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By email: taxtreaties@oecd.org

9 January 2015

Dear Sirs

Re: Follow up work on BEPS Action 6: Preventing treaty abuse

1. Introduction

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.

2. The role of private equity funds as part of the global economy

2.1. Private equity is one of the options which a company may consider in order to meet a need for capital. It fulfils a different role to say stock market capital or bank lending, because private equity investors will tend to take a more active role in the investee business via a position on the board. Private equity is a source of genuine long term investment without which the real economy would be worse off. Private equity funds are held by a diverse range of investors and are not vehicles formed for a purpose of tax avoidance (or indeed any other nefarious purpose) by any investor or group of investors. These factors are essential to a proper understanding of private equity, and each is addressed in greater detail below.

2.1.1 Private equity is a substantial source of genuine long term investment

BVCA research reveals that private equity funds managed in the UK currently back around 3,050 companies, employing around 1.2m people on a full-time equivalent basis (FTEs) across the world. Of these, around 790,000 FTEs are employed in the UK. Of the companies invested in during 2013 in the UK, around 65% were small companies, with around a further 22% being medium-sized companies.

Private equity funds managed in the UK currently have around £147bn assets under management, including around £48bn yet to be invested, of which around £20bn is destined for the UK.

The EVCA has conducted similar research[1] concluding that:

- €307bn was invested by private equity in European companies from 2007 to 2013 in the 12 largest private equity markets in Europe.
- 25,000 companies are backed by private equity in Europe (of which 83% are SMEs).
- €305bn is the economic value of patents granted to private equity backed companies in Europe between 2006 and 2011.
- 12% of all industrial innovation in Europe is attributable to private equity backed companies.
- Private equity backed companies are up to 50% less likely to fail than non- private-equity backed companies with similar characteristics.

It is clear that private equity plays a meaningful role in providing capital to real businesses.

As well as the benefits to the investee companies and those directly or indirectly employed by them, investment by private equity also has wider benefits to communities. Many private equity firms have signed up to the UN's Principles for Responsible Investment[2]. The private equity work stream was launched in 2008 and now has over 130 GPs and Funds of Funds as members. The UN have noted that *"Private equity is highly conducive to responsible investment because of its relatively long-term horizon; the typical holding period for a portfolio company is 3-7 years. In principal, private equity firms have influence over company management and are therefore able to promote ESG initiatives at the company level".*

It is clear that any action which reduces private equity investment will have an adverse impact on the real economy.

2.1.2 Investments into private equity funds come from a range of jurisdictions and investor types

Private equity funds managed in the UK raised around £11.2bn of funds in 2013[3]. The vast majority (around £9bn) of this fundraising came from overseas investors. The biggest sources of fundraising in 2013 were pension funds (£2.9bn); sovereign wealth funds (£1.9bn); funds of funds (£1.4bn); and insurance companies (£1.1bn). These investments were made from a diverse range of locations including the United States (£4.3bn); United Kingdom (£2.2bn); Germany and Canada (£0.5bn each), the Netherlands, Switzerland, China, and Middle East (£0.4bn each).

[1] http://evca.eu/media/323675/evca-essential-work-2014-2019.pdf

[2] http://www.unpri.org/areas-of-work/implementation-support/private-equity/

[3] http://www.bvca.co.uk/Portals/0/library/documents/RIA%20Guides/IAR%20Autumn14-fin.pdf

Separate EVCA research[4] yields a similar picture: investment into private equity is international, and the vast majority of the capital deployed by private equity is sourced from investing entities which would be expected to qualify for treaty benefits.

Any action which restricts the international flow of capital will reduce the capital available for investment into real companies.

2.2. Having established that private funds provide a vital link between sources and users of capital, it is relevant to consider some of the other common features of a private equity fund.

Typically a private equity fund will be closed ended with a life of ten years. It will invest in a range of businesses, might make in the order of ten to twenty investments over the life of a single fund, and often operate with certain provisions included in the fund documentation to protect investors from excessive risk arising from lack of diversification (whether looked at on a jurisdiction, sector, investment size or similar basis).

