OECD Committee on Fiscal Affairs
Working Party No. 11

By email: interestdeductions@oecd.org

6 February 2015

Dear Sirs,

Re: BEPS Action 4: Interest Deductions and Other Financial Payments

We are writing on behalf of the British Private Equity and Venture Capital Association (the "BVCA"), which is the industry body and public body advocate for the private equity and venture capital industry in the UK. With a membership of over 500 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. While our membership is predominantly focussed on private equity and venture capital, a significant number of our members are active in infrastructure, debt and real estate, and some of the comments we make below relate to those sectors specifically.

Our members have invested £30 billion in over 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 790,000 people and almost 90% of UK investments in 2013 were directed at small and medium-sized businesses. The availability of debt finance facilitates this investment in business and jobs growth and the benefits of debt finance in the broader economy should not be underestimated. Potential changes to the tax system, and the uncertainties that this creates, could deter investment at a time when it is much needed.

Overview

While the main policy concerns set out in the Public Discussion Draft on BEPS Action 4 relate to outbound and inbound investment by multinational groups, private equity is mentioned explicitly on a number of occasions. Accordingly, before addressing some of the specific questions and issues raised in the paper, we thought that it might be helpful to provide some general comments on how and why debt is used in a private equity and venture capital context and how private equity and venture capital might be affected by some of the proposals in the Discussion Draft.

Debt

Debt plays an important part in financing private equity and venture capital transactions. In respect of any particular investment and depending on the type of fund and underlying asset class, it may comprise external third party (e.g., bank) debt and / or internal related party (e.g., shareholder) debt.

Bank debt may be used for a number of reasons. Amongst others:

- it can help to finance the acquisition and development of businesses;
- it can improve returns on investments by providing a relatively cheap and stable form of capital;

- it can increase the spending capacity of a fund and thereby the number and size of investments in the fund's portfolio by leveraging investor commitments.

Internal debt, which can cover both loans from a private equity fund to underlying investee companies and loans within a group of companies owned by a private equity fund, may also be used for a number of reasons:

- it can encourage greater investment in and development of new business lines and geographies;

- it can facilitate a quick and immediate investment in an asset, with a view to a subsequent refinancing with external party debt;

- it can ease the repatriation of cash – the repayment of loans and the payment of interest are not usually subject to the same corporate law constraints as the return of share capital and the payment of dividends;

- it can provide comfort and certainty in an insolvency scenario – the rights of loan creditors are generally more clearly defined and rank ahead of shareholders;

- it can create efficiencies which investors find attractive and therefore encourage them to invest further capital.

It will be clear from the list above that the reasons for using debt finance in a private equity and venture capital context are not all tax related. The fact that interest is generally deductible does mean that in some circumstances the cost of capital can be reduced and the returns for investors improved, increasing and encouraging investment in businesses – which we believe has a very important role in promoting growth in the UK and global economy. It does not, however, follow that this amounts to or causes base erosion and profit shifting.

Effect of Proposals

Private equity and venture capital are likely to be affected by some of the proposals set out in the Discussion Draft:

- the group tests and fixed ratio tests will affect portfolio companies and groups owned by (or invested in by) private equity funds, potentially limiting where and how much interest is deductible in any particular entity within that group. They will also be of particular concern to those of our members who are active in infrastructure, real estate and debt, where the levels of debt finance for long established reasons can be much higher than in other industry sectors;

- targeted rules, specifically those relating to related party debt, are likely to affect the deductibility of interest costs payable to private equity investors in respect of their investments.

We therefore have a very real and direct interest in this consultation process and hope that our comments are helpful. We follow the order of the Discussion Draft and chapter references are to the relevant chapters in that paper.

Chapter II – Policy Considerations

We recognise that the use of debt finance and interest expense can, in some circumstances, be used to reduce profits in high tax jurisdictions and increase profits in low tax jurisdictions in a way which does not reflect the real economic activities of the companies in those jurisdictions and that countries involved in this action plan are keen to address those distortions.

