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Brussels, January 2016

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

Response to European Commission Consultation on the re-launch of the Common Consolidated Corporate Tax Base (CCCTB).

Section 7 – Debt Equity Bias, Cross-Border Loss Relief:

The European private equity & venture capital industry does not adhere to the view that there is a "corporate tax debt equity bias" in the EU. As indicated in the online questionnaire, none of the above options (i.e. CBIT, ACE or COCA) would be a suitable course of action to achieve the goals of the re-launched CCCTB, in our view. As expressed in our response to the Capital Markets Union (CMU) Green Paper, we fully support the development of equity investment.[1] The means and ways to successfully promote equity investing should not be seen purely from a tax perspective however. Treating debt and equity as substitutes for each other and therefore assigning similar tax incentives to both forms of financing is not a sound method to promote equity investment. As alluded to in the 2012 Commission Working Paper, we adhere to the "traditional view" that dividends are the remuneration of capital while interest payments constitute a business cost.[2] The inherent differences between debt and equity should be respected, in our opinion. As we explain below, there are many commercial reasons for using debt financing.

We enthusiastically welcome the publication of the CMU Green Paper and CMU Action Plan respectively by the Commission. As noted therein, if European venture capital markets were as deep as those in the USA, as much as €90 billion of funds would have been available to finance companies between 2008 and 2013.[3] We aspire to develop a single European venture capital market as deep as the USA, but we also acknowledge that this is a very long-term goal which will require shaping attitudes towards a culture of equity. While we endorse the efforts of the Commission to promote equity financing, of which private equity and venture capital is an important type, this will not be achieved through changes to corporate tax legislation that assume a binary choice between debt and equity. From a company's perspective, the choice of equity and debt financing is not binary but rather complementary.

We agree that the European Union (EU) needs more investment. For example, in infrastructure, the Commission agrees with the European Investment Bank's estimate that

[1] Public Affairs Executive (PAE) response to the Capital Markets Union Green Paper, May 2015
[2] European Commission Taxation Working Paper N.33 – 2012, The Debt-Equity Tax Bias: consequences and solutions, pp. 6
[3] European Commission Green Paper on Building a Capital Markets Union, February 2015, pp. 2

the EU may need up to €2 trillion in investment in the period up to 2020.[4] While public support through measures such as the €315 billion Investment Plan for Europe (European Fund for Strategic Investment) will help, there is a clear need for more private investment in such projects in the longer term. This private investment needs to be a mix of debt and equity. In private equity-backed companies across the EU for example, financing comes 41.27% from equity and 58.73% from debt on average.[5]

In particular, we are concerned that any transformation of the rules in this area will lead, either directly or indirectly, to an increase in the cost of financing for companies in the EU. The introduction of a Comprehensive Business Income Tax (CBIT) or Cost of Capital Allowance (COCA) rule would introduce a limitation on the deductibility of interest expense and therefore result in an increase in the cost of debt financing. The introduction of an Allowance for Corporate Equity (ACE) rule, even if it has some theoretical merits, may result in a corresponding increase in national Corporate Income Tax (CIT) rates. This is because Member States may seek to compensate a reduction in revenue from lower taxation of dividends with a corresponding increase in other tax rates, as acknowledged in the Commission Working Paper.[6] We would like to stress that debt and equity financing should not be seen as antagonistic or mutually exclusive. Rather, they are often complementary to each other, as can be seen in a typical private equity context.

As explained in further detail below, any increase in the cost of financing for companies throughout the EU will result in the EU becoming a more expensive location in which to do business. This could have important competitiveness implications vis-à-vis other, non-EU, territories.

Equity & Debt in a Private Equity context:

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

[4] European Commission - Fact Sheet, New Rules to Promote Investments in Infrastructure Projects, 30 September 2015

[5] Standard & Poor's Q4 2014 Leveraged Buyout Review
[6] Supra 2, pp.14

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.[7] 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-technology, computer software, infrastructure, and at various stages of the life of the company.

