Australian Private Equity & Venture Capital Association Limited

06 February 2017

The Manager
Base Erosion and Profit Shifting Unit
Corporate and International Taxation Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: BEPS @treasury.gov.au

Dear Sir/Madam,

Further to our submission to Treasury on 29 August 2016, The Australian Private Equity & Venture Capital Association Limited (AVCAL) welcomes the opportunity to comment on Australia's proposed adoption of the BEPS Convention (Multilateral Instrument) pursuant to the consultation paper published in December 2016 (Consultation Paper).

AVCAL represents the private equity (PE) and venture capital (VC) industry in Australia, which has a combined total of around $27 billion in funds under management on behalf of domestic and offshore 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. These investments help support around half a million jobs, and contribute over four percent every year to our national economic output.[1] In the financial year ending 30 June 2016 alone, PE and VC invested around A$3bn into Australia.

1. Background - potential impact of BEPS Action Six on private equity and venture capital

Given that around seventy per cent of the investment capital managed by PE and VC firms is sourced from offshore, Australia's foreign investment policy framework – including double tax treaty network – is vital to the efficient functioning of our industry. As Australia transitions away from resources to innovation as a key driver of growth, it is essential to ensure there is adequate and timely access to capital. Indeed, Australia remains, as it has for many years, a net capital importing nation. The ongoing flow of capital to Australia is therefore of critical importance to our economy and national prosperity.

Certainty of tax treatment is particularly important to Australia's capacity to attract offshore capital investment into our economy. However, in our view, certain proposals that form part of the OECD's BEPS project pose a threat to this certainty. Consistent with our 2016 submission (attached for your reference), our focus in this submission is on two particular aspects of the BEPS Convention which could, depending on domestic implementation, have a negative impact on the continued investment of PE and VC firms into Australia: Article 3 – Transparent Entities; and Article 7 – Prevention of Treaty Abuse.

As Australia formulates its approach to implementing the BEPS Convention, we request that the issues outlined below be addressed. We note that concerns regarding the impact of the BEPS Action Six measures on the global PE and VC industry have been raised by our corresponding industry bodies overseas (including the British Venture Capital Association (BVCA) and Invest Europe) with their respective governments as well as the OECD Secretariat, over a number of months.

[1] Deloitte Access Economics, *The Economic Contribution of Private Equity in Australia*, 2013.

Level 10, Kyle House, 27-31 Macquarie Place, Sydney NSW 2000, Australia • T +61 2 8243 7000 • ABN 84 056 885 708 • avcal.com.au

2. Executive summary

AVCAL supports Australian and the broader OECD's efforts to combat base erosion and profit shifting which undermines the integrity of the domestic and international tax system. However, we believe that the following comments should be taken into account when devising Australia's approach to the implementation of the BEPS Convention:

- Article 3, BEPS Convention: a safe harbour rule should be introduced for fiscally transparent entities so as to reduce the administrative burden on funds and the Australian Taxation Office of complex tracing processes;
- Article 3, BEPS Convention: if the Principal Purpose Test (PPT) is not considered sufficient to safeguard abuse of a safe harbour rule, the safe harbour rule could be supplemented by an additional integrity measure;
- Article 7, BEPS Convention: in the interests of simplicity and fairness to PE and VC funds, implementation should be by way of the Principal Purpose Test, rather than a Simplified Limitation on Benefits Rule.

Our more detailed observations are outlined below.

3. Article 3, BEPS Convention – Transparent Entities

The typical investment structure for PE and VC firms is to pool the funds from global investors via the use of fiscally transparent fund vehicles or collective investment vehicles. These fund vehicles have been categorised as 'non-CIV funds' for the purposes of the OECD's BEPS project and related guidance. In addition, given the global nature of the pool of PE/VC investors, the pooling structures will often include holding companies established in different jurisdictions to that of the fund and the portfolio/investee company. This approach is taken primarily to ensure that all investors are treated consistently when investing into foreign jurisdictions. AVCAL is pleased that this type of structuring has been acknowledged by the OECD in their January 2017 Public Draft Discussion Draft on non-CIV examples (Non-CIV Examples Paper) which has been issued in the context of Action Item 6 (see Appendix 1 to this submission).