Chapter II acknowledges, however, that any proposals must be consistent with a number of other policy objectives, in particular:

- in general groups should be able to obtain tax relief for an amount equivalent to their actual third party interest cost – this would suggest that the countries involved in BEPS Action 4 do not fundamentally disagree with the general principle that interest should be regarded as an ordinary business expense and therefore deductible for tax purposes. We wholeheartedly agree with that. What, therefore, is at stake is where to draw the line between what should be regarded as deductible and what not. It is important to ensure that any such line is not arbitrary and artificial;

- any limitation rules should so far as possible minimise distortions to competition and investment – we believe that this is absolutely critical. Companies or groups, whether they are held by a consortium, a private equity fund, an individual, a trust or the public, should be treated equally so that none is at a competitive advantage or disadvantage in terms of their ability to raise or use debt finance to fund investment; and

- any limitation rules should so far as possible promote economic stability and certainty – again, we very much agree with this. Any rules that limit deductibility by reference to the level of activity in a company year on year or by reference to whether the lender is subject to tax on the interest will necessarily lead to uncertainty and, particularly, in relation to bank debt may make cashflow forecasts more difficult. We should also highlight that the introduction of any proposals, without any grandfathering in respect of existing financing arrangements, could present significant problems for businesses with cashflow and other financial covenants in their loan documentation, where full interest deductibility has been assumed in respect of all interest costs. This is likely to be particularly relevant in the infrastructure and real estate sectors, where financing arrangements will be very closely aligned to the underlying cashflows on the assets.

Chapter IV – What is Interest?

We have no substantial comments on what should be regarded as interest or equivalent to interest in the context of this consultation.

Chapter VI – What should a rule apply to?

We agree that any proposals, if introduced, should operate by reference to the level of interest expense of the group or entity rather than by reference to the level of debt for the reasons set out in the Discussion Draft.

We also agree that any proposals, if introduced, should operate by reference to an entity's net interest expense, rather than gross interest expense. This is particularly relevant in the context of funds which invest in the primary and secondary debt markets, where investments will typically be made by the fund through a special purpose company which is financed with loan notes. The interest receivable by the special purpose company on the underlying loans will therefore be matched by a broadly equivalent interest cost payable to investors. Introducing a limitation by reference to gross interest expense could in this context create significant tax leakage in the holding structure, increasing the cost of capital and reducing liquidity in the debt market.

Chapter VIII – Groups

We recognise the theoretical attractions of the group wide tests considered in Chapter VIII but have the following concerns in relation to how they might work in practice, most of which relate to the risk of distortion and the creation of uncertainty – two of the key policy aims set out in Chapter II. These points are in addition to the concerns which the Discussion Draft itself identifies in relation to any group wide test, i.e., in order for this to work, the proposals have to be adopted internationally, applied on a consistent basis and dovetail with existing domestic restrictions on the deductibility of interest, otherwise there is a significant risk of no deductibility at all (or double non-taxation) and a substantial compliance burden for business.

The allocation of net third party interest expenses amongst the members of a group (the deemed interest rule) or capping the amount of interest expense which may be claimed by the members of a group (the interest cap rule) by reference to the level of economic activity in each of those companies relative to the group as a whole will necessarily create distortion and uncertainty:

- groups do not always operate a centralised financing structure, nor is it sensible for them to do so. Expansion into a new jurisdiction by a group may be financed by third party lenders, who are lending specifically by reference to the assets and expected cashflows in that jurisdiction – allocating the associated interest expenses to other members of the group or capping the amount of any such interest which is deductible in that jurisdiction does not reflect the economic reality of the transaction;

- groups may operate in different sectors and geographies and hold different types of assets, each of which are capable of being financed at different levels. LTV ratios in one jurisdiction in respect of real estate may be completely different to the LTV ratios in another. Similarly, it may be preferable for non-tax reasons to acquire real estate for the business with debt finance in one jurisdiction and to lease it (and pay rent) in another. Again, the application of a deemed interest rule or interest cap rule would not reflect the economic reality of the transaction;

