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

Response to the Secretariat Proposal for a 'Unified Approach' under Pillar One.

Introduction

Invest Europe, on behalf of the Public Affairs Executive (PAE), welcomes the OECD's efforts to develop a consensus solution to the tax challenges arising from the digitalisation of the economy and is pleased to have the opportunity to comment on its public consultation document *Secretariat Proposal for a "Unified Approach" under Pillar One*.

Invest Europe is the world's largest association of private capital providers. We represent Europe's private equity, venture capital and infrastructure investment firms, as well as their investors, including some of Europe's largest pension funds and insurers. By way of background, in 2018 alone, private equity and venture capital (PE/VC) funds invested over €80bn into 7,800 European companies, a large majority of which (86%) are SMEs. Private equity and venture capital funds thereby play a key role in connecting providers of capital from across the EU and beyond with companies in search of financing.

What differentiates PE/VC funds from many other sources of financing is the active involvement of the manager in advising on the running of the businesses invested in, strengthening management expertise, delivering operational improvements and/or helping them to expand into new markets. This hands-on approach is also employed in helping underperforming companies to survive, protecting jobs and delivering successful businesses with a strong future.

A significant proportion of PE/VC funding comes from pension funds and insurance companies that invest the pensions or savings of millions of citizens across the world.[1] Private equity and venture capital is a key asset class for these long-term investors as it generates capital gains on a consistent basis over the long-term. This is important, not least against the backdrop of changing demographics and in today's low yield environment.

[1] The five largest investor categories in EU28 private equity funds between 2014-2018 (% by amount) are: Pension funds (29%), Fund of funds (13%), Insurance companies (10%), Sovereign wealth funds (9%), Government agencies (7%).

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Summary of Key Concerns

The apparatus of a PE/VC investment fund generally consists of four key components – the fund, the investee businesses (referred to as portfolio companies), the investors and the fund manager. Where these portfolio companies are themselves consumer facing businesses they will be subject to the proposed new Pillar One regime in the same way as other Multinational enterprises (MNEs). This is accepted and we certainly welcome the OECD's efforts to bring uniformity to the approach taken to digitalisation in this respect.

However, the characteristics of the PE/VC fund holding these MNEs together with its fund manager are such that very careful crafting of the rules, in particular any potential financial services carve out, will be key to ensure that the industry is not inappropriately brought within the scope of the new regime. We have outlined below our key concerns in this respect. Further detailed commentary can be found in Appendix 1.

1. Definition of MNE Group

As noted above, it is recognised that where they are large, the portfolio companies of PE/VC funds themselves are likely be MNEs that are within the scope of Pillar One. However, these portfolio companies operate as entirely separate businesses and should not be considered as a single enterprise simply because of the PE/VC fund's common holding, such that, for example, the separate portfolio companies' revenues are combined when ascertaining whether the revenue threshold is met.

2. Scope

The fund vehicle

The fund itself is a collective investment vehicle, with investors receiving interests in, rather than goods or services from, the fund. By their nature, the investors are not consumers. As discussed further in appendix 1, the role of these investors is more akin to a passive shareholder in a company rather than a consumer of services. As the fund has no consumers, it is not an enterprise within the scope of the rules.

This should be put beyond doubt by ensuring that the fund vehicle is within any exemption for financial services. If no general exemption for financial services is provided, then it will be crucial that the definition of the term "consumer" clearly excludes investors.

Fund management

If the OECD adopts an exemption for financial services, then it is critical that fund management falls within this, for the following reasons:

- Private equity and venture capital is a crucial pillar of the financial services industry providing access to capital for businesses as they grow. As noted above, the industry injected

€80 billion of capital into European businesses in 2018 alone. Like other financial services (e.g. banking and insurance), fund management is highly regulated: a fund manager is subject to significant regulatory oversight under EU law (i.e. the Alternative Investment Fund Managers Directive).

