Submission

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

17 June 2015

To **Organisation for Economic Co-operation and Development (OECD)**

Re **Consultation on Public Discussion Draft BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances.**

Introduction:

The Public Affairs Executive (PAE) of the European Private Equity and Venture Capital industry is pleased to provide its comments on the third public discussion draft released by the OECD on Action 6 ("the Consultation Document").

We write on behalf of the representative national and supranational European private equity (including venture capital)[1] bodies. Our members cover the whole industry, from the institutional investors who provide the capital for investment to the private equity firms who invest the capital in European companies at all stages of their development.

Summary of Main Points:

- Existing due diligence procedures (such as the requirements under 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.
- Deferring distributions from the private equity fund would have an adverse impact on investors' management of their funding risk and negatively impact the internal rate of return of the fund. There is therefore a strong commercial imperative inherent in private equity fund models to distribute quickly.
- 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.
- The intermediate holding company structures used by private equity funds should not disadvantage such funds in their tax treatment as the structure

[1] The term "private equity" is used in this paper to refer to all segments of the industry, including venture capital. The term "venture capital" is used in specific contexts where there are issues that relate particularly to this segment.

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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 for other non-tax reasons.

- 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.

- We believe that further work could, however, be undertaken on the creation of an additional category of qualified person, to include the concept of a 'qualified fund', provided this were tailored and appropriate to the private equity industry, based on existing reporting requirements.

- We agree with the conclusions of the Working Party that it should continue to explore solutions to issues related to the treaty entitlement of non-CIV funds and their holding companies. In this light, we would like to see the creation of a specific OECD Working Group dedicated to examining solutions to non-CIVs which will continue work beyond the current deadline of September 2015 for Action 6 under the BEPS project.

<u>How Private Equity Operates in Practice:</u>

In our response to the previous discussion draft, we provided an overview of what private equity is, as requested by the OECD. We also provided some brief information as to how private equity operates in practice, explaining who the institutional investors that invest into private equity funds are, the typical sectors into which private equity funds invest, and the average time-periods for the life-cycle of private equity funds and holding of portfolio companies by the fund. In this paper, we would like to provide a concrete example of how a private equity fund works in practice.

Private equity *firms* are often global in nature, having offices in numerous major cities throughout the world. When a private equity firm is considering where it will establish a fund, this choice is mainly made on the basis of criteria such as the residence of the management team and the ability of the structure to be suitable for, and acceptable to the majority of the international investor base. In the EU, given the new European regulatory framework under the Alternative Investment Fund Managers Directive (AIFMD), most management teams prefer to market European funds which are Alternative Investment Funds (AIFs).

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If a private equity firm decides to establish a fund in France for example, there are various legal requirements under both French law and EU law which must be adhered to. French 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.

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

In addition, there is voluntary action around the world to implement multilateral tax information exchange between countries, so as to deal effectively with tax evasion. This started with the introduction of US rules under the Foreign Accounts Tax Compliance Act (FATCA), aimed at tackling tax avoidance by US taxpayers. Further efforts to increase tax information exchange are continuing, both at EU level (such as amendments to the Directive on Administrative Cooperation) and at global level (such as the OECD Common Reporting Standard).

These existing due diligence procedures on the status of a private equity fund's direct and indirect investors, carried out to the greatest extent possible by the private equity fund 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

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not themselves entitled to treaty benefits (this being the first general concern regarding non-CIVs raised by the OECD Working Party).

The financial business model of a private equity fund relies on a strong principle of alignment of interest of investors and the fund manager since the management team always invest a significant amount alongside the investors (between 1% and 3% of the size of the fund) and in addition, can obtain a percentage of 20% of capital gains of the fund (carried interest) after a minimum rate of return received by the investors ("preferred return").

Furthermore, 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. There is therefore a strong investor imperative to distribute quickly.

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 investments.[2] 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.[3] This financial business model is relevant to the second general concern raised by the OECD Working Party.

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.

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

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[2] The fund must pay a fixed priority return (around 7 or 8%) on contributions of investors that have not been yet repaid.