Fund performance and executive incentives are driven by the quantum and timing of cash returns: investors will often measure funds on an IRR basis when considering whether to make commitments to subsequent funds, and executive incentive plans are typically subject to a performance hurdle calculated as an IRR on cash returned to investors. There is an important point which follows from this, which goes to answer a misconception which some may hold: private equity funds are simply not vehicles for rolling up or deferring investment returns, not least because private equity fund managers are motivated to return cash to investors.

Private equity fund managers are often comparatively small businesses. Their resources are directed to sourcing opportunities for investment and divestment, and to engaging with and developing the investment portfolio. They do not have capacity to actively manage the tax positions of investors.

The sources of investment into private equity were discussed above and include a diverse range of source locations and entity types. However, it is common amongst them that investors will often require knowledge of how investments will be held before making an investment. Fund managers may respond to this demand by selecting a holding structure for the fund. Important features of this structure will include:

- Clarity that an appropriate "corporate veil" exists to insulate investors from other legal liability risks.

- Familiarity, consistency and reasonable administrative cost. This is significant, because costs impact returns to investors, and investor reporting is one of the primary communication channels between private equity funds and their

[4] http://www.evca.eu/research/activity-data/annual-activity-statistics/

investors, so it is essential that quality and consistency is maintained.

- Clarity on the ability to extract cash quickly and efficiently when required (some jurisdictions have regimes which restrict the ability to do this).

- A legal system which is attractive to providers of finance, in terms of the ability to grant guarantees, provide security, certainty over enforceability and subordination, etc.

- An ability to accommodate joint venture and co-investment arrangements without undue cost and complexity.

Taxation will of course be a relevant factor in establishing an appropriate strategy for holding investments, as it is for establishing any other business. However, it does not follow that the use of holding companies by private equity funds represents treaty abuse, which seems to be a misconception held by some outside of the industry. It has been seen that investors into private equity are largely institutional investors which would usually be considered to be "good" residents under double taxation agreements. Therefore, for example, to the extent that any holding structure reduces source jurisdiction withholding tax by virtue of double taxation agreements, in the majority of cases it is likely that this simply has the effect of reducing administrative cost for both the source fiscal authority and the investor in obviating the need to reclaim withholding tax. This could hardly be considered to be abusive. In addition, fund documentation will typically prevent the manager from favouring one group of investors over another, so it would be extremely unlikely that a holding structure would be formed, for example, to facilitate avoidance for any particular population of investors. Furthermore, the diverse nature of the investor base in a typical private equity fund means that it would be impractical for a fund to be used to facilitate avoidance, as a fund manager will not possess sufficient information with which to ascertain the consequences of a particular course of action on all of the investors.

Taking the above comments together, it can be seen that private equity funds are entirely commercially arrangements formed for the purpose of collective investment and risk diversification. They make a significant contribution to the real economy. They are not vehicles for tax avoidance.

3. The Public Discussion Draft dated 21 November 2014

3.1. Paragraphs 15 to 17 of the Public Discussion Draft deal with alternative and private equity funds.

Private equity, hedge, infrastructure, real estate, and other alternative investment strategies all have distinct features. It is unlikely that a single solution for granting appropriate treaty access to all of these fund types will be found. Each must be considered separately if it is to be properly accommodated and investment capital for underlying businesses maintained.

3.2. Paragraph 15 highlights certain features of the definition of collective investment vehicle set out in the 2010 Report on The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles and concludes that "Alternative funds / private equity funds generally do not meet these conditions because they typically have a limited number of institutional investors, may not hold a diverse portfolio and are not subject to the same investor-protection regulation".

