EUROPEAN COMMISSION
DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
Direct taxation, Tax Coordination, Economic Analysis and Evaluation
Direct tax policy and cooperation

3 August 2012

PUBLIC CONSULTATION PAPER

Problems that arise in the direct tax field when venture capital is invested across borders

Note:

This document is being circulated for consultation.

The European Commission has launched this public consultation in order to collect evidence on the direct tax problems that arise when venture capital is invested across borders and to obtain suggestions from the public on feasible solutions to any such problems.

This document does not necessarily reflect the views of the European Commission and should not be interpreted as a commitment by the Commission to any official initiative in this area.

The parties concerned are invited to submit their comments no later than

5 November 2012

Comments may be sent by letter, fax or electronic mail to the following address:

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Unit D2 – Direct Tax Policy and Cooperation
Rue de Spa 3
B-1049 Brussels
Belgium
Fax: +32-2-299-80-52
Email: TAXUD-D2-Consultation@ec.europa.eu

1. WHAT IS THE AIM OF THIS PUBLIC CONSULTATION?

In its Communication of 7 December 2011[1] "An Action Plan to Improve Access to Finance for SMEs" the Commission stated that in 2012 it will complete an examination of the tax obstacles that hinder cross-border venture capital investment with a view to presenting solutions in 2013 that would aim to eliminate any such obstacles if this can be done without facilitating tax avoidance and evasion.

Venture capital[2] is an essential source of finance for companies and benefits in particular innovative start-up SMEs that may face difficulty in accessing traditional bank lending or finance through stock exchanges. There are concerns that cross-border venture capital investment in the EU may be hindered by tax, legal and regulatory requirements[3] and that this could lead to the underperformance of the venture capital industry and, consequently, to insufficient venture capital investment within the EU.

The venture capital industry maintains that tax issues are, in fact, a significant obstacle to cross-border venture capital investment. A group of tax experts established by the Commission identified in a report[4] the main ways in which the mismatches between the 27 tax systems across the EU could lead to double taxation, tax treatment uncertainties and administrative obstacles for cross-border VC investment.

Although the Expert Group's Report provided an overview of the tax issues which might arise, there is a lack of empirical evidence that these problems hinder investment or are the reason for the current poor performance of the VC industry. More evidence of the impact on the VC industry of the current mismatches between tax systems and of the potential benefits that could result from changes in tax law if the Commission is to ask Member States to put in place tax structures for VC investment that might involve losses of revenues or alternatives to the controls against tax avoidance and evasion that are currently in place.

The Commission therefore needs to collect factual evidence of direct tax problems which have arisen in practice, to know why the problems arose, the Member States involved,

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[1] COM(2011) 870 final

[2] Venture capital means investment in unquoted companies by investment funds (venture capital funds) that, acting as principals, manage individual, institutional or in-house money and includes early-stage and expansion financing, but not replacement finance and buy-outs. Strictly defined, venture capital is a subset of private equity.

[3] To address regulatory issues and to remove obstacles to cross-border fund raising that venture capital funds currently encounter, the Commission on 7 December 2011 presented a Proposal for a Regulation on venture capital funds. The Regulation foresees that following a simple registration in its home Member State, venture capital managers will be able to market the qualifying funds under their management in all the Member States including in their home Member State. This Proposal does not address tax issues.

[4] http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/initiatives_small_business/venture_capital/tax_obstacles_venture_capital_en.pdf

the amount of money involved and the costs to investors, Member States and the EU's SMEs. Once the Commission has collected this evidence, it will be able to estimate the size of the problem and decide whether there is a need for EU solutions to remedy the problems and what the benefits of any such solutions would be, for Member States and for the VC industry.

2. WHO IS BEING CONSULTED?

All stakeholders – individual citizens, businesses, Member States, tax administrations, intergovernmental, non-governmental and business organisations, tax practitioners and academia - are invited to provide their views on this matter.

3. BACKGROUND

The Commission has been working for some time on facilitating cross-border venture capital investment. In order to obtain a better understanding of the tax problems that arise when venture capital is invested across borders, and to explore possible solutions, the Commission established an Expert Group on cross-border tax obstacles to venture capital investment in 2007. The results of the Group's work were summarised in its Report which was published in 2010.

The Venture Capital Tax Expert Group's Report identified three main tax obstacles, all of which may lead to unrelieved double taxation for venture capital investors.