Article 3 will ensure that income derived by or through a fiscally transparent entity will be considered to be income of a resident for treaty purposes but only where at least one of the jurisdictions treats the income as income of one of its residents under its domestic law. There is no limit on the number of beneficiaries a fiscally transparent entity may have. This measure is intended to prevent double non-taxation (where income is not taxed in either country) but will also facilitate the granting of treaty relief on a look through basis.

As noted above, PE and VC funds are typically structured as fiscally transparent entities meaning that Article 3 is directly relevant to the industry. In AVCAL's 2016 Submission we highlighted that the Australian Taxation Office (ATO) currently provides guidance on when it will look through transparent entities in order to provide treaty relief in respect of Australian source income. Accordingly, subject to the comments below, Australia's proposed adoption of Article 3 is welcome as it will provide non-CIV fund managers (including PE and VC managers) with greater certainty as opposed to relying on an administrative concession granted by the ATO. In particular, adoption in accordance with article 3(5)(d) is preferable, as it would not require any amendment to existing treaties.

However, in AVCAL's 2016 Submission we highlighted the onerous burden this puts on non-CIV fund managers if they are able to claim treaty relief in full, particularly given the widely-held nature of these funds and the large amount of transparent fund-of-fund investors. Indeed the ATO has acknowledged the practical difficulty of collecting the requisite information in their own guidance (TD 2011/25). Pursuant to the ATO requirements in TD 2011/25, this requirement has proven to be the source of much administrative burden since its introduction and in practice is unlikely to have materially impacted related tax collections. It is this administrative burden that we hope can be avoided by creating a practical solution for non-CIV funds in connection with Australia's adoption of Article 3.

In this respect, consistent with the 2016 Submission, AVCAL requests Australia adopt a safe harbour test whereby a widely-held fund – which certifies that at an agreed percentage of its direct and indirect investors are comprised

of investors that would otherwise be eligible for treaty benefits in their own right – would be eligible for full treaty benefits. This is consistent with the approach proposed by the OECD in the Simplified Limitation On Benefits Test which requires the identification of a minimum of 75% of qualifying treaty resident beneficiaries in order for full relief to be available (this test is discussed further below).

We emphasise that this request is an administrative simplification designed to enhance Australia's reputation as an attractive place to do business as opposed to a request for concession. In this regard we note that PE funds, like VC funds, are unlikely to be used as vehicles for tax avoidance given the following factors:

- These funds are formed for genuine commercial reasons, not dissimilar to traditional investment funds, with clear investment mandates;
- Such funds will be marketed to, and primarily comprised of, a very diverse range of institutional investors including pension funds, insurance companies, government agencies, fund-of-funds and sovereign wealth funds;
- Almost all institutional investors are likely to be tax exempt or, broadly entitled to treaty benefits under different provisions, making them a low tax abuse risk;
- Fund managers are independent of investors and unlikely to have the relevant information to 'treaty shop' on behalf of a subset of investors; and
- Fund managers are generally regulated and prohibited from discriminating between investors.

It is also important to note that the availability of treaty relief would be limited by the Principal Purpose Test which Australia proposes to adopt as implementation of Article 7 of the BEPS Convention (see below). If deemed necessary, in addition, Australia could adopt a targeted integrity measure to prevent instances of relief being available where arrangements are put in place to artificially meet the minimum threshold.

By taking such a pragmatic administrative step, Australia would take the lead in promoting the inflow of foreign investment by being seen as a nation that understands the importance of the mobile capital which non-CIV fund managers offer, and enhance its credibility as a regional financial centre.

