, radiological procedures, devices (both internal and external), behavioural treatments, process-of-care changes, and preventive care.

In our view, it would be inconsistent with the objectives of the clinical trial carve-out if the current Bill's definition were not expanded to cover other R&D activities within the life sciences that could radically change the nature of healthcare treatments and interventions in the future, especially when such innovations could have the effect of generating ongoing efficiencies to the increasing costs of publicly-funded healthcare for all Australians.

Maintaining the current definition for the purpose of the clinical trial carve-out may potentially lead to the flawed outcome of constricting R&D funding within a narrow field of research, and disincentivise the funding of R&D work in innovative and newly emerging fields of medical research.

2. Significant global entities

AVCAL has for many years been supportive of reforms to our taxation system that help to ensure our economy is competitive and which encourage the growth and expansion of businesses. In particular, we are supportive of reforms that encourage or tackle barriers to greater levels of PE and VC investment into Australian businesses.

We believe the expanded definition of a significant global entity (SGE) as per the Bill would have detrimental outcomes not only for our industry (including possibly for investors that allocate capital to PE funds) but also for the businesses that are backed by PE investments. It would also have the unintended effect of discouraging investment in Australian companies by PE funds and other investment entities due to the increased reporting and regulatory compliance burden that such entities and underlying portfolio companies would have to bear.

As such, we would urge the inquiry to consider recommending the SGE definition proposed in section 2.2 of this submission, taking into account the potentially negative effects that these changes could have on private capital investment into Australian businesses and the wider economy.

More detailed comments are outlined below.

2.1 Comments on Schedule 7 of the Bill

a) Intention of the legislation

Our understanding is that the intent of expanding the SGE definition is to close an unintended consequence of the current criteria used to determine if an entity is an SGE. The broadened SGE definition seeks to remedy situations where an entity, or a related group of entities undertaking the same business, is currently not considered an SGE solely on the basis that it is owned by an entity which is not required to consolidate its financial statements according to accounting standards.

We also understand the objective and rationale to have consistent treatment of large corporate groups with revenue exceeding the SGE turnover threshold, notwithstanding differences in their ownership between corporate groups and those owned by investment entities such as PE or VC funds or the managers of those funds.

b) Unintended consequences of the legislation

We recognise that the focus of the expanded SGE definition is to ensure that cross-border related party transactions fall within the scope of the package of integrity measures under Country-by-Country (CbC) reporting, Multinational Anti-Avoidance Law (MAAL), and Diverted Profits Tax (DPT) rules.

In a PE context, such cross-border related party transactions occur within a subgroup of related entities rather than between separate portfolio companies controlled by the same investment entity (i.e. controlled by the same PE fund). As such, we believe that the focus of the expanded SGE definition should solely be targeted at subgroups of related entities which satisfy the SGE definition in their own right (by, for example, reaching the $1 billion of global income threshold) notwithstanding being controlled by an investment entity.

In our view the broadened SGE definition has unintended consequences, in that it will effectively 'aggregate' all investments of a PE or VC fund, or a number of funds managed by the same firm, together. The consequence is that Schedule 7 of the Bill would capture individual companies or subgroups of entities conducting separate businesses – which have not entered into transactions with one another, cross-border or otherwise – that on a standalone basis would not exceed the SGE turnover threshold, but which, when aggregated with the other entities the PE fund invests in (which are conducting entirely unrelated businesses), would have a combined income higher than the SGE threshold and be deemed to be an SGE.

The nature of PE investment is such that standalone businesses are operated separately and independently of any other investments the PE fund makes. This is on the basis that the entities owned by the PE fund vary in size, level of management teams, the existence and number of co-investors, geographical location, industry sector, business activity, and investment holding period. This portfolio approach to making investments is comparable to other types of investment strategies such as investing in publicly-listed companies, whereby investments are made on the basis of the value and returns that can be generated by the investment, instead of investing with the sole intention of consolidating businesses together. Similarly, different minority shareholders or debt lenders will be providing capital separately to each portfolio company and would potentially have an influence on the financing or operational decisions of the business.

Whilst these businesses are not commercially related, and not a 'group' for the objectives and purposes of the SGE definition and the measures which apply as a result, a PE fund and the independent and separate portfolio companies it owns could be captured by the broadened SGE definition on an aggregated basis merely by virtue

that they are owned by the same transparent fund vehicle. For instance, we note that the intention of the DPT targets entities within multinational groups that enter into arrangements to divert their Australian profits to offshore related parties in order to avoid paying Australian tax. The broadened SGE definition will bring in-scope entities which have the characteristics of passive investment vehicles, which do not enter into the types of arrangements the DPT seeks to address.

