Brussels, March 2016

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

Re: Reaction to European Commission Proposal for a Directive laying down rules against tax avoidance practices.

General Comments:

The Public Affairs Executive of the European private equity and venture capital industry welcomes the release of the proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (the Proposal). We fully support the European Commission's efforts to eradicate illicit tax practices among multinational groups and the vehicles that facilitate such practices. We fully support the principle that taxes on profit should be paid in the location where the activity that generates that profit takes place.

The European private equity and venture capital industry particularly welcomes the fact that the Commission is seeking to steer Member States to implement these rules in a harmonised manner. We feel this is a much more suitable approach than having individual Member States implement OECD BEPS standards unilaterally which risks creating a fragmented system and would likely increase the scope for arbitrage between different jurisdictions.

We note however that the lack of an impact assessment is a significant omission in the legislative process. According to the explanatory memorandum, the Commission is foregoing developing an impact assessment for several reasons, foremost of which is the fact that there is a strong link to the OECD BEPS work. It is important to recall that the OECD did not produce impact assessments for their BEPS work either. In addition, the Commission Proposal goes beyond the standards laid down in the final OECD deliverables in several areas. Importantly, those OECD deliverables which are addressed in the Proposal are best practice recommendations, not binding minimum standards.

In light of this divergence from the OECD's outcomes, the Commission's assertion that an impact assessment is unnecessary partly because these issues have been discussed at OECD level becomes circular reasoning. Similarly, we have seen that other international standards still need to be accompanied by an impact assessment when a proposal is put forward to implement those standards in the EU. For example, the Capital Requirements Directive IV which was introduced after agreement in the Basel Committee on Banking Supervision was accompanied by an impact assessment even after the standard had been agreed.[1]

It is important to recall that while the OECD serves an important function in proactively developing standards with the input of the OECD Member States, it is not a legislative body responsible for developing binding law. Its structure and process is completely different to the institutional set-up to develop EU law involving the different institutions (European Commission, Parliament, Council of the EU), more checks and balances (such as the co-decision procedure, now known as ordinary legislative procedure), different voting requirements, etc. As such, the OECD is neither intended nor suited to being a lawmaker. Rather, it is intended that their output will be used as the basis for law-making.

From a broader perspective, deviating from the OECD BEPS recommendations may result in the EU becoming a less competitive place in which to do business vis-à-vis third countries if those third countries simply implement the OECD BEPS standards as they are without going further. As mentioned above, the proposed rules seek to implement OECD best practice recommendations and not minimum standards. Non-EU countries may therefore decide not to implement such rules.

What is private equity?

Private equity is a form of equity investment into private companies which are generally not listed on the stock exchange. It is a medium to long-term investment, characterised by active ownership. Private equity ownership builds better businesses by adding and strengthening management expertise, providing strategic guidance on delivery of operational improvements and helping companies to access new markets. Venture capital is a sub-segment of private equity focused on start-up companies. Venture capital funds back entrepreneurs with innovative ideas for a product or service who need investment capital and strategic advice in growing their companies.

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.

Irrespective of the structure chosen, these private equity funds raise capital from institutional investors such as pension funds, insurance companies, sovereign wealth funds or family offices, etc.[2] Private equity funds are managed by specialist investment managers (typically also investors in these funds) who invest capital and expertise in companies across a wide variety of sectors, including consumer, industrial, engineering, life sciences, bio-

[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms

[2] For more information on the investors into private equity funds, please see our 2014 European Private Equity Activity Handbook, pp. 14 & 15

technology, computer software, infrastructure, and at various stages of the life of the company.

The investors in European private equity funds are located all over the world, with a significant proportion being located outside the EU. In 2014, approximately 40% of capital in European private equity funds came from outside Europe.[3]

Private equity funds provide institutional investors access to the necessary skills required for finding, analysing, valuing and negotiating investment into interesting unlisted companies with value creation potential. The managers of private equity funds are actively involved in the management of the companies, through board participation and beyond, guiding the management team on strategic matters and, where necessary, assisting on operational issues. The managers of private equity funds remain involved with these companies until they are ready to take the next step in their development under the stewardship of new owners. A private equity fund holds a portfolio company for a period of between 5 and 6 years, on average.[4]

The vast majority of companies which receive private equity financing are Small and Medium-sized Enterprises (SMEs),[5] a hugely important sector for the EU economy, responsible for driving jobs, growth and innovation. SMEs typically find it more difficult than more mature companies to find financing (due to the higher risks involved) and this situation has been further aggravated in the wake of the recent financial crises.

