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On behalf of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

5 November 2012

To European Commission, Directorate-General Taxation and Customs Union, Unit D2 - Direct Tax Policy and Cooperation

Subject Response to the European Commission Public Consultation Paper on 'Problems that arise in the direct tax field when venture capital is invested across borders'

Table of Contents

Table of Contents....1
Introduction....2
Outline....3
Example 1: Tax transparency from the perspective of the investor....5
Example 2: Tax transparency from the perspective of the SME (the portfolio company) in which a venture capital fund invests....5
Example 3: The "permanent establishment issue" for foreign investors in the home country of the fund....6
Example 4: The "permanent establishment issue" for investors and/or the fund in the home country of the portfolio companies....7
Proposal for a Pan-European Tax Neutral Fund Structure....7

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Introduction

The European Private Equity and Venture Capital Association (EVCA) is a member-based, non-profit trade association that was established in 1983 in Brussels. The EVCA is a member of the Transparency register (ID: 60975211600-74). Our members cover the whole investment spectrum, including the institutional investors investing in a broad range of private equity and venture capital funds, as well as the private equity and venture capital firms raising such funds, who in turn invest in the full life-cycle of unlisted companies, from high-growth technology start-ups, to the largest global buyout funds turning around and growing mature companies.

We welcome the opportunity to respond to the European Commission consultation on direct tax problems linked to cross-border venture capital investment. For many years, the EVCA has been closely involved in the debate and through several representatives has contributed to the production of the 'Report of Expert Group on removing tax obstacles to cross-border Venture Capital Investments' in 2010[1].

Against this background, we would like to make reference to documents previously shared with the European Commission, which aim to shed more light on the current situation and problems faced by Member States. These documents demonstrate that private equity and venture capital funds and their respective investors suffer specific (and sometimes even unintended) tax effects/burdens compared to direct investments.

More recently, the EVCA has taken an even greater interest in this debate due to the current blockage on the proposal for a Regulation on European Venture Capital Funds (EVCFR) over a discussion around taxation.

As an industry we were pleased and hopeful that, through the EVCFR, the European Institutions seemed to recognise the importance of venture capital for financing innovation and growth and the challenges venture capital managers face to raise capital for this important work. This regulation aims to harmonise fundraising rules for our industry across the EU 27, and give venture capital funds access to a pan-European marketing passport.

However, the EVCA strongly regrets that this Regulation is being taken hostage, and without prejudice to the respective positions on this subject, feels that this Venture Capital Regulation is not the appropriate forum for a debate on tax issues. Rather, this specific consultation would provide a more appropriate umbrella. Both initiatives are of crucial importance but should not be mixed. The EVCA therefore encourages the European Commission to undertake the necessary steps based on this consultation to allow the tax debate, which Europe unmistakably needs to have, to continue without polluting other proposals such as the EVCFR.

We stand ready to provide whatever further contribution to this work the European Commission might find helpful, including attending meetings and contributing further materials in writing.

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[1] Expert Group, Report on removing tax obstacles to cross-border venture capital investment, 30 April 2010. See also the press release (IP/10/481) and the questions and answers (MEMO/10/160). For more information: http://ec.europa.eu/taxation_customs/taxation/company_tax/initiatives_small_business/venture_capital/index_en.htm.

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Outline

1. The European private equity and venture capital (PE/VC) industry is capable of providing an alternative form of long-term financing to a number of innovative high-growth companies and SMEs. However, the venture capital industry is confronted with obstacles in attracting international investors.

2. Investors are faced with the risks of double taxation or unexpected taxes which make investing, through PE/VC co-investment structures, in private companies less attractive than investing in listed companies or even investing directly in private companies. The fiscal environment, which is a very important factor for the venture capital industry, can therefore either reduce or reinforce the natural risk aversion of private investors.

3. In this respect, it is important to underline the impact of double taxation. The threat of double taxation is significant, since other types of investment or asset classes may partly or entirely escape this double taxation issue, in particular where no intermediate vehicle is used for the purpose of investment. In response to the fragmentation, investors may be tempted to focus on tax-neutral structures, which exist at national level only, or on other asset classes.

