Australian Private Equity &
Venture Capital Association Limited

17 August 2018

Brian McKay
Base Erosion and Profit Shifting Unit
Corporate and Income Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via email: BEPS@treasury.gov.au

Dear Brian,

Extending the definition of a Significant Global Entity (SGE)

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to comment on exposure draft legislation and associated explanatory material, released in July 2018, extending the definition of a Significant Global Entity (SGE) to include members of large business groups headed by proprietary companies, trusts, partnerships and investment entities.

AVCAL represents the private equity (PE) and venture capital (VC) industry in Australia, which has a combined total of around $30 billion in funds under management on behalf of domestic and overseas investors including Australian and offshore superannuation and pension funds, sovereign wealth funds, and family offices. Our member firms invest billions of dollars in early stage and established businesses spanning across almost every sector of our national economy. In the financial year ending 30 June 2017 alone, our sector invested around $3.6 billion into Australian businesses.

AVCAL has for many years been supportive of reforms to our taxation system that help to ensure our economy is competitive and which encourage the growth and expansion of businesses. In particular, we are supportive of reforms that encourage or tackle barriers to greater levels of PE and VC investment into Australian businesses.

We believe that expanding the SGE definition would have detrimental outcomes not only for our industry (including possibly for investors that allocate capital to PE funds) but also for the businesses that are backed by PE investments. It would also have the unintended effect of discouraging investment in Australian companies by PE funds and other investment entities due to the increased reporting and regulatory compliance burden that such entities and underlying portfolio companies would have to bear.

Our detailed comments in response to the exposure draft are outlined below.

1. Comments on the exposure draft legislation

a) Intention of the legislation

Our understanding is that the intent of expanding the SGE definition is to close an unintended consequence of the current criteria used to determine if an entity is an SGE. The broadened SGE definition seeks to remedy situations where an entity, or a related group of entities undertaking the same business, is currently not considered an SGE solely on the basis that it is owned by an entity which is not required to consolidate its financial statements according to accounting standards.

We also understand the objective and rationale to have consistent treatment of large corporate groups with revenue exceeding the SGE turnover threshold, notwithstanding differences in their ownership between corporate groups and those owned by investment entities such as PE or VC funds or the managers of those funds.

b) Unintended consequences of the legislation

We recognise that the focus of the expanded SGE definition is to ensure that cross-border related party transactions fall within the scope of the package of integrity measures under Country-by-Country (CbC) reporting, Multinational Anti-Avoidance Law (MAAL), and Diverted Profits Tax (DPT) rules.

In a PE context, such cross-border related party transactions occur within a subgroup of related entities rather than between separate portfolio companies controlled by the same investment entity (i.e. controlled by the same PE fund). As such, we believe that the focus of the expanded SGE definition should solely be targeted at subgroups of related entities which satisfy the SGE definition in their own right (by, for example, reaching the $1 billion of global income threshold) notwithstanding being controlled by an investment entity.

In our view the broadened SGE definition has unintended consequences, in that it will effectively ‘aggregate’ all investments of a PE or VC fund, or a number of funds managed by the same firm, together. The consequence is that the proposed legislation would capture individual companies or subgroups of entities conducting separate businesses – which have not entered into transactions with one another, cross-border or otherwise – that on a standalone basis would not exceed the SGE turnover threshold, but which, when aggregated with the other entities the PE fund invests in (which are conducting entirely unrelated businesses), would have a combined income higher than the SGE threshold and be deemed to be an SGE.

The nature of PE funds mandates that standalone businesses are operated separately and independently of any other investments the PE fund makes. This is on the basis that the entities owned by the PE fund vary in size, level of management teams, the existence and number of co-investors, geographical location, industry sector, business activity, and investment holding period. Similarly, different minority shareholders or debt lenders will be providing capital separately to each portfolio company and would potentially have an influence on the financing or operational decisions of the business.

Whilst these businesses are not commercially related, and not a ‘group’ for the objectives and purposes of the SGE definition and the measures which apply as a result, a PE fund and the independent and separate portfolio companies it owns could be captured by the broadened SGE definition on an aggregated basis merely by the virtue that they are owned by the same transparent fund vehicle. For instance, we note that the intention of the DPT targets entities within multinational groups that enter into arrangements to divert their Australian profits to offshore related parties in order to avoid paying Australian tax. The broadened SGE definition will bring in-scope entities which have the characteristics of passive investment vehicles, which do not enter into the types of arrangements the DPT seeks to address.

Having regard to the implications which follow from an SGE classification for a company, it is difficult to see that such implications were intended or would be warranted for, say, a PE investment into a small-to-medium sized enterprise whose turnover on a standalone basis is considerably lower than $1 billion. This unintended consequence would have a significant impact of the PE sector locally, and potentially deter future PE investment into critical parts of the Australian economy from offshore.

c) Impact on the PE sector

Portfolio companies within a standard PE fund operate as standalone businesses as they are separately managed and normally have no transactions between themselves. The standalone portfolio companies within a PE fund often operate in different and unrelated industries as well as different geographies.

The purpose of acquiring stakes in each of the portfolio companies by the PE fund is to generate investment returns for fund investors. Other co-investors may also take stakes in those companies alongside the PE fund at the time of investment.

Each portfolio company is run by a different and separate management team, may have a separately arranged and managed debt package as part of its capital structure, and does not typically transact with other portfolio companies owned by the PE fund. Importantly, the fund entity is not required to consolidate the financial statements of individual portfolio companies for reporting purposes. We therefore believe that it is not appropriate to aggregate separate portfolio companies owned (fully or partly) by a PE fund or other collective investment vehicle into a single consolidated group.