The investors into 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.[8]

Private equity funds provide the institutional investors with whom it co-invests the necessary skills for finding, analysing, valuing and negotiating the investment into interesting unlisted companies with value creation potential and then, through active board participation, guides and monitors these companies until they are ready to take the next step in their development under the stewardship of new/additional owners. The management teams of these companies implement and execute the strategies originally facilitated by the private equity funds and subsequently adopted by the boards of directors. A private equity fund holds a portfolio company for a period of between 5 and 6 years, on average.[9]

The vast majority of companies which receive private equity financing are Small and Medium-sized Enterprises (SMEs), 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 CMU Green Paper and subsequent CMU 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?” [10]

[7] For more information on the investors into private equity funds, please see our 2014 European Private Equity Activity Handbook, pp. 14 & 15
[8] Ibid, pp. 20 & 21
[9] Invest Europe Research
[10] Supra 3, pp. 17 & 19

Why is debt financing relevant to private equity?

(i) Buyout operations:

While the vast majority of companies which receive financing from private equity funds are SMEs,[11] buyout operations described in this subsection are more typical of the strategy used to acquire established, larger companies. 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 from borrowings to purchase the target company. 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 on 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. In any event, unless a guarantee has been negotiated, lenders have no recourse to the assets of the private equity fund (except for any shares of the target portfolio company that were pledged by the fund to secure the borrowing), of any other portfolio company in which that private equity fund has made an investment, or of the private equity firm.

Except perhaps for a 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 of the assets of the fund or 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. Often, 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 optimistic economic outlook.

[11] Supra 7, pp. 56

(ii) Business expense:

As the European Commission considers various measures designed to promote equity financing vis-à-vis debt financing, we note the importance of interest deductibility 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."[12] According to the OECD, small and medium-sized enterprises and entrepreneurs across OECD countries continue to use debt to a large extent to finance their growth and development. [13] Indeed recent statistics show that 95% of SMEs in Europe finance their operations at least in part by using bank loans. [14]

While the October 2015 ECB bank lending survey (BLS) showed that euro area banks reported a net easing of credit standards on loans to enterprises in the third quarter of 2015,[15] 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. The withdrawal of interest deductibility would make credit more expensive to serve thereby reducing the ability of borrowers to service future debt. As a consequence, lenders 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.

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.

Comments on the 3 different options:

CBIT and COCA:

The net effect of either the Comprehensive Business Income Tax (CBIT) or Cost of Capital

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

Allowance (COCA) rules would be a reduction in interest deductions from debt (albeit at different rates between CBIT and COCA). As pointed out in the Commission Working Paper, the CBIT is "not exempt of problems"[16] and we examine these under our general comments section below.

Regarding a COCA rule (which the Commission Working Paper also refers to as an Allowance for Corporate Capital (ACC) rule), we note that the research acknowledges that it would preserve financing neutrality and also "reduce possible negative effects of each of the pure ACE or CBIT systems."[17] Similar positive statements are expressed in another Commission Working Paper which states that "[g]iven that the various options for addressing the debt bias discussed above all have some drawbacks, there may be some merit in combining limits on the deductibility of interest costs with a deduction for the notional return on equity, in order to minimise the adverse effects of each of these measures."[18] While the latter point may be correct i.e. a half-way house rule between full COCA and CBIT rules would temper the disadvantages of each, the overall big-picture result is that such a rule would still lead to a negative effect in that there would be an increase in the cost of debt financing.

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.[19] 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.[20] 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%.[21]

Similar to an ACE rule (discussed below), the introduction of a COCA or CBIT rule with a simultaneous reduction in national CIT rates would have negative implications for financing EU businesses. While proponents of a COCA or CBIT rule may argue that any limit on interest deductibility would be offset by the commensurate deduction in CIT, it is important to underline the results of the US study mentioned above, which showed that even with such 'revenue-neutral' reforms there would be a negative impact on growth.

