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## **BVCA response to the OECD consultation – Secretariat Proposal for a “unified Approach” under Pillar One**

The British Private Equity and Venture Capital Association (“BVCA”) welcomes the OECD’s efforts to develop a consensus solution to the tax challenges arising from the digitalisation of the economy and are pleased to have the opportunity to comment on its public consultation document “Secretariat Proposal for a “Unified Approach” under Pillar One” (the Condoc).

The BVCA is the industry body for the private equity and venture capital industry in the UK. With a membership of over 750 firms, the BVCA represents the vast majority of all UK-based private equity and venture capital firms, as well as their investors and professional advisers. Over the past five years (2014-2018), BVCA members have invested over £38bn into nearly 2,800 companies based in the UK. Our members currently back around 4,330 companies, employing close to 1.6 million people on a full-time equivalent basis (“FTEs”) across the world. Of these, around 843,000 FTEs are employed in the UK. Of the UK companies invested in during 2018, around 87% were SMEs.

What differentiates private equity and venture capital funds (PE/VC funds) from many other sources of financing is the active involvement of the manager in advising on the running of the businesses invested in, strengthening management expertise, delivering operational improvements and/or helping companies to expand into new markets. This active approach is also employed in helping underperforming companies to survive, protecting jobs and delivering successful businesses with a strong future.

A significant proportion of private equity and venture capital funding comes from pension funds and insurance companies who invest the pensions or savings of millions of citizens across the world. Private equity and venture capital is a key asset class for these long-term investors, as it generates capital gains on a consistent basis over the long-term. This is important, not least against the backdrop of changing demographics and in today’s low yield environment.

### **Summary of Key Concerns**

The apparatus of a PE/VC investment fund generally consists of four key components – the fund, the investee businesses (referred to as a portfolio company), the investors and the fund manager. Where these portfolio companies are themselves consumer facing businesses they will be subject to the proposed new Pillar One regime in the same way as other MNEs. This is accepted and we certainly welcome the OECD’s efforts to bring uniformity to the approach taken to digitalisation in this respect.

However, the characteristics of the PE/VC fund holding these MNE’s together with its fund manager are such that very careful crafting of the rules, in particular any potential financial services carve

out, will be key to ensure that the industry is not inappropriately bought within scope of the regime. We have outlined below our key concerns in this respect. Further detailed commentary in respect of these concerns is attached as appendix 1.

## **1. Definition of MNE Group**

As noted above, it is recognised that where they are large the portfolio companies of PE/VC funds are likely to themselves be MNEs that are within the scope of Pillar One. However, these portfolio companies operate as entirely separate businesses and should not be considered as a single enterprise simply because of the private equity/venture capital fund's common holding, such that, for example, the separate "portfolio companies" revenues are combined when ascertaining whether the revenue threshold is met.

## **2. Scope**

### *The fund vehicle*

The fund itself is a collective investment vehicle, with investors receiving interests in, rather than goods or services from, the fund. By their nature, the investors are not consumers. As discussed further in appendix 1, the role of these investors is more akin to a passive shareholder in a company rather than a consumer of services. As the fund has no consumers, it is not an enterprise within the scope of the rules.

This should be put beyond doubt by ensuring that the fund vehicle is within any exemption for financial services. If no general exemption for financial services is provided, then it will be crucial that the definition of the term "consumer" clearly excludes investors.

### *Fund management*

If the OECD adopts an exemption for financial services, it is critical that fund management falls within this. This is for the following reasons:

- Private equity and venture capital is a crucial pillar of the financial services industry providing access to capital for businesses as they grow. As noted above, the industry injected €80 billion of capital into UK and European businesses in 2018 alone. Like other financial services (e.g. banking and insurance), fund management is highly regulated: a fund manager is subject to significant regulatory oversight under UK and EU law (i.e. the Alternative Investment Fund Managers Directive).
- Fund management services are provided to the private equity and venture capital funds (or their general or managing partners, which are business entities). Therefore the customer of such services is not a "consumer".
- Even if a look through approach was adopted such that the fund itself was ignored, investors in PE/VC funds are not mere recipients of goods or services – by investing in the funds, they become the owners of the funds. They will typically be entitled to share in the majority of any profits or gains realised by the funds; ordinarily they will have limited governance rights over the fund and are not actively involved in the management of the funds' investments, they will however have information rights in respect of the funds' investments. In this regard investors are more akin to passive shareholders than consumers.

