INVEST EUROPE

27 August 2021

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

Position paper on the European Commission's Consultation on Fighting the use of shell entities and arrangements for tax purposes

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors. Our members provide an essential source of funding for innovative businesses at key stages of their growth journey, taking a long-term approach to investing in privately-held companies, from start-ups to established firms. They inject not only capital but also 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.

By way of background, in 2019 alone, private equity and venture capital funds invested over €94bn into 7,900 European companies, a large majority of which (84%) 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.

As for the European Commission's initiative to explore options to ensure that shell entities will not benefit from tax advantages in the EU, Invest Europe would note that a number of initiatives have already taken place during the recent years in order to tackle tax avoidance. Very commendable and strong anti-tax avoidance rules have been drawn up in the EU, which has led to significant advances in tackling abusive tax avoidance. Should the European Commission however decide to introduce additional measures, we would urge that the following considerations are taken into account.

Private Equity investment - structure outline

Private equity (PE) is one form of equity investment into private companies which are generally not listed on the stock exchange. PE is a medium to long term investment, characterised by active ownership. Investments are made by PE and similar alternative investment funds on behalf of global investors into a diverse range of companies across Europe, many of them being start-ups, scale-ups and SMEs, which would otherwise not have been able to get capital elsewhere or it would have been too expensive. Investors into PE funds are typically institutional investors such as pension funds, insurance companies, sovereign wealth funds, banks, etc.

Institutional investors often lack the resources to be able to identify suitable investment opportunities that match their risk-profile and thus rely on the knowledge and experience of PE managers. PE managers provide the institutional investors with whom they co-invest the necessary skills for finding, analysing, valuing and negotiating the investment into interesting unlisted companies with value creation potential and then, through active board participation guides and monitors these companies until they are ready to take the next step in their development under the stewardship of new/additional owners. A typical PE fund could hold investments in sectors as diverse as industrial products, life sciences, computer & consumer electronics, energy & environment, transportation and agriculture.

In general, the use of intermediaries such as holding companies by PE and similar alternative investments funds serves several commercial purposes. Firstly, a holding company allows a fund to become an investor under the same terms and conditions as other investors in the same asset, even if the fund is resident in a different country. Secondly, they can provide practical benefits such as allowing participation in shareholder meetings and votes, and making the conclusion of contracts more straightforward. Finally, in certain jurisdictions they can ensure fund investors are afforded greater certainty regarding insulation from legal liabilities. The presence of a holding company therefore protects the investors from the imposition of additional obligations and duties by virtue of their foreign location.

As illustrated in the diagram below, an investment made by an alternative investment fund, in casu a PE fund, typically involves setting up multiple entities in order to facilitate an investment or acquisition. They can either have the form of a corporate entity with legal personality or a partnership entity without legal personality.

These entities all have a commercial purpose, which can include both an existing purpose from the outset or a future anticipated purpose to achieve certain objectives or facilitate transactions going forward.

The entities or vehicles illustrated in green in the diagram below are typically involved for the following commercial purposes:

- The PE fund: Most PE funds use a limited partnership as their legal structure, which involves two main types of actors: (1) a general partner (GP) and (2) limited partners (LPs). A PE firm is called a general partner (GP) and its investors that commit capital are called limited partners (LPs). Limited partners generally consist of institutional investors such as pension funds, insurance companies, sovereign wealth funds, banks, etc.

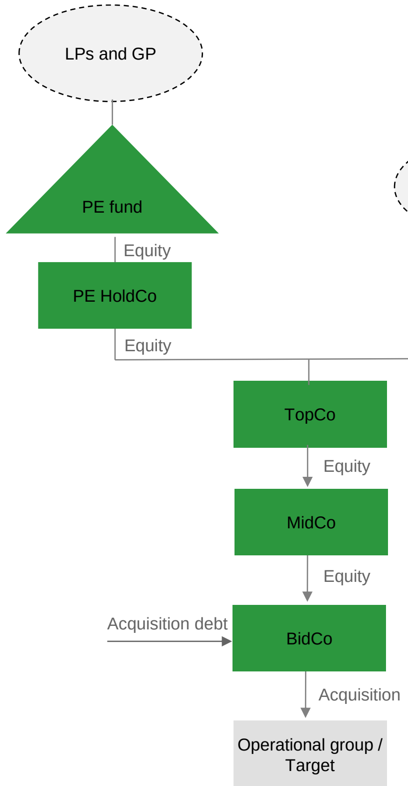
- A designated holding company of the PE fund (PE HoldCo): The limited partnership typically does not make direct investments into target companies. A holding company is created to invest (alongside potential co-investors and management). Such holding company is also established with the purpose to ring fence different investments of the PE fund into separate vehicles. Typically, one holding company is established per investment or investment platform.