4. Furthermore, obstacles faced by private equity and venture capital funds will hinder their ability, both to efficiently channel funds to the most promising EU businesses and to offer professional management to investors.

5. We believe that tax provisions can be instrumental in overcoming the risk aversion of investors. For many years, the EVCA has called for the creation of a **pan-European tax-neutral vehicle**, which aim is first and foremost **to eliminate the discriminatory and prejudicial treatment of investors as soon as they are 'pooled' in a fund** and to ensure that investors are treated the same as if they had invested directly into the underlying portfolio companies and in parity with holding and selling listed shares.

6. The purpose for such a vehicle is not to facilitate tax avoidance, but to ensure greater transparency and predictability in the way venture capital funds make a fair contribution to government finances.

7. This pan-European tax neutral vehicle should accommodate the needs of both domestic and non-domestic investors. Any failing in this area could lead to non-EU investors becoming reluctant to invest into EU funds, with also EU investors and EU fund managers preferring to seek out foreign structures (incurring significant set-up and transaction costs, which are often then prohibitive for smaller fund managers). This leads to an overall reduction of amounts that can actually be invested into European small and mid-sized companies. The legal structure of a fund needs to allow the fund manager to channel capital freely to the most promising entrepreneurial projects. Without this, investee companies will struggle to expand their businesses, especially in the early phase of their development.

8. We believe that such a tax-neutral vehicle is key to removing the remaining barriers to cross-border fundraising and investment in order to ensure a level playing field for PE/VC

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investments alike; and is in accordance with the conclusions of the Expert Group report on removing tax obstacles to cross border venture capital investments[2].

9. In its consultation document, the European Commission requests input regarding actual direct tax problems and obstacles that have arisen when venture capital has been invested across borders, including any available details of their financial impact on investors, the funds, and the SMEs as investee companies.

10. The EVCA gathered examples of such direct tax problems and obstacles, typical for cross-border venture capital funds. In addition, the EVCA refers to its Memorandum of 19 July 2011 and the EVCA Overview, dated 19 July 2011. These examples are still valid.

11. The ultimate objective should be that the **collective investment through a venture capital fund in SMEs should be at least -- from a tax point of view -- be treated fiscally neutral as compared to a direct investment by the respective investors**. In other words, the investors in a venture capital fund should not be confronted with higher tax costs as compared to the tax liability of a direct investment.

12. The aforementioned objective could generally be achieved if the fund entity is ignored for tax purposes, i.e., a situation in which the home state of the investor, the home state of the fund, and the home state of the investee company treat the fund entity as tax transparent. Reference is made to Examples 1 and 2 below.

13. Even if such fully transparent situation could be achieved by harmonizing the entity classification rules for tax purposes in all Member States, the aforementioned objective would still not be achieved if the investor is deemed to be engaged in business activities solely because the fund is deemed to be engaged in business activities for tax purposes. Reference is made to Examples 3 and 4 below.

14. The best and most effective solution to resolve the problems and obstacles referred to above, at least within the EU, would be to **create the possibility to use a fund vehicle (i) which is to be treated as fiscally transparent in all Member States** irrespective of whether the Member State is the home country of the investor, the fund entity, or the investee company (the "Transparency Rule"), **and (ii) that is not be considered to be engaged in business for tax purposes** (the "Non-Business Rule").

15. This may be achieved either by way of introducing a European fund entity (similar to the introduction of the European Economic Interest Grouping[3]) or by way of introducing a Regulation that requires Member States to observe the Transparency Rule and the Non-Business Rule if the fund and its investors elect the application of this Regulation.

16. This may not resolve all tax problems and issues for non-EU investors in EU funds, or non-EU investments by EU funds, but it should eliminate most of the direct tax problems within the EU.

17. Again, the objective is to eliminate all cases of prejudicial treatment of investors as soon as they are 'pooled' in a fund, and to meet the reasonable expectations of these investors that

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[2] See footnote 1.

[3] Council Regulation 2137/85 of 25 July 1985 on the European Economic Interest Grouping (EEIG).

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their tax treatment would be the same as if they had invested directly into the underlying portfolio companies.