Having regard to the implications which follow from an SGE classification for a company, it is difficult to see that such implications were intended or would be warranted for, say, a PE investment into a small-to-medium sized enterprise whose turnover on a standalone basis is considerably lower than $1 billion. This unintended consequence would have a significant impact of the PE sector locally, and potentially deter future PE investment into critical parts of the Australian economy from offshore.

c) Impact on the PE sector

Portfolio companies within a standard PE fund operate as standalone businesses as they are separately managed and normally have no transactions between themselves. The standalone portfolio companies within a PE fund often operate in different and unrelated industries as well as different geographies.

The purpose of acquiring stakes in each of the portfolio companies by the PE fund is to generate investment returns for fund investors. Other co-investors may also take stakes in those companies alongside the PE fund at the time of investment.

Each portfolio company is run by a different and separate management team, may have a separately arranged and managed debt package as part of its capital structure, and does not typically transact with other portfolio companies owned by the PE fund. Importantly, the fund entity is not required to consolidate the financial statements of individual portfolio companies for reporting purposes. We therefore believe that it is not appropriate to aggregate separate portfolio companies owned (fully or partly) by a PE fund or other collective investment vehicle into a single consolidated group.

The OECD's own Public Discussion Draft report on *BEPS Action 4: Interest Deductions and Other Financial Payments*[3] highlights two potential issues that arise when grouping PE portfolio companies for group-wide tax rules:

> *Firstly, in applying a group-wide rule an entity would need to obtain financial information on the position of its connected parties which would not be included in the group's consolidated financial statements. This could impose a significant burden on entities and tax administrations. Secondly, under this approach, the total third party interest expense of two connected groups (for example, those held by the same private equity fund) would be combined and allocated between entities in both groups. This could lead to undesirable results, particularly where the two groups operate in different sectors and have different funding needs.*

As the passage above highlights, changes to the SGE definition could potentially create a significant compliance burden. Investment entities such as PE funds generally have no centralised treasury or financial reporting function (which in itself reinforces the fact that typically there are no related party transactions across a group of portfolio companies). In order to abide by the rules that apply to SGEs, PE funds would need to address this issue either through internal resourcing or the use of external accountants and advisers, thereby increasing their tax compliance costs. Conversely, an individual company would be limited in its ability to self-assess whether or

[3] *BEPS Action 4: Interest Deductions and Other Financial Payments*, OECD, December 2014

not it itself is an SGE, and would need to place reliance on the above mentioned sources as arranged by the PE fund, including information relating to other companies owned by the PE fund. This again would be a difficult position to reconcile in circumstances where individual portfolio companies have no commercial relationship.

Ultimately, bringing in investment entities such as PE funds (including the fund manager entity and all underlying portfolio companies) under the same anti-avoidance rules that have been put in place for multinationals would see no material benefit to government revenue or the Australian tax base. Instead, there would be an increase in costs and a reporting burden for PE funds which provide much needed capital to many Australian businesses. The proposed amendments may deter them from making further investments in the future. An inflation in compliance costs for PE or VC fund managers may even be passed on to fund investors such as domestic superannuation funds, which would be an adverse outcome for superannuation fund members.

d) Impact on individual portfolio companies

In addition to the potential impact of the legislation at the PE fund level, the broadened SGE definition may have unintended and undesirable outcomes on each portfolio company. For example, the undertaking of commercial opportunities or the use of debt in the company capital structure by each portfolio company could be affected due to these entities being deemed SGEs and being subject to certain group-wide rules.

It may also create costly reporting obligations for the underlying portfolio companies (which vary in size and level of management function) or affect the way that these businesses operate, to the detriment of the financial performance of those companies.

2.2 Proposed definition

A simplified solution would be to have a harmonised definition of SGEs across CbC reporting and general purpose financial statement obligations, with the definition being the current CbC reporting entity definition. This definition should also apply in respect of MAAL and DPT for individual companies or subgroups of related companies. Under the current legislation, such entities would – in our view unfairly – meet the definition of an SGE solely by being part of a notional listed company group while not meeting the SGE annual global income threshold.

3. About AVCAL and Australia's private equity and venture capital industry

AVCAL represents PE and 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 an estimated $5.5 billion into Australian businesses.

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

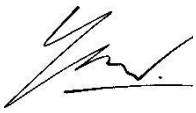
- In FY2016, private-equity backed businesses contributed $43 billion in total value added to the Australian economy – equal to 2.6% of Australian GDP;
- PE-backed businesses supported 327,000 FTE jobs (172,000 directly, and 155,000 indirectly);

- In FY2016, private equity-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 private-equity businesses introduced some type of process or product innovation in FY2016, far greater than the average profile of non-PE backed businesses.

Next steps

We would like to thank you for the opportunity to provide a submission in response to the inquiry. If you would like to discuss any aspect of this submission further, please do not hesitate to contact me or Kosta Sinelnikov, AVCAL's Policy & Research Manager, on 02 8243 7000.

Yours sincerely,



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