The first arises because it is generally necessary for the venture capital fund manager to be present himself or have a representative present in the Member State into which an investment is made, in order to assist in the management of the target company[5]. This local presence may mean that the Member State in question will treat the fund manager as a branch or *"permanent establishment"* of either the fund or of the investors and apply taxation accordingly. If the country or countries where the fund and investors are located also apply taxation to the return on the investment, the relevant double taxation treaties may not provide for credit for the tax imposed in the Member State of the deemed *"permanent establishment"*. As a solution the Expert Group suggested that tax authorities should normally treat the local activities of a venture capital fund manager as those of an *"independent agent"* that would not create a *"permanent establishment"* for the venture capital fund.

[5] The managers of venture capital funds may carry out management functions in the country where the investment is made, including 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.

The second tax obstacle that the Expert Group identified was the fact that venture capital funds may currently be treated in very different ways for tax purposes by different Member States. One Member State may treat a fund as transparent for tax purposes, looking through the fund to tax the individual investors, whilst another may treat the fund as non-transparent and therefore taxable in its own right. This mismatch in tax treatment may cause difficulties in the application of double taxation treaties and consequent unrelieved double taxation. In some cases the different classifications of the funds may also result in double non-taxation; income and gains may not be taxed anywhere either at the level of the fund or of the investors. To address the double taxation, the Expert Group suggested the mutual recognition of the classification for tax purposes of the legal forms of venture capital funds. This would entail all Member States recognising the tax classification and tax treatment applied by the home country of a venture capital fund (i.e. as transparent or non-transparent; subject to tax or not subject to tax; trading or non-trading). If this approach is not feasible, the Group suggested that Member States would agree on an EU-wide common classification of certain commonly used forms of venture capital funds and publish a list indicating in each case whether they are non-transparent or transparent. Failing that, at least the publication by each Member State of information on how it treats different types of venture capital funds for tax purposes would be beneficial.

The third tax obstacle identified by the Expert Group is the fact that investors in transparent venture capital funds may currently have to file individual claims with foreign tax authorities for any cross-border double taxation treaty relief to which they are entitled. This can be difficult in practice due to the complexity of the claim procedures and may mean that many investors will not claim the relief to which they are entitled to. The Expert Group therefore proposed that venture capital funds should be able to claim tax treaty relief on behalf of their investors.

The venture capital industry states that in practice, in order to avoid the risk of double taxation or to increase legal certainty about how venture capital investments will be taxed, they have to set up offshore or to use various costly and complex fund structures and tax planning techniques. This is not an optimum solution either from the industry's or from the EU's perspective.

It appears, therefore, that any tax measure to facilitate cross-border venture capital investment should aim to ensure that legal certainty for investors is increased and that problems of discrimination and double taxation are removed. In addition, however, in line with the EU's goal of combating tax avoidance and evasion, any such tax measure would have to ensure that Member States' taxing rights are safeguarded and that no tax loopholes are created.

4. QUESTIONS SUBMITTED TO THE STAKEHOLDERS CONCERNED

The Commission services would like to receive contributions regarding any actual direct tax problems that have arisen when venture capital has been invested across borders, including any available details of their financial impact on investors, investment activities, Member States and SMEs. The Commission services would also welcome any

information available on the structures that have to be put in place to avoid such tax problems and the extra costs involved. Furthermore, suggestions for any feasible solutions to remedy current problems are welcome together with any estimates of how these solutions could reduce costs and how cross-border investment activity might increase as a result.

Any factual information you provide will be used by the Commission services as an evidence base in its evaluation of the substance of the problems, their real size and their financial impact. The Commission services would like information on actual rather than theoretical problems.

I. General identification of the stakeholder[6]

Name: **Department of Inland Revenue, CYPRUS** Surname:**N/A**

State of residence/ establishment: **CYPRUS**

State of tax residence (if different): **N/A**

Contact details (address, telephone, email):

Address: Central Income Tax Office, Ministry of Finance Building, M. Karaoli & G. Afxentiou Corner, 1096 Nicosia, CYPRUS

Tel. : 0035722601902

Email: director@ird.mof.gov.cy

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[6] Neither the content of your contribution nor your identity will be published on the Internet unless you give your specific assent to this by indicating "Yes" in the relevant boxes in the questionnaire. The Commission reserves the right to not publish all contributions. If your contribution is not published, its content will be taken into account in the preparation of a general summary of all the contributions. You should include any comments you have in this regard in your reply or send them to the service responsible for the consultation (see Contact information in the Specific Privacy Statement).

