OECD
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2 May 2014

Dear Sir or Madam,

Re: BEPS Action 2

I am writing to you on behalf of the British Private Equity and Venture Capital Association (the "BVCA"), which represents the interests of members of the private equity and venture capital industry. The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 250 private equity, mid-market, venture capital firms and angel investors, together with over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

This note has been prepared by and is being sent on behalf of the BVCA's Tax Committee, whose remit is to represent the interests of members of the industry in taxation matters. The BVCA welcomes the opportunity to submit formally its comments on the two Public Consultation documents entitled BEPS ACTION 2: Neutralize the Effects of Hybrid Mismatch Arrangements (Treaty Issues) and (Domestic laws) released by the OECD on 19 March 2014 (the "**Consultation Documents**") and how it might affect members of our industry. Our comments in respect of the Consultation Documents are set out below.

1. Introduction

The BVCA fully appreciates the concerns of the OECD that action is needed to effectively prevent the use of hybrid instruments and hybrid entities to obtain tax advantages as a result of double deductions and deduction with non-inclusion. The BVCA also supports a coordinated and comprehensive international approach to tackle these important issues.

Private equity funds (and venture capital funds, which are not referred to separately in this note for reasons of clarity but operate in a very similar manner) exist to aggregate and deploy capital in order to generate investment returns. Investors into private equity funds are typically pension funds, family offices, insurance companies, banks, other investment funds (which may be in corporate, trust, partnership or other form), sovereign wealth entities, not for profit organisations such as local authorities, educational endowment funds and charities and individuals (including officers and employees of the fund manager or vehicles aggregating the interests of such persons). Investment may be made directly into a particular private equity fund or via a "fund of funds".

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British and other European private equity funds typically raise funds from investors in a broad range of jurisdictions, which tends to increase fund size and increase economies of scale, and typically invest in companies in a broad range of jurisdictions, which tends to diversify risk and maximise investment opportunities. It is therefore critical to many private equity funds that they can operate cross-border without undue tax problems, for the benefit of investors.

Private equity operates very differently from the large multi-national organisations on which BEPS is largely focused, and it is vital that these differences are understood and accommodated in order that the industry is not inappropriately disadvantaged, which would in turn lead to a disruption in global investment flows, impacting countries that rely on inward investment and reducing economic growth across the globe.

2. Hybrid instruments in the context of private equity

As explained above private equity raises funds from a diverse group of investors and deploys the funds to invest across a wide variety of jurisdictions. Private equity funds may, where considered appropriate, use complex instruments such as hybrids in the context of acquisition structures in order to meet the needs of investors. These instruments play an important role in matching those seeking to invest capital with those requiring investment. The framework for using hybrid instruments is a function of the wide and varied investor base of private equity funds and the wide range of their investment jurisdictions. The acquisition structures are typically not designed to give rise to non-inclusion or a double deduction, but are designed to provide flexibility to remit cash to investors and deal with the different needs of a diverse investor base, ensuring that investors pay tax at the time when they receive a cash return.

Unlike an international corporate group, a private equity fund has a finite life (between five and ten years, often with the possibility of a two year extension). From the outset of an investment, the manager of the fund must be mindful of and plan for this constraint. The mechanism for investing must enable the fund to be able to return all proceeds to investors from underlying investments within this time-frame – there is no mechanism for returning funds after the private equity fund has run its course. It is this imperative which drives the choice and terms of the instruments used to make the investment which might be a mix of equity, plain vanilla debt and – potentially – loans which have some equity-like features (so-called ‘hybrid’ instruments).

A private equity fund cannot and does not structure its investments to be tax efficient for each investor. But if a particular group of investors face a specific and commercially problematic tax problem, the fund may factor this into its choice of investment instrument. For example, the US tax system taxes investors on an accruing yield basis which would result in investors potentially being taxed before receiving cash from the fund (sometimes referred to as the “phantom income” problem). To the extent there is a tax advantage in the use of a hybrid instrument in this context, it is generally a timing advantage: the use of a loan note which has equity features may mean that tax is due when cash is realised.

If investors were to suffer tax before receiving any cash return on their investment, at a time when future cash returns are uncertain, this would effectively reduce investment returns, increase investment risks for investors and reduce the attractiveness of private equity as an asset class for many investors. This would be likely to reduce the amount of private equity capital available for investment.

