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On behalf of the European Private Equity and Venture Capital Association (EVCA)

Industry Response to Notices 2010-60, 2011-34, 2011-53 and 2011-55 in respect of the Foreign Account Tax Compliance Act (FATCA) Provisions incorporated in Chapter 4 of the Hiring Incentives to Restore Employment Act

We write to you on behalf of the European Private Equity and Venture Capital Association (EVCA) being the voice of European private equity ("PE") and venture capital ("VC"), representing more than 1,300 members. Our members cover the whole of the private investment fund spectrum, from venture capital funds investing into high growth technology start-ups, to the largest global buyout funds turning around and growing mature companies. Further, our member base includes institutional investors in PE and VC funds. EVCA members are very active in the US through offices located within the US and such located outside the US. EVCA member's European offices invested Euro 3.4 billion in US companies between 2008 and 2010, which made up 4%, 5% and 5% of their total investment for 2010, 2009 and 2008 respectively.[1]

The nature of investment activities in the PE/VC industry differs significantly from other financial institutions such as banks, hedge funds and mutual funds. It is our view that without consideration of the industry's specificities it will be unduly burdensome for the PE/VC industry to implement FATCA, as currently proposed, and there will be a negative impact in foreign investment by the PE/VC industry into the United States.

[1] EVCA / PEREP_Analytics statistics 2012.

It should be noted that the risk of tax evasion should be considered to be low within the PE/VC industry. The fact that the funds are closed-ended and the investments are of a long-term illiquid nature (typical life of a fund is approximately 13-17 years) would not make PE/VC funds an attractive investment vehicle via which investors could evade tax as the invested funds are unavailable for long periods of time and are not within the control of the investor. In addition, acceptance of investors into the fund is a relatively long process with significant levels of due diligence involved. Under global anti-money laundering regulations, PE/VC funds are required to perform certain procedures to verify the identity of the investors. Given that tax evasion would be considered money laundering, any investors suspected of money laundering would not be accepted by the fund at the time of investment. Furthermore, investors in PE/VC funds are typically institutional, such as pension funds of large corporate or state organisations, and sovereign wealth funds, which the PE/VC industry consider would pose a low risk of money laundering and/or tax evasion.

We have set out below our key concerns which we consider would significantly impact the appetite for the European PE/VC industry to invest in the United States. Particularly, we are concerned that the proposals as currently drafted could impose a punitive withholding tax and regulatory burden on the private equity and venture capital industry which is inequitable, disproportionate to the US tax at stake, and will also negatively impact the attractiveness of those funds which choose to invest in and conduct business with United States entities.

We would welcome the opportunity to discuss these issues with you in greater detail.

This representation relates to the guidance as it currently stands, and as the regulations develop, the industry may well have further points to make or different approaches to solving the issues we have addressed may become available. We would therefore appreciate having an ongoing dialogue with the Treasury and the IRS as regulations are being drafted.

Introduction

We understand that the intention of Chapter 4 is that Foreign Financial Institutions ("FFIs") and Non-Financial Foreign Entities ("NFFEs") should obtain and report information in relation to the US source income of US investors and beneficial owners to the IRS. In this context US source income means Fixed, Determinable, Annual and Periodical ("FDAP") payments from US sources (which include interest, dividends, personal services fees, licenses, rents, pension payments and litigation fees) and the gross proceeds from the sale of property which can produce US source interest and dividends. We acknowledge that Chapter 4 forms part of the US Treasury's initiative to detect US taxpayers who evade tax through offshore holdings and to discourage such practices. Therefore, whilst we are supportive of the spirit of the initiative, we are concerned about significant reporting and compliance burdens that are completely out of line with the risk of tax evasion in PE/VC structures.

How a PE or VC fund works and their structure

By way of background, we have set out at Appendix 1 a diagrammatic representation of a typical European PE fund and a summary of its major components.

