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LONG TERM INVESTORS

Brussels, 22 April 2016

On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Re: Response to OECD Consultation on Treaty Entitlement of non-CIV Funds

Introduction:

The European private equity industry[1] is pleased to respond to the above-mentioned consultation. In line with our commitment to finding a suitable solution to the question of treaty access for private equity funds, we have now responded to all 4 OECD Action 6 consultations with the submission of this paper.

As outlined in the consultation document, we will only be responding to those questions which are relevant for the European private equity industry as they are connected to points we made previously in our OECD BEPS Action 6 submissions.

SUGGESTION THAT TREATY BENEFITS BE GRANTED TO REGULATED AND/OR WIDELY-HELD NON-CIV FUNDS

1. What would be the threshold for determining that a fund is "widely held" for the purpose of such a proposal?

For example, in order for a fund to be considered widely held a fund would need to have 20 different investors with no single investor providing more than 10% of the aggregate investor commitments.

2. What types of regulatory frameworks would be acceptable in order to conclude that a fund is "regulated" for the purposes of such a proposal? For instance, would these include the types of regulatory requirements described in paragraph 16 of the 2010 CIV report (i.e. "regulatory requirements relating to concentration of investments, restricting a CIV's ability to acquire a controlling interest in a company, prohibiting or restricting certain types of investments, and limiting the use of leverage by the CIV") as well as disclosure requirements relating to distribution of interests (e.g. "know your customer" rules)?

Different jurisdictions have put in place their own regulatory frameworks for non-CIVs. In this response we focus on the regime in place in the European Union, whilst recognising

[1] The term private equity is used to refer to both private equity and venture capital. The term venture capital is used in specific circumstances when there are particular characteristics which relate to that asset class.

that in other parts of the world the local regulatory framework will determine the appropriate prudential requirements in a manner consistent with local circumstances.

The EU Alternative Investment Fund Managers Directive (AIFMD)[2] would be acceptable in order to conclude that a fund is regulated for the purposes of such a proposal. The AIFMD entered into force on 22 July 2013 in the European Union. It regulates the management and marketing of alternative investment funds in the European Economic Area. The objective of this Directive is to create a comprehensive and effective regulatory and supervisory framework for Alternative Investment Fund Managers (AIFMs) at European level.

AIFMs are required to obtain authorisation and are subject to on-going regulation and supervision. In this way, the AIFMD aims to:

- Increase the transparency of AIFMs towards investors, supervisors and the employees of the companies in which they invest;
- Equip national supervisors, the European Securities & Markets Authority (ESMA) and the European Systemic Risk Board (ESRB) with the information and tools necessary to monitor and respond to risks to the stability of the financial system that could be caused or amplified by AIFM activity. Even though, as the De Larosière Report into the causal effects of the financial crisis noted, the private equity industry was not a contributing factor; [3]
- Increase the accountability of AIFM holding controlling stakes in companies towards employees and the public at large, and
- AIFMs are required to inform competent authorities about their use of leverage at fund level, so that the authorities can assess whether the use of leverage by the AIFM contributes to the build-up of systemic risk in the financial system. This information is shared with the ESRB. Where the use of leverage deployed by an AIFM poses a substantial risk to financial stability supervisors have the power to intervene.

The AIFMD introduces safeguards to ensure that investors in alternative investment funds, who are mainly professional or semi-professional, are well informed and adequately protected. For example, the AIFMD requires that:

- Conflicts of interest are avoided or managed and disclosed;
- AIFMs employ adequate systems to manage risks to which the fund is exposed, and to ensure that the liquidity profile reflects the obligations towards investors;

[2] Alternative Investment Fund Managers Directive 2011/61/EU
[3] Report of the High-Level Group on Financial Supervision in the EU chaired by Jacques De Larosière, February 2009

- A fund's assets are safe-kept, or monitored, by an independent depositary subject to a high liability standard;
- Valuation is performed properly and independently; and
- Strict conditions are met when AIFM delegates functions to third parties.

Depending on the type of Alternative Investment Fund (AIF) they manage, an AIFM with assets under management amounting to less than €500 million (for unleveraged funds with long 'lock-in' periods) or €100 million for other types of alternative investment fund will be subject to a tailored regime. These AIFMs will be required to register with national authorities and comply with harmonised transparency requirements, as well as additional requirements applied at national level.

The AIFMD also provides for the possibility for these sub-threshold AIFMs to 'opt-in' so as to avail of passporting rights in return for full compliance with the AIFMD. Therefore, while not all fund managers will be subject to the AIFMD regime, due to the size thresholds that recognise their specific risk characteristics, the vast majority of EU-based private equity fund managers are regulated (authorised or registered) under the Directive..

Funds and managers in other jurisdictions will have their own regimes that address many of the same issues that are covered by the AIFMD in a manner consistent with local circumstances. In some cases these may be very similar to AIFMD (e.g. in those jurisdictions that have expressly decided to mirror the EU regime in order to facilitate access to an EU marketing passport).

3. Since the proposed exception would apply regardless of who invests in the funds, it would seem relatively easy for a fund to be used primarily to invest in a country on behalf of a large number of investors who would not otherwise be entitled to the same or better treaty benefits with respect to income derived from that country. How would this treaty-shopping concern be addressed?