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3. Example structure and timing differences

(a) Our general comments above can be illustrated by reference to the structure described at figure 12 at paragraph 207 of the consultation document headed “Imported Mismatch from Hybrid Financial Instrument”. That kind of structure is, in very broad terms, relatively common in a private equity context, subject to our comments below about the tax impact of the structure. In a private equity context, the structure is designed to provide flexibility in relation to returning funds to stakeholders but also match cash to tax payments in the hands of investors.

Typically in a private equity context the acquisition of a European group would be effected using a holding company financed by the fund. The fund (typically a tax transparent partnership) would incorporate an intermediate holding company which would in turn incorporate a local acquisition vehicle. The local acquisition vehicle would be financed with a mixture of equity and loans by the intermediate entity which would also be financed by a mixture of ordinary equity and loans. Some or all of the loans provided to the intermediate entity may take the form of hybrid instruments, in the sense that the instruments might be considered to be loan instruments for local tax and accounting purposes but equity in the tax jurisdiction of some of the ultimate investors.

In the intermediate company’s residence jurisdiction, the return on the instrument may be treated as interest, which may be deductible on an accruals basis depending on the domestic laws of the relevant territory. Typically domestic laws will provide for appropriate base erosion protection (eg. rules on thin capitalisation, transfer pricing and re-characterisation) designed to ensure that only appropriate levels of interest are deductible. The intermediate company will also be receiving taxable income and will be taxable on its profit from the transactions, and in many cases the amount of that taxable profit will need to be supported by an appropriate transfer pricing methodology and report.

The ultimate investors will pay tax on the return in their residence jurisdiction depending on their domestic tax rules and their own tax attributes.

Many jurisdictions will treat this type of instrument as debt in exactly the same manner as the intermediate holding company’s residence jurisdiction and therefore the instruments will not be a “hybrid” in relation to those two jurisdictions. The UK would be an example where instruments of this kind are typically treated as a debt, and where taxable investors would be taxed on the return as interest.

However, in the residence jurisdiction of some investors the return on the instrument may be taxed instead as a distribution. For example, in the hands of US taxable investors the return may be taxable as a distribution, such that it is taxed as ordinary income on receipt. The effect of this US treatment is essentially to delay taxation until cash is received when the return is paid.

(b) It is accepted that such structures can lead to timing differences as investors may not be taxed until the investment returns are received.

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Typically the maximum deferral is between two and four years depending on when the investment is realised. There is no possibility of a long term deferral as there is a requirement to remit cash to investors as soon as possible as the fund managers are measured on cash returns. In addition, private equity funds' agreements with their investors will normally provide for a maximum investment period fund life, typically five and ten years, with the possibility of a two year extension. This leads to a natural fund cycle where commitments are sought from investors, investments are made in the first five years and realised within five to ten years. Consequently the concept of a long term deferral is not a characteristic of private equity.

We believe that mere timing differences of the kind described above should not be affected by the proposals in the consultation document.

We note that the consultation document appears to confirm that mere timing differences are not intended to be caught. The document states at paragraph 88 that: "[t]he recommendation is not intended to impact on questions of timing in the recognition of payments. Thus, a hybrid mismatch does not arise simply because the issuer accrues original issue discount over the term of the bond while the holder only recognises the corresponding income as redemption premium once the bond is repaid." This same principle should apply to timing differences of the kind described above.

(c) Indeed, if hybrid instruments which produce a mere timing difference were to be caught by the proposals, there would need to a relieving mechanism when such timing differences are reversed, to avoid double taxation for investors (ie. to avoid tax on accruals and tax again on receipt) or penal asymmetry (ie. tax for investors with no deduction for the payer). Such a mechanism might be possible, but it would be hugely complex across a diverse investor base. In addition, changes in investors and changes in fund profit sharing ratios would make administering the arrangements very difficult in practice.

(d) For completeness, we note that there can be cases in a private equity context where hybrid instruments give rise to permanent rather than mere timing benefits, including tax rate benefits, although we believe that such cases are a distinct minority of cases and we believe that such benefits are often not intended at the outset of a transaction. We acknowledge of course that the points made above in this section, relating to mere timing differences, would not apply in such cases.