- there may be banking, company and currency law constraints which restrict the amount of debt which can be put into any particular jurisdiction and allocating interest expenses to companies in those jurisdictions (to the disadvantage of other companies in the group), when there is no realistic possibility of ever introducing leverage there due to legal and commercial constraints, would seem perverse;

- allocations by reference to relative levels of economic activity in a group also present problems. If allocation is by reference to earnings, EBITDA and performance are likely to vary across different jurisdictions year on year (and may even do so by reference to FOREX movements). Similarly, in the early years of expanding into a new business line or geography, EBITDA may be low but the growth prospects good. If allocation is by reference to assets, there would be particular difficulties for private equity-backed companies – for example, the assets of many early growth stage companies backed by private equity funds are likely to include an unusually high proportion of self-generated intangible property which may have no balance sheet value, which might lead to distorted allocations of interest expense; and if assets are required to be measured on a fair value basis, this would be particularly difficult in the case of the unquoted, illiquid securities in which private equity funds typically invest. Adjusting the allocations year on year by reference to these movements not only risks some of the distortions highlighted above but also creates a significant administrative burden for business and uncertainty in terms of modelling cashflows, which are often key in terms of setting and meeting the financial covenants in third party loan documentation. Furthermore, the reallocation of interest expenses year on year may not even be possible, if existing restrictions on interest deductibility in some or all of the jurisdictions in which a group operates are retained;

- the proposed rule could distort behaviour on acquisitions and disposals. For example, on the sale of a company which has existing debt, the impact of the rule could be that bidders with higher levels of external leverage are able to offer a higher price, because the post-acquisition impact of the group allocation rule on the target company is likely to be lower than in the case of a less leveraged bidder. In other words, the rule could incentivise bidders to become more leveraged.

The application of a net interest expense test in the context of an international group also raises the question of whether it is right that a group which is looking to start up a business or invest in a Country A should be in a completely different position depending on whether it finances its subsidiary with a shareholder loan from Country B or third party debt. In the former, the subsidiary would obtain no deduction because the group would have no net external interest expense; in the latter it (or other members of the group) might. Is it really profit shifting where if a deduction were available in both cases, the taxable profits in Country A would be the same? The net interest expense test in isolation may be able to operate appropriately in respect of a single entity or in respect of a group of companies in the same jurisdiction but in the context of an international group it raises fundamental questions of principle such as this.

In relation to the scope of what would constitute a group for these purposes, we completely agree with the comments at paragraph 143 of the Discussion Draft. Combining two connected groups (e.g., two groups held by the same private equity fund) for the purposes of the group tests would be undesirable and distortive for the reasons given. This policy objective should, in our view and for the same reasons, be applied consistently across private equity funds whatever their form, whether they are structured as limited partnerships, limited partnerships with an underlying master holding company structure, single purpose corporates or corporates comprising multiple compartments effectively representing multiple funds with different investor bases and investment parameters.

Chapter IX – Fixed Ratios

As with the group wide proposals, we recognise the obvious attractions of a fixed ratio test.

We do, however, share the concerns raised in the Discussion Draft that fixed ratio tests are inflexible and do not take account of the fact that businesses operate in different sectors with different funding requirements. This would be particularly true for those of our members who are active in infrastructure, real estate and debt, where leverage levels and interest to income ratios are traditionally high.

We believe that, on balance, a fixed ratio test linking interest deductibility to earnings is probably more sensible than linking it to assets but, again, the appropriateness of this will vary from business to business, what sector it is in and whether it is an established business or a developing one.