- Fund management services are provided to the PE/VC funds rather than to any particular investor. Therefore the customer of such services is not a "consumer".
- Even if a look through approach was adopted such that the fund itself was ignored, investors in PE/VC Funds are not mere recipients of goods or services – by investing in the funds, they become the owners of the funds. They will typically be entitled to share in the majority of any profits or gains realised by the funds; ordinarily they will have limited governance rights over the fund and are not actively involved in the management of the fund's investments, they will however have information rights in respect of the fund's investments. In this regard, investors are more akin to passive shareholders than consumers.
- More importantly, the significant majority of investment made by investors in PE/VC funds is by institutions (predominantly pension funds, insurance companies and sovereign wealth funds) and are not consumers. Indeed, for the period 2014 to 2018, only 6% of investment in private equity in the 28 European Union member states came from private individuals. Where, an alternative investment fund does admit individual investors, these will typically be highly sophisticated and invest in a professional or quasi-professional manner (in line with regulation governing the marketing of these funds). Such investors will ordinarily agree to invest in funds only after careful due diligence and following arm's length, business-to-business discussions/negotiations with the manager or promoter of the fund and so should not be considered "consumers" in this context.
- All of the above is, we would submit, a world away from the kind of cases at which the *Unified Approach* is aimed, where consumers are purchasing goods or services "passively" from businesses operating though on-line presences and there is scope for generating profit from the asymmetric nature of the relationship (including in the case of multi-sided business models).
- The strict regulation of fund management means that fund managers are careful not to carry out regulated activities outside of their jurisdiction(s) of regulation. There is a risk that the requirement to file local tax returns and register locally could extend to other local compliance burdens or, in a worst case scenario, give rise to concerns that the fund manager should be subject to financial services regulation in the taxing jurisdiction too. This risks adding costly and duplicative layers of regulation in an already highly regulated industry.

  In any case, the structure and operation of a fund manager should be driven by commercial requirements. They should not be disincentivised from carrying out activities outside of their home jurisdiction through concern that, if they have a taxable nexus in other jurisdictions, they will need to incur time and resource getting advice as to why such presence does not require regulation.
- The fund management industry is not highly digitised and, unlike the business models which appear to be the original target of the digitalisation project, does not benefit from

intellectual property held outside home jurisdictions which is then utilised to enable remote selling.

Rather, on the whole, asset management is primarily an advisory business that succeeds because of the advice given by its individual fund management teams who help to identify portfolio companies, negotiate to acquire them, deliver/advise on operational improvements and – in the long term – work towards an exit to help deliver value to the fund on behalf of its investors. The fees payable to a fund manager reward this people functionality and so it is a business model where all or substantially all the profit should be categorised as routine profit or non-reallocable non-routine profit.

3. Double Taxation

As an overriding principle we would note that it is critical for all businesses that are within the scope of the new rules that (i) there should be no double taxation on the same profit, (ii) the re-allocation of profit and the process for tax filing is as straightforward as possible, and (iii) where tax is due on Amount A, credit should be given simultaneously in the jurisdiction of residence of the MNE's parent company or other appropriate jurisdiction.

4. Complexity and compliance burden

For all businesses affected by the Unified Approach, their tax affairs will become more complex, more uncertain and subject to challenge by competing jurisdictions. Inevitably, tax authorities would also be drawn into the uncertainty.

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APPENDIX 1

Detailed commentary on the Questions for public comments

Scope

A. Overview of the private equity and venture capital sector

PE/VC funds act as vehicles into which a diverse group of investors can pool their capital and access investment opportunities in the private markets that may not otherwise be available to them. Private equity and venture capital has a broad investor base with the majority of investment being by institutional investors: pension funds, sovereign wealth funds, insurers and fund of funds provide the majority of funding.

Investment from private individuals typically forms an extremely small minority of overall investment and, to the extent it is present, will almost always be by sophisticated investors, rather than "retail" investors. In Europe, this is reflected in the regulatory regime that applies to the fund and its manager (the AIFMD rules rather than the retail-focused UCITS rules). This is discussed in more detail in section D below.