As a general point, this question imposes a presumption of wrongdoing on non-CIV funds and their managers. Providing a thorough and comprehensive rebuttal of the *potential* wrongdoing identified in the question is quite difficult as it is akin to proving a negative. Nevertheless, we believe that we can demonstrate the high degree of unlikelihood that these practices are commonly taking place.

Existing due diligence procedures (such as the requirements under CRS, FATCA and Anti-Money Laundering legislation) already offer an efficient means of ensuring that private equity funds are not used to provide treaty benefits to investors who are not themselves entitled to treaty benefits.

Before admitting an investor into the fund, the fund must comply with several specific due diligence procedures regarding the status of the potential investor. If we take an example

of a French private equity fund, pursuant to Articles L. 561-2 et seq. of the French Monetary and Financial Code (Code Monétaire et Financier), which implements domestic provisions on the fight against money laundering and the financing of terrorism, a fund manager must:

- assess the risks of money laundering and financing of terrorism; and
- verify, as far as possible, the identity of each investor and the effective beneficial owner of the investment in the private equity fund.

Each investor must complete an anti-money laundering and anti-financing of terrorism questionnaire and provide all necessary information including:

- constitutive documentation in respect of such investor;
- a declaration made by the investor in relation to the determination of the nature and the provenance of any funds invested;
- an annual report; a certificate of incorporation or registration;
- (where applicable) a copy of any relevant passports or identity documentation;
- a list of effective beneficial owners;
- and a declaration and supporting evidence regarding the residence of any effective beneficial owners.

These existing due diligence procedures on the status of a private equity fund's investors - carried out to the greatest extent possible by the private equity fund manager upon the creation of the fund and before acceptance of the subscription of an investor - already offer an efficient means of ensuring that private equity funds are not used to provide treaty benefits to investors who are not themselves entitled to treaty benefits.

The LOB test threatens the private equity industry's ability to make these investments. It risks discriminating against private equity if investing into this asset class is treated differently than direct investment into the same types of asset. It also introduces significant additional compliance costs that reduce the return to investors and / or the capital available to support and grow businesses., Private equity fund managers already devote time and resources to carry out due diligence on their investors and have invested significantly in systems to comply with FATCA and to be CRS-ready. But these existing regimes (the anti-money laundering rules, FATCA and CRS) find an appropriate balance between the compliance burden placed on financial institutions and the need to mitigate the particular risks with which the regimes are concerned. For example, if an investor in a private equity fund is itself FATCA-compliant, the private equity fund does not need to make any further report in relation to it. Similarly, the focus of most national anti-money laundering laws is on identifying the beneficial owners of those investors with a stake of 25% or more. As set out in our previous submissions, satisfying the LOB test would be significantly more onerous for a widely held non-CIV fund than complying with these existing regimes.

4. Is it correct that investors in a non-CIV are typically taxable only when they receive a distribution? Would there be mandatory distribution requirements for a fund to be eligible for the proposed exception and if yes, would intermediate entities be required to distribute earnings up the chain of ownership on a mandatory basis? If not, how would concerns about deferral of tax be addressed?

There is a strong commercial imperative inherent in private equity fund models to distribute quickly. It is important for investors to be able to manage cash flows effectively, which also impacts the ability to better manage the funding risk of their investment. In this regard, deferring distributions would not be helpful to investors and it would negatively impact the internal rate of return (the 'IRR') they achieve.

The result of this financial model is that the fund manager will make its best efforts to ensure that the fund distributes to its investors as soon as practical the amounts received from realised investments. In any case, as private equity fund structures are most often tax transparent and many investors are tax exempt, any deferral of distributions would not necessarily result in any tax deferral. There are, of course, instances where distributions are affected by meeting costs of the transaction, repaying loans and re-investing proceeds.

A private equity fund as such cannot be used to defer recognition of income. The OECD's concern for investors in non-CIVs is thus a separate question of investors and their tax status in their respective locations. The debate should not be misconstrued in the framework of the treaty benefits of fund structures.

5. States that support the inclusion of LOB rules in their treaties are unlikely to agree to a broad exception from the LOB rule that would apply to any widely-held fund, even if it is regulated, especially since that exception would seem more generous than the exception already provided for publicly-listed companies. What features could be incorporated into a specific non-CIV exception in order to make it more acceptable to these States?

Firstly, we disagree with the assertion that an exception from the LOB rule for a widely-held fund should be more generous than the exception already provided for publicly-listed companies.

As included in the final Report on Action 6 from October 2015, publicly-traded companies and entities would satisfy the LOB if:

(i) a company's principal class of shares is regularly traded on one or more recognised stock exchanges; and

(ii) the company's or entity's primary place of management and control is in the Contracting State of which it is a resident; or at least 50 per cent of the aggregate voting power and value of the shares (and at least 50 per cent of any disproportionate class of shares) in the company or entity is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subdivision i) of this subparagraph, [provided that, in the case of indirect

ownership, each intermediate owner is a resident of either Contracting State];[4]

In our view, the equivalent criteria for non-CIVs would be for the fund to be regulated and widely held. As we have demonstrated above, private equity funds are regulated. As we will demonstrate below under question 8, private equity funds are widely held. We believe it is inaccurate therefore to conclude that an exception for non-CIVs should be "more generous" than the exception for publicly-listed companies. Objectively, such an exception for non-CIVs would be providing equal treatment rather than special treatment.

