BVCA Funding the future

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*Tax Treaties,*
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by email: taxtreaties@oecd.org

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Dear Sir or Madam

**BEPS Action 6**

I am writing to you on behalf of the British Private Equity and Venture Capital Association (the "BVCA"), which represents the interests of members of the private equity and venture capital industry. The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 250 private equity, mid-market, venture capital firms and angel investors, together with over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

This note has been prepared by and is being sent on behalf of the BVCA's Tax Committee, whose remit is to represent the interests of members of the industry in taxation matters. The BVCA welcomes the opportunity to submit its comments on the Public Consultation document entitled BEPS ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES released by the OECD on 14 March 2014 (the "**Consultation Document**") and how it might affect members of our industry. Our comments in respect of the Consultation Document are set out below.

*Introduction*

The BVCA fully appreciates the concerns of the OECD that action is needed to prevent *"*double non-taxation*"*, as well as cases of no or low taxation*,* associated with practices that artificially segregate taxable income from the activities that generate it. The BVCA also supports a coordinated and comprehensive international approach to tackle these important issues.

*Context for private equity*

Private equity funds (and venture capital funds, which are not referred to separately in this note for reasons of clarity but operate in a very similar manner) exist to aggregate and deploy

capital in order to generate investment returns. Private equity funds are not vehicles for tax avoidance: they play an important role in matching those seeking to invest capital with companies requiring investment. Investors into private equity funds are typically pension funds, family offices, insurance companies, banks, other investment funds (which may be in corporate, trust, partnership or other form), sovereign wealth entities, not for profit organisations such as local authorities, educational endowment funds and charities and individuals (including officers and employees of the fund manager or vehicles aggregating the interests of such persons). Investment may be made directly into a particular private equity fund or via a "fund of funds". Ultimately many of these investors will be of a kind which would allow them to benefit from double taxation agreements in their jurisdictions of residence.

British and other European private equity funds typically raise funds from investors in a broad range of jurisdictions, which tends to increase fund size and increase economies of scale, and typically invest in companies in multiple jurisdictions, to diversify risk and maximise investment opportunities. It is therefore critical to many private equity funds that they can operate effectively cross-border.

Private equity operates very differently from the large multi-national organisations on which BEPS is largely focused, and it is vital that these differences are understood and accommodated in order that the industry is not disproportionately disadvantaged, which would in turn lead to a disruption in global investment flows, impacting countries that rely on inward investment and reducing economic growth across the globe.

Implementing the Action 6 proposals as currently drafted could, for example, cause investors in private equity funds to suffer taxation which is not consistent with their substantive treaty position as a matter of principle, for example because a holding company is denied treaty benefits such that its receipts are received net of withholding taxes, with no facility for investors to claim the treaty benefits which would be available had they invested directly. In other words, the proposals will reduce returns to investors by subjecting them to double (or undue) taxation, making the asset class overall less attractive. In turn this is likely to reduce the pool of capital available for business investment. A critical element of our industry is that investors suffer tax based on their tax attributes. So if the investor is a normal taxpayer, the investor should pay the same amount of tax that the investor would pay on a similar investment made direct. Similarly if the investor is exempt, for instance because it is charity or pension fund, then normally it would not expect to pay a higher rate of tax on a private equity investment as compared to any of its other investments.

It is therefore of fundamental importance to the private equity industry, pension fund and similar investors, and potential recipients of investment capital, to work with the OECD to find an approach to the Action 6 proposals which accommodates the private equity industry and its diverse range of stakeholders, while implementing the policy of preventing the granting of treaty benefits in inappropriate circumstances.

*Proportionality*

The Consultation Document does not adequately consider the impact that the proposals may have on genuine commercial activity. The proposals give rise to significant complexity and uncertainty, which will increase costs for business and make cross-border activity less attractive where the underlying activity will in most cases be of the sort which double taxation treaties seek to facilitate.

A related issue is that recent experience, for example in respect of domestic implementation of FATCA or AIFMD, demonstrates that while the ambition for a particular proposal may well be to effect uniform implementation across a number of jurisdictions, this is unlikely to occur in practice. This further increases the burden on international business.

It is not clear to us that the proposals set out in the Consultation Document are proportionate to the perceived mischief.

*Impact on Collective Investment Vehicles generally*

Many of the challenges presented to the private equity industry by the Consultation Document are borne of the fact that the document does not consider the position of investment funds and other collective investment vehicles ("**CIVs**") to any extent. This is perhaps to be expected, given that CIVs are not a particular focus of BEPS, but it remains the case that the failure to consider the position of CIVs has directly led to many of the issues noted in this letter. Private equity funds are a category of CIV and will be referred to as such in this letter.