B. PE/VC fund vehicles

PE/VC funds are simply pooling vehicles to facilitate collective investment. Participants in funds are investors and should not be considered consumers (or, indeed, customers). A participant in a PE/VC fund will contribute capital in return for an interest in the fund, which will then use that capital to make investments. A participant will then be entitled to their share of the profits (if any) of the investments made by the fund. This business model is entirely different from the "consumer-facing" businesses targeted by the Pillar One proposals.

In this regard, we note that paragraph 20 of the consultation document states:

"*This supports the idea that the proposed "Unified Approach" should be focused on large consumer-facing businesses, broadly defined, e.g. businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element*[.]",

and that the footnote to paragraph 19 states:

"*The term "consumer" generally refers to individuals who acquire or use goods or services for personal purposes (i.e. outside the scope of a professional or business activity), while the term "customer" generally includes all recipients of a good or service (including business customers that are not end-users).*"

It is thus clear that PE/VC funds are not intended to, and do not, fall within the category of consumer-facing businesses targeted by the Pillar One proposal and, accordingly, we recommend that such funds are expressly exempted from that regime.

If no general exemption for financial services is provided or, contrary to our recommendation, such exemption does not include PE/VC funds, then it will be crucial that the definition of the term "consumer" makes it clear that it does not include investors.

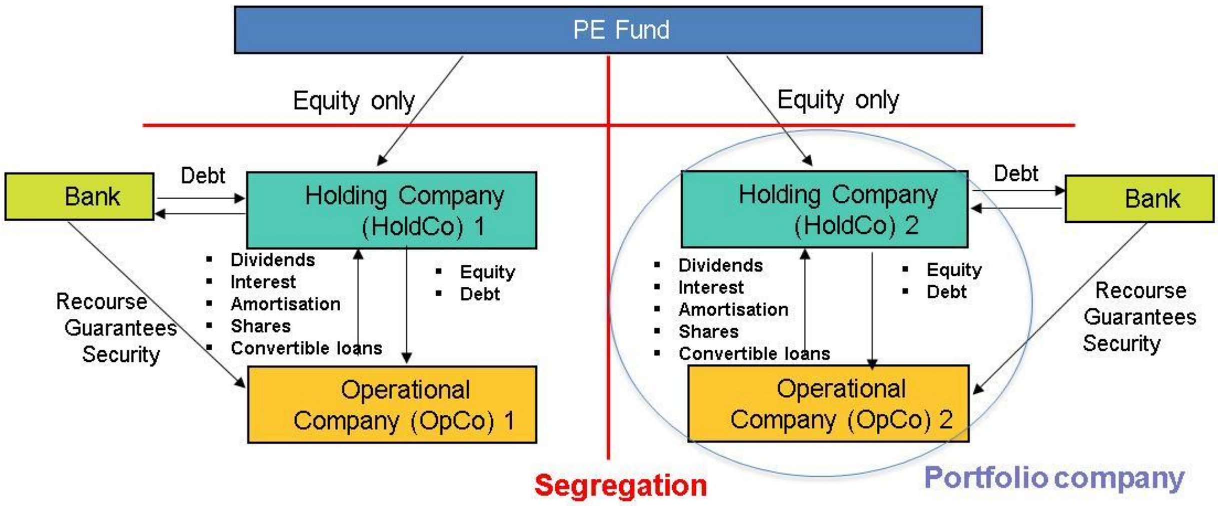
C. Portfolio companies

As noted above, we recognise that portfolio companies which are themselves MNEs should be subject to the proposed new Pillar One regime in the same way as other MNEs.

Although the consultation document does not specifically discuss how "MNE group" should be defined, it is implicit from the discussion of the determination of Amount A, where the group's consolidated financial statements are the proposed starting point (see paragraph 53 of the consultation document), that such statements will also be the basis of the definition of "MNE group".