We would also like to highlight the significant concerns that the European Commission has with the operation of the LOB, as currently drafted. In its Anti-Tax Avoidance Package (ATAP) which was released in January, the European Commission, through both hard-law and soft-law measures, is attempting to implement several of the OECD BEPS standards in the EU in a uniform fashion. According to the Chapeau Communication of the ATAP, the Commission explains that:

> "[I]ssues relating more to tax treaties have not been included in the Directive. Nonetheless, a coordinated approach is needed now to prevent negative spill-overs. The Commission is therefore presenting a Recommendation on the implementation of measures relating to Permanent Establishments, as well as to the G20/OECD report on Tax Treaty abuse. In this context, the Commission is concerned that the G20/OECD report includes Limitation of Benefits clauses as an option, although it is acknowledged that this may not be appropriate in all regions. These clauses limit the benefits of tax treaties to entities owned by residents of only one Member State, and therefore can be seen as detrimental to the Single Market by discouraging cross border investment. These rules can be problematic for the Capital Markets Union."[5]

The accompanying Recommendation then provides guidance to EU Member States on how to implement the PPT in an EU-law compliant manner.[6]

6. One argument that was put forward in relation to suggestions for a specific LOB exception for non-CIV funds was that it would avoid or reduce the cascading tax when investment is made through a chain of intermediaries. In practice, what is the intermediate entity-level tax, if any, that is typically payable with respect to income received from a State of source? Are there special purpose vehicles that are commonly used by funds to invest indirectly? How are intermediate entities typically funded, debt or equity? If debt, is it unrelated party financing?

Intermediaries such as special purpose vehicles are commonly used by private equity funds.

[4] Preventing the Granting of Treaty Benefits in Inappropriate Circumstances ACTION 6: 2015 Final Report, Section A, pp. 26
[5] European Commission, Communication from the Commission to the European Parliament and the Council, Anti-Tax Avoidance Package: Next steps towards delivering effective taxation and greater tax transparency in the EU, 28 January 2016, pp. 6
[6] European Commission, Commission Recommendation of 28.1.2016 on the implementation of measures against tax treaty abuse, 28 January 2016,

The legitimate use of intermediaries is acknowledged in the OECD 2010 Report: "CIVs thus act as both issuers of securities and investors in securities. As a result, there may be layers of intermediaries both below the CIV (i.e. between the issuer of the security in which the CIV is invested and the CIV), and above the CIV (i.e. between the CIV and the beneficial owner of the interests in the CIV). In many cases, those intermediaries will not be located in the country in which the issuer is located and may not be located in the country in which the investor is located."[7]

The OECD 2010 Report acknowledges the difficulty for CIVs in identifying the ultimate investors in the fund: "[t]he difficulty in tracing of course also is compounded by the fact that interests in CIVs frequently are held through layers of intermediaries. In those cases, the CIV's records will show the names of the intermediaries through which the investors hold their interests in the CIV, rather than the names of the investors themselves."

As further explained in the consultation document:

> "[A] key practical difficulty in the application of the transparent entity provision to non-CIV funds is that it requires that the State of source be provided with all the relevant information concerning the investors in the non-CIV. The same practical difficulty would arise with respect to any approach under which the treaty entitlement of a non-CIV would be related to the treaty entitlement of all, or a high percentage of, the investors in that non-CIV. A number of commentators indicated that at least some types of non-CIV funds may be unable to identify the tax residence of their investors despite the evolving requirements of anti-money laundering legislation and tax reporting regimes. Examples that were provided were that of a securitisation company which "may not be in a position to identify who its bondholders are", a fund of funds and "where a financial institution invests in a collective investment scheme on behalf of its own clients or for the purposes of structured investments which it sells to its own clients". One commentator suggested that even solutions based on the principles of the TRACE project would not offer a practical solution for private equity funds."[8]

Indeed, the private equity industry emphasised that the TRACE project would not be suitable for private equity funds for these reasons.

The intermediate holding company structures used by private equity funds should not disadvantage such funds in their tax treatment as the structure is not designed to facilitate tax avoidance. Rather, they serve to prevent the tax distortion and barriers to investment that exist under the current laws, due to the lack of global harmonisation of the treatment of entities used in fund structures and are used for other non-tax reasons to meet the needs of investors. They allow a fund to invest in an asset on the same level as other

[7] OECD THE GRANTING OF TREATY BENEFITS WITH RESPECT TO THE INCOME OF COLLECTIVE INVESTMENT VEHICLES2010 Report, 23 April 2010, pp. 6
[8] OECD Public Discussion Draft, Treaty Entitlement of non-CIV Funds, 24 March 2016, pp. 6

investors in that asset. They can facilitate access to tax treaty provisions for investors in the fund without those investors having to make treaty claims individually. They can also provide practical benefits such as allowing participation in shareholder meetings and votes, and making the conclusion of contracts more straightforward.

Holding companies in certain jurisdictions can ensure that fund investors are afforded greater certainty regarding insulation from legal liabilities that might flow out of a domestic structure to non-domestic parents. This matter is particularly relevant where shareholder consent outside of the investee jurisdiction is given, or entities are deemed to be subject to a controlling parent which can give rise to liabilities arising in the controllers' hands. An intermediate holding jurisdiction can often provide the only meaningful shield to these risks.

