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CREATING LASTING VALUE

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By e-Mail to grace.perez-navarro@oecd.org

Attn: Grace Perez-Navarro
Deputy Director, CTPA
OECD

EVCA comments on the discussion draft on the definition of "permanent establishment" in the OECD Model Tax Convention

Dear Ms. Perez-Navarro,

The European Private Equity & Venture Capital Association ("EVCA") welcomes the opportunity to submit comments on the public discussion draft of the OECD on the "Interpretation and application of Article 5 (Permanent Establishment) of the OECD Model Convention" (the "OECD Discussion Draft") prepared by a working group (the "Working Group") composed of delegates to Working Party 1 on Tax Conventions and Related Questions of the OECD Committee on Fiscal Affairs.

Introduction

Private equity investments are long-term by nature, providing equity capital to companies across all stage of their development and are continuously looking to expand into new markets, often across national borders. In this context, it is very important to the industry and its institutional investor base, that the investment vehicles used ("funds") by this investor base do not create permanent establishments for those investors. This is also important to retain the parity of choice between public and private investment funds.

As outlined in the VC Expert Group Report, the venture capital industry could make a greater contribution to the EU economy if cross-border tax obstacles were removed. In particular, if funds were able to freely operate internationally, they would achieve economies of scale and competition would increase. Moreover, due to the uncertainty determined by the permanent establishment issue, in certain cases it is difficult for companies to find venture capital investments, thus creating a negative effect on the growth of economy. For a more specific description of the effects of the cross-border tax obstacles reference is made to the VC Expert Group Report.

About the EVCA

EVCA is a member-based, non-profit trade association which is based in Brussels and was established in 1983. EVCA is the voice of the European private equity and venture capital industry and represents, promotes and protects the interest of the asset class. EVCA's more than 1,300 members cover the whole private equity fund spectrum, from venture capital funds investing into high-growth start-ups, to the largest global buy-out funds turning around and growing mature companies. Further, EVCA's member base includes institutional investors in the asset class.

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EVCA's Comments

Therefore, EVCA would like to take the opportunity to comment specifically on the contents of chapter 23 of the OECD Discussion Draft regarding the activities of the fund managers.

For the purposes of the present comments, reference is made to the following documents:

- the OECD Discussion Draft;
- letter sent by EVCA to the OECD on 23 December 2008 in relation to Articles 5 and 7 of the OECD Model Convention;
- "Report of Expert Group on removing tax obstacles to cross-border venture capital investments" (the "VC Expert Group Report") published on 30 April 2010.

I. Chapter 23 of the OECD Discussion Draft regarding "Activities of fund managers"

The Working Group indicated that, in the particular case of an enterprise taking the form of a fiscally transparent partnership, such enterprise should be seen as a distinct enterprise carried on by the partners and that paragraph 19.1 of the Commentary on Art. 5 confirms that position. Applying this analysis to a venture capital fund set up as a transparent limited partnership, according to the Working Group the fund forms a distinct enterprise carried on jointly by the limited partners and the general partner. This enterprise, being carried on by each partner, constitutes an enterprise of each Contracting State of which a partner is a resident as regards the share of that particular partner.

According to the Working Group, the reference in Art. 5(5) of the OECD Model Convention ("MC") to the dependent agent must be applied with respect to the partnership (i.e. not to the investors). Therefore, if the conditions of Art. 5(5) MC are met, the partnership will be considered to have a permanent establishment and the result will be that an enterprise of each Contracting State of which a partner is a resident will be considered to have a permanent establishment (in proportion to the share of profits of that partner).

The same analysis would apply for the purposes of Art. 5(6) MC and the independent status of a local fund manager should therefore be determined in relation to the partnership itself rather than by reference to each investor of the partnership.

II. Issues

The two main permanent establishment issues for the private equity industry are:

1. Whether a tax transparent fund may constitute a business activity; and

2. Whether the fund manager creates a permanent establishment for the fund or whether it should be classified as an independent agent of the fund.

1. Whether a tax transparent fund may constitute a business activity

With respect to the considerations of the Working Group regarding the qualification of partnerships as enterprises, it is essential to note that there is a great distinction between "regular" partnerships carrying out a commercial activity and partnerships used as vehicles for investment funds. While there is no doubt about the “enterprise” status of the “regular” partnerships, the nature and the investment activities of investment funds in the form of partnerships are totally different.

Investment funds themselves do not carry out any business activity but are merely used for passive investments generating solely passive income (dividends, interest or capital gains). This is the case whether the investment fund is formed as a listed vehicle or a limited partnership.

Therefore, in light of the fact that investment funds do not carry out any business activity, EVCA believes that it is not appropriate to apply the conclusions of paragraph 19.1 of the Commentary on Article 5 (generally regarding tax transparent partnerships) to the specific case of investments funds in the form of a tax transparent partnership.

Moreover, it should also be noted that, as there is no business activity of the fund (but only passive investment activity), there can be no permanent establishment of the fund or the investors in the country where the investment takes place.

2. Whether the fund manager creates a permanent establishment of the fund or whether it should be classified as an independent agent of the fund.