[16] Supra 2, pp. 13
[17] Supra 2, pp. 15
[18] Commission Tax Reforms in EU Member States 2015, Tax Policy challenges for economic growth and fiscal sustainability, September 2015, pp. 49
[19] European Commission, Findings from the 2015 corporate debt bias conference, pp. 2
[20] 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
[21] Ibid

Moreover, such a reform would have an important distributional impact, with a particularly negative impact on new businesses. Start-up companies would be impacted as they typically endure a number of years of loss-making or breaking-even after setting up business before they turn a profit.

For example, if an entrepreneur develops a new product or service and wishes to bring it to the market, the initial period in establishing a company and then selling that product or service are typically the most hazardous. Significant costs are incurred in, *inter alia,* carrying out market research, seeking legal advice, hiring staff, purchasing insurance, buying stock and raw materials, organising production facilities, etc. Regardless of how innovative or promising a new product/service is, establishing a presence in the market takes time and involves significant up-front costs.

As the data shows, SMEs tend to use debt financing for these expenses, often in tandem with other forms of finance, such as venture capital. Introducing a COCA or CBIT rule would mean that such a start-up would no longer be able to deduct its interest expenses from its tax bill (under a CBIT rule, or would face less deductions under a COCA rule), and its cost of running a business would thus increase. Any potential reduction in the CIT rate - while designed to achieve revenue neutrality - would bring no benefit to the start-up. As it is not yet making a profit, the lower CIT rate would not be relevant (or would only become relevant much later, should it achieve profitability). But it *would* see an immediate impact in its cost of doing business.

Such an increase in costs would come at the most vulnerable time for a new business: during its early years when it is not making a profit but has extensive costs, many of which have to be met through borrowing. COCA or CBIT rules would thus become a tax on start-ups.

ACE:

We agree with the assertion in the Commission Working Paper that the Allowance for Corporate Equity (ACE) is a "promising tax system to establish a symmetric tax treatment between debt and equity at the corporate level."[22] As pointed out in the Commission Tax Reforms in EU Member States 2015 Report, "[a]n important practical advantage of the ACE is that it has already been seen to have been successfully implemented in a number of countries", i.e. Italy, Belgium and Portugal (for SMEs only).[23]

The 2012 Working Paper describes the ACE and CBIT options as "more radical alternative designs of the corporate tax systems."[24] It is the uncertainty which is inherent to a "radical" proposal that creates hesitation on the part of investors. Specifically, the introduction of an ACE rule may lead to corresponding increases in national CIT. As the Commission Working

[22] European Commission Taxation Working Paper N.44 – 2014, Addressing the Debt Bias: A Comparison between the Belgian and Italian ACE Systems, pp.2
[23] Supra 18, pp. 49
[24] Supra 2, pp. 12

Paper explains – "[i]f designed in a revenue-neutral way, an ACE would achieve the opposite result than a CBIT by decreasing the tax base (which in turn would have to be compensated by increasing the CIT rate)."[25]

An increase in the CIT rates across EU Member States is something that the European private equity and venture capital industry would oppose. As the Working Paper acknowledges, an ACE rule can indeed be designed in a non-revenue-neutral manner meaning that there would be no intended corresponding increase in CIT (for example the Belgian domestic law on *déduction d'intérêt notionnel*). The setting of CIT rates is of course a Member State competence however, and if the CCCTB were to be adopted with an ACE rule included therein, EU Member States would be entirely within their legislative prerogative to increase their CIT rate to ensure no lost revenue as a result of granting tax deductions for equity investment. All things being equal, the introduction of an ACE rule would create a strong incentive for Member States to move in the direction of an increase in CIT rates.

Net Effect of CBIT, COCA & ACE:

As acknowledged in the CMU Green Paper, venture capital in Europe often lacks the necessary scale and is too fragmented in order to emulate the success of the American venture capital model.[26] By making debt financing more expensive, it does not follow that affordable equity will automatically become available to fill that financing gap. While the CMU project will hopefully help to increase the supply of equity, in the meantime these rules would simply penalise businesses with higher costs and we could simply end up with less investment in Europe.