Note also that the information you provide will be used strictly in accordance with the provisions of Regulation (EC) No 45/2001 on the protection of individuals with regard to the processing of personal data by the Community institutions and bodies and on the free movement of such data. The personal data collected and further processed are data important for the participation in the public consultation, such as name/surname/profession/ postal & e-mail addresses/phone number/fax number, in particular to avoid duplication of answers. Your contact data will not be used for any other purpose and will be destroyed after the consultation has been completed (see point 6 of the Specific Privacy Statement).

Are you:

- An investor in venture capital (please specify whether you are a corporate investor, bank, government agency, fund of funds, pension fund, private individual, etc.)
- A venture capital fund manager
- A venture capital fund
- An industry representative
- **Tax administration of a Member State**
- Tax advisor or tax practitioner
- An academic
- Other (please specify what is your interest in this matter)

If you are a fund/ investor, please specify: **N/A**

- the country/countries into which you invest
- the ratio of your venture capital investments to your total investments

Do you agree to the publication of your response?

- **Yes**
- No

Do you agree to the publication of your name and other personal data?

- **Yes**
- No

II. Problems encountered in practice

1. General **N/A**

Have you experienced direct tax obstacles in connection with your cross-border venture capital investment? If so, please provide details of:

a) The tax obstacles and the reasons why they occurred

b) The countries involved

c) The result for these obstacles (e.g. double taxation, tax treatment uncertainties, administrative obstacles, additional costs, etc.).

2. Permanent establishment issues

If a permanent establishment has been deemed to exist in the country of the target company, please provide details about:

a) The reasons for the deemed existence of the permanent establishment

For direct tax purposes, the existence of a permanent establishment in Cyprus is acknowledged, if it has an actual physical presence in Cyprus, as stipulated by the relevant Cyprus direct legislative provisions and the provisions of any Double Tax Agreement in force between Cyprus and the state of the owner of the permanent establishment.

b) Whether the permanent establishment is in respect of the income of the venture capital fund manager himself or of the venture capital fund or of the investors

For direct tax purposes, the permanent establishment is acknowledged as mentioned above and it is taxed in respect of its income.

c) Which Member State has deemed the permanent establishment to exist

As mentioned above, the Cyprus direct tax authority acknowledges the existence of a permanent establishment, if it satisfies the relevant Cyprus direct legislative provisions and any relevant Double Tax Agreement provisions.

d) What percentage/part of total profits have been attributed to that permanent establishment

100% of the profits earned as a result of the activities of the permanent establishment.

e) What method was used for the profit attribution

The method of profit attribution is vested with the business itself and its auditors/accountants, having regard to the OECD relevant guidelines and any relevant legal or other provisions.

f) Whether the profits attributed to the permanent establishment have suffered unrelieved double taxation as a result and if so, why double taxation was not relieved

If the income of a permanent establishment in Cyprus is also taxed in another state, that other state has an obligation to relieve double taxation, in accordance with any relevant Double Tax Agreement provisions (if any) and also in accordance with its national legislative provisions.

g) The amount of the unrelieved double taxation **N/A**

h) Whether some Member States, despite deeming a permanent establishment to exist, nevertheless in practice exempt the profits of that deemed permanent establishment and which are these Member States.

N/A in Cyprus. A Cyprus permanent establishment is always subject to tax in Cyprus, in accordance with the provisions of the relevant direct tax legislation.

3. Entitlement under double taxation conventions

Have you suffered unrelieved double taxation due to the fact that the tax classification and tax treatment of venture capital funds varies from one country to another? If so, please specify: **N/A**

a) The exact reasons for the double taxation

b) The countries involved?

c) The amount of unrelieved double taxation

d) Whether the OECD Partnership Report[7] and the Commentary to the OECD Model[8] have provided guidance/assistance in resolving the issue (the Partnership Report and the Commentary to the OECD Model suggest generally that the classification of a partnership as transparent or non-transparent applied by an investor's country of residence should be the decisive one as far as the taxation and double taxation relief of the investor are concerned).

e) How often the mutual agreement procedure provided for in double tax conventions based on the OECD Model has been applied in practice and whether it was efficient.

4. Avoiding the risk of double taxation

If there was a risk of double taxation of your investment returns, which you managed to avoid in practice, please specify: **N/A**

a) How you managed to avoid the risk and the extra costs and complexities involved

b) The EU and non-EU countries involved

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[7] http://www.oecd-ilibrary.org/docserver/download/fulltext/2399521e.pdf?expires=1340028069&id=id&accname=ocid194935&checksum=934A17F5F9BED80F33551A78F2B1551D

[8] http://www.oecd.org/document/37/0,3746,en_2649_33747_1913957_1_1_1_1,00.html

5. Risks of double non-taxation/ tax avoidance and evasion

Are you aware of any cases in which mismatches between Member States' domestic tax rules might lead to double non-taxation or tax planning? **NO**

If so please provide:

a) Details, including the jurisdictions involved.

b) An estimation of the amounts of lost tax revenue.