18. Please find below four examples of the most eminent tax obstacles. Each example is based on current tax rules in the respective EU Member State. Each example is given from the perspective of a certain Member State, but may also be true for similar situations in various other Member States.

Example 1: Tax transparency from the perspective of the investor

If a Belgian individual decides to invest directly in a portfolio company and realizes a capital gain at the occasion of the exit, he will generally not be taxed on the capital gain, irrespective of whether the capital gain is realized with the sale of a Belgian portfolio company or a non-Belgian portfolio company.

If however he decides to invest the same amount into a fund entity, and the fund realizes the capital gain (assuming tax free), the distribution of the proceeds by the fund to the Belgian investor will in most cases be considered as the distribution of a dividend which will be taxable at a rate of 15% or even 25%. If, however, the fund was deemed to be tax transparent for Belgian tax purposes, the Belgian investor would be deemed to earn (his pro rata portion of the) capital gains, as a consequence of which he would be taxed as if he had invested directly.

Solution: Allow the Belgian investor to overrule the Belgian entity classification rules by enabling him to elect the fund to be tax transparent for Belgian tax purposes. This may be achieved, for instance, by enabling the Belgian investor to participate in a pan-European fund vehicle that is mandatorily tax transparent for tax purposes within the European Union.

Example 2: Tax transparency from the perspective of the SME (the portfolio company) in which a venture capital fund invests

If a non-Dutch (EU) investor directly invests in a Dutch portfolio company for less than 5% (say 2%) of the share capital, this foreign investor is not subject to Dutch income tax on the capital gain upon exit. If the same foreign investor, together with, for example, nine other investors -- each for the same commitment -- invests in the (same) Dutch portfolio company through a non-Dutch (EU) venture capital fund (the fund acquiring 20% of the share capital and each investor owning indirectly 2% of the Dutch portfolio company), the non-Dutch (EU) venture capital fund is generally subject to Dutch income tax on the capital gain upon exit, and therefore indirectly the foreign investors are subject to Dutch income tax whereas such tax liability does not arise if invested directly by the investors.

The reason for this income tax liability is that (i) the Netherlands generally apply an income tax on capital gains on shares realized by non-resident shareholders if the shareholding comprises 5% or more of the share capital of a Dutch resident company, and (ii) the Netherlands apply domestic entity classification rules, which in practice means that almost all non-Dutch (EU) venture capital funds are treated as non-transparent.

In many situations, the above mentioned tax liability leads to incremental tax, for instance for all investors that are tax exempt either because of their status (e.g. pension funds) or because capital gains are tax exempt or taxed against lower tax rates than the Dutch tax rate (25%).

Solution: Allow the non-Dutch (EU) investor and the non-Dutch (EU) venture capital fund to overrule the Dutch entity classification rules by enabling them to elect the fund to be tax transparent for Dutch tax purposes. This may be achieved, for instance, by enabling the non-Dutch (EU) venture capital fund to adopt the form of a pan-European fund vehicle that is mandatorily tax transparent for tax purposes within the EU.

Example 3: The "permanent establishment issue" for foreign investors in the home country of the fund

If a non-Finnish investor invests in a tax transparent venture capital fund that is actively managed by a management team operating from Finland and making investments in Finland, the foreign investors are generally deemed to be engaged in business activities through a Finnish permanent establishment. The fund management activities by the Finnish manager are deemed to constitute a business for Finnish tax purposes. Due to the tax transparency of the fund, the income and gains derived by the fund are allocated to the investors in the fund in proportion to the equity stake of the investors. The Finnish fund management is deemed to form a "permanent establishment" in Finland for the foreign investors. The income that is allocated to the foreign investors may be taxed in Finland, as it is deemed to be business income from a Finnish permanent establishment.

For many foreign investors, such Finnish tax will lead to incremental tax, as their home country will not provide for double taxation relief. A bilateral tax treaty concluded between the home country of the foreign investor and Finland will generally not force the home country to grant double taxation relief, as such bilateral tax treaties – generally based on the OECD model treaty – do not provide for binding authority in case of a mismatch between two treaty countries in determining whether or not certain activities are deemed to constitute a trade or business enterprise.[4]

A direct investment by the non-Finnish investor in a Finnish SME (by-passing the fund) would not trigger such Finnish tax liability, simply because the investor would not be deemed to have a business enterprise in Finland solely by reason of making a direct investment in the Finnish SME.