The European Commission in the Capital Markets Union Green Paper and subsequent Action Plan recently acknowledged private equity's contribution to the real economy. The Green Paper stated "[a]s an alternative form of funding to traditional bank loans or issuing debt or equity, private equity and venture capital play an important role in the European economy" and then went on to ask "[h]ow can the EU further develop private equity and venture capital as an alternative source of finance for the economy?" [6]

<u>How is interest deductibility relevant to private equity?</u>

(i) <u>Buyout operations & business development:</u>

Some private equity funds, such as buyout funds, purchase companies using equity (from the fund and, where necessary, third-party co-investors) and debt (usually from banks and other institutional lenders). In a buyout transaction, a buyout fund may for example incorporate an acquisition vehicle and make an equity investment; the acquisition vehicle then uses the capital from the fund along with cash derived from borrowings to purchase the target company.[7] The buyout transaction is often used as an opportunity to develop the

[3] Ibid, pp. 20 & 21
[4] Invest Europe Research
[5] Supra 2, pp. 56
[6] European Commission Green Paper on Building a Capital Markets Union, February 2015, pp. 17 & 19
[7] In 2014, EU private equity deals were financed on average with 41.27% equity and 58.73% debt, although some portfolio companies may be materially more or less leveraged. These private equity purchases on average held a debt/EBITDA ratio

company. Money borrowed is used to invest in new fixed assets such as premises, production facilities and machinery while the company may also expand into new markets by launching new product/service lines.

The repayment of at least a portion of the debt is secured by security over the assets of the target company and a pledge by the fund or a holding company of the shares of the target company. The use of debt in a buyout can vary significantly from one transaction to another, depending on the analysis done by the private equity firms and lenders involved of the amount of debt that can be serviced by the business that is to be acquired.

There are many variations of this simplified buyout structure, but all buyout acquisitions result in a similar situation: once the acquisition is complete, the fund owns an equity stake in an operating business that, like almost all operating businesses, has some degree of debt on its books that the company (not the fund) is obliged to repay from its earnings. If the business fails, the lenders and other creditors of the company will be repaid before the fund or other equity holders are entitled to any return of or on their equity investments.

Except for a specifically negotiated pledge by a private equity fund of the shares of a portfolio company that it owns as security for the company's borrowings, the obligations of that portfolio company are generally not guaranteed by or secured by pledges on the assets of the fund as such or on the assets of any other portfolio company. Therefore, the failure of one portfolio company does not impact the fund's other portfolio companies.

This is the first step in the process, i.e. acquiring the portfolio company. At this point, the private equity fund manager will take a hands-on approach to growing the company. Sometimes, private equity funds target companies which are struggling to perform, and then over a period of 5-6 years on average, turn these companies into profitable undertakings with a much more positive outlook. More typically, investments are made in companies that simply need that crucial financial and human capital input to help them grow to the next stage in their development. The capital raised from borrowing plays an integral role in this investment plan and without this debt (which typically includes a restructuring component), it is unlikely the fund will be in a position to develop the company and in due course deliver a return on investment to the investors.

(ii) Beneficial Role of Corporate Debt

Debt is a fundamental part of a typical company's capital structure and is often used to finance day-to-day operations and essential business activities such as buying raw materials, making capital expenditures, building new facilities, paying salaries and financing asset acquisitions. All these financed expenditures are incurred in the ordinary course of a trade or business, and the interest on these loans is therefore tax-deductible.

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of 5.14x. Source: Standard & Poor's Q4 2014 Leveraged Buyout Review.