[3] For more information on who the investors into private equity funds are, please see pages 3 & 4 of our Response to the 2nd OECD Consultation Document on Action 6 which was submitted in January 2015

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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, the private equity fund is expected to invest 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.

Although some of the above requirements imposed on the fund and fund manager may be specific to French law as per this example, equivalent rules are found across the EU and indeed beyond. Therefore while the specifics of a private equity fund's operations may differ from country to country, the essence of the fund's activities generally remains the same. This is due to natural harmonisation of rules as investors who invest their money across borders feel more protected when the differences between regulatory environments are minimised.

As can be seen, the above example shows that private equity funds, being closed-ended and unleveraged, use intermediary holding company structures and channel capital from institutional investors to the real economy. Contrary to some other vehicles which are classed as non-CIVs throughout the rest of the world, there is business substance in these intermediary holding structures and they perform valuable functions.

The LOB test presents two threats to these investments made by the private equity community. The first is the compliance burden. As set out above private equity funds devote time and resources to carry out due diligence on their beneficial owners 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) adopt a pragmatic approach in balancing the burden placed on financial institutions against the risks which the regimes are intended to mitigate. 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 those beneficial owners 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.

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The second and more critical concern (as set out in the examples in our previous submission) is that a private equity fund using a structure such as the one just described would face double taxation due to the inability of the fund and/or its holding structure(s) to satisfy the LOB test.[4]

We have also previously provided examples of how the proposed Principle Purpose Test (PPT) is too wide and is likely to be implemented inconsistently across BEPS participant jurisdictions.[5] We believe that the PPT rule should be re-drafted to apply only in cases where it is determined that "the principal purpose" of an arrangement is to obtain tax treaty benefits, rather than being "one of the principal purposes".

Use of Intermediary Structures by Private Equity:

As can be seen in the example described above of a private equity fund domiciled in France, private equity funds usually use holding companies to acquire portfolio companies. The legitimate use of intermediaries for investment funds 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."[6]

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."[7]

The intermediate holding company structures used by private equity funds should not disadvantage such funds in their tax treatment as the structure is not

[4] Please see pages 6 & 7 of our Response to the 1st OECD Consultation Document on Action 6 which was submitted in April 2014

[5] Please see pages 17 & 18 of our Response to the 2nd OECD Consultation Document on Action 6 which was submitted in January 2015.

[6] OECD Report:The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles, April 2010, pp 6.

[7] ibid, pp7

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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 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 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.

Tax Status of Investors:

As can be seen from the example described above of a private equity fund domiciled in France, 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 Consultation Document states that future work in this area should address two general concerns: firstly that non-CIVs may be used to provide treaty benefits to investors that are not themselves entitled to treaty benefits, and secondly, that investors may defer recognition of income on which treaty benefits have been granted.

In our view, it is misaligned to conflate these two concerns with the tax treaty eligibility of fund structures. As can be seen in the example, as soon as the fund divests the assets, that return on capital will be distributed to the investors in the fund. Thus, a private equity fund as such cannot be used to defer recognition of income.

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-channeling 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 in the example described above, this potential is significantly mitigated by the fund manager’s due diligence requirements. Rather, we believe the OECD should focus on fund structures having a wide investor base - as explained in our previous response - and as such identify those funds which are not structured for treaty shopping purposes.

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

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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.

Importance of Private Equity in Financing the Real Economy:

We are pleased to see that the Consultation Document states that the Working Party "recognised the economic importance of these funds and the need to ensure that treaty benefits be granted where appropriate."[8] Indeed, the economic importance of private equity & venture capital funds must not be overlooked. The recent publication of the Capital Markets Union Green Paper[9] by the European Commission is illustrative in this regard. The goal of the Capital Markets Union (CMU) is to reduce the reliance on bank financing, unlock investment in Europe's companies and infrastructure, thereby creating a true single market for capital for all 28 Member States in the EU, and in so doing create jobs and growth.