The OECD's own Public Discussion Draft report on *BEPS Action 4: Interest Deductions and Other Financial Payments*[1] highlights two potential issues that arise when grouping PE portfolio companies for group-wide tax rules:

> *Firstly, in applying a group-wide rule an entity would need to obtain financial information on the position of its connected parties which would not be included in the group's consolidated financial statements. This could impose a significant burden on entities and tax administrations. Secondly, under this approach, the total third party interest expense of two connected groups (for example, those held by the same private equity fund) would be combined and allocated between entities in both groups. This could lead to undesirable results, particularly where the two groups operate in different sectors and have different funding needs.*

As the passage above highlights, the proposed changes to the SGE definition could potentially create a significant compliance burden. Investment entities such as PE funds generally have no centralised treasury or financial reporting function. In order to abide by the rules that apply to SGEs, PE funds would need to address this issue either through internal resourcing or the use of external accountants and advisers, thereby increasing their tax compliance costs. Conversely, an individual company would be limited in its ability to self-assess whether or not it itself is an SGE, and would need to place reliance on the above mentioned sources as arranged by the PE fund, including information relating to other companies owned by the PE fund. This again would be a difficult position to reconcile in circumstances where individual portfolio companies have no commercial relationship.

Ultimately, bringing in investment entities such as PE funds (including the fund manager entity and all underlying portfolio companies) under the same anti-avoidance rules that have been put in place for multinationals would see no material benefit to government revenue or the Australian tax base. Instead, there would be an increase in costs and a reporting burden for PE funds which provide much needed capital to many Australian businesses. The proposed amendments may deter them from making further investments in the future. An inflation in compliance costs for PE or VC fund managers may even be passed on to fund investors such as domestic superannuation funds, which would be an adverse outcome for superannuation fund members.

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[1] *BEPS Action 4: Interest Deductions and Other Financial Payments*, OECD, December 2014

d) Impact on individual portfolio companies

In addition to the potential impact of the proposed legislation at the PE fund level, the broadened SGE definition may have unintended and undesirable outcomes on each portfolio company. For example, the undertaking of commercial opportunities or the use of debt in the company capital structure by each portfolio company could be affected due to these entities being deemed SGEs and being subject to certain group-wide rules.

It may also create costly reporting obligations for the underlying portfolio companies (which vary in size and level of management function) or affect the way that these businesses operate, to the detriment of the financial performance of those companies.

2. Proposed definition

A simplified solution would be to have a harmonised definition of SGEs across CbC reporting and general purpose financial statement obligations, with the definition being the existing CbC reporting entity definition. This definition should also apply in respect of MAAL and DPT for individual companies or subgroups of related companies. Under the exposure draft legislation, such entities would – in our view unfairly – meet the definition of an SGE solely by being part of a notional listed company group while not meeting the SGE annual global income threshold.

The proposed definition of a CbC reporting entity in the exposure draft would give rise to the same outcome as would arise under the model legislation in Action 13 of the BEPS Action Plan, but without the unintended consequences and impact of the broadened SGE definition as it currently stands on our industry and investment entities more generally.

We therefore propose that this definition (as set out below for CbC reporting entities) also be used as the definition of an SGE.

> <u>*Proposed CbC definition; Section 815-370 of ITAA 1997*</u>
>
> *815-370 Meaning of country by country reporting entity*
>
> *(1) An entity is a country by country reporting entity if the entity would be a significant global entity, assuming that:*
>
> > *(a) the entity were a global parent entity; and*
> >
> > *(b) paragraph 960-575(4)(a) were disregarded.*
>
> *(2) To avoid doubt, the assumption in paragraph (1)(a) does not include an assumption that the entity is not controlled by another entity (according to the principles mentioned in section 960-560).*
>
> <u>*Proposed Paragraph 960-555(2)(a)*</u>
>
> *(a) any of the following requirements are satisfied:*
>
> > *(i) the entity is a member of a group of entities that are consolidated for accounting purposes as a single group;*
> >
> > *(ii) the entity is a *member of a * notional listed company group in relation to the entity or any other entity; and*

3. About AVCAL and Australia's private equity and venture capital industry

AVCAL represents the PE and VC industry in Australia, which has a combined total of around $30 billion in funds under management on behalf of domestic and overseas 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. In the financial year ending 30 June 2017 alone, PE and VC invested around $3.6 billion into Australian businesses.

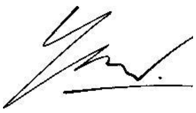
An April 2018 study by Deloitte Access Economics provides some deeper insights into the economic contribution of PE including:

- In FY2016, private-equity backed businesses contributed $43 billion in total value added to the Australian economy – equal to 2.6% of Australian GDP;
- PE-backed businesses supported 327,000 FTE jobs (172,000 directly, and 155,000 indirectly);
- In FY2016, private equity-backed businesses added almost 20,000 FTE jobs, accounting for 11% of total Australian employment growth in FY2016;
- PE-backed businesses typically delivered annual revenue growth of 20%, while boosting the size of their workforce by 24%;
- More than 85% of private-equity businesses introduced some type of process or product innovation in FY2016, far greater than the average profile of non-PE backed businesses.

4. Next steps

We would like to thank you for considering the views outlined in this submission. If you have any further questions in relation to this matter, please do not hesitate to contact either me or Kosta Sinelnikov, AVCAL's Policy & Research Manager, on 02 8243 7000, if you have any questions or require further input to the final design of these tax reforms.

Yours sincerely



Yasser El-Ansary
Chief Executive