The BVCA agrees that certain features of private equity are different to other funds which may fall within the definition of a CIV fund. However, taking the three broad areas highlighted in Paragraph 15 in turn:

- As discussed above, private equity funds typically *do* have a diverse investor base, both in terms of the source jurisdiction of invested capital and the organisational nature of the investors;

- As discussed above, private equity funds typically *do* hold a diverse portfolio; and

- Private equity funds are subject to significant regulation (as are CIV funds). Within the EU regulation in this area comes mainly from the Alternative Investment Fund Managers Directive. The fact that the Directive operates over the manager of the fund rather than the fund itself does not mean that investors are exposed to an environment which is entirely free of regulatory supervision. Similarly, in the United States private equity funds and their advisers are subject to extensive regulatory supervision, arising from a range of provisions including the U.S. Securities Act of 1933, the Foreign Corrupt Practices Act, and the U.S. Investment Advisers Act of 1940 as amended by the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, amongst others.

These observations are important as they underline that private equity funds simply do not exist to facilitate tax avoidance or evasion for any investor or set of investors, should that view persist; private equity is a genuine investment strategy chosen by a broad range of investors, it provides genuine investment into portfolio businesses, and is subject to extensive regulatory scrutiny. In this broad sense private equity funds are no different to CIV funds and have the same commercial validity.

Notwithstanding that private equity funds share certain broad commercial features with CIV funds, it is important to make clear that the solutions proposed for dealing with treaty challenges for CIV funds cannot readily be adopted by private equity funds. These solutions are largely based on the TRACE project, which developed proposals which were designed to apply to CIV funds, which explicitly excluded private equity. Having not been designed to apply to private equity, a TRACE solution cannot readily be adopted by private equity; private equity was not represented during the development of TRACE.

This highlights one of the differences between CIV funds and private equity funds: CIV funds operate in an environment where service providers offer fund platforms, paying agent services, and intermediary services (for example) to support the operations of the funds, but these roles largely aren't required by private equity funds. As such, the manager would be required to operate TRACE.

Private equity fund documentation does not grant the manager of the fund the necessary power to obtain the information which would be necessary in order to operate TRACE in any form, and managers do not have the systems and processes in place to deal with such information if they could access it. As described above, private equity funds typically exist for periods of around ten years. Even if funds raised after the conclusion of the BEPS work on Action 6 began to include terms which could facilitate the operation of a system like TRACE it would be many years before such terms were observed in the majority of funds. For these reasons we consider that the proposals made in sections 4 and 5 below are preferable to any solution modelled on CIV funds.

3.3. Comments are invited on whether the Public Discussion Draft accurately describes the treaty entitlement issues for private equity funds and how to address these issues without creating opportunities for treaty shopping. We have provided these comments below.

3.4. Section 17 of the Discussion Draft invites examples which could be included in the Commentary on the PPT rule. These are provided in section 5 below.

4. Limitation on Benefits

For the reasons set out above, private equity funds will rarely if ever hold an investment directly – it will usually be held via an intermediate holding company which will ensure consistency of treatment amongst investors. Because of this, in what follows references to private equity funds include references to their controlled holding structures, which need to be accommodated as part of a solution which seeks to maintain treaty access for private equity and the viability of private equity as a source of international capital investment.

4.1. Treaty entitlement issues for private equity funds

Private equity funds would largely fail to qualify for treaty benefits under the draft LOB provisions because they:

- Would not usually be listed on a recognised stock exchange;
- Would not be carrying on an active trade or business as defined; and
- Could not avail themselves of the derivative benefits provisions because of the diversity of ownership outlined above.

The above points set out the technical issues which arise in considering how a private equity fund would be seen as measured by the draft LOB. However, of course, the underlying and more meaningful issue is an economic one: if action on treaty abuse makes international investment into private equity less attractive then investment may fall, and the private equity fund industry and the support it provides for the real economy may contract as a result.