6. Tax burden and additional costs for venture capital investors investing across borders

a) Are your proceeds from cross-border venture capital investment taxed in the country of the target company? **N/A**

- If so, please indicate how they are taxed; please specify the type of proceeds (capital gains, dividends, etc.), the tax rate applied and any special tax incentives/ tax regimes applicable
- If not, please specify why not – e.g. because the country where the target company is established does not tax capital gains, etc,.

b) Are your proceeds from cross-border venture capital investment taxed in the country where the fund is established? **N/A**

- If so, please indicate how they are taxed; please specify the type of proceeds (e.g. capital gains, dividends) and the tax rate applied, whilst mentioning any special tax incentives/ tax regimes applicable
- If not, please specify why not – e.g. because the fund is a tax exempt entity or transparent for tax purposes, etc.

c) Are your proceeds from cross-border venture capital investment taxed in your state of residence? **N/A**

- If so, please indicate how they are taxed; please specify the type of proceeds (e.g. capital gains, dividends) and the tax rate applied, whilst mentioning any special tax incentives/ tax regimes applicable
- If not, please specify why not – e.g. because your state of residence does not tax capital gains, dividends; because you are a tax exempt entity, etc.

d) What is the effective tax burden on your cross-border venture capital investment? **N/A**

e) Have you suffered any additional costs due to your cross-border investment in venture capital? If so, what are the annual additional costs related to your cross-border venture capital investment? Please specify per category, e.g. for advisory fees, unrelieved double taxation, foregone tax relief, administrative costs, etc. **N/A**

7. Possible discrimination of cross-border venture capital investment compared to domestic venture capital investment

a) Does the country where the target company is established tax proceeds from venture capital investment differently depending on whether the investors are resident or non-resident? For example, are there specific VC benefits, such as exemption, deferral/investment reserves, lower tax rates, relief from economic double taxation, etc available only to domestic fund and investors? Or is capital gains tax applicable only on (some or all) sales of shares of non-resident investors? Please provide details about any differences in treatment and the countries in which these occur.

The Cyprus direct tax legislation does not contain any discrimination provisions against non Cyprus tax residents.

The imposition of capital gains tax is not based on the tax residency status of the taxpayer.

b) Does the country where the fund is established tax receipts of the venture capital fund differently depending on whether these arise from domestic or foreign sources? Does the country where the fund is established tax differently dividends paid to non-resident investors compared to dividends paid to resident investors? Please provide details about any such differences in treatment and the countries in which these occur.

The Cyprus direct tax legislation does not contain any discrimination provisions against foreign source funds.

Dividends paid to non Cyprus tax residents are fully tax exempt.

c) Does your country of residence tax the income and gains you receive from a non-resident venture capital fund or non-resident target company differently to income and gains you receive from a domestic VC fund or target company? Please provide details about any such differences in treatment and the countries in which these occur.

The Cyprus direct tax legislation does not contain any discrimination provisions against non Cyprus tax residents.

III. Possible solutions to the tax obstacles encountered when venture capital is invested across borders

a) What are your proposals for possible solutions to the tax obstacles you encounter? **N/A**

b) Why do you prefer this solution/ these solutions? Please outline the advantages and disadvantages of your suggestion. **N/A**

c) How should your suggested solution(s) be implemented e.g. by EU legislation or by changes in different national laws? **N/A**

d) How would your suggested solution(s) impact on the investors' return of investment and governments' tax revenues? **N/A**

e) How would your suggested solution(s) impact on Member States' tax legislation, their double taxation conventions and existing EU law, e.g. on direct taxation, State Aid, etc.? **N/A**

f) What would the advantages be for Member States in adopting the proposed solution? Would there be winning and losing Member States and if so how could the losing Member States be persuaded to agree to the solution? **N/A**

g) If you are a fund or fund manager and are currently established outside the EU, would your suggested solution make it more attractive for you to move into the EU? **N/A**

h) Can you recommend any best practices in any EU Member States or third countries in the area of taxation of venture capital? **N/A**

i) Are you aware of any statistics or legal or economic studies which could further contribute to the analysis of the costs and benefits of implementing the solution(s) you suggest? **NO**

Do you have any other comment or thoughts to share as regards cross-border taxation of venture capital? **NO**