Finally, we note the anecdotal evidence in Part C of Chapter IX that the benchmark ratios in countries which have adopted fixed ratio tests have been set too high to be effective and that, to provide some sort of better benchmark, data relating to the interest expenses of multinationals in the non-financial sector of the "Global top 100 companies by market capitalisation" has been quoted. Needless to say, the financing requirements of the Global top 100 will be completely different to the developing businesses which are the focus of private equity and venture capital and the data takes no account of industry sector. We do not, therefore, believe that this is an appropriate or helpful benchmark by any measure, unless of course any proposals which do flow from Action 4 are limited to truly global multinationals. The inclusion of this data does, however, illustrate very clearly the difficulties associated with any 'one-size-fits-all' fixed ratio proposals and if benchmarking in this manner were recommended, we believe that the smaller companies and developing businesses in which private equity and venture capital predominantly invest should be carved out because their financing requirements and ability to obtain finance vary so greatly across sectors and geographies and they do not have the same established worldwide cashflows and assets as multinationals against which to leverage, putting them at a potential disadvantage.

Chapter X – Combined Approach

We have, as set out above, concerns about the application of the group wide tests and the fixed ratio tests and whether they are an appropriate means of limited interest deductions in practice. Those concerns apply equally to any combined approach.

Chapter XI – Targeted Rules

One of the concerns expressed in Chapter VIII (Groups) is how to deal with related party debt because related party debt will not be caught by the group wide test if the group (sensibly and properly) stops at the parent company of the consolidated group.

Related party debt restrictions are of particular concern to private equity and venture capital because they could, depending on how related party debt is defined, affect much of the internal debt finance which funds typically look to lend down by way of shareholder loan to finance the acquisition or development of their underlying investments. Before addressing, therefore, some of the potential concerns with the targeted rule in respect of connected or related party debt proposed in the Discussion Draft, we believe that it is important to ask two important policy questions:

- is it right to propose targeted related party debt rules simply because related party debt will not be caught by, for example, the group wide test, without regard to whether that related party debt actually results in base erosion and profit shifting? It is clear that any such rules will not avoid distortion because, if they are introduced, groups which are funded by way of related party debt may be at an artificial disadvantage to those companies with an equivalent amount of third party debt and, if they are not, may be at an artificial advantage; and

- does the use of related party debt, particularly in the context of private equity and venture capital, give rise to the type of base erosion and profit shifting which BEPS Action 4 is looking to address? If the primary focus of BEPS Action 4 is to counteract the movement of profits from high tax jurisdictions to low tax jurisdictions, we do not believe that it does. In any particular fund, the investor base is likely to be diverse in terms of type and geography. Interest payable to the fund will generally reduce the taxable profits of the portfolio company, subject to any domestic restrictions, in exactly the same way as interest payable on any third party debt. That interest will then be distributed to investors. Those investors may be resident in the same jurisdiction as the underlying portfolio company; they may be tax exempt pension funds or taxpaying financial institutions. Against that background, it seems extremely difficult to identify any concerted base erosion and profit shifting. Imagine a portfolio investment in Country A is funded with bank debt and shareholder debt. Interest payable to the bank will generally be deductible. If, however, the bank is resident in Country B, no domestic tax in Country A may be collected on the receipt. If interest payable to the fund is not deductible because it is paid in respect of related party debt, there may be no deduction in Country A but tax in Country A on any investors resident there. What is more, even if the portfolio company obtained a deduction for the interest payable to the fund, there may be more base erosion in Country A in respect of the bank debt than in respect of any interest which is distributed to investors resident there.

In terms of the targeted rule proposed in respect of connected or related parties, this is inherently unattractive for a number of reasons:

- generally, defining what should constitute a connected or related party for these purposes is difficult. Is a 25% interest in an entity the right measure? Does it create a cliff edge and an artificial barrier to increasing a shareholding in an entity from below 25% to 25% or above? How should transparent entities, such as partnerships be dealt with – on a look-through or single entity basis;

- in relation to (i), the disallowance of all interest payments to connected and related parties may not be appropriate:

    - where a shareholder or a person connected with that shareholder acquires or holds a tranche of what was originally third party debt, alongside genuine third party lenders. It does not seem right that in those circumstances part of the interest costs on the third party debt should cease to be deductible;