In this respect, it is key to note that in operating the fund the various portfolio companies of the fund are viewed as separate investments, the majority of PE/VC funds do not, and are not required to prepare consolidated accounts. In principle, therefore, provided the same approach is taken as was taken in relation to country-by-country reporting (i.e. the fund was not required to consolidate its portfolio companies) we support the use of consolidated accounts as a starting point..

This is important because it allows clear ring fencing of liabilities to ensure cross contamination risks are managed and an inability for profits/losses from one portfolio investment to be offset/pooled with that of another. An illustration of this relationship is provided below.



Here, it is key to reiterate that the aim of PE/VC is to put their portfolio companies on a sustainable growth path, with a holding period on average between five and seven years. It is also important to note that funds do not always take control positions.

In light of the segregation and temporary nature of the relationship between funds and their portfolio companies, we argue that PE/VC funds are clearly different in nature from MNE Groups.

As such, it is very sensible that the majority of funds is not required to consolidate entities and would not have any requirement to produce consolidated accounts. Any change/approach that would require them to do so, would be at odds with the accounting practices and incur significant annual cost across the portfolio to collate and verify the data as entities are bought and sold in the portfolio.

As such, it will be critical to ensure that the portfolio companies of PE/VC funds are not considered to be a single enterprise simply because of their common ownership, such that, for example, their revenues are combined when ascertaining whether the revenue threshold is met.

In this regard, the approach taken in relation to country-by-country (CbC) reporting should be followed. Indeed, the OECD's guidance (Part III, section 1 (*Application of CbC reporting to investment funds (June 2016)*)) acknowledges that where the accounting rules for investment funds instruct funds not to consolidate portfolio companies those portfolio companies should not form part of a group for CbC reporting purposes with either the fund or separate portfolio companies.

D. Fund managers

Fund management enterprises should be out of the scope of the Pillar One regime for the reasons set out below.

Highly regulated financial services

Firstly, we understand that an exemption for financial services may be introduced. Private equity and venture capital is a fundamental pillar of the financial industry, providing crucial access to funding for businesses.

Like other financial service providers (e.g. banks and insurers) the fund management industry is highly regulated, providing a high level of protection for investors.

In the European Economic Area, the Alternative Investment Fund Managers Directive (AIFMD) regulates the management and marketing of alternative investment funds (AIFs). The Directive creates a comprehensive and effective regulatory and supervisory framework for Alternative Investment Fund Managers (AIFMs) at EU level.

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

- Increases the transparency of AIFMs towards investors, supervisors and the employees of the companies in which they invest;
- Equips national supervisors, the European Securities and Markets Authority (ESMA) and the European Systemic Risk Board (ESRB) with the information and tools necessary to monitor and respond to risks to the stability of the financial system that could be caused or amplified by AIFM activity; and
- Increases the accountability of AIFMs holding controlling stakes in companies towards employees and the public at large.

The AIFMD introduced safeguards to ensure that investors in alternative investment funds are well informed and adequately protected. For example, the AIFMD requires that:

- Reasonable steps are taken to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, where applicable, disclose such conflicts;
- AIFMs employ adequate systems to manage risks to which the fund is exposed, and to ensure that the liquidity profile reflects the obligations towards investors;
- A fund's assets are safe-kept, or monitored, by an independent depositary subject to a high liability standard;

- AIFMs have appropriate and consistent procedures for proper and independent valuation of the AIF's assets; and
- Strict conditions are met when AIFMs delegate functions to third parties.

Looking ahead, from August 2021 AIFMs will be subject to further regulatory requirements, by way of Directive (EU) 2019/1160 and Regulation (EU) 2019/1156 (part of the European Commission's wider Capital Markets Union plan) which will change the existing AIFMD regime in respect of cross-border distributions of collective investment undertakings in the EU. The review of the AIFMD overall is also underway, with any legislative amendments expected towards the end of 2020.

We would note that funds and managers in other (non-EU) jurisdictions will have their own regimes that address many of the same issues that are covered by the AIFMD in a manner consistent with local circumstances.