- More importantly, the significant majority of investment made by investors in PE/VC funds is by institutions (predominantly pension funds, insurance companies and sovereign wealth funds) and are not consumers. Indeed, in 2018 only 2.6% of investment in private equity and venture capital in the UK came from private individuals. Where, an alternative investment fund does admit individual investors, these will typically be highly sophisticated and invest in a professional or quasi-professional manner (in line with regulation governing the marketing of these funds). Such investors will ordinarily agree to invest in funds only after careful due diligence and following arm's length, business-to-business discussions/negotiations with the manager or promoter of the fund and so should not be considered "consumers" in this context.
- All of the above is, we would submit, a world away from the kind of cases at which the "Unified Approach" is aimed, where consumers are purchasing goods or services "passively" from businesses operating through on-line presences and there is scope for generating profit from the asymmetric nature of the relationship (including in the case of multi-sided business models).
- The strict regulation of fund management means that fund managers are careful not to carry out regulated activities outside of their jurisdiction(s) of regulation. There is a risk that the requirement to file local tax returns and register locally could extend to other local compliance burdens or, in a worst case scenario, give rise to concerns that the fund manager should be subject to financial services regulation in the taxing jurisdiction too. This risks adding costly and duplicative layers of regulation in an already highly regulated industry.

In any case, the structure and operation of a fund manager should be driven by commercial requirements. They should not be disincentivised from carrying out activities outside of their home jurisdiction through concern that, if they have a taxable nexus in other jurisdictions, they will need to incur time and resource getting advice as to why such presence does not require regulation.

- The fund management industry is not highly digitised and, unlike the business models which appear to be the original target of the digitalisation project, is not based on the use of intellectual property held outside home jurisdictions to enable remote selling.

Rather, on the whole asset management is primarily an advisory business that succeeds because of the advice given by its individual fund management teams who help to identify portfolio companies, negotiate to acquire them, deliver/advise on operational improvements and – in the long term – work towards an exit to help deliver value to the fund on behalf of its investors. The fees payable to a fund manager reward this people functionality and so it is a business model where all or substantially all the profit should be categorised as routine profit or non-reallocable non-routine profit.

### **3. Double Taxation**

As an overriding principle, it is critical for all businesses that are within the scope of the new rules that there should be no double taxation on the same profit, that the re-allocation of profit and the process for tax filing is as straightforward as possible and that where tax is due on Amount A, credit should be given simultaneously in the jurisdiction of residence of the MNE's parent company or other appropriate jurisdiction.



#### 4. Complexity and compliance burden

For all businesses affected by the Unified Approach, their tax affairs will become more complex, more uncertain and subject to challenge by competing jurisdictions; inevitably, tax authorities would also be drawn into the uncertainty.

We would very much welcome the opportunity to meet in person to discuss our response in more detail and would be happy to walk through any of the characteristics of our industry that we have outlined in this letter. Please contact [Chris Elphick](#) for further information.

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'Mark Baldwin', with a long horizontal flourish extending to the right.

Mark Baldwin  
Chairman of the BVCA Tax Committee

## Appendix 1

### Detailed commentary on the Questions for public comments

#### 1. Scope

##### A. Overview of private equity and venture capital sector

PE/VC funds act as vehicles into which a diverse group of investors can pool their capital and access investment opportunities in the private markets that may not otherwise be available to them. Private equity and venture capital has a broad investor base with the majority of investments being by institutional investors: pension funds, sovereign wealth funds, insurers and fund of funds provide the majority of funding.

Investment from private individuals typically forms an extremely small minority of overall investment and, to the extent it is present, will almost always be by sophisticated investors, rather than "retail" investors<sup>1</sup>. In Europe, this is reflected in the regulatory regime that applies to the fund and its manager (the AIFMD rules rather than the retail-focused UCITS rules). This is discussed in more detail in section D below.

##### B. PE/VC fund vehicles

PE/VC funds are simply pooling vehicles to facilitate collective investment. Participants in funds are investors and should not be considered consumers. A participant in a PE/VC fund will contribute capital in return for an interest in the fund, which will then use that capital to make investments. A participant will then be entitled to their share of the profits (if any) of the investments made by the fund. This business model is entirely different from the "consumer-facing" businesses targeted by the Pillar One proposals.