Impact of FATCA for PE/VC funds

The inherent nature of how a PE/VC fund operates gives rise to concerns and complexities in the ability of a fund to comply with the regime. In particular, we note the following:

1. A typical PE/VC fund is closed-ended. Because of the illiquid nature of the underlying portfolio company investments, a typical PE/VC fund often exists for 13-17 years as portfolio exits become available. The partners of existing PE/VC funds have signed up to partnership agreements which govern the relationship between the partners

and which will have required the partners to provide comprehensive information for "know-your-customer" ("KYC") and money laundering check purposes but may not fully satisfy the FATCA regime. EU harmonised anti-money laundering law (Directive 2005/60/EC of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing) requires that the identity and home address of each investor (or in the case of a non-individual investor the identity and home address of one of the directors) be ascertained prior to funds being committed. The critical issue for our industry is that in the event that one of the investors is found to be 'recalcitrant' for whatever reason, the PE/VC fund will have no mechanism to force the investor to withdraw from the partnership for FATCA non-compliance. Moreover even if it were possible, such a step would create significant commercial problems for the PE/VC fund and its managers as it would lead to a shortfall in funding available for investment, and in turn adversely impact the commercial strategy of the PE/VC fund - both for the manager as well as for the other institutional investors in the PE/VC fund.

2. PE/VC funds may use a range of investing vehicles and such vehicles may not fall within the general definitions of 'holding companies' under the FATCA regime. A typical PE/VC fund may have ten to forty portfolio investments, with each investment involving a number of holding companies due to commercial and legal reasons (refer to the diagram in Appendix 1). These holding companies could all be construed as FFIs for the purposes of FATCA for the reasons set out below even where such companies are considered to be part of the trading group of the portfolio companies. Accordingly, the withholding and administrative burden may be disproportionately increased for European PE/VC funds.

3. As noted above, each PE/VC fund would typically invest in a relatively small number of investments (e.g., 10-40) each being held for an average 3-7 year period. The current drafting of the Pass-thru Payments regulations would require valuation of these illiquid investments more frequently than a PE/VC fund would typically undertake; thus creating a large, costly, and onerous administrative burden contrary to industry best practices. Furthermore, they could result in withholding in connection with payments (i.e. dividends) and exits from non-US portfolio companies where the PE/VC fund holds amongst other assets, US portfolio companies. In view of the small number of investments, European PE funds are capable of tracing their income and proceeds flows through on an actual basis.

We have addressed each of the above concerns and have set out our request for clarification/ proposed solutions in further detail below.

1. Recalcitrant partners in existing partnerships

Issue 1:

The typical life of a PE/VC fund is approximately 13-17 years. The rights and obligations of partners are determined by the partnership agreements which can normally only be changed with unanimous agreement if any economic changes are involved. Partnership agreements for existing PE/VC funds will not have considered the impact of FATCA. Therefore the PE/VC fund will have no means of collecting the information where an investor does not wish, for whatever reason, to provide it (to the extent the information which existing PE/VC funds have collected is insufficient to meet the requirements under the FATCA regime). This will give rise to a clearly unacceptable situation whereby a recalcitrant partner will in effect be subsidised by other partners as the partnership agreement also does not enable the withholding to be targeted at the recalcitrant partners. Given that this was not foreseen in current partnership agreements, this could create an issue for those partners who comply as income received in their hands will be subject to withholding and will almost certainly result

in extensive litigation against the PE/VC fund for the monetary damages caused by the additional financial burden.

We note that whilst partnership agreements may address that distributions to partners may be subject to withholding if required by law, it is unlikely that this provision would be effective in this case as the PE/VC fund could be construed as "electing in" to a withholding regime. The issue of recalcitrant partners can be accommodated and dealt with for new PE/VC funds whereby provisions can be included in the partnership agreements such that proceeds can be traced to ensure the recalcitrant partners are penalised without giving rise to negative implications for compliant partners. However, there is a need for a solution in respect of partners who are admitted to a partnership on or before the Regulations are issued.

Removing recalcitrant partners is not a viable solution as existing partnership agreements typically do not provide the fund with the powers to do this unless the consent of all the partners (including the recalcitrant partner) is obtained. Additionally, there could still be a requirement to pay future distributions to recalcitrant partners even after their removal from the partnership (because it is unlikely the partnership would be able to make liquidating distributions to the recalcitrant partner at the time of removal) and therefore even this would not necessarily resolve the withholding issue since the recalcitrant partner would remain a partner for US federal income tax purposes. The removal of recalcitrant partners will also create a funding gap within the partnership as the level of committed capital will decrease as a result of removing recalcitrant partners. It is typical for a PE/VC fund to draw down on investor capital commitments in tranches over the life of the fund and therefore the removal of the recalcitrant partners during the life of a PE/VC fund would be a real issue. Taking this into consideration, changes to partnership agreements to allow the removal of recalcitrant partners may not be commercially viable as they could trigger a failure to meet the PE/VC fund's investment strategy, e.g. spread of investors. This failure would affect not only the PE/VC fund's manager, but also the other complying institutional investors in the fund.