In addition, the Markets in Financial Instruments Directive (MiFID) regulates many EU portfolio managers and investment advisers. Such firms are required to obtain authorisation and are subject to organisational and conduct of business requirements as well as on-going supervision. In particular, MiFID includes strict rules for the protection of investors including:

- a requirement to act honestly, fairly and professionally in the best interests of clients;
- a requirement to prevent or manage conflicts of interest; and
- information and disclosure requirements.

Regulatory capital requirements will also generally apply to such firms. The new Investment Firms Regulation and Investment Firms Directive are expected to impose stricter regulatory capital requirements on MiFID investment firms including EU portfolio managers and many EU investment advisers.

Investors invest and do not 'consume'

Second, as described above, fund management services are provided to PE/VC funds rather than to any particular investor. A PE/VC fund clearly does not fall within the definition of "consumer" and so, fund management is outside the intended target of the Pillar One regime.

Although it is investors who indirectly bear the cost of fund management fees, as mentioned above, the significant majority of investment is made by institutional investors (predominantly pension funds, insurance companies and sovereign wealth funds), with any investors who are individuals typically being sophisticated and investing in a professional or quasi-professional manner (as governed by the regulation governing the marketing of such funds). Accordingly, even if investors are considered customers of a fund manager, they should not be considered "consumers" as they are not receiving services "outside the scope of professional or business activity". The role of these investors is more akin to a passive shareholder in a company rather than a consumer of services.

Fund management returns (whether day-to-day or performance linked) are best characterised as routine profit or non-reallocable non-routine profit

Third, the value provided by fund management services reflects time spent by investment professionals in their home jurisdiction (and not, for example, any benefit arising from digital technology or intellectual property held outside of the home jurisdiction) and so profits received for such services should be taxed there.

Fund managers are very much linked to their home jurisdiction. They will be subject to stringent regulatory requirements there, including the need for regulatory capital and sometimes pay regulation. The team identifies investment opportunities and then helps to deliver operational improvements to portfolio companies in order to secure investor returns. These people-driven, geographically confined activities mean that the profits arising from fund management services are best characterised as routine profits or non-re-allocable non-routine profits not targeted by the new taxing right.

Risk that local taxpaying results in wider compliance or regulatory burdens

Fourth, the strict regulation of fund management means that fund managers are very careful not to carry out regulated activities outside of their jurisdiction(s) of regulation. If the Pillar One regime were to mean that fund managers have a taxable presence in other jurisdictions, this would potentially put pressure on regulators in such other jurisdictions to start regulating fund managers. This risks adding costly and duplicative layers of regulation in an already highly regulated industry. In addition, even if no further regulation is introduced, fund managers may be disincentivised from carrying out activities outside their home jurisdiction out of concern that, if they have a taxable presence there, they will need to incur time and resource getting advice as to why such presence does not require regulation.

A corollary of the second and third points above is that, were fund management to be within the scope of Pillar One, in practice this would raise little or no revenue susceptible to the new taxing right but would generate a significant tax compliance burden for the fund management industry.

If no general exemption for financial services is provided or, contrary to our recommendation, such exemption does not include fund management, then it will be crucial that the definition of the term "consumer" makes it clear that sophisticated individuals acting as investors in PE/VC funds are not considered consumers of the fund's fund managers.

E. Threshold

We consider that aligning the Pillar One threshold closely with that applying to CBCR would be a sensible outcome. Certainly, given the compliance burden which the new taxing right will generate, we do not consider it appropriate to apply it to enterprises falling below that revenue threshold.

<u>Questions 2 – 7 of consultation document</u>

We have discussed above the characteristics of funds and their managers and why we believe they should not be within the scope of the new taxing right. However, we would make the following points about the operation of the new rules more generally.

Q2. Nexus

- As noted above, transactions involving Funds should not be within scope of the new rules. It is critical that the legislation is crafted such that asset management is either exempt from Pillar One or, at a minimum, confirmation is given that investors in a fund are not "consumers", rather their interest is more akin to that of a passive shareholder.