The ability to deduct interest expenses is important to corporate capital structures. Corporate debt is an essential tool used by businesses, small and large alike, to grow and finance operations. As noted by UN research, "the availability and use of debt is widely recognized as an important element of a healthy business environment. Indeed, a lack of credit can deter economic growth."[8] According to the OECD, SMEs and entrepreneurs across OECD countries continue to use debt to a large extent to finance their growth and development.[9] Indeed recent statistics show that 95% of SMEs in Europe finance their operations at least in part by using bank loans. [10]

While recent ECB data showed that euro area banks reported a net easing of credit standards on loans to enterprises in the third quarter of 2015,[11] important long-term factors such as new capital requirements for banks have contributed to constrained credit ability overall. The data above shows how important debt financing remains to European businesses. This is recognised in EU efforts to promote private financing in Europe such as the European Fund for Strategic Investments (EFSI). In light of this, any move which would make existing credit *more* expensive to serve - and by extension tighten the ability of lenders to grant such credit - would be counterproductive when placed against the backdrop of the Commission's goal of stimulating growth and jobs.

Limiting the ability to deduct interest expense would make credit more expensive to serve thereby reducing the ability of borrowers to service future debt. As a consequence, lenders (and possibly financial market supervisors) would need to respond to borrowers' more constrained position by applying stricter credit eligibility criteria (such as loan-to-income ratios), and by holding more capital on their balance sheets. This would have the overall effect of reduced lending.

Article 4 – Interest Limitation Rule:

General Comments:

Limiting interest deductibility will increase the marginal effective tax rate on investment and could stifle growth in the EU, undermining one of the most important goals of the Commission's agenda. According to the explanatory memorandum, the goal of this rule is to put an end to the practice of shifting profits from high-tax jurisdictions to low-tax jurisdictions through "inflated" interest loans. We regret that the approach taken by the Commission does not differentiate in terms of the origin of the debt, i.e. related party debt is treated in the same manner as unrelated party debt. In spite of this, it is important to consider related party debt in the context of private equity funds. In a typical private equity fund, there will be diverse types of investors located in several different

[8] UN Papers on Selected Topics in Protecting the Tax Base of Developing Countries, Limiting Interest Deductions, Peter Barnes, September 2014, pp. 5
[9] Financing SMEs and Entrepreneurs 2014: An OECD Scoreboard
[10] European Investment Fund, Financing Patterns of European SMEs: An Empirical Taxonomy, Working Paper 2015/30, November 2015
[11] European Central Bank, The euro area bank lending survey, Third quarter of 2015,

jurisdictions. Interest payable to the fund will generally reduce the taxable profits of the portfolio company, subject to any domestic restrictions, in exactly the same way as interest payable on any third party debt. The interest paid by the portfolio company and received by the fund will then be distributed to the investors in the fund. Those investors are likely to be tax exempt pension funds or other financial institutions who are tax-exempt. In this light, it is difficult to see any base erosion and profit shifting activities taking place here.

If the Commission approach would have followed the OECD best practice recommendation, then it would have been possible to distinguish between related and unrelated party debt. In light of the importance of debt financing for business operations as described above, we believe, as a general point, that any new rules should continue to allow full deduction for unrelated party interest expense. Third party interest expense is less of a risk from a BEPS perspective as there is very limited scope to artificially ‘place’ this debt in high tax jurisdictions. Even at today's historically low interest rates, interest costs on bank and other external loans to portfolio companies are in many instances likely to exceed 30 per cent of EBITDA. For some sectors such as infrastructure, leverage ratios have traditionally been much higher and thus the importance of an exception here is even more important.

We believe that transfer pricing would be a more logical basis for determining the legitimacy of interest deductibility as it relates specifically to the borrowing capacity of the underlying company rather than an approach based on a rigid, inflexible, fixed ratio. The existence of a rule to determine whether interest expense has been incurred for a valid business reason (even when exceeding the fixed ratio threshold) would tackle abusive profit shifting mechanisms as it would catch “inflated” interest debt but would still allow legitimate borrowing arrangements to continue unimpeded for corporates.

Alternatively, it should be noted that a debt-to-equity ratio, assessed on a stand-alone basis, is easier to operate for many enterprises than a computation of EBITDA. It is also less pro-cyclical than an EBITDA ratio. The determination at a group level may be tricky for a number of SMEs and it is critical that they have a straightforward reference based on their existing stand-alone financial statements. Therefore, for operational reasons, we would recommend allowing enterprises to rely on a debt-to-equity ratio, determined on a stand-alone basis, if the EBITDA test is not met. This approach already exists in jurisdictions such as France or the US.