During its life-cycle, it is impossible for the private equity fund to take into account the tax status of each of its ultimate investors when the fund manager decides the structuring of the fund's investments, as to do so would create significant conflict of interest issues given the different tax situations of investors. In addition, there is no universal rule on the tax transparency of a private equity fund. As a result, the investee countries may refuse (i) to recognise the tax transparency of a fund that is established in another country and (ii) the tax residence of the fund as it is not subject to tax. This has the effect of denying treaty relief to treaty eligible investors.

For these reasons, a private equity fund invests through one or more wholly-owned holding companies. There is no doubt that these holding companies have a real business substance because they are the financial pillars of the investment made by the fund. In order to benefit from the protection of tax treaties, a private equity fund generally arranges the governance within the holding companies so that the decision that these companies make are taken locally at their level. In addition, to strengthen the limited liability of investors in the fund (which is a key criterion for the investors), it is advised to have a strict distinction between the management of the fund localised at the level of the fund manager.

A private equity fund cannot and does not attempt to structure its investments to be tax efficient for each investor. Whilst it is relatively simple for certain types of corporate groups (closely held company with a limited number of investors) to deal with the different tax attributes of group members, that possibility is not available to a private equity fund as in many cases it will not have access to full information regarding the underlying nature and tax treatment of the investors. For private equity funds, whilst the tax treatment at the intermediary holding company level can be ascertained, they are most unlikely to have thorough information as to the tax treatment of the ultimate beneficial investors.

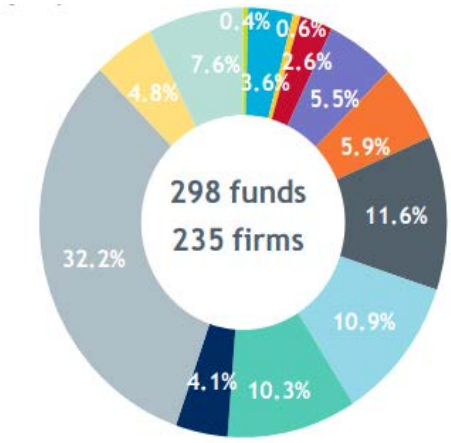
Generally speaking, private equity funds make equity investments and debt investments. The normal exit is to sell their equity and debt investments after five years or more. In addition, the investment by the fund is usually made with third-party debt financing (e.g. mezzanine debt, senior bank debt). In such a context, a private equity fund cannot make investments without creating an interposed wholly-owned holding company in order to

make its investments and also to locate the mezzanine debt and the senior bank debt.

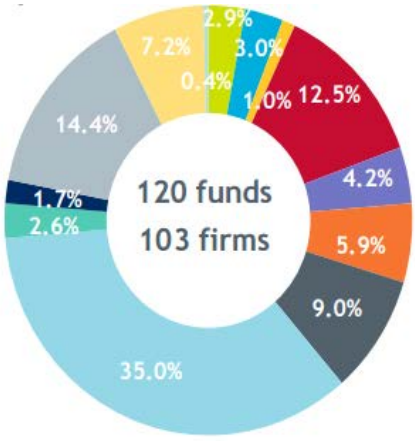
8. The rationale that was given for the above proposal refers to the fact that "investors in Alternative Funds are primarily institutional investors, and are often entitled to benefits that are at least as good as the benefits that might be claimed by the Alternative Fund". What is the meaning of "institutional investors" in that context? In particular, does it include taxable entities or other non-CIVs? Absent a clear definition of "institutional investors", how can it be concluded that institutional investors "are often entitled to benefits that are at least as good as the benefits that might be claimed by the Alternative Fund"? Also, is it that "institutional investors" are less likely to engage in treaty-shopping and, if yes, why?

In our previous responses to Action 6 consultations, we provided detailed information on who the investors into private equity funds are. We are happy to elucidate this information here again. In 2014, the investors into European private equity funds were the following:

