

International Cooperation and Tax Administration Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2 rue Andre Pascal
75775 Paris Cedex 16
France

Sent by email: taxpublicconsultation@oecd.org

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Global Private Equity industry response to the OECD consultation – Global Anti-Base Erosion Proposal (“GloBE”) (Pillar Two)

We welcome the OECD’s efforts to develop a consensus solution to the tax challenges arising from the digitalisation of the economy and are pleased to have the opportunity to comment on its public consultation document (Condoc) on the Global Anti-Base Erosion Proposal (“GloBE”) (Pillar Two).

What differentiates private equity and venture capital funds (PE/VC funds) from many other sources of financing is the higher level of involvement of the manager in advising on the running of the businesses invested in, strengthening management expertise, delivering operational improvements and/or helping companies to expand into new markets. This active approach is also employed in helping underperforming companies to survive, protecting jobs and delivering successful businesses with a strong future. Even where a fund manager is less active (for example, where they have a minority stake) the manager injects long-term and patient capital for the business to deploy.

A significant proportion of private equity and venture capital funding comes from pension funds and insurance companies who 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. Definition of MNE Group

Consistency between Pillar One and Pillar Two regimes

We note that the Condoc does not discuss how "MNE Group" should be defined. However, we can see no compelling reason why the definition of MNE Group for the Pillar Two proposal should be different from that used for the purposes of the Pillar One. Any other approach will increase complexity and cost whilst reducing the certainty of the scope of both regimes.

Consolidated accounts based test for MNE group

We also note that, in the context of the discussion about the use of financial accounts to determine income, the Condoc (at paragraph 23 and question 1(e)) expressly envisages entities which do not form part of a consolidated group for accounting purposes, being members of the same MNE group.

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

Subject to the comments we make in section 2 regarding segregation of separate investments, we recommend that accounting consolidation be the starting point for determining whether entities are within the same group, allowing taxpayers to use information available to them and concepts with which they are familiar. Whilst there are a number of issues to be addressed in the mechanics of any effective tax rate calculation (e.g. minority interests which are consolidated but not subject to tax at the MNE level) we believe starting with consolidated accounts has the advantage of being consistent with the country-by-country reporting (CBCR) regime and, we understand, with the expected Pillar One regime.

In this regard, we do not think that the fact that some large groups do not have an obligation to prepare consolidated accounts would be problematic, as a "deemed listing provision" similar to that used in CBCR could be adopted. In the context of CBCR that provision applies where an enterprise would otherwise be the "Ultimate Parent Entity" but is not required to prepare consolidated accounts in its jurisdiction of tax residence. The effect is that the group includes all entities that would be included in the consolidated accounts that the relevant enterprise would be required to prepare if it was listed on a public securities exchange. This recommendation (in relation to determining membership of an MNE group) is entirely separate from whether or not the OECD ultimately considers that financial accounts should be used to determine income.

Threshold

Both regimes should only apply to large MNEs. In the context of GloBE, we anticipate that the new regime will lead to significant extra compliance costs (quite separate from any increases in tax liability) and procedural complexity (such as the need for new internal processes and procedures) for MNEs. These additional burdens are such that they should only be borne by the largest enterprises. Such enterprises are more likely to have the resources (both in terms of cash and personnel) to allow effective compliance with the regime. In addition, focussing the scope of the proposal in this way should ensure that only those whose tax affairs are most likely to lead to significant reductions in the global tax revenues within the goals of the regime are targeted.

In this regard, we would recommend that, for simplicity and consistency, the same threshold is used as for the Pillar One new taxing right.