Finally, we note that the Proposal does not include a “public benefit exemption” (for projects funded by third party debt that provide wider public benefits such as large infrastructure projects) which was included in the OECD best practice recommendation. While we acknowledge that there is an interaction between State aid rules and having a public benefit exemption, given the importance of developing our infrastructure facilities in Europe, we believe this is something which should be examined more closely as its inclusion would be beneficial for European society as a whole.

€1 Million Threshold:

We believe that the monetary threshold rule should be increased from €1 million to €3 million, similar to the German rule on which it appears to be based. According to the explanatory memorandum of the Proposal, "multinational groups often finance group entities in high-tax jurisdictions through debt and arrange that these companies pay back 'inflated' interest to subsidiaries resident in low-tax jurisdictions."[12] The explanatory memorandum then further explains that "the aim of the proposed rule is to discourage the above practice by limiting the amount of interest that the taxpayer is entitled to deduct in a tax year."

If the target of this rule is indeed multinational groups, then the threshold should be set at least at €3 million in order to avoid capturing SMEs. This threshold will help to ensure that the illicit tax practices of large groups will be constrained, but the relatively smaller actors will not be unwittingly caught in the cross-fire.

Both France and Germany have introduced domestic rules to this effect. In both countries, it was decided that a threshold of €3 million was appropriate as it would not affect those companies which are unlikely to have the sufficient size and complexity in order to carry out such profit shifting measures.

Group Ratio Rule:

In line with the best practice recommendation from the OECD, we are of the view that different portfolio companies owned by the same private equity fund should not be considered to be part of the same group for the purposes of the fixed ratio or group ratio rule. While Recital 6 of the Proposal provides that the portfolio companies of a fund would not be held to be part of the same group (as they are not part of a group which files statutory consolidated accounts), there may nevertheless be issues with transposition or a potential change to the accounting rules in the future which could challenge this view. This approach - i.e. viewing different portfolio companies as not being part of a group - should be applied to private equity funds regardless of whether they are structured as limited partnerships or limited partnerships with an underlying master holding company structure.

As explained above under the section "how is interest deductibility relevant to private equity", although different portfolio companies may be owned by the same fund, they will receive financing on an individual basis, will usually be involved in different, unrelated sectors and often will be at different stages of development. This is the reason why different portfolio companies will receive financing on an individual basis as different banks will view diverse sectors in a different light. If the interest costs in each of the portfolio companies were determined by reference to the economic performance and

[12] Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, pp. 7

financing arrangements of other portfolio companies, this would be an illogical and arbitrary approach.

Although the group ratio rule presented in Article 4, paragraph 3 is optional for Member States, for those countries which decide to implement this rule, we would like to highlight that in a private equity context, the vehicle used to make the investment usually receives loans from banks and/or the fund but does not have sufficient EBITDA on its own as it is an investment holding company, while the operating companies below the vehicle do have sufficient EBITDA that should be utilized in this context. The proposed rule does not allow for the non-absorbed EBITDA to be transferred to another group entity belonging to the same tax unit (i.e. between 2 related persons which file consolidated tax accounts).

The Italian domestic rule on interest limitations for example provides for such a possibility which is of great importance when the borrowing costs are allocated to a holding company with little or no EBITDA while the participating companies do have positive EBITDA and little or no borrowing costs. We believe that a rule modeled on the Italian domestic rule allowing the transfer of non-absorbed EBTIDA would be very beneficial here while still remaining very much within the spirit of the proposed group ratio rule. We advocate therefore that the proposed rule in Article 4, paragraph 3 should be amended by providing the possibility for the non-absorbed EBITDA to be utilised by another group entity belonging to the same tax unit.

We welcome the fact that the proposed rule does not limit the EBITDA carry-forward to a fixed time limit. This is important when the business plan determines a reduction of the borrowing costs and/or an increase of the EBITDA over a long period (for example, more than 5 years). Otherwise, if there were a fixed time limit for EBITDA carry-forward, the effect would be to penalise those looking to take a long-term approach to investing in and developing their businesses, which would be contrary to a range of other EU initiatives on long-term investment.