In this regard, we note that the paragraph 20 of the consultation document states:

*"This supports the idea that the proposed "Unified Approach" should be focused on large consumer-facing businesses, broadly defined, e.g. businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element[.]",*

and that the footnote to paragraph 19 states:

*"The term "consumer" generally refers to individuals who acquire or use goods or services for personal purposes (i.e. outside the scope of a professional or business activity), while the term "customer" generally includes all recipients of a good or service (including business customers that are not end-users)."*

It is thus clear that PE/VC funds are not intended to, and do not, fall within the category of consumer-facing businesses targeted by the Pillar One proposal and, accordingly, we strongly recommend that such funds are expressly exempted from that regime.

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<sup>1</sup> In 2018 in the UK, pension funds provided 39% of all capital raised followed by fund of funds (13%), sovereign wealth funds (10%), and insurance companies (10%). As stated previously private individuals make up only a small amount (2.6%). Please see our [Report on investment Activity 2018](#) for further information

If no general exemption for financial services is provided or, contrary to our recommendation, such exemption does not include PE/VC funds, then it will be crucial that the definition of the term "consumer" makes it clear that it does not include investors in funds.

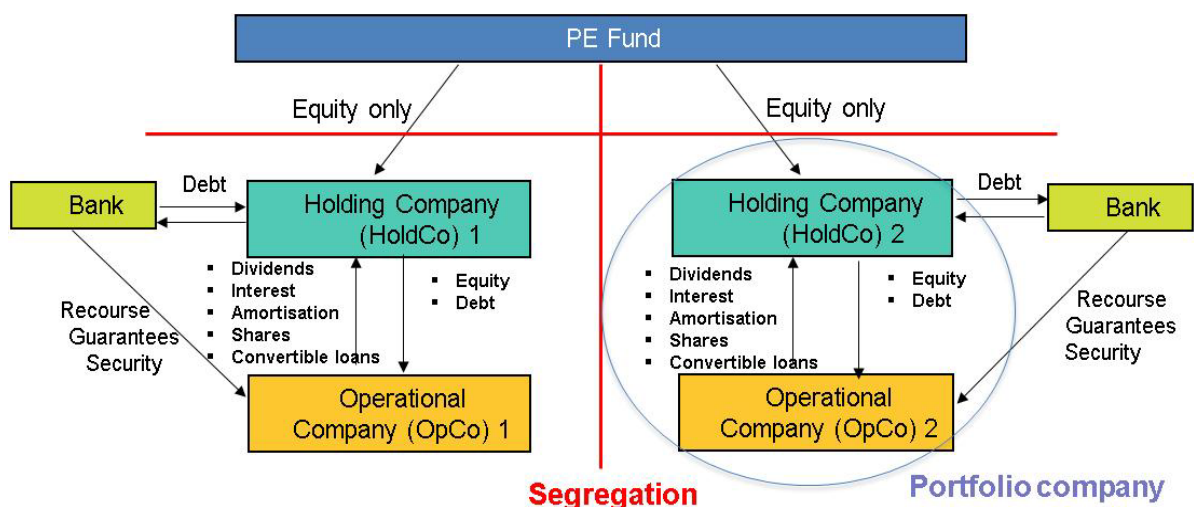
### C. Portfolio companies

As noted above, we recognise that portfolio companies which are themselves MNEs should be subject to the proposed new Pillar One regime in the same way as other MNEs.

Although the Condoc does not specifically discuss how "MNE group" should be defined, it is implicit from the discussion of the determination of Amount A, where the group's consolidated financial statements are the proposed starting point (see paragraph 53 of the Condoc), that such statements will also be the basis of the definition of "MNE group".

In this respect, it is key to note that in operating the fund the various portfolio companies of the fund are viewed as separate investments, the majority of PE/VC funds do not, and are not required to, prepare consolidated accounts. In principle therefore, provided the same approach is taken as was taken in relation to CBCR (i.e. the fund was not required to consolidate in portfolio companies) we support the use of consolidated accounts as a starting point.

This is important because it allows clear ring fencing of liabilities to ensure cross contamination risks are managed and an inability for profits/losses from one portfolio investment to be offset/pooled with that of another. An illustration of this relationship is provided below.



Here, it is key to reiterate that the aim of private equity and venture capital funds is to put their portfolio companies on a sustainable growth path, with a holding period on average between five and seven years. It is also important to note that funds do not always take control positions.

Against the backdrop of the segregation of and relatively temporary nature of the relationship between funds and their portfolio companies, it seems to us that private equity and venture capital funds are clearly different in nature from MNE Groups.

As such, it is very sensible that the majority of funds are not required to consolidate entities and would not have any requirement to produce consolidated accounts. Any change/approach that would require them to do so would be at odds with the commercial reality (see above) and with the

applicable accounting practices and would result in significant annual cost across the portfolio to collate and verify the data as entities are bought and sold in the portfolio.