Proposed solution:

We request that grandfathering provisions are introduced for partners who are admitted to partnerships on or before the date the Regulations are issued such that there is a transitional period during which the FATCA provisions do not apply to such partnerships in respect of existing investors. We accept that any new partners who are admitted to the partnership after this date would need to be FATCA compliant.

We understand that similar grandfathering provisions were introduced in respect of the publicly traded partnership rules (Treasury Regulations section 1.7704). Under these transitional rules (section 1.7704-2) the publicly traded partnership rules only applied to taxable years beginning after 31 December 1997 as opposed to taxable years beginning after 31 December 1987 in the case of an existing partnership.

2. Holding companies exemption

Issue:

Notice 2010-60 sets out guidance in respect of certain holding companies which would be excluded from the definition of a financial institution and as such, would not be an FFI under the FATCA regime.

The guidance states that a traditional holding company of a group of operating subsidiaries engaged primarily in a non-financial institution business would be excluded but that this will not include any entity functioning as an investment such as a PE fund, VC fund, etc., whose

purpose is to acquire or PE/VC fund the start-up of companies and then hold these companies for investment purposes for a limited period of time.

Accordingly, it would appear based on the above that in the context of PE and VC, every new acquisition vehicle (i.e. Bidco - see Appendix 1) could be an FFI. However, it is important to note that in a PE/VC investment context, a number of holding companies may be set up for a particular investment depending on commercial, legal, tax requirements, and it is not known at which level the investment would be divested in the future as this could depend on the buyer's preferences. In this regard, it is not clear whether any of the holding companies could be regarded as a traditional holding company, and whether it would continue to hold the investment for an unlimited period of time.

Finally, it should be noted that the holding structure for a PE/VC portfolio investment often becomes the new parent of the operating group. To the extent that the holding companies which are set up as part of the acquisition process are considered FFIs, the compliance and regulatory burden would fall on the finance/operational personnel of the business. The PE and VC industry is anxious to ensure that the burden of compliance with regulations, such as FATCA, is minimised for non-financial portfolio businesses in order that senior management time and resources are not distracted from the key objective of growing the operating business. Absent their ownership by the PE/VC fund, these holding companies would otherwise have been considered NFFEs, which we note are subject to reduced compliance requirements.

Proposed solution:

Treating each intermediate holding company as an FFI would create a huge compliance burden for the typical PE/VC fund with no additional meaningful information for the IRS. Therefore we request that holding companies in a PE/VC investment structure that are parent companies or affiliates of an operating company/group engaged primarily in a trade or business other than that of a "financial institution" are excluded from the definition of a financial institution. We accept that a holding company which is used as a fund vehicle (i.e. where the external investors invest directly into a holding company) will be construed as an FFI.

3. Passthru payments

Issue 1:

We understand that the intention of FATCA is to prevent US taxpayers from avoiding US tax on their income by investing in the US through non-US financial institutions and offshore investment vehicles and to encourage such information disclosure by non-US entities by imposing a penalty on items under the control of a US withholding agent.

We also understand that the intention of the passthru percentage was to simplify the calculation of the FATCA withholding for FFIs with extensive or complex investment portfolios given that cash is fungible. In a PE/VC fund context, the passthru percentage calculation has the opposite effect, giving rise to increased complexity as a PE/VC fund typically holds a small number of investments. Moreover the investments are normally illiquid, and therefore the valuation of such investments can be complicated and subjective. In addition, the calculation of the passthru percentage requires quarterly valuations. PE/VC funds generally undertake valuations on a half-yearly or even yearly basis, and therefore quarterly valuations would create significant administrative burden.

Under the current guidance, the withholding required on passthru payments is determined by the passthru percentage of the FFI and does not have a bearing on whether the underlying payment is derived from a non-US or US asset. In this regard, distributions from non-US assets

can result in FATCA withholding if the fund includes US assets. On the basis that the objective and emphasis of FATCA is to collect information, and not the tax, this result appears to go against the spirit of the proposed rules. In addition, the methodology for calculating the FATCA withholding under the current proposals appears to give rise to a greater overall withholding for a mixed US and non-US asset fund compared to a situation where the withholding only applied on payments derived from US sources. In this regard, we consider that the current proposals create an unfair result and are not fully aligned with the intended purpose of FATCA (i.e., to capture information on US investors investing in US assets to assist the US tax authorities to collect taxes which are due to them from such investors via their tax returns). We have set out an illustration of this at Appendix 2.