4.2. *How treaty entitlement issues for private equity funds can be addressed without creating opportunities for avoidance*

We believe that private equity/non-CIV funds should be explicitly excluded from the LOB work under Action Point 6 such that their ability to access treaty benefits is not compromised. However, in the event that the OECD are unable to accept this recommendation we set out below an alternative proposal. An additional category of qualified person would be required, to include the concept of a qualified fund. The four broad features of a qualified fund test would be:

A - Diversity of investors. The fund would be intended to be diversely held and would be marketed appropriately.

B - Appropriate regulation. The fund or manager, as appropriate, would be regulated by a recognised regulator.

C - Substance. Any holding structure would be subject to a minimum standard of investment in the local economy, measured perhaps in terms of locally incurred expenditure commensurate with investment activity.

D - Reporting. In order to be a qualifying fund, the fund would elect to participate in a reporting regime developed from existing mandatory reporting requirements. This reporting regime would be designed to deliver information about investors and underlying investments.

Of course, work would be required in order to refine this regime so that it could be included in the model LOB. However, in principle it is clear to see that such features would minimise the possibility of treaty abuse being facilitated by private equity funds. Taking the features in turn:

- The diversity of investors condition would ensure that a fund could not be used for purposes of treaty abuse by, say, a single dominant investor or indeed for any group of investors, bearing in mind the diversity of jurisdictions and entity types which contribute capital to private equity and the requirement to not favour any group of investors over another.

- Appropriate regulation will provide comfort that only genuine investment business qualify for the qualified fund definition. In this regard we would note that the administrative burden and financial cost of obtaining appropriate regulatory approval would act as a significant disincentive to abusing the qualification.

- The substance condition should provide comfort that holding structures are not mere “shells” and that real business is being carried on – businesses cannot support unproductive costs.

- This reporting regime once developed should provide comfort to source jurisdiction fiscal authorities that no significant treaty abuse is occurring. If over time it became apparent that abuse was occurring then we accept that further action may be necessary – but we do not believe that this will be the case.

We would be pleased to work with the OECD to develop this proposal further.

As stated above, we do not consider that any solution based on the principles of the TRACE project could be a practical solution for private equity funds.

5. Principal Purposes Test

5.1. Treaty entitlement issues

While we support the approach of having a PPT (and not a LOB) as part of a minimum standard, the current proposals are not conducive to international business because they do not provide reasonable certainty for any party to an investment transaction. While of course the BVCA supports the aims of the work to prevent treaty abuse, the outcomes must also balance the need to support international investment, and we consider that, as currently drafted, an appropriate balance has not been reached.

As described above, private equity operates internationally, and all international funds will have experienced how different fiscal authorities view substantially identical fact patterns differently, leading to different treaty qualification outcomes. The current proposals will do nothing to alleviate this challenge and will indeed exacerbate the problem.

The main deficiency in the current proposals is that the PPT currently refers to “one of the principal purposes”. The commentary recognises that the test is subjective, but there is nothing which adequately explains the boundary between an acceptable activity of merely considering the tax consequences of a particular course of action on the one hand, and that consideration rising to become an unacceptable principal purpose on the other. It is inevitable that different tax authorities will interpret the test differently given the same set of facts. As a matter of principle all parties to the BEPS process should consider this to be an unacceptable outcome in designing an appropriate PPT.

Principle 1.4 of the G20/OECD High-level principle so long-term investment financing by institutional investors report[5] concludes that "Investment frameworks should as far as possible be made consistent across counties to facilitate the cross-border flow of long-term financing". As currently drafted the PPT will not ensure consistency across countries.

We consider that the PPT should be drafted so as to be a test of *the* principal purpose of an arrangement. We accept that this is a stricter standard which will require greater effort to apply. However, only by modifying the PPT in this way can the subjectivity which will be a barrier to international investment be minimised.

5.2. Example for inclusion in the Commentary

The following examples are provided on the assumption that the PPT remains in substantially the form as currently proposed.