The European Commission explains why they are pursuing their goal of creating a CMU, pointing out that if European venture capital markets were as deep as the US, "as much as €90 billion of funds would have been available to finance companies between 2008 and 2013."[10] According to the CMU Green Paper, "private equity and venture capital play an important role in the European

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[8] Consultation Document, Revised Discussion Draft BEPS Action 6: Prevent Treaty Abuse, May 2015, pp 9

[9] European Commission, Green Paper: Building a Capital Markets Union, February 2015

[10] ibid, pp 2

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economy."[11] The Green Paper then specifically asks "[h]ow can the EU further develop private equity and venture capital as an alternative source of finance for the economy?"[12]

We note that the OECD Working Party has agreed that pension funds should be considered to be a resident of the State in which it is constituted regardless of whether it benefits from a limited or complete exemption from taxation in that State. Pension funds are important investors into private equity funds. The previous Action 6 Consultation Document was correct therefore when it stated that "pension funds, like sovereign wealth funds, are often among the institutional investors that invest in alternative funds and private equity funds and these may be established in third countries".[13]

Indeed, 32% of capital which is invested into private equity funds comes from pension funds.[14] In 2014, the total investment into European private equity funds from pension funds amounted to just over €14 billion. [15] Echoing similar statements from European institutions, the 2014 OECD Report on Institutional Investors and Long-term Investment correctly identified that pension funds are increasingly investing in private equity funds, not just on a European basis but indeed globally.[16]

Solutions & Way Forward:

Although the Consultation Document judges that "most suggestions included in the comments received did not sufficiently take account of treaty-shopping concerns", the basis for this conclusion (i.e. the tax status of investors themselves) is a consideration which is not factored in as part of the fund structuring. Rather, this is 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.

Despite the OECD's concerns, we believe that further work could, however, be undertaken on the creation of an additional category of qualified person, to

[11] ibid, pp 17.

[12] ibid, pp 19.

[13] The previous discussion draft, Follow Up Work on BEPS Action 6: Preventing Treaty Abuse, November 2014, pp 6

[14] Further information can be found in the EVCA Yearbook - 2014 European Private Equity Activity: Statistics on Fundraising, Investments & Divestments, May 2015.

[15] Ibid, pp 15.

[16] OECD Institutional Investors and Long-term Investment, Project Report, May 2014, pp 14.

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include the concept of a 'qualified fund', provided this were tailored and appropriate to the private equity industry, based on existing reporting requirements and not on TRACE which is inappropriate for our industry. We do not consider that any solution based on the principles of the TRACE project could be a practical solution for private equity funds. If the OECD feels that there is insufficient time to properly deal with such negotiations then we would ask that non-CIV funds are carved-out of the current proposals and the status quo maintained until such time as treaty entitlement for private equity funds can be properly addressed.

With this document, we have now responded to all three consultations which the OECD has issued on Action 6. As can be seen, we are committed to continued engagement with the OECD and to give further explanation and information on how private equity operates in order to allow the OECD to achieve its goals of designing rules to stop base erosion and profit shifting, while still allowing investment funds to continue their important task of channelling capital to the real economy.

We are more than willing to further engage with the OECD on this issue, and if necessary become more closely involved in the work in this area. <u>We agree with the conclusions of the Working Party that it should continue to explore solutions to issues related to the treaty entitlement of non-CIV funds and their holding companies. In this light, we would like to see the creation of a specific OECD Working Group dedicated to examining solutions to non-CIVs which will continue work beyond the current deadline of September 2015 for Action 6 under the BEPS project.</u>

<u>Conclusion:</u>

Private equity funds are not in the business of treaty shopping. They pursue a genuine business purpose, i.e. the co-investment arrangement or pooling of capital to make investments into companies. 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.

In the context of the Consultation Document, private equity funds, irrespective of shape or form, typically raise and invest funds internationally and it is imperative that the location as well as the structure chosen for the fund is tax neutral for the investors. In other words, the co-investment or pooling of the investments via the fund entity should not trigger *additional* tax for investors when compared with a

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situation in which the investors invest directly in those companies. This is a general principle for structuring funds which is not unique to private equity.

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.

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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 EVCA

The EVCA is the voice of European private equity.

Our membership covers the full range of private equity activity, from early-stage capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. We represent 650 member firms and 500 affiliate members.

The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

We explain private equity to the public and help shape public policy, so that our members can conduct their business effectively.

The EVCA is responsible for the industry's professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.

We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis.

The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is heard.