In our view the ability to determine passthru payments on an actual basis is not only more accurate but more equitable. Therefore tracing the source of distributions to the individual underlying assets would be more appropriate in the context of the PE/VC industry on the basis that proceeds are easily traceable given the relatively small number of investments in any particular fund.

Proposed solution:

PE/VC funds should be permitted to calculate the FATCA withholding on passthru payments by tracing actual US-source distributions rather than the FATCA withholding to be based on passthru percentages.

Issue 2:

It is not clear from the guidance how cash would be deemed to be a US or a non-US asset for the purposes of the passthru percentage calculation. For example, would the proceeds of a sale of a non-US asset be classified as a US asset if it is held by a US bank, or a US branch of a non-US bank?

Request for clarification:

- Please confirm the conditions under which cash may be considered a US asset or non-US asset

Issue 3:

The current statute contains a provision in section 1471(b)(3) which permits a participating FFI to elect to have a US withholding agent withhold relevant amounts allocable to recalcitrant or non-participating FFIs. It goes on to say that, in such case, the requirements of paragraph (1)(D), which impose the passthru payment rules, shall not apply.

Request for clarification:

- We assume that a non-US venture capital or private equity fund could enter into such election, which would then result in the inapplicability of the passthru payment rules. Please confirm.

Summary

As noted above, we would emphasise that the risk of tax evasion by PE/VC fund investors should be low, and the regulatory/administrative burden envisaged under the FATCA regime appears disproportionate to the perceived risk. Accordingly, we would be grateful of the opportunity to discuss with you our key areas of concern. We have summarised these below:

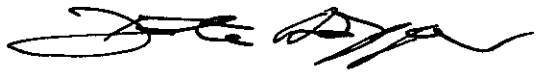
- Grandfathering provisions for partners who are admitted to partnerships on or before the Regulations are issued;

- Exclusion of holding companies in a PE/VC investment structure from the definition of a financial institution;

- Tracing methodology for calculating FATCA withholding on passthru payments and election to avoid passthru payment withholding.

In addition, there are a number of other operational issues which we believe will have an impact on the European private equity and venture capital industry which we would also like to discuss with you.

Yours sincerely,



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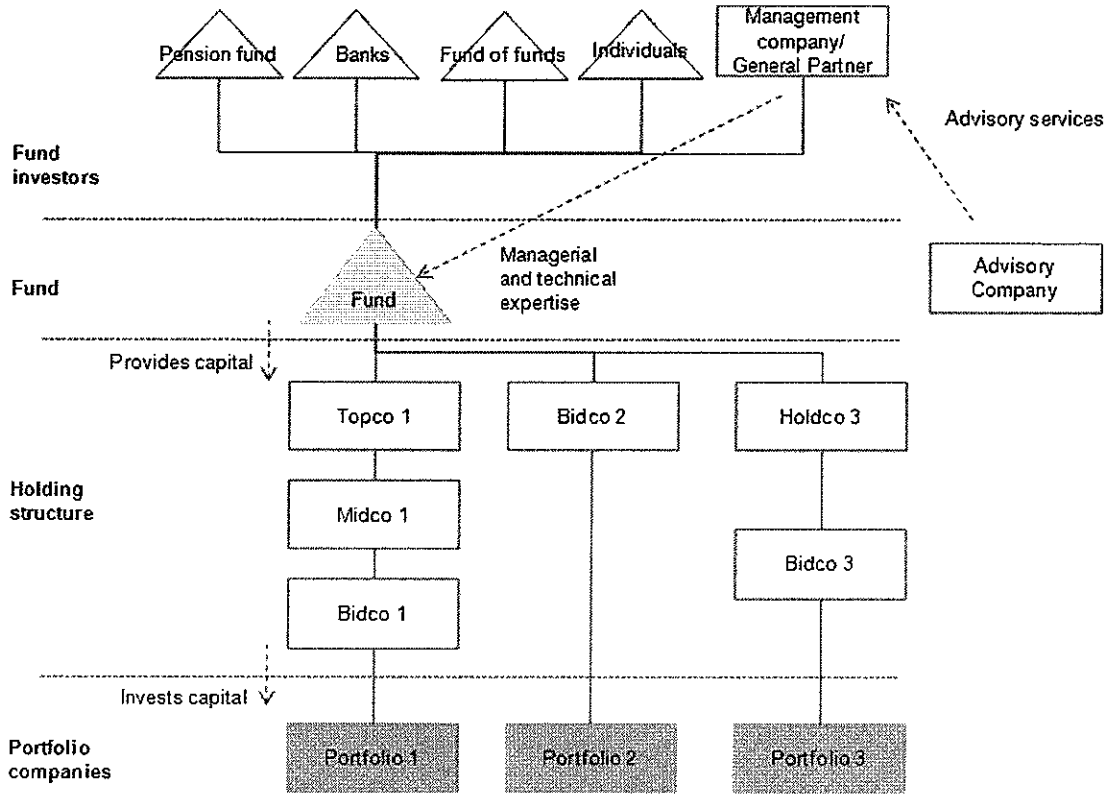
Appendix 1: Typical Private Equity Fund structures for cross-border investments