There are other problems with the proposed rule that we have identified. One is that a group rule could unfairly discriminate against an entity or jurisdiction which is more highly leveraged than the group as a whole, due to non-tax commercial reasons such as stronger own cash-flow generation due to a large proportion of advance payments for example, only cash sales, higher margins or shorter payment terms. It could also have better access to local financing and better quality of assets to pledge as security. Such a group rule would allow entities in groups with higher net interest expense:EBITDA ratios, than that specified under the fixed ratio rule, to deduct disallowed interest expense up to the level of the group ratio.

From our perspective, a group ratio rule that operates off a net interest expense:EBITDA ratio, will result in a more coherent set of interest deductibility restrictions than a group rule based on an equity:total assets ratio, since it is comparing like with like. Such a rule would also operate more favourably in relation to highly leveraged entities than the all or nothing approach of an equity:total assets group ratio rule proposed by the Commission.

This is because an entity with a higher net interest expense:EBITDA ratio than the group ratio, would still be able to deduct its interest expense up to the level of the group ratio. In contrast, an entity with an equity:total assets ratio that was lower than the group ratio would not be able to deduct any extra disallowed interest.

Another issue is that a balance sheet measure on its own could also have a pro-cyclical effect e.g. in an economic downturn, asset values could plummet, causing tax relief on interest to be restricted at exactly the wrong time for the company.

Grandfathering rules:

We firmly believe that any new rules imposing limits on interest deductibility should include appropriate grandfathering provisions. As explained in the section "what is private equity", companies are typically held for a period of between 5 and 6 years by a private equity fund before being divested. Term financing in some sectors such as infrastructure are often even longer. We believe that the most sensible approach would be for businesses in receipt of private equity financing to be able to affirm the deductibility of future interest costs by reference to the EBITDA of the group at the time the financing arrangements are entered into, with the clock then reset when the financing arrangements are varied or supplemented. This would protect businesses from the potential consequences of falling EBITDA in circumstances when they most need to protect their deductions.

We acknowledge that there may need to be special consideration given to credit lines such as revolving credit facilities but for non-complex credit arrangements, the existence of grandfathering provisions are of crucial importance.

Further comments:

By not differentiating between related and unrelated party debt, it would appear that the goal of preventing BEPS is being juxtaposed with a policy desire to reduce leverage more generally. Indeed, according to the explanatory memorandum of the Proposal, the interest limitation rule "is also expected to mitigate the bias against equity financing."[13] This is a separate issue which we have addressed in other discussions, most recently in the public consultation of the re-launch of the Common Consolidated Corporate Tax Base (CCCTB).[14] According to the consultation, the Commission is considering 3 different options to address the so-called debt-equity bias.

In our view, it is not good legislative procedure to release a proposal while simultaneously deliberating on a further legislative proposal to be released in the near future on the same issue. Having a multi-step approach to legislation can be beneficial, but in this case, the first step is being taken while the second step is still unknown. Needless to say, this creates massive uncertainty and we would like this work to be more coordinated. Indeed, two of

[13] Supra 12, pp 7
[14] Response of the Public Affairs Executive of the European Private Equity & Venture Capital Industry to the European Commission Consultation on the re-launch of the Common Consolidated Corporate Tax Base (CCCTB), January 2016.

the options considered in the CCCTB consultation document would remove the ability for companies to deduct interest expense, either partially or completely, thus rendering the current proposed rule either redundant or more far-reaching than intended. It remains to be seen how exactly these different proposals will fit together.

On a technical point, we note that there are no definitions of “equity” or “assets” in the Proposal. The use of these measures is likely to give rise to quantification problems and uncertainties. For example, it is not clear how off-balance sheet assets such as goodwill would be brought into account. This might be a particular issue for groups which do not have a lot of tangible assets such as technology and services groups. Similarly, will equity simply be the amount of share capital on a company’s balance sheet or will it include retained earnings (or take account of losses)?