- Provided our recommendations above are followed, no specific nexus considerations should apply to funds and/or their investors. However, for completeness of response, we would note that significant complexities would arise in particular if investors or a sub class of investors were brought into scope.

- Primarily, the concept of creating a taxable nexus for an Asset Manager in respect of transactions with all or a subset of its investors, in particular where those investors constitute a small proportion of their committed capital, would create significant compliance costs which could create disincentive for Asset Managers in seeking investment from investors in territories in which they have no physical presence. The disincentive for Asset Managers would clearly be harmful and create market distortions.

- Where businesses are in scope setting appropriate revenue thresholds will be key to reduce complexity and compliance costs for MNE's. If territorial thresholds are set at too low a level this would create significant compliance cost for businesses selling into those territories that are disproportionate to their revenues.

Q3. Calculation of Group profits

In respect of the calculation of profit, we agree with the approach outlined in the consultation document proposing consolidated accounts as the starting point for this calculation. As noted above, a key issue here will be to ensure that the MNE Group is defined appropriately to avoid aggregation of separate portfolio companies.

In addition, we would note that:

- Whilst we agree in principle with the use of consolidated accounts of an MNE group we would note that this approach is likely to give rise to significant complexity, for example, a group could have a consolidated profit whilst the company in the home territory could be loss making on a stand-alone basis.

  Likewise, any segregation of a business into stand-alone business lines will inevitably need to be industry specific which will lead to complexity and inconsistency. Clear guidelines will be needed outlining how such segregation will take place and who will be responsible for deciding what segments should exist within the MNE.

- Detailed discussions around what adjustments are required to accounting profits to cover matters such as depreciation, deferred tax, interest costs, employee incentives etc. will be needed. Adjustments of this nature could lead to MNE Groups incurring tax costs which are not representative of economic profit.

  Certain businesses are subject to significant fluctuations in their business profits - how should such business profits be smoothed to mitigate the impacts of these variations? Should an average over a number of years be taken?

Q4. Determination of Amount A

There are a number of complexities here in understanding not only how routine and residual profits should be identified but also in determining what constitutes a market, what allocation keys are used to distribute those profits, how you identify the surrendering and home territory and how losses should be dealt with.

We see a significant potential risk for taxpayers as it would make them vulnerable to contest from countries on both calculation and allocation. This would lead to not only more uncertainty for taxpayers as to their tax position but also an inevitable increased compliance cost for MNEs.

Q5. Elimination of double taxation in relation to Amount A

As discussed, a fundamental concern with the Pillar One proposal is to ensure that all businesses within scope should not be subject to double taxation on the same profit. The structure and operation of existing domestic double taxation relief rules and the network of double tax treaties utilised by MNEs are unlikely to function in this respect.

In addition, it will be imperative that the mechanism for filing and collecting of any tax, in particular in countries where the MNE has no existing presence, is as simple as possible. One possible solution would be to require the home territory to report tax due under Amount A to its local tax authority together with the calculation of how it should be reattributed. The local tax authority would then share the reattributed amounts with the tax authorities in the consumer jurisdiction rather than this filing being done by the business – effectively building on the tax authority sharing model that has already been introduced in the context of CRS (Common Reporting Standard).

Q6. Amount B

We see a clear need to better understand what constitutes marketing/distribution, particularly in the context of a fund management business which may operate a mixture of both closed and open ended funds.

Q7. Amount C/dispute prevention and resolution

It is imperative that any dispute resolution mechanisms put in place in respect of the Unified Approach Proposal apply not only in relation to Amount C but all aspects of the new taxing right. As highlighted in our comments above, Amount A is open to scrutiny/disagreement not only in how it should be calculated, but also how that amount should then be allocated. It is unlikely that existing mechanisms will be sufficient to deal with the complexities of the proposal.

Contact

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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's Tax Committee is chaired by Marco de Lignie (Loyens & Loeff) and its International Tax Working Group is chaired by Clare Copeland (The Carlyle Group).

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