Solution: The fund management activities of a venture capital fund manager should not constitute a trade or business enterprise for tax purposes. As a consequence, an investor in a tax transparent venture capital fund cannot, solely because of its investment in the fund, be considered to be engaged in business activities. If the fund (and therefore the investors too) is not deemed to be engaged in business activities, the permanent establishment issue cannot arise. This is basically the approach adopted by the UK. This may be achieved, for instance, by enabling the Finnish management team to set up a venture capital fund in the form of a pan-European fund vehicle that is (i) mandatorily tax transparent for tax purposes within the EU, and (ii) not deemed to be engaged in a business or trade for tax purposes within the EU.

The broad principle under UK law is that only the profits of a trading permanent establishment of a non-UK resident would be taxable in the UK and it would be very unusual for a fund to be regarded as trading in securities because the securities are held for a longer term investment purpose.

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[4] See OECD Commentary 2010 on Article 3 paragraph 1 (the term 'Enterprise').

Firstly a non-UK resident is not liable to tax on capital gains or investment income (interest and dividends) generated in the UK (subject to some minor exceptions).

For capital gains, this would normally be where the asset is used in a trade carried on by the investor's permanent establishment in the UK. A passive investment activity in a fund is unlikely to be regarded as a trading activity except for an investor which is, itself, a dealer in securities or otherwise a financial trader. A similar analysis would apply to investment income.

Even where there is a theoretical risk of a permanent establishment, there is an additional legislative provision known as the "investment management exemption". These rules are designed to promote the UK as a centre of investment management and broadly provide that provided the manager is remunerated on arm's length terms and is not otherwise connected to the investor, the UK manager cannot be assessed on the profits of the non-resident investor. For this reason, there is no to limited risk of a tax charge arising in the UK from the activities.

These two principles have contributed to the attractiveness of the UK for private equity and venture capital fund management in Europe.

Example 4: The "permanent establishment issue" for investors and/or the fund in the home country of the portfolio companies

This tax problem resembles the situation described under Example 3. A foreign fund that invests in certain EU countries may be deemed to be engaged in business for tax purposes under the local tax rules of such EU country, for instance in cases where the fund maintains a local office in such country through which one or more of the fund managers (generally a tax resident of such country) carry out their daily activities. Such a local team may be seen, due to its local connections in the home country of the portfolio company, as constituting a local trade or business and a local permanent establishment for the foreign fund in the respective country. This may lead to a tax liability of the fund and its investors on the income and gains attributable to this local trade or business / local permanent establishment, typically the income and gains derived from investments made in the same country.

<u>As pointed out in Example 3, such permanent establishment taxation generally constitutes incremental tax since bilateral tax treaties generally do not prevent double taxation in such situations.</u>

Solution: See Example 3.

Proposal for a Pan-European Tax Neutral Fund Structure

The EVCA strongly encourages / urges the European Commission to propose a legislative framework establishing a pan-European tax neutral fund vehicle for private equity and venture capital investment funds alongside existing national structures. Such a structure would facilitate cross-border activities and foster capital formation in Europe.

It would be an EU fund structure that permits all EU and international investors to invest freely in private equity and venture capital on a pan-European basis, without prohibitions and exorbitant costs while at the same time eliminating the risk of double taxation as well as unfavourable tax treatment, allowing all investors to only be subject to tax in their respective home jurisdictions.

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Such a fund structure would ensure investors were in no worse a position if investing through a fund than if investing directly in the underlying companies or listed shares for that matter. On top of this, certainty in legal and tax treatments would simplify both fundraising and administration. Reinforcing the European PE/VC industry and its capacity to raise funds world wide, would be of interest to the EU at large.

Facilitating fund raising and attracting international investors to the asset class will increase the contributions to the asset class helping to finance the EU's most innovative high-growth companies and SMEs. This remains the ultimate goal.