- The management equity plan (MEP) pooling vehicle: The management of the operational group/target typically invests alongside the PE fund into the structure in order to incentivize the management with an equity investment opportunity (a management equity plan or MEP). The managers generally do not invest directly into the target company either but are usually ‘pooled’ into a combined investment vehicle with representatives of the PE firm as director of the pooling vehicle for governance purposes. Such pooling vehicle can either take the form of a corporate entity or transparent vehicle.

- <u>The top holding company of the group (TopCo):</u> A joint holding platform for all investors is created at the level of TopCo with the purpose to amalgamate all equity investors into one combined vehicle issuing securities to the investors in return for the equity contribution commensurate with the desired capitalization.

- <u>An intermediate holding company for financing purposes or to facilitate future events (MidCo):</u> An equity blocker company, junior debt issuing vehicle or recapitalization or IPO facilitator is typically created in between TopCo and the entity making the investment, to establish a single point of enforcement for the external lenders with a 'clean' ownership.

- <u>A holding company bidding for the acquisition of the target (BidCo):</u> This company can contract the external debt with lenders, and it invests in the target company, using the funds from the equity contributions through the chain of companies and the external leverage.



The overview above and the illustration in the diagram are not exhaustive, as additional entities or vehicles could be set up dependent on e.g. the financing needs and the objectives of the investment structure.

Definition of shell entities

We support the aim of tackling the use of abusive and aggressive tax structures and discouraging the use of entities without legitimate purposes. However, it is important that legitimate structures are not disrupted, and entities with genuine commercial purposes should thus not fall under the definition of shell entities.

Therefore, we would like to stress that substance in terms of employees, offices, etc. is not the only relevant indicator for determining whether an entity is a shell entity or not. The commercial purpose and commercial rationale for establishing the entity is a much better indicator, and must thus be taken into account.

There are many valid reasons why companies have entities without so-called “substance”. Such entities are in most cases established due to legitimate commercial reasons, and are in no way used for aggressive tax planning or tax evasion.

As described above, in the context of the PE industry, it is quite normal for groups to set up holding companies for various genuine and substantive commercial or legal purposes. These holding companies may have minimal activity on their own, they do not need a lot of substance for their function, and they are mainly active when there is an investment activity (e.g. acquisition and disposal, further acquisitions, advancing further capital to the group, etc.). However, they are required for investment purposes, and this facilitates international investment and ultimately the creation of the more than 10 million[1] jobs in the EU that derive from PE and VC investments.

A definition of shell entities based on absence of activity in a single individual entity would be inappropriate and distort the position. Rather it should be based on the aggregate activities of the group in each location and the commercial purpose for establishing the entity within this context.

Any definition of shell entities should thus clearly articulate that entities or vehicles with genuine commercial purposes are not included. With respect to the notion of real economic activity, this should be interpreted as testing whether there has been a substantive purpose, other than obtaining a tax advantage, to incorporate the entity. In this respect, a single purpose for an entity, provided that it is genuine and substantive should be sufficient. In the context of the PE industry, such purpose could for example be to offer lenders single point of enforcement, to organize governance amongst various shareholders, in order to ring fence investment by a category of investors (e.g. management), for regulatory purposes, in order to launch an IPO, etc.

It is important to get the definition of shell entities right in order to ensure that entities created with the purpose of aggressive tax planning are captured, and at the same time that structures and entities with genuine commercial purposes will not incorrectly fall within the scope and be impacted unintendedly.

It would be detrimental to the PE industry and its ability to invest, should the possibility to continue using existing investment structures and entities with genuine commercial purposes be limited. This would have serious negative consequences for the EU economy and the many EU businesses, jobs and communities depending on these investments, since PE investments are an essential driver of European growth, employment, innovation, and economic and social prosperity. This would particularly be problematic in the times during and in the aftermath of the COVID-19 crisis, where investments in EU businesses and the EU economy are all the more needed.

[1] 10.2 million European employees worked in PE backed companies in 2019. For more information, please see the Invest Europe Private Equity at Work research report (published May 2021).

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

For more information please visit www.investeurope.eu.