2. Portfolio companies for separate investments

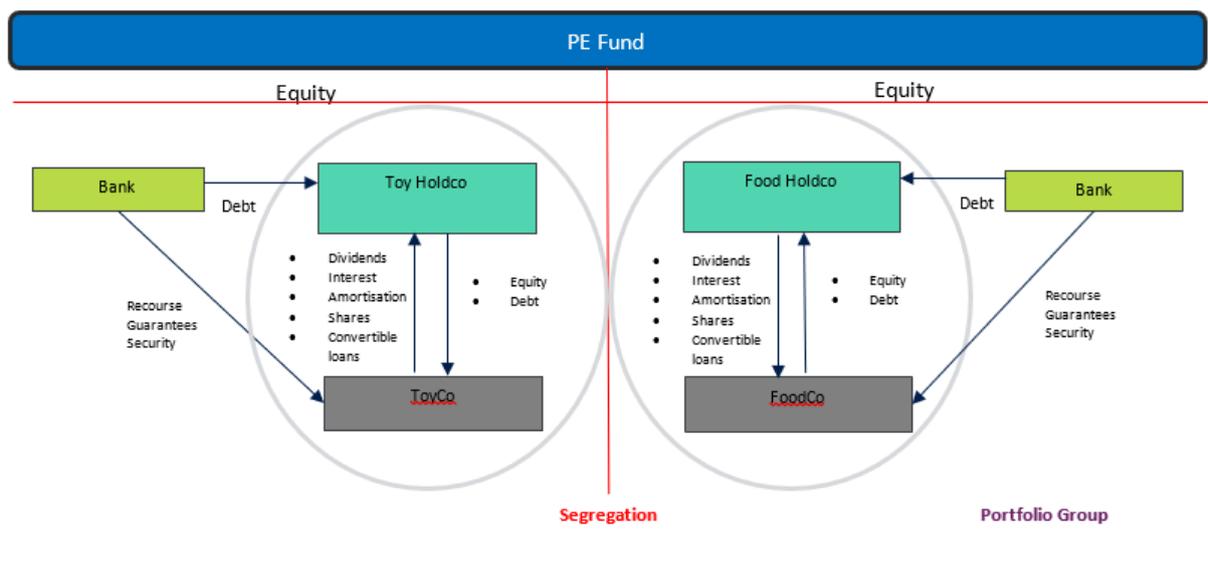
It is recognised that the investee businesses (portfolio businesses) of PE/VC funds are likely to themselves be MNEs that are within the scope of Pillar Two where they meet the threshold requirement.

That being said, although, as mentioned above, we recommend basing the GloBE MNE group definition on the accounting consolidation requirements, whatever approach is taken, it will be important that portfolio companies for separate portfolio investments of a PE/VC fund are not treated as part of the same MNE group simply because of the PE/VC fund's holding, such that, for example, the separate portfolio companies' revenues are combined when ascertaining whether the revenue threshold is met.

In this respect, it is key to note that in operating an investment fund, its various portfolio investments are entirely separate. This approach is supported by the accounting treatment; [very few] PE/VC funds prepare, or are required to prepare, consolidated accounts.

This separation is important not only because it reflects the very separate nature of each business (i.e. reflects commercial reality), it also allows clear ring-fencing of liabilities as between their separate businesses to ensure cross contamination risks are managed. Consequently, profits/losses from one portfolio investment cannot be offset/pooled with that of another.

By way of an example, if a PE/VC fund establishes a company (Toy Holdco) to acquire an existing toy manufacturing company (Toyco) and separately establishes another company (Food Holdco) to acquire a company that sells food (Foodco), the fund would treat Toy Holdco and Toyco as a separate group from Food Holdco and Foodco.



Here, it is key to reiterate that the aim of private equity and venture capital funds is to put their portfolio businesses 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.

Against the backdrop of the segregation and temporary nature of the relationship between funds and their portfolio investments, it is clear that private equity and venture capital funds generally view investments in portfolio companies separately, which is clearly different in nature from typical MNE groups which run their business as a whole strategically and operationally. In this regard, it is important to note that unlike a conglomerate organisation portfolio groups have independent and separate boards and management teams, with there being no single controlling mind directing overall strategy for multiple groups. Each of these management teams is responsible for the operation and strategic oversight of their portfolio group only, with no managerial responsibility for the other portfolio businesses that may be held within the same fund. This is reflected in the ring-fenced nature of the financial relationships of the business e.g. compensation packages which track results only of the individual portfolio group and banking relationships which again generally track results only at individual portfolio group level when assessing covenants etc.