More generally, we would like to re-iterate that in the findings from the European Commission 2015 corporate debt bias conference, it was noted that rules limiting interest deductibility do indeed increase the cost of capital.[15] In the absence of an EU study in this area, guidance can be taken from the USA. According to a US study, negative macroeconomic impacts on the US economy would result from a revenue-neutral reduction in the corporate income tax (CIT) rate financed by an across-the-board limitation on corporate interest expenses.[16] Specifically, a 25% across-the-board limitation on corporate interest expenses and the approximately 1.5 percentage-point reduction in the CIT rate it could finance would have a negative net effect on the US economy in the long-run (within a decade) as output would be estimated to fall by 0.2% and investment would be estimated to fall by 0.3%. Furthermore, economic welfare (measured by the value of household’s consumption and their leisure) would be estimated to fall by 0.4% and finally, total employee compensation would be estimated to fall by 0.05%.[17] Such research makes a detailed impact assessment all the more imperative, in our view.

Article 6 – Switch-over Clause:

Similar to Article 8 on Controlled Foreign Companies (CFCs) which we discuss below, the lack a provision for tax credits would appear to be an omission in this proposed rule. Recital 5 states that “where the application of those rules give rise to double taxation, taxpayers should receive relief through a deduction for the tax paid in another Member State or third country, as the case may be.” Notwithstanding this, we suggest that inserting such a provision in this Article will bring greater clarity.

Again, similar to the rules on CFCs, both provisions refer to the concept of “low taxation” to either re-attribute the income of a low taxed third country CFC to its parent company or to

[15] European Commission, Findings from the 2015 corporate debt bias conference, pp. 2
[16] Ernst & Young, Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses, July 2013
[17] Ibid

tax low-taxed third country income. The concept and the 40% threshold are used in both provisions. Page 9 of the explanatory memorandum refers to "[t]he analysis above about the threshold of low taxation is also valid for CFC rules". However article 6 (switch over clause) refers to 40% *statutory* tax rate whereas article 8 (CFC) refers to 40% *effective* tax rate. In our view, it would be beneficial to either align the two (in favour of statutory) or bring more clarity to this distinction either in the Recitals or in an impact assessment.

It is also important to include a safe harbour provision under which the switch-over clause will not apply to distributions from a foreign entity that (i) has a genuine business activity (industrial or commercial) carried on in the jurisdiction where it is organised or (ii) when the main purpose of the transactions of said entity is not to attribute profits to low-taxed jurisdictions.

Article 7 - General Anti-Abuse Rule

The private equity and venture capital industry appreciates the rationale of having a general anti-abuse rule (GAAR). Certain tax practices may develop or evolve and end up slipping between the different prescriptive rules thereby necessitating a general, flexible rule which will act as a safety net. Provided this is applied in a proportionate manner, we do not see any unintended consequences here. However, we note that provision creates a GAAR to fight against "non-genuine arrangements or a series thereof carried out for the essential purpose of obtaining a tax advantage defeats the object or purpose of the otherwise applicable tax provisions…" This new provision therefore adds another GAAR into the tax environment and introduces the concept of "essential purpose" which differs (at the very least linguistically) from the "main purpose" test which is found in the Parent-Subsidiary Directive.[18]

We appreciate that the Commission is attempting to ensure consistency of EU legislation with the jurisprudence of the European Court of Justice, but the existence of previous GAARs (in this Proposal, double tax treaty GAAR, PSD GAAR, local third countries GAAR) will mean that taxpayers will face multiple GAARs which may create tax uncertainty for businesses. It is our view that the "essential purpose" test introduced in the Proposal should not be more restrictive than the "main purpose" test introduced previously in order to avoid the uncertainty inherent in such a distinction. We would welcome more clarification on this point. In France for example, the French Constitutional Court has considered that the "essential purpose" test is relevant in situations where abusive schemes give rise to specific tax sanctions/fines. In those situations, the essential purpose test imposes a higher standard.

[18] Council Directive (EU) 2015/121 of 27 January 2015 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

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Article 8 - Controlled Foreign Companies:

Similar to Article 6 on the Switch-over Clause (discussed above), the lack of a provision for tax credits would appear to be an omission in this rule. Recital 5 states that "where the application of those rules give rise to double taxation, taxpayers should receive relief through a deduction for the tax paid in another Member State or third country, as the case may be." Notwithstanding this, we suggest that inserting such a provision in this Article will bring greater clarity.