4. Article 7, BEPS Convention – Prevention of Treaty Abuse

Article 7 implements recommendations outlined in the BEPS Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) report. Article 7 will modify jurisdictions' bilateral treaties to include the following:

- A general anti-avoidance rule — the Principal Purpose Test (PPT) — to deny treaty benefits where obtaining the benefit was one of the principal purposes of the arrangement unless granting the treaty benefits would be in accordance with the object and purpose of the relevant provisions of the treaty; and
- A supplementary, optional rule — the Simplified Limitation on Benefits rule (S-LOB rule) — to grant treaty benefits only to specified 'qualified persons' (individuals, government entities, listed companies, non-profit organisations, pension funds, entities engaged in active business or entities that meet specified ownership requirements) (see Appendix 2 to this submission).

Based on the summary of the Consultation Paper (page six), we understand that Australia proposes to adopt the PPT but not the S-LOB rule. AVCAL would strongly support such a position, however we seek confirmation that this is the case given the Consultation Paper suggests that Australia may seek to introduce a S-LOB clause in tax treaties that do not already contain similar clauses (see pages 13-14, Consultation Paper).

In the 2016 Submission, we highlighted that the LOB would be unworkable from a PE perspective. This was on the basis that the LOB would essentially deny treaty benefits unless the person claiming them satisfied one of a number of prescriptive tests – including being listed on a recognised stock exchange or carrying on an active trade or business in the country in which it is a resident (the holding or management of investments is specifically excluded). Typically, a PE fund (and any holding company owned by it) will not be listed and will be holding investments, meaning it will not satisfy these tests.

The OECD has acknowledged this issue and chosen not to mandate a detailed LOB, instead requiring a PPT as a minimum standard, with the S-LOB optional. In respect of the S-LOB, the working group has sought to the address concerns raised by non-CIV funds by including the following wording:

A resident of a Contracting Jurisdiction to a Covered Tax Agreement that is not a qualified person shall also be entitled to a benefit that would otherwise be accorded by the Covered Tax Agreement with respect to an item of income if, on at least half of the days of any twelve-month period that includes the time when the benefit would otherwise be accorded, persons that are equivalent beneficiaries own, directly or indirectly, at least 75 per cent of the beneficial interests of the resident.

Whilst this change will be helpful to certain non-CIV funds, for example pension funds, it will not address all of the concerns of the PE and VC industry. In order to be an equivalent beneficiary, the relevant investor must be a qualifying resident which includes, inter-alia, individuals, pension funds, sovereign wealth funds and trading companies. Holding companies and other investment entities are excluded from this definition. Such an approach would be problematic for PE and VC funds, given that their commitments come from a wide range of investors who may not be able to access the tax relief, including family offices and certain corporates, as structures typically involve an investment holding platform. Based on the drafting of the S-LOB, such residents would be excluded from treaty benefits. Our understanding is BEPS Action item 6 does not intend to exclude such resident entities from availing themselves of treaty benefits, provided the entities are fully taxable residents of their home countries.

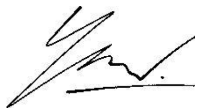
As such, this demonstrates that the S-LOB rule does not cater for all non-CIV funds and that adopting such a prescriptive measure would inhibit investment from non-CIV funds backed by a diverse range of investors.

Further, the Non-CIV Examples Paper provides three examples of common non-CIV backed holding company structures that the OECD states should be entitled to treaty benefits. Using the first example (refer to Appendix 1) as an illustration, it is clear the S-LOB rule could unduly prejudice PE & VC funding. In this example, a regional holding company is established by an institutional investor. Based on those facts and circumstances, the OECD confirmed that the PPT should not apply to deny treaty benefits. However, if the institutional investor was a PE fund and the S-LOB rule was required to be satisfied, it is possible that the holding company would not be entitled to treaty benefits. This seems an unjust outcome and highlights real concerns with the adoption of a prescriptive LOB clause as opposed to a more general integrity measure such as the PPT.

5. Next steps

We would like to thank you for considering the views outlined in this letter. Given the potential impact implementation of the BEPS Convention could have on the Australian PE and VC industry, we would welcome the opportunity to discuss the above issues with you further. Please do not hesitate to contact either me or Christian Gergis, AVCAL Head of Policy & Research, on 02 8243 7000, if you have any queries.