    - where a lender becomes a shareholder of the group on an insolvency or restructuring event and part of the original loan remains outstanding or is restructured and remains held by the lender – a relatively common scenario over the last few years; or

    - in the context of a debt fund, where, as set out above, underlying debt assets will be acquired through a special purpose company funded by way of loan notes so that there is an effective pass-through of interest. Creating a substantial taxable profit in the special purpose company would be completely disproportionate to the economic activity carried out there;

- in relation to (ii), allowing deductions only in respect of interest paid to connected or related parties subject to a minimum level of taxation on the receipt cannot be the right way to determine whether interest expenses should be deductible or not for the reasons set out in Action Plan 2 in relation to Hybrid Instruments. This is particularly relevant in the context of private equity funds, which are often structured as tax transparent limited partnerships, and deductibility would then turn on the composition and status of the investors from time to time. It would be extremely difficult to apply this rule in a private equity context, where information about the precise tax treatment of income received by fund investors is not generally available to fund managers or indeed to investee companies. Either there is base erosion and profit shifting going on or there is not. The fact that the recipient is not subject to tax on interest receipts may be indicative of base erosion and profit shifting but the issue cannot turn on that as a matter of principle;

- in relation to (iii), a fixed ratio is unattractive for the reasons set out above in relation to Chapter IX.

Chapter XII – Carry Forward

We believe that interest expenses disallowed under a general limitation rule should in principle be capable of being carried forward and set against profits in future periods for the reasons given in Part B of Chapter XII, i.e., if as a matter of policy interest expenses are deductible up to a certain level, anything below that should not be capable of constituting base erosion or profit shifting.

We also believe that any restrictions on the carry forward of interest expenses following a change of control should be limited, e.g., only where there has been a fundamental change in the nature of the business or the losses are to be used in sheltering profits of an unrelated group business. This may be particularly relevant in a private equity context where there has been an investment in business which is expanding or requires significant capital investment and carry forward losses may be significant at the point of sale but future trading is expected to be strong. It would seem odd in those circumstances for those carry forward losses to cease to be available to set against the future profits of the business.

Chapter XIII – Specific Sectors

Some of our members are active in infrastructure and real estate. It is critical to them that the sector specific issues raised in Chapter XIII in relation to those two asset classes are properly addressed. Infrastructure and real estate development are key to future growth, both in developing and developed countries where there are increasing populations and infrastructure needs. Increasing the cost of capital and reducing returns for investors in these sectors would reduce investment.

It is also very important that debt funds are considered in the context of financial sector businesses other than banks and insurance companies. As set out above, underlying loan assets are typically acquired by a special purpose company, which itself is funded by loan notes issued directly to investors or through a fund vehicle, e.g., a limited partnership. Direct lending funds and funds operating in the secondary debt market are critical to the supply of credit in the wake of the banking collapse. Introducing additional costs into those structures by denying tax relief for interest expenses would risk reducing investment in that area.

Grandfathering

Many existing financing arrangements have been entered into on the basis that deductions will be available in respect of a specific level of interest expense over the life of the financing. If any of the proposals set out in the paper are introduced without any grandfathering provisions in respect of existing arrangements and those proposals result in a reduction in the amount of interest which is deductible, financial covenants under those financing arrangements could be breached and the ability of the borrower to refinance those arrangements would be severely limited.

We would therefore ask that grandfathering provisions be considered as part of any best practice recommendation or proposal in respect of Action 4.

Alternative Solutions

We note that transfer pricing and the arm's length test were specifically excluded from this consultation process.

We do, however, believe that transfer pricing and the arm's length test represent the most effective and appropriate way of addressing the policy objectives of Action 4, in conjunction with (and given the existence of) existing domestic restrictions on the deductibility of interest and some of the other workstreams being undertaken as part of the BEPS Project. Transfer pricing does not result in all the arbitrary distortions and anomalies potentially created by group and fixed ratio tests and targeted rules in respect of connected and related party debt. It is flexible and adaptable to industry sectors and funding requirements. It is also more consistent with the wider country-by-country reporting proposals and the policy objective of more closely aligning taxable profits in a particular jurisdiction with the economic activities carried out there.