The diagram below illustrates a typical private equity fund structure.



There are five major components to a private equity fund and its investments: the investors, the fund, the portfolio company, the management company/General Partner of the fund ("Fund Manager"), and one or several advisory companies.

i) Investors

Investors provide capital, which is pooled together by the Fund Manager into collective investment vehicles (usually called private equity funds). The investors seek Fund Managers with the investment objectives, track record and capabilities that best match their requirements.

In the case of a transparent fund structure (the most common type), the investors are the fund's "Limited Partners" with limited liability.

The vast majority of private equity financing comes from investors with long-term investment horizons, such as institutional investors, (including banks, sovereign wealth funds, family offices, funds of funds and pension funds) and high net-worth individuals. They invest for a period of approximately 13-17 years on behalf of themselves and their investors (who are acting on behalf of their own policy holders, e.g., pension policy holders) to achieve risk-adjusted returns. The usual return the investors receive takes the form of capital gains.

ii) The fund

This is a collective investment vehicle into which the investors commit their capital. Typically the fund's life is 13-17 years, but this varies considerably between funds. PE/VC funds can be established under a variety of legal forms and regimes - typically:

- Partnerships - with or without legal personality (usually transparent for tax purposes)
- Corporations - with legal personality (non-transparent for tax purposes)

In the EU, PE/VC funds are typically structured as transparent limited partnerships.

iii) The portfolio company

The fund acquires portfolio companies using a mixture of the fund's capital (in the form of equity or shareholder debt) and external borrowings. Typically the fund will set up an acquisition structure consisting of holding companies to acquire the portfolio companies - depending on the fund, there may be a common holding company which holds all of the fund's investments, or a holding company structure may be set up for each of the fund's investments.

The acquisition structure typically consists of a number of holding companies whereby the number of holding companies is driven by commercial, legal or tax requirements. At a minimum, a Bidco would be incorporated to facilitate the acquisition of the portfolio company. Further holding companies may be created to facilitate structural subordination of shareholder debt, to separate the fund's holding of equity and debt instruments etc.

Portfolio companies are typically unlisted companies, but a fund may also acquire listed companies (public-to-private transactions). The objective of the fund is to help the companies achieve growth and add value through active ownership.

iv) The Fund Manager

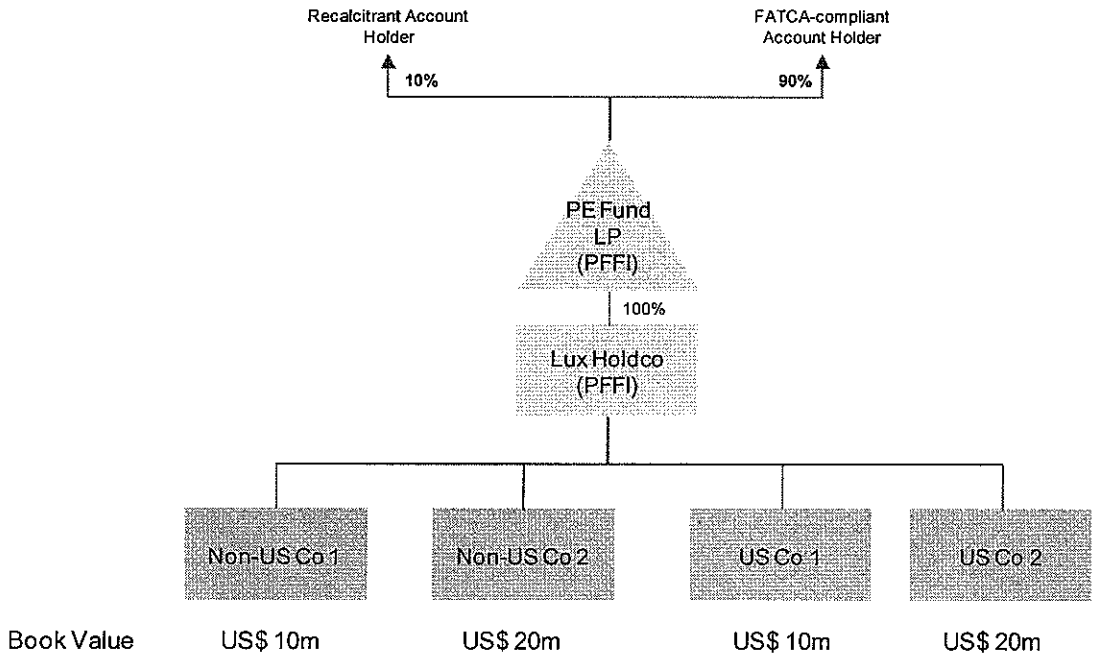
This entity manages the fund. In the case of a transparent fund structure, the Fund Manager is usually the fund's 'General Partner' with unlimited liability. In certain cases, the General Partner may be a related entity in the Fund Manager's group.