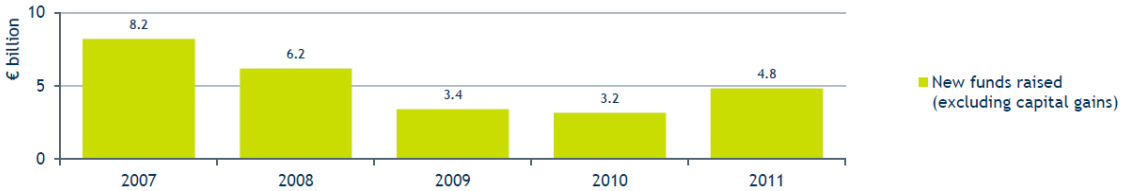
Today, many European SMEs struggle because of difficulties in accessing finance markets. As highlighted by the European Commission, the tightening of credit conditions during the crisis has made access to finance difficult, especially for SMEs. Corrective measures have been adopted, but access to finance continues to be difficult.[5]

High-growth firms are found in all industries and in all regions, and tend to be innovative. Venture capital channels the flow of equity into such innovative companies from institutional investors such as pension funds and insurance companies as well as family offices, corporate investors and high net worth individuals; it contributes to the financing of SMEs and to their growth and addresses a significant need of SMEs. For these reasons, venture capital plays a positive role in supporting the real economy in Europe and should be nurtured and grown, particularly in an economic environment characterised by low macro-economic growth.

However, to this day, the European venture capital market remains underdeveloped, in particular when compared with the US venture capital market. The economic crisis has clearly taken its toll on the venture capital market in Europe.

Venture capital fundraising has decreased; investments have been postponed; investors are withdrawing from the asset class; there are fewer exits and returns are lagging behind those possible in other asset classes. Many venture capital funds in Europe are also too small to support the later stage funding rounds required to help innovative companies reach their true potential.

In the wake of the financial crisis, fundraising in the European venture capital industry has been significantly more difficult. In spite of some improvements and signs of recovery, it has not fully recovered back to its 2007 levels, as seen in the graph below:



Source: EVCA / PEREP_Analytics

[5] COM(2011) 642 final, COMMUNICATION FROM THE COMMISSION, Industrial Policy: Reinforcing competitiveness. See also COM(2011) 702 final, COMMUNICATION FROM THE COMMISSION, Small Business, Big World — a new partnership to help SMEs seize global opportunities.

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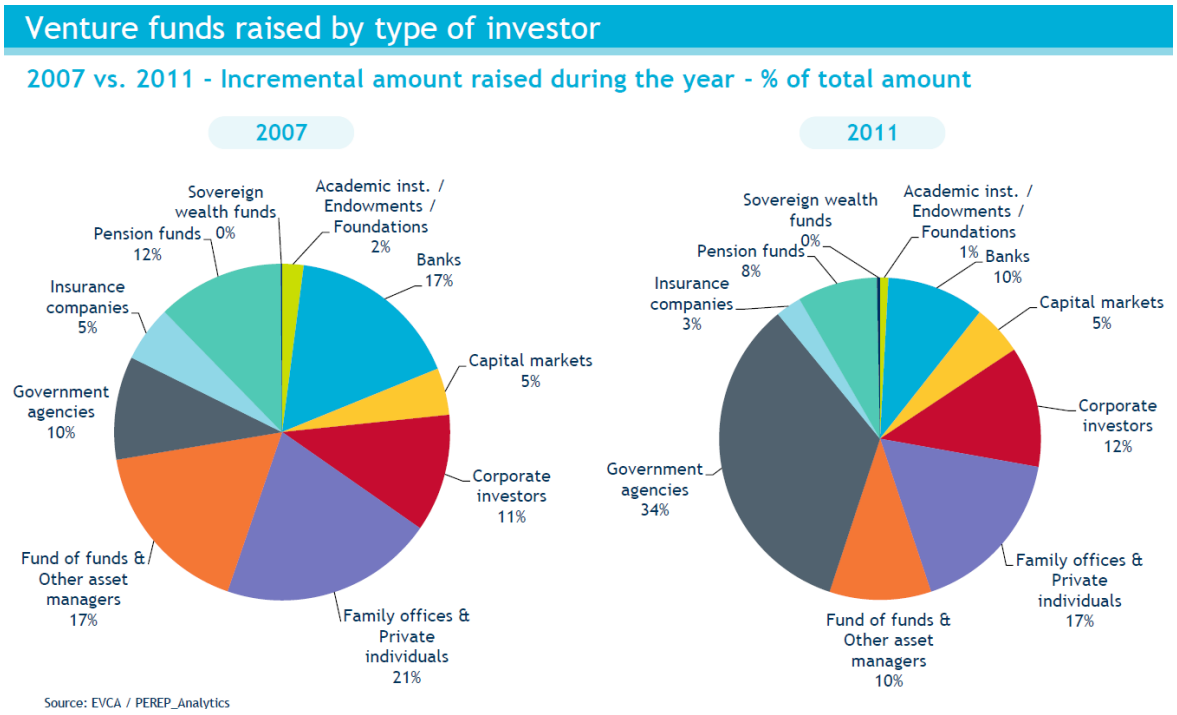
Incremental amounts raised by venture capital funds during the year reached over EUR 8 billion in 2007, over EUR 6 billion in 2008, over EUR 3 billion in both 2009 and 2010, and EUR 4.85 billion in 2011 (for 135 new funds).