4. Lack of information needed to determine hybrid tax effects

The proposed rules on hybrid instruments would require that:

i) The jurisdiction of the payer should deny a deduction for any payment made using a hybrid financial instrument, to the extent that that the payee/investor does not include the receipt as ordinary income under the laws of any jurisdiction.

ii) Jurisdictions should require a payee/investor to include any payment under a hybrid financial instrument as ordinary income to the extent the payer is entitled to claim a deduction for such a payment or equivalent tax relief and the payer's jurisdiction does not apply a hybrid mismatch rule under (i) above.

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iii) A dividend exemption should not be granted under domestic law to the extent that the amount is deductible so that in these situations no mismatch will arise.

Further complex rules are proposed in relation to "imported mismatches" – see in particular paragraph 228 of the consultation document regarding the proposed interaction of the tax treatments in Country A, Country B and Country C.

In the case of a widely held private equity fund, it would be extremely difficult in practice to apply these rules. It will be very difficult for payers to know whether particular investors are required to treat payments as taxable income under their domestic tax laws and on what basis. Private equity fund managers will not generally be in a position to determine the precise tax treatment of any particular flow of income in the hands of their investors. Some information may be available to private equity fund managers, but not the entirety as some investors will be "funds of funds" and therefore the available information about the investors will be restricted to this point. Even if the information is available to the private equity fund manager, it may not be able to provide this information to the payer as the details may be confidential.

Some funds will be "open ended" or listed and in these circumstances the difficulties indicated above will be exacerbated as clearly it will be almost impossible to obtain information in relation to a constantly changing investor base.

The implementation of "imported mismatch" rules would be even more challenging, because it would require transparency of information at three levels (ie. fund investors, intermediate holding company and acquisition company).

5. Economic impact of disallowance

We also note that any disallowance of deductions under proposed rules is likely to have a distortive economic effect in the context of a private equity fund. The denial of a deduction will depend on the tax treatment of particular investors. However, the economic cost of that disallowance will be spread across the entire investor base. It will be borne in proportion to the amounts invested by fund investors, and therefore the cost of the disallowance will be suffered partially by investors for whom there is no hybrid arrangement.

6. Hybrid Entities

It is unusual for European private equity funds to use a hybrid entity but such entities are sometimes used as a pooling vehicle or fund vehicle particularly in the US. These entities are usually not set up to benefit from mismatches, but are hybrid due to the diversity of investors in different jurisdictions and the diversity of jurisdictions these vehicles invest in. Such an arrangement is not based on aggressive tax planning, but merely the result of different rules in different jurisdictions. These pooled vehicles rarely result in 'double non-taxation'. Their goal is to make it possible for different investors to pool their investments without creating an additional layer of tax, i.e. tax neutrality.

For example, it is common for the common investment vehicle to be structured as a partnership, but if, for example, investing in the United States, the vehicle will elect corporate treatment for US domestic tax purposes. The effect of this hybrid is twofold. First, investors that are resident in jurisdictions that have an income tax convention with the United States can maintain the same

treaty benefits the investor would have obtained if the investor had made the investment directly due to the fiscal transparency rules commonly applied in most income tax conventions. Second, if the investment generates income subject to net income taxation, the choice to make the vehicle non-transparent for US domestic tax purposes means that the vehicle, rather than the investors, will be subject to US net income taxation and the accompanying filing and reporting burdens. This avoids having the numerous investors, often hundreds and sometimes thousand, being subjected to filing tax returns in the United States. But it does not reduce the tax burden.

Taking into account their diverse ownership and structure, these pooled investment vehicles may become innocent victims of anti-treaty shopping rules and anti-hybrid rules and therefore should be carved out from the BEPS work streams. For example, if a fund has 200 investors from 10 different countries and ten US investors use a hybrid vehicle for their investment in the fund, it could trigger application of rules based on the Action 2 recommendations. Even though the other investors might be taxed on their investment income from the CIV, or may be exempt under local law, the recommended imported mismatch rules could allow all of the jurisdictions involved in making deductible payments through the CIV to deny deductibility for the entirety of their respective payments. Potentially, the sum of these disallowed deductions could be many times greater than any income that is not included as a result of the hybrid.

In such circumstances, we believe that any hybrid mismatch rules should only apply on a look-through basis to each investor (rather than tarring all of the CIV's investors with the same brush) and, in any case, should not apply to unrelated parties.