v) The advisory company

In the case of cross-border investments a local presence in other EU jurisdictions may be required to enable the Fund Manager to find new investments in those jurisdictions and oversee investments once acquired.

These advisory entities analyse the local market, identify and evaluate potential investment opportunities and prepare investment proposals with appropriate input from the Fund Manager. These proposals are then submitted to the Fund Manager for a decision on whether to proceed with an investment or not.

Appendix 2: FATCA withholding - passthru percentage vs tracing



- PE Fund LP ("LP") is an FFI with a mixed US and non-US portfolio
- Any payments made by LP to its investors will be caught by FATCA as a passthru payment
- LP is a PFFI but has a 10% recalcitrant account holder

Example

Quarter 1:

Lux Holdco has sold Non-US Co 1 for US$10m. Lux Holdco distributes the proceeds to LP, and LP in turn distributes the proceeds to its investors.

	Book Value (US$m)
Non-US Co 1	-
Non-US Co 2	20
US Co 1	10
US Co 2	20
Non-US cash (from sale of Non-US Co 1)	10
Total	**60**
US assets (passthru %)	**50%**

Quarter 2:

Lux Holdco has sold Non-US Co 2, US Co 1 and US Co 2 for US$20m, US$10m and US$20m respectively. Lux Holdco distributes the proceeds to LP, and LP in turn distributes the proceeds to its investors.

	Book Value (US$m)
Non-US Co 2	-
US Co 1	-
US Co 2	-
Non-US cash (from sale of Non-US Co 2)	20
US cash (from sales of US Co 1 and US Co 2)	30
Total	**50**
US assets (passthru %)	**60%**

Scenario 1: Passthru %

- No withholding on payments to Lux Holdco as it is a PFFI.
- Payments from Lux Holdco to LP is a passthru payment but no withholding applies on this payment as LP is a PFFI.
- Quarter 1 distribution made by LP to investors is a passthru payment. FATCA withholding applies on this payment as there is a recalcitrant account holder.

  FATCA withholding = US$10m x 10% (recalcitrant) x 50% (passthru %) x 30% (withholding) = US$150,000.
- Quarter 2 distribution made by LP to investors is a passthru payment. FATCA withholding applies on this payment as there is a recalcitrant account holder.

  FATCA withholding = US$50m x 10% (recalcitrant) x 60% (passthru %) x 30% (withholding) = US$900,000.

Total FATCA withholding on distributions made by LP = US$1.05m.

Scenario 2: Tracing

- No withholding on payments to Lux Holdco or from Lux Holdco to LP as both Lux Holdco and LP are PFFI's (same as scenario 1)

- No withholding on Quarter 1 distribution made by LP to investors as the payment relates to sale proceeds derived from a non-US asset

- FATCA withholding applies on Quarter 2 distribution made by LP to investors as part of the payment relates to sale proceeds derived from US assets

  FATCA withholding = US$30m (proceeds derived from sale of US assets) x 10% (recalcitrant) x 30% (withholding) = US$900,000

Total withholding on distributions made by LP = US$900,000

Under the above example, the passthru % scenario gives rise to an additional US$150,000 of withholding compared with tracing.