All Private Equity funds



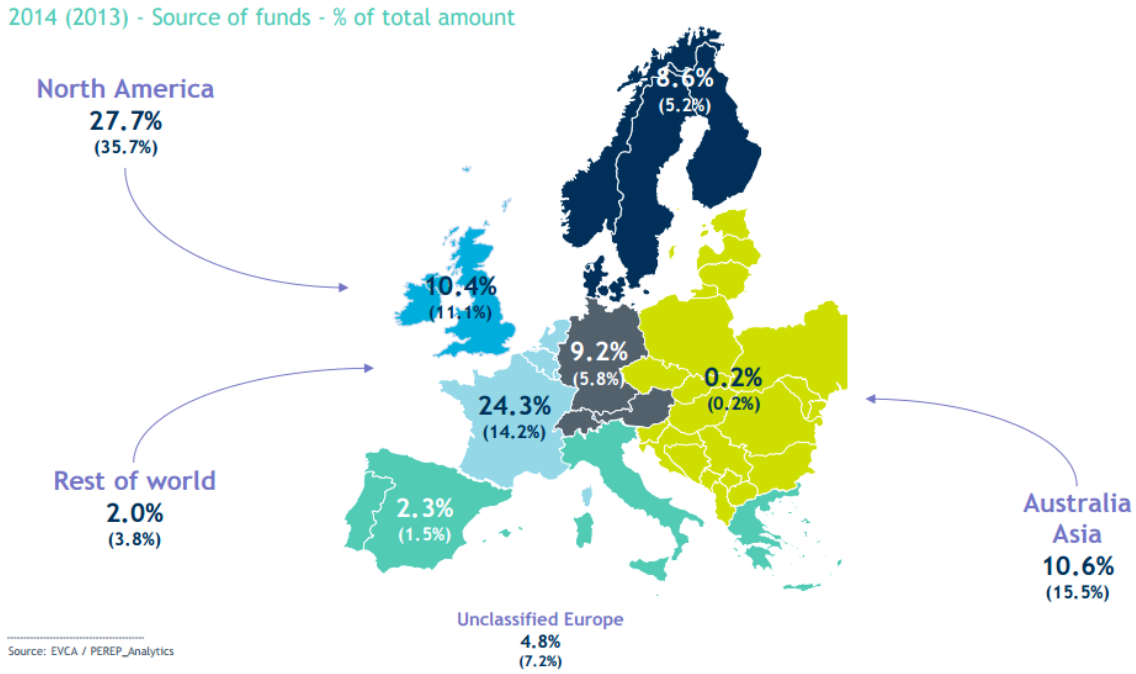
Venture Capital funds



- Academic institutions
- Banks
- Capital markets
- Corporate investors
- Endowments and foundations
- Family offices
- Fund of funds
- Government agencies
- Insurance companies
- Other asset managers
- Pension funds
- Private individuals
- Sovereign wealth funds

This information is contained in the Invest Europe Yearbook.[9]

As can be seen from the illustration below,[10] the investors into European private equity are located all over the world, with a significant proportion being located outside the EU. The choice of location for the private equity firm as well as for the funds managed and/or advised by the firm is normally made on the basis of various factors (residence of the management team, investment strategy, regional or national investment focus, addressed investor base, access to advisory infrastructure, stable and predictable tax and legal environment, etc).



The investors in a typical private equity fund will usually consist of numerous, globally dispersed investors. On average a private equity fund has 7 different types of investors (e.g. pension funds, sovereign wealth funds, etc as listed on the previous page in the graphic) and a typical fund might have dozens of individual investors. These investors are either subject to (corporate) income tax in their country of residence (insurance companies, family offices), or are exempt from such tax by their nature (pension funds, charities).

9. Unlike CIVs, which are defined in paragraph 6.8 of the 2010 Report on CIVs, the term "non-CIV" has no established definition. What would be the main types of investment vehicles to which the proposal could apply?

The OECD 2010 Report states that for the purposes of the Report, "the term "CIV" is limited

[9] 2014 European Private Equity Activity: Statistics on Fundraising, Investments & Divestments, May 2015, pp 15.
[10] Ibid, pp. 20

to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established."[11] In the 2nd consultation on Action 6, the OECD stated that non-CIVs do not share these characteristics with CIVs. In our response to that consultation, we demonstrated that this assertion was wholly inaccurate.[12] We would like to reiterate that non-CIV is not somehow the opposite of CIV. In the EU, we generally do not use the term non-CIV, instead using the term alternative investment fund, as per the AIFMD, which is explained above under Question 2.

Although "alternative investment fund" captures a wide variety of funds, some may infer from this that there is uniformity between these funds that simply does not exist. The range of fund types under the AIFMD family is quite diverse and private equity funds are one type that exists within the wide framework. While there may be certain similarities between some private equity structures and structures used by other fund types, private equity funds are quite different from many of the fund types found under the AIFMD umbrella, such as hedge funds, as they neither issue securities that can be traded nor do they themselves trade in securities on a regular basis.

What are commonly referred to as private equity funds in reality take many different shapes and form, ranging from the unitized fund structures seen in many European jurisdictions, and which are governed by the relevant fund laws, to co-investment arrangements typically in the form of negotiated limited partnership agreements (e.g. English or Delaware) governed by civil law. In France for example, private equity structures are usually FPCIs or FPSs that can have legal personality. These structures are not in the scope of French income tax or corporate tax and as a result, they are not considered as tax resident entities and cannot automatically benefit from the tax treaties which other Member States have signed with France.

To be more precise, what are referred to as private equity funds are, in the majority of cases not funds as legally defined by fund law but rather co-investment arrangements organized in limited partnership or other form. Investors who put their capital into listed shares and bonds do so in order to diversify risk and build portfolios of assets. In doing so, they are taxed once in their home jurisdictions for capital gains or dividend income, etc. Institutional investors also want to invest into unlisted companies of all sizes in different sectors. But as these companies are much harder to find, analyze, value and manage, these institutional investors prefer to invest together with a partner that has that expertise in this area, along with the added benefit of risk-sharing and rewards. While doing these co-investments in an organized and negotiated form, these investors are still conscious of the principle of being taxed once in their home jurisdiction, just as if they had held the underlying unlisted shares directly and in the same way as holding listed shares.

Thus, the structure chosen for this type of co-investment needs to be tax-neutral and

[11] Supra 7, pp3.
[12] Invest Europe Response to OECD BEPS 2nd Consultation on Treaty Abuse (Action Point 6), January 2015

transparent. It is only a means of organizing these investments more efficiently with the specialized partner taking the management responsibility. Ideally, one would use the limited partnership structure and the negotiated agreement setting out the rights and responsibilities of the different partners. In jurisdictions where the limited partnership structure can create risks of permanent establishment for any of the investors or is otherwise not feasible, special vehicles have been developed over the years to guarantee this tax neutrality like limited liability companies or special funds and other vehicles. The purpose here is to organize one's investments into unlisted companies in as efficient way as possible while ensuring that the investor is only subject to taxation in their home jurisdiction.