Basing the MNE group definition on the accounting position would facilitate this approach (i.e. the non-aggregation of portfolio companies relating to separate investments), assuming the same position were taken as was taken in relation to CBCR (where it is acknowledged in the OECD's guidance (Part III, section 1 (*Application of CbC reporting to investment funds (June 2016)*))) 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 CBCR purposes with either the fund or portfolio companies relating to separate investments).

However, if an accounts-based approach similar to that taken in relation to CBCR is not adopted, it will be crucially important that the principle that separate portfolio companies relating to separate investments should not be seen as part of the same MNE group is nevertheless adopted.

3. The fund vehicle

The fund itself is a collective investment vehicle for private equity and venture capital investment. Private equity and venture capital investment is a crucial pillar of the economy, providing access to capital for businesses as they grow. Private equity funds have injected large amounts of capital in to businesses around the world: estimates for 2018 have put deal value in the Asia-Pacific region at \$159 billion², the US at \$735 billion³, and total European deal value at €466.8 billion⁴. Further, the returns on investments made by private equity funds are an important source of revenue for pension funds, insurers and other vehicles pursuant to which individuals look to provide for their retirement, illness or disability.

A key principle of collective investment is that an investor should not be in a worse tax position through investing via a collective investment vehicle than if they had invested directly in the underlying asset (primarily through double taxation i.e. tax at both fund and investor level). This is recognised in tax regimes throughout the world where special regimes or vehicles are made available to ensure the tax neutrality of collective investment.

It will therefore be important that the GloBE proposal does not treat the PE /VC fund vehicle and its infrastructure as an MNE within GloBE proposals as this would cut across national regimes that ensure tax neutrality and potentially significantly deter those who would otherwise provide key capital for investment.

Some domestic regimes achieve this tax neutrality through the use of a fund vehicle that is transparent for tax purposes, and our understanding from the Condoc (section 3.4 (*Allocating income of a tax transparent entity*)) is that the GloBE proposal intends to respect such transparency – a position we support.

However, it is also important to recognise that these vehicles can take many forms, such as the UK investment trust or the French *fonds commun de placement à risques* or FCPR. Fund vehicles are increasingly corporate in nature, with investors benefiting from the same extensive regulatory oversight (such as, in the European Economic Area, the Alternative Investment Fund Managers

² [Bain and Company, Asia-Pacific Private Equity Report 2019](#)

³ [Pitchbook, US PE Breakdown Q3 2019](#)

⁴ [Pitchbook, European PE Breakdown Q3 2019](#)

Directive that regulates the management and marketing of alternative investment funds) as apply in relation to the more established transparent fund vehicles, for example, limited partnerships.

In these types of structures neutrality is also often achieved through the use of specific tax privileged/exemption regimes which apply to the fund vehicle. Many jurisdictions now offer (and have created for the purpose of encouraging tax neutral collective investment) such fund vehicles regimes which look to tax returns earned by the vehicle as they are passed out to investors rather than at the level of the vehicle itself.

Accordingly, were GloBE to apply to funds, it would give rise to the arbitrary consequence of preserving the position of domestic regimes that provide tax transparent fund vehicles (which would not be subject to tax) but altering the position of those that have chosen to provide opaque but tax exempt ones (which would be subject to tax).

Accordingly, we recommend that the GloBE regime contains a targeted exemption for the infrastructure through which investors invest collectively. We have referred here to the relevant infrastructure to make the point that frequently investment in a collective investment arrangement is made by investors through different vehicles (e.g. parallel and/or feeder vehicles used to allow investment in different currencies or investments with different fee structures) and it will be important that the exemption is appropriately crafted to apply to such situations.

