The OECD's mission to clamp down on tax avoidance

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Widespread political and public concern that multi-nationals are able to avoid paying their "fair share" by moving profits to low tax jurisdictions has given rise to a view that the international tax system is no longer fit for purpose. However, until now – and despite many rhetorical proclamations – national governments have struggled to co-ordinate a response. But that may now have changed: an initiative by the Organisation for Economic Co-operation and Development ("OECD"), which has G20 support, looks like it might have the potential to catalyse major change, and a paper published in March as part of this initiative should be taken as a very serious statement of intent.

The paper, which is on 'preventing the granting of treaty benefits in inappropriate circumstances', is part of the OECD's broader Base Erosion and Profit Shifting ("BEPS") Action Plan. And while few people would argue with the general thrust of the international initiative, this paper has caused considerable concern in private equity circles, because as written it could have very significant unintended consequences for the private funds industry.

The target of the OECD's proposals is 'double non-taxation' and it regards so-called 'treaty shopping' as a key issue. Put simply, the OECD wants to stop investors using intermediate vehicles to bridge the gap between two countries which do not have a double tax treaty with each other. The use of such intermediate vehicles, usually in a country with a good network of double tax treaties, can have the effect of reducing the tax that an ultimate investor would otherwise suffer.

The private equity industry does use this type of structure, but typically for quite different reasons. For example, a fund which has investors from, and itself invests in, a wide range of countries saves itself a compliance nightmare by channelling investments through a central treaty-eligible structure. But the approach taken in drafting the 'anti-abuse' tests which would be used to determine whether an entity should have access to double tax treaty benefits presupposes that the beneficiary of the treaties is a member of a multi-national corporate group. Under the current drafting (which the OECD have based on some recent tax treaties) it is unlikely that any private equity fund would be able to make use of tax treaty eligible investment vehicles. This would be so even where all (or a vast majority) of the fund's investors are themselves tax exempt or eligible for treaty relief, as is often the case.

There is yet some hope that the drafting will change though. The OECD has itself previously recognised in its paper *The Granting of Treaty Benefits with respect to the income of Collective Investment Schemes* that investing through a fund should not trigger more tax for an investor than if it were investing directly in a company, and many tax exempt investors will no doubt press national governments hard to make sure they are not caught in the crossfire of a war on tax avoiders.

Meanwhile, the BVCA and EVCA are working hard to bring the potential unfairness in the current drafting to the OECD's attention. But, although the OECD is aware that funds have been overlooked in its draft report, we expect them to be cautious about granting wholesale exemptions for fear of creating loopholes or pressure from other sectors.

This issue was discussed as part of our 17th Annual Private Equity Investment Funds Seminar on 8 May, in which we reviewed the fundraising market, standard terms and regulatory and taxation developments. The seminar will be repeated on Thursday 22 May, commencing at 4:30pm. Spaces are still available. Please contact Karis Berthier should you wish to attend.