We acknowledge that countries may be nervous that they do not have the expertise or knowledge necessary to be able to carry out a proper transfer pricing exercise in respect of financing arrangements and that they may have to invest in it. That should, however, be no bar to adopting this proposal from a policy perspective, if it delivers a more appropriate outcome.

Conclusions

To conclude, therefore, our key observations on the Discussion Draft are as follows:

- interest should be regarded as an ordinary business expense and generally deductible for tax purposes;
- it is important that any limitations on that general principle do not create artificial or arbitrary distortions across borders and different industry sectors and between companies and groups depending on how they are held and by whom;
- it is also important that any limitations do not create uncertainty or place an unduly significant compliance burden on companies and groups;
- the group and fixed ratio tests are largely arbitrary and artificial because they do not reflect the subtleties of different industry sectors, geographies and markets. Nor, arguably, are they fit for purpose because the existence of a cross-border intra-group loan or the

existence of interest expenses in excess of a fixed ratio does not necessarily mean that base erosion and profit shifting is taking place, which is the focus of the paper;

- some of the shortcomings of the group and fixed ratio tests are highlighted by the recognition in the paper that they are not really appropriate in the context of certain industry sectors;

- some of our members are active in those sectors – infrastructure, real estate, finance (debt funds) – and they are very keen to ensure that investment in those areas is not adversely affected by any proposals which may come out of Action 4;

- the group wide tests will only work well if they are applied internationally on a consistent basis and can accommodate (or adapt to) the manifold and varied domestic restrictions on interest deductibility currently in existence around the world;

- it is very important that, if any group wide tests are recommended, the identification of the relevant group is clear and that, in the context of private equity and venture capital, neither companies owned by the same private equity fund nor funds managed by the same firm should be connected or grouped for these purposes;

- if fixed ratios are to be benchmarked by reference to the financial position of very large multinationals, we would recommend a carve-out or more appropriate benchmark for small and medium-sized enterprises;

- the targeted rules in respect of connected and related party debt are of particular concern to private equity and other private funds because, again, the tests seem arbitrary and could create distortion. It is also not clear to us that related party debt in the context of private equity and venture capital ordinarily results in the base erosion and profit shifting which is the focus of BEPS Action 4 and it should not therefore be affected;

- the grandfathering of existing arrangements needs to be addressed otherwise financial covenants in respect of those arrangements could be breached upon the introduction of any new regime;

- transfer pricing does in our view offer, in conjunction with existing domestic provisions, the more appropriate means by which to address the policy concerns which are the focus of Action 4 – i.e., what level of interest deductibility is appropriate in any particular entity before it begins to result in base erosion and profit shifting. We note from the Discussion Draft that the arm's length principle has been excluded from this consultation process. We do, however, believe that, in light of the distortions and uncertainties that are likely to accompany any of the proposals, two outcomes the Discussion Draft is clear from a policy perspective it wants to avoid, it does have a place in this discussion. It can accommodate differences in sector, geography and size and should therefore provide in any particular jurisdiction a much better guide as to what level of interest deductibility should be regarded as appropriate, it is consistent with the wider country-by-country reporting proposals and the alignment of profits with economic activity and it does not subject interest expenses to a potentially completely different regime to other ordinary business expenses; and

- if any of the proposals considered in the Discussion Draft are developed further and put forward as best practice recommendations, we would suggest that existing domestic restrictions on interest deductibility which go beyond the restrictions contained in those recommendations should be withdrawn to enable interest costs in a group to be aligned (on a deductible basis) with its more profitable geographies.

Please let us know if you would like us to expand on any of the themes explored in this letter or would like any further information from us.

Yours faithfully,

David R Nicolson

Chairman of the BVCA Taxation Committee