7. "Bottom up" vs. "Top down" approach

The "top down" approach would effectively be based on the premise that every hybrid arrangement must be caught unless specifically excluded. We hope that our commentary above demonstrates that, in a private equity context, hybrid instruments do not typically produce a tax result which should be caught by the proposals. A regime based on including all hybrids and then providing carve-outs or exceptions is likely to be practically difficult to implement and increases the level of uncertainty to an unacceptable level. We strongly urge a more limited "bottom up" approach to the anti-hybrid rule which can be more targeted and is less likely to impact on commercial activity.

8. Related parties

(a) In addition, we would suggest that there should be a much clearer separation between anti-hybrid measures applicable to instruments held by related parties and all other circumstances. The proposals in section IV.5. of the consultation document would create a multitude of implementation, information and technical concerns in a private equity context. Our recommendation is to treat collective investment arrangements, such as private equity and other forms of pooled investment, as a separate category, to take account of their specific facts and circumstances and the wide variety of investors by type, origin and tax status.

(b) We can appreciate that entities that are consolidated for financial accounting purposes represent members of the same control group, and therefore as policy matter must be within the rules.

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(c) However, the term "related party" (paragraph 128) includes companies, funds and other entities and arrangements that would generally be expected to take into account the position of their non-portfolio investors (i.e. 10% or greater) when entering into their arrangements with those investors. The 10% threshold is too low given the complexity and risks of double taxation inherent in these rules. Therefore we suggest that the rules should not apply to unrelated parties and the definition of related party should be based on an ownership test of at least 50%. In the absence of central control a taxpayer who makes a payment to a 10% investor would not be in a position to obtain information on the tax treatment in order to comply with the rules on imported mismatches or reverse hybrids.

(d) The related party test also includes relationships described as "acting in concert" - parties that have a material interest in engineering a particular tax outcome where there are coordination mechanisms in place that allow them to undertake collective action. This includes shareholders or voting agreements, joint ventures and private equity funds under the control of a common manager. The consultation makes the assumption that such arrangements raise relationship issues that are similar to those presented by related parties under common control and should therefore be treated in a similar manner. We dispute the contention that in a private equity context all fund investors, who will typically be acting at arm's length from each other and from the fund manager, should be treated effectively as if they are all members of the same control group as each other and any company owned by the fund. Investors in private equity funds will typically consist of numerous dispersed investors. The position is very similar to the investors in a "widely held" instrument discussed at paragraphs 147 to 157 of the consultation document and therefore private equity funds with a wide investor base should be treated in a similar manner.

(e) We assume that, in any event, the debt which is typically borrowed by private equity sponsored companies from banks and other third parties, including the senior debt which is typically borrowed from a syndicate of banks, will fall outside the proposed rules because it will not be owned by any person "related" to the borrower and the bank syndicate (or other similar lenders) will not be viewed as "acting in concert". It would be useful if that could be clarified.

9. Administration

The comments above point to some of the issues for the private equity sector in administering these arrangements. To the extent that hybrid instruments are caught, the most practical approach would be that any disallowance is at the level of investors as they will be in the best position with deal with the administration required. It is essential the rules are implemented consistently and that the associated costs are minimised such that it does not impact on the wider business community. If the consequence is that different countries implement the rules differently and there is no consistency this would represent a major setback for business.

10. Purpose test

Objective mechanical tests may offer apparent certainty, but do not take into account situations that are not abusive but just happen to fall within the definition. To ensure that global commerce operates without distortion resulting from income tax considerations, such unintended applications of mechanical tests – which would be costly and counter-productive – must be avoided.

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We believe a structured purpose test is essential to reduce the likelihood of unintended consequences and limit the collateral damage that could arise if the implementation of these proposals affects innocent parties or gives rise to double taxation. A structured purpose test would provide a subjective test of a taxpayer's motive, that is, whether the intent of a particular hybrid entity or transaction test is tax avoidance. Such a test would require a consistent standard, such as 'principal intent' or 'substantial purpose,' which could be applied to all situations. In order to ensure consistency, a structured purpose test should also include certain presumptions based on specified hallmarks of potential abuse.

A purpose test seems particularly important in the context of transactions between unrelated parties, where the potential for abuse is generally much lower.

Even in a related-party context, a structured purpose test would be helpful in ensuring that routine intercompany transactions reflecting normal business practices are not penalised simply because a hybrid transfer or entity happens to be involved. Alternatively, rules implementing the Action 2 proposals could include a 'business purpose' exception for related-party transactions, where the taxpayer has the burden of proof to show that such transactions have no tax avoidance motive.