It is clear from previous OECD publications such as the 2010 OECD report on the treatment of collective investment vehicles, and the January 2013 TRACE implementation package, that the OECD is aware of the particular challenges faced by CIVs in relation to treaties. This recognition is to be welcomed, but we strongly urge the OECD to turn this recognition into a workable plan for the treatment of CIVs. We see two alternatives in this regard:

- That CIVs of all descriptions are explicitly excluded from the current Action 6 agenda, and provision is made in the proposed amendments to the model treaty to make clear that the LOB provision and/or purpose test will not act to restrict the ability of a CIV (or associated investment structure) from accessing treaty benefits. A new work stream would be created to address the particular circumstances of CIVs, building on the past OECD CIV initiatives. This is our preferred approach; or alternatively

- that the position of CIVs of all descriptions should be taken into account as part of the Action 6 work, and that actions to address the particular circumstances of CIVs should be adopted at the same time as and as part of the output of the Action 6 work.

Any proposals should consider how to deal with funds of funds and similar situations where the ultimate beneficiaries of investment returns may not be party or visible to the underlying CIV or where it might not be possible to establish the treaty status of such beneficiaries.

We have commented below on two aspects of the Consultation Document, notwithstanding that we consider that the overall approach to Action 6 needs to be re-worked for CIVs, to include all CIVs which are subject to recognised regulation, including, in an EU context, regulation under rules implementing the Alternative Investment Fund Managers Directive. We would of course be happy to assist the OECD in seeking to develop these proposals into a workable solution for CIVs and holding companies controlled by CIVs.

*Limitation on benefits provision*

We do not consider that a limitation on benefits ("LOB") provision is proportionate or necessary to meet the policy objective of preventing treaty shopping, if the main purpose provision is properly implemented. As such we consider that the LOB provision should be

abandoned. This is in recognition of the significant cost and complexity which will arise if new arrangements have to take into account both an LOB provision and a main purpose provision (in addition to existing concepts such as beneficial ownership), which taken together would represent a considerable burden and act as a disincentive to international investment.

As currently drafted many private equity investment funds and holding companies owned by such funds would not meet the LOB test because:

- the fund and the holding companies will not be listed;
- neither the fund nor the holding companies will be treated as carrying on an active trade or business for the purposes of the proposed LOB test. Under the formulation of the LOB test currently proposed, the making or managing of investments will be deemed not to satisfy this test unless carried on by a bank, insurance company or securities dealer; and
- the "derivative benefits" provision currently proposed is very narrow. Given that many private equity funds purposefully raise funds from a broad range of jurisdictions, it will rarely be the case that 50% or more of the investors in the fund are resident in the same jurisdiction as the fund or holding company. In any event, it may be very difficult in practice to establish the treaty status of the investors in the fund (see further below).

Further comments on these concerns are as follows:

*1. Active trade or business*

There are of course a number of good commercial reasons why private equity funds and other CIVs are formed to aggregate investors' funds and make investments. There are also a number of good commercial reasons why holding companies may be formed, including insulation of legal liability, a desire to hold instruments issued from several jurisdictions via a single platform, flexibility to return investment proceeds to investors, finance requirements (including those required by banks), facilitating co-investment arrangements, and a desire to centralise holding and administrative functions.

As mentioned above, under the LOB test currently proposed, the making or managing of investments will be deemed not to satisfy the "active trade or business" test unless carried on by a bank, insurance company or securities dealer. It is not clear to us why the making and managing of investments in the course of a CIV's business (or that of a holding company controlled by a CIV) is not considered to be an activity capable of qualifying under paragraph 3 of Article X. We would urge the OECD to expand the paragraph to make clear that such activity may qualify a resident for entitlement to benefits.

*2. Derivative benefits provision*

Investors in private equity funds are often entitled to treaty benefits, and with further effort it may be that an expanded derivative benefits provision could in some cases afford some relief from the double taxation which certain investors into private equity arrangements are likely to suffer should the proposals proceed as drafted.

At a minimum, the derivative benefits provision should refer to owners who are entitled to equivalent benefits under treaties with third party jurisdictions.

However, there will in any event be significant challenges to applying a derivative benefits provision, for example in the case of investment into private equity funds by other fiscally transparent funds. It might not be possible even to identify the ultimate beneficiaries of such an investment fund, which might invest in the fund through nominees, clearance systems or similar arrangements. Secondary transfers of interests in such funds may exacerbate the problem. Even where the ultimate beneficiaries can be identified, it will often not be possible for the fund to establish their treaty status.