Questions related to the identification of the investors in a non-CIV

13. Is the ownership of interests in non-CIV funds fairly stable or does it change frequently like the interests in a typical collective investment fund that is widely distributed?

The ownership of interests in a non-CIV fund does not change frequently like the interests in a typical collective investment fund. The limited partnership agreement drawn up between the manager and investor will stipulate exactly under what conditions the investor may sell their stake in the private equity fund in the secondary market. The inclusion of such restrictions on the sale of units/shares in a private equity fund is essential in order to guarantee the fund's long-term nature and avoid a situation whereby investors may be unable to meet capital calls issued by the fund manager.

The exact conditions for sale of a stake in a private equity fund on the secondary market will vary between different limited partnership agreements. But, for example, it is typical that in an English limited partnership no sale of a partnership interest may be made without the consent of the General Partner and the number of sales permitted in a 12 month period is limited. The typical private equity fund will be self-liquidating with a defined term, and will have investors who each make a significant investment with the intention of holding that investment until maturity, and most will in fact hold until maturity.

Global data shows that the volume of transactions on the secondary market was in the region of 40 billion dollars in 2015. [13]

14. How would the proposal address the concern, expressed by some commentators, that many non-CIV funds would be unable to determine who their ultimate beneficial owners are and, therefore, would not know the treaty residence and tax status of these beneficial owners?

The specific tax status of many ultimate investors is something that the fund is unable to control or influence and, in many cases, ascertain due to investors investing via funds of funds and other indirect methods. The legitimate use of intermediary vehicles is addressed above under question 6.

[13] Greenhill Cogent, Secondary Market Trends & Outlook, January 2016

As addressed under question 4 on deferral of income above, as soon as the fund divests the assets, that return on capital will be distributed to the investors in the fund. At this point, the taxation of those returns in the hands of the investors is an issue which is beyond the reach of the fund manager. It would be illogical, in our view, to penalize those non-CIVs which perform a legitimate capital-channelling function simply because there is a *potential* that the investors into those funds may not be fully tax compliant on a standalone basis in their particular jurisdictions. As demonstrated above under our answer to question 3, this potential is significantly mitigated by the fund manager's due diligence requirements.

Although a significant percentage of investors in certain fund structures are entitled to relief in their own right by making a claim through a double tax treaty if they were a direct investor, administratively it is far more efficient that they receive the correct return in the first place without having to resort to treaty claims. This is especially so if the investor is tax exempt like most pension funds. In this case, the tax levied becomes a de facto cost as there is no tax levied in the investor's home jurisdiction against which this tax can be offset. This is also an issue where withholding tax is applied to interest income and dividends or more importantly, capital gains tax is levied on non-resident investors.

Should the fund manager take on the role of processing tax reclaims on behalf of investors, then it will still involve increased resources and costs, thereby reducing returns. It will also mean that there could be a significant delay in some investors receiving all the proceeds due to them as the processing of repayment claims by tax authorities can be slow (sometimes taking years, rather than days). Without an intermediary holding company, funds could also be exposing their investors to local tax filing requirements, which is not the aim of Action 6 nor the BEPS project overall. Even where all the investors are entitled to relief in their own right, inconsistencies in the tax treatment of commonly used fund entities can still create barriers to obtaining relief in practice. There is also a risk that if fund managers are obliged to take on a tax claim-processing role then they may chose to start excluding certain investors from their funds which would be very detrimental to the investors.

15. What information do those concerned with the management and administration of non-CIV funds currently have concerning persons who ultimately own interests in the fund (for example under anti-money laundering, FATCA or common reporting standard rules)?

The management of a non-CIV fund will have the standard information on those persons who hold interests in the fund, as per the CRS standard. This information includes all relevant financial income including interest, dividends, along with information on account balances and sale proceeds from financial assets.

The management of a non-CIV fund will not have the same information on any further beneficiaries of those legal persons for the reasons explained in our answers to previous questions.

16. Is this information currently sufficient for relevant parties to identify the treaty benefits that an owner would have been entitled to if it had received the income directly? If not,

what types of documents and procedures could be used by a non-CIV to demonstrate to tax authorities and/or payors that the residence and treaty entitlement of its ultimate beneficial owners are such that the non-CIV qualifies for treaty benefits under that suggested derivative benefits rule? What barriers would exist to the communication of these documents or the implementation of these procedures? In particular, does intermediate ownership present obstacles to obtaining information about ultimate beneficial ownership and, if yes, how might these obstacles be addressed?

No, this information is not currently sufficient for relevant parties to identify the treaty benefits that an owner would have been entitled to if it had received the income directly. Some information may be available to the private equity fund but not the entirety as some investors will be funds of funds (as mentioned above) and therefore the available information as to the investor will be restricted to this point. Even if the information were to be available to the private equity manager in this instance, such details will be confidential and thus not transferable beyond the confines of the legal relationship between the ultimate beneficial owner and its counterparties. While not representative of the majority of private equity funds, some funds will be open-ended or listed and in these circumstances the difficulties indicated above will be exacerbated as clearly it will be almost impossible to obtain information around a changing investor base. As indicated above, private equity investors are spread across the globe and it is simply impossible to understand each investor's tax position.