Adopting a COCA or CBIT rule would not be conducive to increase venture capital financing but would indeed have the opposite effect of making the operating cost of a start-up company more expensive. While the Commission Working Paper concludes that the introduction of an ACE or CBIT rule could "potentially bring substantial benefits in terms of reducing leverage, systemic risk and profit-shifting",[27] we believe these apparently substantial benefits will not exist in a vacuum however and need to be considered against the detriment of increasing the cost of financing. According to UN research "if tax rules impose additional costs on the use of debt, that may affect investment decisions; not all investors will be willing to bear those additional tax costs."[28]

In any event, academic studies have also found that interest deductibility does not lead to greater financial distress[29] and also show that limiting interest deductibility would lead to

[25] Supra 2, pp.14
[26] Supra 3, pp. 17 & 18
[27] Supra 2, pp. 16
[28] Supra 12, pp. 23
[29] Graham, John R., Hazarika, Sonali and Narasimhan, Krishnamoorthy, "Financial Distress in the Great Depression" (September 2011). NBER Working Paper Series, Vol. w17388, pp. -, 2011.

higher instances of default and increased credit spreads.[30] We therefore urge policymakers looking to create a safer financial system to examine these proposed rules in more detail.

General Comments:

Debt and equity should not be seen as antagonistic or mutually exclusive. Rather, they are complementary to each other. In most countries, the tax law is symmetric with respect to debt. Generally, each euro of interest deducted from the borrower's income is a euro included in the creditor's taxable income. Debt creates an environment of commercial discipline as lenders examine business plans prior to lending and keep a close watch on the progress and growth of the borrower's business.

The ability to access debt capital creates options for business owners and investors looking to finance a new business or engage in expansion. Debt permits business owners to raise capital and finance growth without having to relinquish control or decision-making authority in their companies. This is particularly important for start-up enterprises whose entrepreneurs often have a defined vision and may not want to dilute their control by issuing equity (and equity financing will not always be readily available, as discussed earlier).

As explained in the Commission Working Paper, "suppressing the interest deductibility can impact on hedging, increase the cost of capital and, all else equal, decrease firms' values. The effect on bankruptcy is moreover also unclear. On the one hand, reducing leverage reduces the probability of defaulting but on the other hand, the increase in the cost of capital would increase the probability of defaulting."[31]

Limiting interest deductibility would significantly increase the marginal effective tax rate on new investment and could stifle growth in the EU, undermining one of the stated goals of the current corporate tax reform agenda. In light of the continued reliance on bank financing for companies across OECD Member States as mentioned above, changing the traditional rules of capital formation by limiting or eliminating the ability to deduct interest on corporate debt would make the EU a less attractive place for business and job creation relative to those non-EU OECD Member States where such rules on interest deductibility would be maintained (such as those countries whose rules are consistent with the OECD BEPS best practice recommendation on interest deductibility).

Similarly, we believe that limitations on the deductibility of corporate interest would have negative effects on output and investment across the EU as companies' returns on investment would decrease, even taking into account the benefits of any corresponding reduction in CIT rates. As noted above, in the USA, output was estimated to fall by 0.2% in

[30] Glover, B., J.F. Gomes, and A. Yaron. 2011. "Corporate Taxes, Leverage, and Business Cycles." http://www.andrew.cmu.edu/user/gloverb/Research_files/GGY_Taxes_Aug2011.pdf.
[31] Supra 2, pp.13

the long-run if a limit on interest deductibility were introduced. This could be even higher in Europe as there is proportionally less debt financing for companies in US due to their more mature venture capital system. The drop in output would thus be amplified in Europe.

Limiting interest deductibility would especially penalize enterprises that lack easy access to equity and instead rely on external financing to create jobs or invest in plant and equipment. Early-stage and innovative companies would be disproportionately impacted because they often rely on debt financing to fund growth initiatives.

Conclusion:

Limiting the ability to deduct ordinary business expenses, or changing the longstanding definition of those expenses to exclude interest, would have a negative impact on capital formation and growth. While we recognise the theoretical benefits of an ACE rule, the complexities and potential for unintended consequences which would accompany the introduction of such a rule make it unattractive. We thus encourage the maintenance of the full deductibility of interest on business debt as it exists under current law in most countries.

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.

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