Other requirements to gather information on investors do not provide an answer to this issue. Private equity funds carry out Know-Your-Customer and anti-money laundering checks when investors subscribe for interests in the funds, but of course that process does not yield information about the treaty status of investors. The implementation of FATCA will not result in fund managers having access to information about the treaty status of each ultimate beneficiary of investment returns from the fund, given that the focus of FATCA is, very loosely, on identifying whether recipients of income are likely to be US taxpayers or whether they will themselves be compliant with FATCA, rather than whether they are resident in any other particular jurisdiction or satisfy the conditions of a treaty. The OECD’s proposed Common Reporting Standard, if and when implemented, would provide funds with greater information about the residence of investors, but it will not go so far as to deal with all of the conditions for relief in treaties (for example, whether an investor is acting through a permanent establishment).

*3. Specified CIVs to be “qualifying persons”*

Given the above, while we do not support the concept of an LOB provision, if this aspect of the proposals does proceed then we would urge the OECD to include specific provision for CIVs in the proposed LOB provision, recognising that this would have to work as part of a wider framework for treaty access for CIVs.

In particular, consideration should be given to including a CIV in the definition of a “qualifying person”, provided that certain conditions are met (for example, that the CIV is not controlled by one or a small number of investors and is subject to recognised regulation, including, in an EU context, regulation under rules implementing the Alternative Investment Fund Managers Directive). Similarly, holding companies controlled by such a CIV should be treated as satisfying the LOB test.

*Main purpose provision*

Subject to the following discussion we consider that the proposal to include a purpose test along the lines of the new paragraph 6 of Article X set out in the Consultation Document is in principle preferable to the current LOB proposal. We have not been able to identify a circumstance where unacceptable treaty shopping could not be countered by such a test and so, as noted above, we consider that the proposal for an LOB provision should be abandoned and more effort invested in arriving at a purpose test which is proportionate and manageable for international business.

The examples given at paragraph 33 of the Consultation Document make clear that it is acceptable to take treaty access into account when making investment decisions. On the face of it this would seem at odds with the paragraph 6 test, which introduces unwelcome uncertainty. Our members will wish to avoid protracted debate which will inevitably arise in

circumstances where it is accepted that access to treaty benefits was a consideration in arriving at a particular arrangement but there is disagreement over whether or not accessing those benefits was a main purpose or a subsidiary purpose. Such disagreements would be costly and time consuming to resolve and, in the case of private equity, it is quite possible that a fund may wish to sell an investment related to the arrangement after a relatively short holding period, during which it would be unrealistic to resolve such a dispute. As such, the proposals as drafted may disproportionately affect the normal commercial operation of a fund. For these reasons, we consider that the current drafting of the test, which turns on establishing *one of the main purposes*, is unnecessarily broad and should be revised to be a singular test of establishing whether or not access to treaty benefits was *the main purpose* of a particular arrangement.

We agree with the text of paragraph 30 of the Consultation Document, which broadly explains that it in order for the test to not apply it is not sufficient to merely assert that access to treaty benefits was not a main purpose of an arrangement; it must be right that all available evidence is taken into account in determining the purpose of an arrangement. However, we do not consider that the objective approach described under Paragraph 29 is appropriate. In answering the question of the main purpose of an arrangement it is the facts and circumstances which the parties actually took into account in arriving at that arrangement, not what an independent third party believes that they should have taken into account, which should be relevant. To do otherwise would, again, be disproportionate and likely to affect normal commercial arrangements as parties will have no appetite for engaging in protracted discussions over what facts and circumstances are relevant to establishing purpose. As such the test should be subjective, not objective.

It should also be clarified that if the relevant transactions or arrangements would have been the same in the absence of the relevant treaty benefits, then the obtaining of treaty benefits cannot be "a main purpose" or "the main purpose" of the transaction or arrangements.

*Conclusion*

To reiterate the comments made above:

- The position of CIVs in relation to treaty access must be considered and addressed before the AP 6 work stream continues. Our preference is that CIVs including private equity are excluded from the current Action 6 work and a new work stream is created to focus on CIVs.

- We do not consider that a limitation on benefits provision is proportionate or necessary in order to meet the policy objective, if a properly considered purpose test is put in place. If the OECD does ultimately decide that a limitation on benefits provision is required then we would urge the OECD to modify the proposed active trade or business concept to include CIVs and holding companies controlled by CIVs, or to include specified CIVs and holding companies controlled by such CIVs within the definition of a "qualifying person".

- The purpose test should be a subjective and not objective test, and should turn on establishing *the* main purpose of an arrangement. Where it can be demonstrated that arrangements would have been entered into in the absence of treaty benefits it should be made clear that any treaty benefits cannot be the main purpose (or one of the main purposes) of the arrangements.

Thank you in anticipation for taking our comments into account as part of the consultation process. We would welcome an opportunity to engage more fully with the OECD in due course on this matter and would be pleased to discuss any of the comments made.

Yours faithfully,

Dominic Spiri

On behalf of the BVCA Taxation Committee