11. Implementation and transition

It is clear from the complexity of the issues contained both in the consultation documents and our comments above that the scale of the issues in Action 2 is challenging. The objective of seeking a coordinated response across multiple jurisdictions is, we believe, essential. Nevertheless, such a coordinated approach will be very difficult to achieve in practice because individual jurisdictions have developed their tax laws to reflect a policy decision, for example, to allow a tax deduction in order to attract inward investment, which is their prerogative to do.

The debate on Action 2 can be distinguished from the BEPS work-stream on issues such as permanent establishment and profit attribution. In that domain, where one entity has a permanent establishment in another jurisdiction, both jurisdictions want to exercise taxing rights and look to the OECD to give guidance on a fair and consistent approach. In relation to hybrids, however, the OECD seems to be encouraging jurisdictions to tax instruments in certain circumstances even though it has made a policy decision not to do so and failure to implement this approach in a fully uniform manner will mean that it will not work as anticipated.

Therefore we feel it is essential that sufficient time is dedicated to allow for modifications to the design of the recommendations. In addition to adequate time, appropriate transitional arrangements should be put in place in order to ensure smooth implementation of any new rules, to ensure that they are focused only on abusive outcomes and do not result in outcomes which give rise to double taxation.

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12. Summary

To reiterate the comments made above:

i. We believe the action designed to neutralize the tax effects of hybrids is an appropriate policy response.

ii. Private equity does use hybrid instruments – i.e. instruments which are treated as debt in the payer jurisdiction and equity in the recipient jurisdiction - but they generally give rise only to short term timing differences. We do not believe that such timing differences should be caught by the proposed rules. Indeed, it appears that the consultation document is not seeking to catch timing differences, but the position needs to be clarified.

iii. If timing differences were to be caught, there would need to be further complicated provisions to avoid double taxation for investors or penal asymmetry.

iv. The proposals require the relevant payers and payees to have detailed knowledge of the other's tax treatment, and that is very difficult in the context of a private equity fund. It is extremely difficult for private equity fund managers to establish the precise nature and timing of investors' domestic tax treatment on a particular flow of income.

v. In the event that an instrument is caught by the hybrid rules, the primary response should be inclusion at the investor level. This is consistent with the principle underlying a private equity fund that the investors should take responsibility for tax on investment income and gains. In addition a disallowance at the level of the portfolio company would result in the disallowance being borne by all investors and not just those benefitting from the hybrid treatment.

vi. In relation to whether the definition of hybrid should be "top down" and effectively treat all hybrids as bad with certain carve outs or focused on specific circumstances (the "bottom up" approach), our clear preference is for a "bottom up" approach as it will be more focused and less likely to lead to inadvertent commercial issues harmful to investment and the overall economy.

vii. The rules should only apply to related parties and the related party definition should be based on 50% ownership. A test based on a lower level of ownership will mean that taxpayers are not in a position to obtain information on the recipient's tax treatment and comply.

viii. The suggestion that investors and private equity firms represent "concert parties" is inappropriate. The investors in a private equity fund are similar to other public shareholders, indeed in many cases they will be same investors who are also shareholders across the listed markets and should be treated in a similar manner.

ix. Many countries already have extensive rules in relation to interest deductibility and therefore further limitations based on the use of hybrids seems "overkill" and will be harmful to economic activity. It is also important that any limitations are coordinated and consistent with BEPS Actions 3 & 4 on interest deductibility.

x. These rules will ultimately impose additional costs on business, for the payer and ultimate recipient, if only to ensure compliance with their obligations. Therefore it is incumbent on governments to ensure action is focused and costs are minimised otherwise this will impact the wider economy.

xi. The rules should include a purpose test to ensure the proposals do not inadvertently catch innocent transactions, reduce the compliance burden and ensure the rules do not impede international trade.

xii. The rules for hybrid entities should be clear and apply on a look through basis to each investor and in all cases should not apply to unrelated parties.

xiii. Given the complexity of the issues sufficient time should be provided to ensure that there is consensus and the rules can be enacted in a consistent manner. This should include appropriate transitional arrangements.

Thank you in anticipation for taking our comments into account as part of the consultation process. We would welcome an opportunity to engage more fully with the OECD in due course on this matter and would be pleased to discuss any of the comments made.

Yours faithfully,

Dominic Spiri

On behalf of the BVCA Taxation Committee