The OECD 2010 Report acknowledges this same issue for CIVs – "[t]he difficulty in tracing of course also is compounded by the fact that interests in CIVs frequently are held through layers of intermediaries. In those cases, the CIV's records will show the names of the intermediaries through which the investors hold their interests in the CIV, rather than the names of the investors themselves."[14]

The barriers that exist, as addressed in our previous response, is that investors invest in private equity funds via indirect means and as such there is usually no contractual relationship between fund and ultimate investors.

Yes, intermediate ownership does present obstacles to obtaining information about ultimate beneficial ownership.

Questions related to the prevention of treaty-shopping

17. Since beneficial interests in non-CIV funds are frequently held through a chain of intermediaries, including multiple subsidiary entities (which is not the case of typical CIVs), how would the proposal overcome the difficulties derived from such complex investment structures with multiple layers and ensure that a fund is not used to provide treaty benefits to investors that are not themselves entitled to treaty benefits?

[14] Supra 7, pp. 15

This question appears to be a combination of questions 3 and 6, simply phrased differently.

18. The proposal would grant treaty benefits if a certain high percentage of a non-CIV is beneficially owned by investors entitled to similar or better benefits. Even a percentage as high as 80% would leave substantial room for treaty-shopping as a 20% participation in a very large fund could represent a significant investment. How could this concern be addressed?

It is clear to us that the determination of whether ultimate investors into non-CIVs are entitled to access tax treaties is a difficult question to resolve from a policymaker's perspective. We have demonstrated, through examples and statistics, that the structure and rationale of private equity funds significantly minimises the possibility for these funds to be used to grant treaty benefits to those investors who would not otherwise be entitled to such benefits. Nevertheless, the OECD has not accepted these submissions.

In order to avoid disadvantaging the private equity industry and disrupting the vital cross-border flow of capital to the real economy which private equity funds provide, the European private equity industry is now suggesting an approach which will allow tax authorities to evaluate the treaty eligibility of investors without imposing additional burdens on private equity funds and their managers.

The European private equity industry believes the most optimal solution would be a test whereby a fund - which certifies that at least 50% of its direct and indirect investors are comprised of investors that would otherwise be eligible for treaty benefits in their own right - would be eligible for treaty benefits. In other words, we propose that private equity funds and their subsidiary holding companies be eligible under the LOB Rule for the benefits of a particular treaty to the extent that a fund is able to certify that at least 50% of its direct and indirect investors are comprised of pension funds and other tax-exempt investors, governmental entities or instrumentalities and their controlled subsidiaries, and investors that would otherwise be eligible for the benefits of the applicable treaty in their own right, and/or other private equity funds (such as funds of funds) that satisfy the requisite ownership threshold in their own right (collectively "Eligible Investors"). While this approach is informed by the inclusion of a derivative benefits provision in the Final Report, it is intended to be applied as a separate exception from the LOB rules.

For purposes of certifying whether a fund satisfies a minimum 50% Eligible Investor ownership threshold to qualify for treaty benefits, the fund and its sponsor should be entitled to rely on certifications that the investors provide regarding their status as Eligible Investors for purposes of an applicable treaty. Under this approach, a private equity fund or its sponsors would obtain a certification from each of its investors as to the jurisdictions for which such investor is an Eligible Investor, possibly under new draft OECD US W8-BEN equivalents. The fund or the sponsor, on behalf of the fund, would then provide an appropriate certification as to the fund's eligibility for treaty benefits under a particular treaty each time benefits are sought by the fund based upon the self-certifications received by the fund from its investors. We similarly believe that such an approach should also be

applied to any fund of fund that invests in a non-CIV.

While private equity funds would be required to track the reported Eligible Investor status of its direct investors across the jurisdictions in which the fund is investing, such funds would not be required to act as a withholding agent or otherwise be required independently to verify the status of its indirect beneficial owners through multiple tiers of ownership. We believe that such a reporting protocol will help to alleviate concerns of treaty shopping, while balancing the administrative and practical realities that many private equity funds encounter, as described in greater detail in our earlier comments.

The 50% threshold that we propose is influenced by the exemption for publicly-listed entities and our belief that equivalent treatment should be available to different means of investing (as explained above under question 5) so as to avoid any distortion of investor decisions. We acknowledge the difficulty that policymakers face in determining an appropriate threshold. In our view, a 50% threshold test for funds that are widely held and regulated is appropriate as these are the equivalents to the characteristics under the publicly listed exemption of being traded on a regulated platform and ownership held at least 50% by entities entitled to benefits. Nevertheless, in line with our commitment to finding a final workable outcome on this topic, we are willing to engage constructively on determining an alternative appropriate threshold that would be proportionate for granting treaty access and would not distort investor choice.

If the OECD deems that this approach is not suitable, then we envision that a further approach could be possible. This would be based on the principle that private equity fund managers will continue to provide national competent authorities with the information on investors stipulated under CRS & FATCA. National competent authorities will then use that information - potentially in conjunction with further reporting information granted by those immediate investors themselves – in order to identify exactly who the ultimate investors are and subsequently, what their tax treaty eligibility is. At that point, the relevant national competent authorities will be able to delineate between the investors who are eligible in their own right to treaty benefits, and those who are not. Those investors who are eligible will receive the appropriate tax credits, while those who are not would receive the appropriate tax bill.