In relation to Article 5, under the perspective of venture capital and private equity funds, the main issue is whether the fund manager, that supply management services to the funds, may constitute a permanent establishment under Art. 5(5) MC of the investors or of the fund in the different countries where the management activity is carried out.

As noted in the VC Expert Group Report, this issue may lead to double taxation (in the country where the investment takes place and in the country where the investors are located).

In order to avoid the risk, the fund managers have to limit the activities at the local level (i.e., in the country where the investment is made) to the mere provision of advice and cannot provide full management functions. This situation is highly inefficient, costly and complex and can potentially deter investments. Moreover, it does not completely eliminate the risk of permanent establishment.

In the opinion of EVCA and in line with the conclusions in the VC Expert Group Report, the activities carried out by the fund manager should be classified as those of an independent agent and therefore cannot create a permanent establishment of the fund or the investors in the country where the fund manager carries out management functions (similarly to what happens for public equity funds, i.e. funds investing in listed securities).

According to the Working Group “*it would be difficult to provide specific guidance as the situation was highly factual and was not restricted to venture capital funds*”.

EVCA, however, believes that specific guidance can actually be provided by identifying the main features of the fund managers’ activity to which the guidance should apply. The following is a description of the typical activities carried out by fund managers that could be useful to define the scope of application of the guidance.

The relationship between the fund manager and the investors is in substance that of a mandate from the investors (as clients) to the fund manager for the management of their funds through the investment in assets (typically shares and other securities) identified by the fund manager. This is the case whether the fund is a listed investment vehicle or a private equity fund partnership. The fund manager typically carries out the following activities:

- *fundraising*: the fund manager seeks investors (normally a plurality of investors) who commit themselves to invest a certain amount in the fund; at this stage, the fund manager negotiates with the investors the contents of the agreement that shall govern the fund and the remuneration for the management activity;

- *fund management* which can be broadly summarised as follows:

    - activity of research and selection of potential investments, evaluation of such investments, preparation of the business and financial model, drafting of a proposal of investment;

    - supervision and coordination of the due diligence activity carried out by the tax, legal and technical counsels;

    - negotiation of the contracts and conduct of the acquisition process until completion with the assistance of the tax, legal and technical counsels;

    - monitoring of the investments, in particular through the exercise of shareholder rights and the rights attached to a seat with supervisory role at the investee company;

    - identification of potential buyers and alternative exit strategies;

    - reporting to the investors, regulatory compliance.

In this respect, as requested by sub-paragraph 37 of the Commentary on Art. 5, the fund manager (i) is independent of the investors both legally and economically and (ii) acts in the ordinary course of its business.

In relation to the test of legal and economic independence, it should be noted that the fund manager is not subject to detailed instructions of the investors and decides autonomously how to invest the funds committed by the investors. Typically, investors rely on the special skills and knowledge of a fund manager, which is an indication of independence according to sub-paragraph 38.3 of the Commentary on Art. 5.

Moreover, the fund manager bears the entrepreneurial risk. In fact, if the fund does not perform well or the investors terminate the relation before the envisaged term of the fund, then it will be difficult for the fund manager to start a new fund, which in any event would be a separate fund with most likely new investors.

Also under the perspective of the number of principals, the fund manager is to be regarded independent as normally a plurality of investors participates in the fund. A manager or the employees of the manager often serve more than one fund and therefore will also not be dependent of a single fund.

Finally, no doubts should arise in relation to the fact that the fund manager acts in the ordinary course of its business. In this respect, it can be noted that the activities carried out by the fund manager do not belong to the sphere of the investors.

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III. Proposed amendment of the Commentary on Art. 5

In light of the considerations illustrated above, EVCA proposes the insertion of a sub-paragraph in the Commentary on Art. 5 aimed at clarifying the position of fund managers. The language of this additional sub-paragraph could be the following:

> *"For the purposes of paragraph 6, managers of investment funds carrying out management functions are independent of the investors and the fund both legally and economically and act in the ordinary course of their business and therefore qualify as independent agents.*
>
> *For the purposes of paragraph 6, the definition of "management functions" includes activity of research and selection of potential investments, evaluation of such investments, preparation of the business and financial model, drafting of a proposal of investment, supervision and coordination of the due diligence activity, negotiation of the contracts and conduct of the acquisition process until completion, monitoring of the investments, identification of potential buyers and alternative exit strategies, reporting to the investors, regulatory compliance."*

IV. Summary of conclusions

In light of the comments above, the following conclusions can be made:

- investment funds (whether listed vehicles or private equity funds) themselves do not carry out any business activity but are merely used for passive investments generating solely passive income (dividends, interest or capital gains). Since there is no business activity, there can be no permanent establishment of the fund or the investors in the country where the investment takes place;

- there is a need of specific guidance in relation to the qualification of the activities of the fund manager. The situation is not highly factual as the activities of the fund managers can be summarised as described above and the guidance would apply solely to the situations falling in such description;

- the activities of the fund manager (as described above) qualify as those of an independent agent under Art. 5(6) MC.

On the basis of those conclusions, EVCA proposes to introduce an explanatory paragraph in the Commentary on Art. 5 (see proposed text above).

Yours sincerely,

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Past Chairman of the EVCA Tax
and Legal Committee