The experience of our membership is that certain fiscal authorities will interpret the same facts aggressively whereas others will be satisfied that no treaty abuse is occurring. As noted above, it is vital that the commentary delivers a PPT which is not only workable but will be applied consistently across all BEPS participant jurisdictions. It is therefore necessary to include a range of examples in the commentary, in order to deliver this consistency.

Example A: a fund structured as a limited partnership, which is not resident in any state, is marketed to a diverse range of potential investors and as part of this fundraising process indicates to potential investors that investments will be held via intermediate holding companies. In due course the fund is raised and it is necessary to form an intermediate holding company in anticipation of making a particular investment in a company in State S. The fund manager considers a range of potential jurisdictions for the intermediate holding company and as part of this process considers the treaty positions of companies in each potential jurisdiction as well as staff costs, property costs, regulatory costs, etc. The holding company is ultimately formed in State T.

Taking into account the fact that the investors into the fund and therefore into the holding company are diverse in jurisdiction and in nature, the fact that treaty entitlement was considered as part of the decision to form a company in State T rather than any other state cannot not mean that treaty entitlement was a principal purpose of the arrangement; the holding company is not formed for the treaty abuse purposes of any investor or group of investors. The diversity of the investor group is a strong indication that obtaining treaty benefits was not a principle purpose of the arrangements.

Example B: same facts as Example A, but the fund manager is aware that a significant majority of investors into the fund are of a type which would not be entitled to treaty benefits in respect of an investment into State S, and furthermore there is no identifiable

[5] http://www.oecd.org/daf/fin/private-pensions/G20-OECD-Principles-LTI-Financing.pdf

commercial purpose to establishing a holding company for this investment. Nevertheless the fund manager forms a holding company in State T in order to secure treaty relief for all investors.

The PPT applies but the holding company formed in State T may not avail itself of treaty benefits in respect of this arrangement.

Example C: same facts as Example A, but the fund manager decides to set up an intermediate holding company which will be used as a joint venture vehicle between the fund and one or several co-investors for the purposes of investing into one or several specific assets. An intermediary holding company or a chain of intermediate holding companies may also be set up to provide for structural subordination between different external financings (e.g. mezzanine loans).

In these circumstances, the set-up of the intermediate holding company or the chain of intermediary holding company is mostly driven by legal and commercial reasons.

Obtaining treaty benefits should thus not be considered as being one of the main purposes of the arrangements.

6. Conclusions

To reiterate our main comments above:

- Private equity funds represent an important source of capital for businesses and have a positive impact on the real economy.

- Private equity funds are diversely held. The majority of capital committed to private equity funds is sourced from pension funds and other institutions which would usually be considered to be "good" treaty beneficiaries. Private equity funds are not vehicles for treaty abuse or tax avoidance more generally; they are vehicles formed for genuine investment and risk diversification.

- The LOB test as currently drafted would have the effect of removing treaty benefits for holding companies owned by private equity funds. This would reduce returns to investors and potentially expose them to double taxation. Given that pension funds represent the largest grouping of investors into private equity funds, it is pensioners, largely in the United States and the United Kingdom, who will bear the cost of this double taxation. In the longer term there is a risk that investment into private equity funds and therefore into the real economy falls as a result.

- We have put forward a proposal to include a concept of a "qualified fund" as part of the LOB test. We appreciate that it would take time to develop the details of such an additional qualification. If the OECD feels that there is insufficient time to properly deal with this then we would ask that private equity funds are carved-out of the current proposals and the status quo maintained until such time as treaty entitlement for private equity can be properly addressed.

- The PPT as currently drafted is excessively subjective and will result in fiscal authorities reaching a range of inconsistent views on similar sets of facts. The OECD have recognised that inconsistency is undesirable in itself. The solution to this issue is not further commentary and examples as this will just change the nature of the subjectivity. The PPT should be amended to be a test of the (single) principal purpose of a particular arrangement.

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. The BVCA has registered to attend the consultation meeting on 22 January.

Yours faithfully,

David Nicolson

Chairman of the BVCA Taxation Committee