This approach would differentiate between the fund and its investors. The fund and associated structures would continue to access tax treaty benefits while any illicit tax treaty access by investors would be dealt with at the investor level. As stated above, it would be illogical, in our view, to penalize those non-CIVs which perform a legitimate capital-channelling function simply because there is a *potential* that *some* investors into those funds may not be fully tax compliant on a standalone basis in their particular jurisdictions.

We believe that if the tax authorities were to take this approach, then the vast majority of ultimate investors into private equity will satisfy the treaty tests of their own accord. It is for this reason that we feel confident to suggest such an approach.

19. One of the proposed requirements for the application of the suggested derivative

benefits rule would be a 50% base erosion test. Since one of the main concerns expressed by governments relates to the possible use of non-CIV funds for treaty-shopping purposes, wouldn't the 50% threshold proposed for the base erosion test be too generous?

We would like to highlight our response to question 5 where we analyse the publicly-listed company exemption which is based partially on a 50% beneficiary ownership test.

20. According to the proposal, acceptable ultimate beneficial owners would include persons who would "include their proportionate share of the fund's income on a current basis". How would a State of source be able to determine when this requirement is met? Also, what would be considered an acceptable anti-deferral regime? In particular, would a regime under which a taxpayer is taxed on a deemed amount of income or deemed return on investment be considered as an anti-deferral regime even if the amount that is taxed is significantly lower than the actual return? Would the United States PFIC regime be an example of an acceptable anti-deferral regime?

We would like to highlight our response to question 4 where we deal with the issue of deferral of income.

ADDITIONAL EXAMPLES FOR THE COMMENTARY ON THE PPT RULE

25. Commentators wishing to suggest new examples related to the application of the PPT rule to common types of legitimate arrangements that are commonly entered into by non-CIV funds are invited to do so. These examples should be brief and should focus on common transactions that do not raise concerns related to treaty-shopping or inappropriate granting of treaty benefits.

Proposed company owned non-CIV fund PPT example:

A non-CIV fund, which could take any legal form, including a partnership, is a 'financial institution' resident for these purpose in a jurisdiction that is participating in the CRS and/or FATCA regimes, and has not been categorised as a 'non-participating financial institution' for any such purposes. This non-CIV fund will make a number of investments and will make them, or some of them, through one or more companies, likely to be resident in a jurisdiction with a range of double tax treaties.

The company or companies used have been put in place for administrative efficiency and simplicity, to centralise any treaty claim process, and/or to avoid issues that commonly arise given the inconsistent recognition of the tax transparency or tax status of fund vehicles across different jurisdictions.

The company and the non-CIV fund distribute almost all income remaining after tax and expenses to investors. The company pays tax in its country of residence on any non-distributed income.

The non-CIV fund has a geographical and/or sector oriented investment strategy, which is central to the investors' decision to invest. The investors' decision to invest is not driven by

any particular investment made by company and the investment strategy of the non-CIV fund is not controlled by investors.

Investors in the non-CIV fund are identified and categorised for CRS and/or FATCA purposes and provide any information required to enable the non-CIV fund to comply with its obligations under the regimes applicable to it. Each investor that is itself a financial institution is resident for these purposes in a jurisdiction that is participating in the CRS and/or FATCA regimes, and has not been categorised as a 'non-participating financial institution' for any such purposes.

On the basis of the information above, the majority of investors are tax exempt (including pensions funds, charities or sovereign wealth funds) and/or are resident in jurisdictions which have treaties with the countries in which investments are made reducing or eliminating withholding in a similar way (and/or are themselves 'financial institutions' resident for these purpose in a jurisdiction that is participating in the CRS and/or FATCA regimes, which have not been categorised as a 'non-participating financial institution' for any such purposes), but a minority may be resident in non-treaty states.

The fact that in making the decision as to where to locate the company or companies in question the non-CIV considered the terms of any applicable double tax treaty is insufficient to trigger the PPT.

Conclusion:

Private equity funds are not in the business of treaty shopping. The primary purpose of private equity, just like other CIVs, is a business purpose, i.e. the co-investment arrangement or pooling of capital to make investments. As long as different countries' interpretations of what constitutes a permanent establishment are not harmonised across the globe, tax treaty access will remain crucial in order to achieve tax neutrality for funds, and to avoid double or even triple taxation in genuine bona fide investment structures.

The private equity industry fully appreciates the concerns of the OECD that action is needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. We also support a proportionate international approach to tackle these important issues.

THE VOICE OF PRIVATE CAPITAL
VENTURE CAPITAL
PRIVATE EQUITY
INFRASTRUCTURE
LONG TERM INVESTORS

Contact

Thank you in advance for taking our comments into account as part of the consultation process. We would be more than happy to further discuss any of the comments made in this paper.

For further information, please contact Danny O' Connell at Invest Europe (formerly known as the European Private Equity & Venture Capital Association (EVCA)).

Phone +32 2 715 00 35

danny.oconnell@investeurope.eu www.investeurope.eu

About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information, please visit www.investeurope.eu

Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20
F +32 2 725 07 04

www.investeurope.eu
info@investeurope.eu

VAT: BE 0424.557.716
IBAN: BE33 3300 5785 0046
BIC/SWIFT: BBRUBEBB

European Transparency
Register: 60975211600-74