Recital 10 of the Proposal states that "CFC rules should exclude financial undertakings from their scope where those are tax resident in the Union, including permanent establishments of such undertakings situated in the Union. This is because the scope for a legitimate application of CFC rules within the Union should be limited to artificial situations without economic substance…." [19]

Article 8 then clarifies that financial undertakings may fall under this provision if 50% of an entity's income comes from transactions with the taxpayer or its associated enterprises. In a private equity context, the CFC rules will apply if 50% of a private equity-backed entity's income (such as capital gains, dividends, interest payments) are realised from taxpayers or associated enterprises. While associated enterprises are not defined, we believe that this category should not include portfolio companies, as these are not associated with the taxpayers. It should also be clarified that the 50% taxpayer requirement is not based on all EU taxpayers in aggregate, but rather on a Member State basis.

We believe that the list of income categories in Article 8.1 should exclude dividends and capital gains along with income generated by venture capital companies. It should also be clarified that later distributions are tax exempt, as a tax credit may not operate to counteract double taxation in this instance.

It is also important to include a safe harbour provision under which the CFC rules will not apply to a foreign entity that (i) has a genuine business activity (industrial or commercial) carried on in the jurisdiction where it is organised or (ii) when the main purpose of the transactions of said entity is not to attribute profits to a low-taxed jurisdictions.

Article 10 – Hybrid Mismatches:

The proposed rules on hybrid mismatches take a different direction to the OECD standard. By focusing on the EU, Article 10 creates different rules for payments within the EU on the one hand, versus payments between EU Member States and third countries on the other hand. In practice, depending how the rules are implemented by Member States, this could actually lead to mismatches and possible breaches to the free movement of capital enshrined under the Treaty on the Function of the European Union.

While the principle of mutual recognition may require that the OECD standard be modified

[19] Supra 12, pp 13

to respect European Court of Justice jurisprudence, the operation of the proposed rule is not clear to us. For example, in a deduction/non-inclusion scenario caused by hybrid entity legal characterization, how exactly can the payee Member State - by simply following the payer Member State legal characterization – automatically include the income in its tax base? It appears that other questions will have to be addressed in the tax system of the payee Member State before being able to include the income. Those questions include the characterisation of the income, characterisation of the instrument generating the income, application of exemptions, etc.

From a broader perspective, the proposed rule in Article 10 does not seem to tackle the concerns raised at the OECD level and addressed in their final deliverable. Similarly, the UK has published draft domestic legislation off the back of the OECD standard (intended to have effect on payments made on or after 1 January 2017) which as drafted seems to go far beyond the provisions contained in the Commission Proposal.[20] There may be resulting competitiveness and arbitrage issues arising therefore.

Country-by-Country Reporting Proposal

Investment funds such as private equity and venture capital funds do not appear to be intentionally within the scope of this Proposal. As currently drafted, investment funds are unlikely to fall within the €750 million revenue threshold as they are not required to consolidate controlled investees at the fund level. This is due to the Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27) clarification published by the IASB in 2012.[21]

Despite the lack of a requirement for consolidation, there is always the possibility that the accounting rules may change in the future and investment funds would then be required to publish country-by-country reporting to tax authorities. If this were to happen, the data that that regulators will get from funds would be meaningless and would not be in the spirit of the proposal. We therefore feel it is important to have an explicit exemption not only for fund entities but also for their holding company/companies through which they invest in the portfolio companies, in particular in the case of a master holding for various portfolio companies.

Allowing a potential future change in accounting rules to determine to whom the country-by-country reporting rules apply would be akin to allowing the tail to wag the dog. Various industries that operate through the financial intermediaries of investment funds such as private equity and venture capital should either be expressly in or out of these rules. We would welcome firmer delineation of this in the text.

[20] Draft legislation contained in clause 33 Finance Bill 2016 which, subject to the Finance Bill receiving Royal Assent, inserts a new Part 6A of Taxation (International and Other Provisions) Act 2010.
[21] Investment Entities Amendments to IFRS 10, IFRS 12 and IAS 27, October 2012

Conclusion:

We would like to re-iterate our support for the Commission's work in this area. We fully share the efforts to clamp down on illicit tax practices. As outlined in this Position Paper, we urge that caution be taken in certain delicate areas so that there are no unintended consequences on sectors and practices unrelated to the main targets of this Proposal. In particular, we urge the Commission to be mindful of the goals outlined in the Capital Markets Union Green Paper and subsequent Action Plan, and avoid throwing the baby out with the bathwater.

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