4. Taxation of investment returns

Given the importance of sustainable and long-term investment in business, it is unsurprising that many national regimes provide exemptions or lower rates from tax on:

- (i) gains arising from long-term investments in many businesses; and/or
- (ii) distributions.

Further, as with national regimes ensuring tax neutrality for investment funds (see above), exemptions or lower rates for these investment returns are often designed as a way of preventing or reducing double taxation e.g. where (taxed) trading profits is repatriated to investors through tiers of companies.

The GloBE regime should also carve out investment returns. This will ensure that, where a domestic regime provides an exemption (including a partial exemption) from tax (or lower rate) on gains arising from long-term investment in businesses and/or distributions, the GloBE proposal does not inappropriately cut across this domestic policy decision by imposing a minimum level of taxation on the gain or distribution.

The exemption for investment returns within the GloBE regime should be implemented by excluding the relevant revenue entirely from the calculation of income for the purposes of the regime. Such an approach has the advantages of clarity and simplicity (for example, over an approach where the revenue was recognised as income but then exempted).

In the context of distributions, if the consolidated accounts were used as the basis for the calculation of financial income, we would expect the consolidation to mean that dividends paid intra-group would be ignored. However, this would not protect dividends paid in relation to minority holdings and the

rationale as to why they should not come within the scope of the regime is just as valid in that context. Accordingly, even if consolidated accounts were used as the basis for the calculation of financial income, the exemption described above for investment returns should expressly apply to dividends.

5. Ensuring that other workstreams are not undermined

As a result of the original BEPS action points, many jurisdictions have implemented, or are in the process of implementing, a number of changes to their domestic taxation regimes. A number of these changes have already significantly altered behaviour and, in effect, provide boundaries within which businesses can be comfortable that they are engaging in acceptable behaviour. For example, the interest restriction rules significantly reduce the availability of interest deductions but also allow a group to be comfortable that interest below the relevant limit (broadly, generally 30% of EBITDA) should be deductible. Layering the GloBE proposals on top of these domestic rules implementing BEPS undermines certainty for businesses that have spent large amounts of resource ensuring compliance with those domestic rules and so it will be important to consider how the GloBE rules will interact with (and not disturb) the application of existing rules.

6. Timing

The introduction of the OECD's Pillar One proposal for a new taxing right will be a fundamental change to the taxation regime for MNEs and will undoubtedly have unforeseen impacts on the nature and application of international taxation. The introduction of GloBE proposal will be just as fundamental a reform. Simultaneously introducing both proposals would lead to huge uncertainty and confusion given the massive scope of the changes to the global tax system that would be being introduced.

We therefore recommend that the GloBE proposal is not introduced until an appropriate amount of time has passed after the introduction of the Pillar One new taxing right. We would suggest at least five years. As well as reducing the uncertainty and confusion described above, this staggered introduction would provide time for the changes made by the implementation of the Pillar One proposal to bed in, during which problems that arose from such introduction could be addressed.

Representatives from our industry would be happy to discuss this in further detail at your offices at a time that is convenient for you.

Please contact [Chris Elphick](#) (BVCA), [Simon Tosserams](#) (Invest Europe), and [Jason Mulvihill](#) (AIC) for any further information regarding this consultation response.

Letter supported by:



- American Investment Council (AIC)
- Australian Investment Council (AIC)
- Canadian Venture Capital and Private Equity Association (CVCA)
- Emerging Markets Private Equity Association (EMPEA)
- Hong Kong Venture Capital and Private Equity Association (HKVCA)
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- US National Venture Capital Association (NVCA)
- Invest Europe, on behalf of the Public Affairs Executive (PAE)⁵, which includes the following associations:
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 - Portuguese Private Equity and Venture Capital Association (APCRI)
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 - Swiss Private Equity and Corporate Finance Association (SECA)
 - South Eastern Europe's Private Equity Association (SEEPEA)
 - Slovak Venture Capital and Private Equity Association (SLOVCA)
 - Swedish Private Equity and Venture Capital Association

⁵ The 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 and venture capital associations. 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.