Yours sincerely,



Yasser El-Ansary
Chief Executive

Appendix 1 – Example from the OECD's January 2017 Public Draft Discussion Draft on non-CIV examples

Regional investment platform example

Example [XX]: RCo, a company resident of State R, is a wholly-owned subsidiary of Fund, an institutional investor that is a resident of State T and that was established and is subject to regulation in State T. RCo operates exclusively to generate an investment return as the regional investment platform for Fund through the acquisition and management of a diversified portfolio of private market investments located in countries in a regional grouping that includes State R. The decision to establish the regional investment platform in State R was mainly driven by the availability of directors with knowledge of regional business practices and regulations, the existence of a skilled multilingual workforce, State R's membership of a regional grouping and use of the regional grouping's common currency, and the extensive tax convention network of State R, including its tax convention with State S, which provides for low withholding tax rates.

RCo employs an experienced local management team to review investment recommendations from Fund, approve and monitor investments, carry on treasury functions, maintain RCo's books and records, and ensure compliance with regulatory requirements in States where it invests. The board of directors of RCo is appointed by Fund and is composed of a majority of State R resident directors with expertise in investment management, as well as members of Fund's global management team. RCo pays tax and files tax returns in State R.

RCo is now contemplating an investment in SCo, a company resident of State S. The investment in SCo would constitute only part of RCo's overall investment portfolio, which includes investments in a number of countries in addition to State S which are also members of the same regional grouping. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30 per cent to 5 per cent. Under the tax convention between State S and State T, the withholding tax rate on dividends is 10 per cent.

In making its decision whether or not to invest in SCo, RCo considers the existence of a benefit under the State R-State S tax convention with respect to dividends, but this alone would not be sufficient to trigger the application of paragraph 7. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 7 applies to an investment, it is necessary to consider the context in which the investment was made, including the reasons for establishing RCo in State R and the investment functions and other activities carried out in State R. In this example, in the absence of other facts or circumstances showing that RCo's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCo.

Appendix 2 – Extract from Article 7 of the Multilateral Convention

9) A resident of a Contracting Jurisdiction to a Covered Tax Agreement shall be a qualified person at a time when a benefit would otherwise be accorded by the Covered Tax Agreement if, at that time, the resident is:

- an individual;
- that Contracting Jurisdiction, or a political subdivision or local authority thereof, or an agency or instrumentality of any such Contracting Jurisdiction, political subdivision or local authority;
- a company or other entity, if the principal class of its shares is regularly traded on one or more recognised stock exchanges;
- a person, other than an individual, that:
    - is a non-profit organisation of a type that is agreed to by the Contracting Jurisdictions through an exchange of diplomatic notes; or
    - is an entity or arrangement established in that Contracting Jurisdiction that is treated as a separate person under the taxation laws of that Contracting Jurisdiction and:
    - that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that Contracting Jurisdiction or one of its political subdivisions or local authorities; or
    - that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in subdivision A);
- a person other than an individual, if, on at least half the days of a twelve-month period that includes the time when the benefit would otherwise be accorded, persons who are residents of that Contracting Jurisdiction and that are entitled to benefits of the Covered Tax Agreement under subparagraphs a) to d) own, directly or indirectly, at least 50 per cent of the shares of the person.

10) A resident of a Contracting Jurisdiction to a Covered Tax Agreement will be entitled to benefits of the Covered Tax Agreement with respect to an item of income derived from the other Contracting Jurisdiction, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in the first-mentioned Contracting Jurisdiction, and the income derived from the other Contracting Jurisdiction emanates from, or is incidental to, that business. For purposes of the Simplified Limitation on Benefits Provision, the term “active conduct of a business” shall not include the following activities or any combination thereof:

- operating as a holding company;
- providing overall supervision or administration of a group of companies;
- providing group financing (including cash pooling); or
- making or managing investments, unless these activities are carried on by a bank, insurance company or registered securities dealer in the ordinary course of its business as such.