However, in spite of signs of recovery, fluctuations have been witnessed over the past years regarding the basis of investors (see graph below), particularly regarding pension funds, banks and insurers, which contribution has significantly decreased.



A pan-European tax neutral fund structure can play a positive and supporting role in SMEs' access to finance and addressing wider issues in regards to the development of the European venture capital industry.

To achieve optimal conditions for such a structure, the following issues should be addressed:

- **Tax transparency**

  The most efficient tax structure for investments in private equity and venture capital is one based on the principle of tax transparency. Put simply, it is necessary to prevent double taxation: first, at the fund level, when it receives income or realises an investment; and second, when an investor receives income or capital from the fund. **Tax transparency ensures investors are only subject to tax in their home jurisdictions, just as they would be when investing directly in company shares**. Investors should not be in a worse position investing in unlisted companies through a fund than they would have been if they invested directly in the underlying companies or in listed shares.

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- **A fund structure suitable for investors in other Member States or for international investors**

  Certain Member States, where investments are made, may charge tax on capital gains made by non-residents. Therefore, a **suitable international fund structure should ideally be transparent**, in order to prevent double taxation; the taxing at source of capital gains should also be minimised. In addition, from a public perception point of view, establishing a tax-neutral fund structure in the EU may be preferable to creating off-shore fund vehicles. The fund structure should be flexible enough to allow international investment by accommodating requirements of particular investors from countries that do not recognise certain vehicles as tax transparent.

- **Preventing the application of a "trade or business" and as a "permanent establishment" presumption regarding the fund and/or the investors**

  It is essential that the fund does not create a trade or business (and therefore not a permanent establishment) that could result in taxation for itself or for the investors in the country/countries in which the management or advisory team operates or invests. This would make investing in these private markets unattractive to investors.

  Using a structure not based on the above mentioned principle is likely to make the fund unattractive for investors. If the main goal is to enforce the free movement of capital, double taxation of the fund's profits as a result of creating permanent establishments is inefficient and complex and can potentially deter investment.

- **No undue restriction on the type of investments that can be made**

  To enhance the competitiveness of the fund and strengthen the free movement of capital by establishing a system based on the recognition of the structures used in other Member States, the EU should **not impose undue restrictions on the type of investments that can be made**.

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About EVCA

The EVCA is the voice of European private equity.
We represent venture capital, mid-market private equity, the large majority investors and institutional investors, speaking for 700 member firms and 400 affiliate members.
In the last five years, EVCA members have invested 160 billion euros in 7,000 companies across Europe, making a valuable contribution to growth and innovation.
The EVCA shapes the future direction of the industry, while promoting it to stakeholders like entrepreneurs, business owners and employee representatives.
We explain our industry to the public and engage in debate with policymakers, so that our members can conduct their business effectively.
The EVCA is responsible for the industry's professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.
Thanks to our industry research teams, we have the facts when it comes to European private equity. The EVCA has 25 dedicated staff working in Brussels to make sure the industry is heard.