As such it will be critical to ensure that the portfolio companies of PE/VC funds are not considered to be a single enterprise simply because of their common ownership, such that, for example, their revenues are combined when ascertaining whether the revenue threshold is met.

In this regard, the approach taken in relation to country-by-country (CBC) reporting should be followed, where it is acknowledged in the OECD's guidance (Part III, section 1 (*Application of CbC reporting to investment funds (June 2016)*)) that where the accounting rules for investment funds instruct funds not to consolidate portfolio companies those portfolio companies should not form part of a group for CBCR purposes with either the fund or separate portfolio companies.

#### **D. Fund managers**

Fund management enterprises should be out of scope of the Pillar One regime for the reasons set out below.

##### **Highly regulated financial services**

Firstly, we understand that an exemption for financial services may be introduced. Private equity and venture capital is a fundamental pillar of the financial industry, providing crucial access to funding for businesses.

Like other financial service providers (e.g. banks and insurers) the fund management industry is highly regulated, providing a high level of protection for investors.

In the European Economic Area, the Alternative Investment Fund Managers Directive (AIFMD) regulates the management and marketing of alternative investment funds (AIFs). The Directive creates a comprehensive and effective regulatory and supervisory framework for Alternative Investment Fund Managers (AIFMs) at EU level.

AIFMs are required to obtain authorisation and are subject to on-going regulation and supervision. In this way, the AIFMD:

- Increases the transparency of AIFMs towards investors, supervisors and the employees of the companies in which they invest;
- Equips national supervisors, the European Securities & Markets Authority (ESMA) and the European Systemic Risk Board (ESRB) with the information and tools necessary to monitor and respond to risks to the stability of the financial system that could be caused or amplified by AIFM activity; and
- Increases the accountability of AIFMs holding controlling stakes in companies towards employees and the public at large.

The AIFMD introduced safeguards to ensure that investors in alternative investment funds, are well informed and adequately protected. For example, the AIFMD requires that:

- Reasonable steps are taken to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, where applicable, disclose such conflicts;
- AIFMs employ adequate systems to manage risks to which the fund is exposed, and to ensure that the liquidity profile reflects the obligations towards investors;



- A fund's assets are safe-kept, or monitored, by an independent depositary subject to a high liability standard;
- AIFMs have appropriate and consistent procedures for proper and independent valuation of the AIF's assets; and
- Strict conditions are met when AIFMs delegate functions to third parties.

Looking ahead, from August 2021 AIFMs will be subject to further regulatory requirements, by way of Directive (EU) 2019/1160 and Regulation (EU) 2019/1156 (known as the “Omnibus proposals” and part of the European Commission’s wider Capital Markets Plan) which will amend the existing AIFMD regime in respect of the cross-border distributions of collective investment undertakings in the EU. The existing AIFMD is also under review, with the European legislative amendment process beginning towards the end of 2020.

Funds and managers in other jurisdictions will have their own regimes that address many of the same issues that are covered by the AIFMD in a manner consistent with local circumstances.

In addition, the Markets in Financial Instruments Directive (MiFID) regulates many EU portfolio managers and investment advisers. Such firms are required to obtain authorisation and are subject to organisational and conduct of business requirements as well as on-going supervision. In particular, MiFID includes strict rules for the protection of investors including:

- a requirement to act honestly, fairly and professionally in the best interests of clients;
- a requirement to prevent or manage conflicts of interest; and
- information and disclosure requirements.

Regulatory capital requirements will also generally apply to such firms. The forthcoming Investment Firms Regulation and Investment Firms Directive are expected to impose further requirements for MiFID investment firms including EU portfolio managers and many EU investment advisers.

### **Investors invest and do not “consume”**

Second, as described above, fund management services are provided to PE/VC funds (or their general or managing partners) rather than to any particular investor. A PE/VC fund (and its general or managing partner, which will be a business entity) clearly does not fall within the definition of “consumer” and so, fund management is outside the intended target of the Pillar One regime.

Although it is investors who indirectly bear the cost of fund management fees, as mentioned above, the significant majority of investment is made by institutional investors (predominantly pension funds, insurance companies and sovereign wealth funds), with any investors who are individuals typically being sophisticated and investing in a professional or quasi-professional manner (as governed by the regulation governing the marketing of such funds). Accordingly, even if investors are considered customers of a fund manager, they should not be considered “consumers”. The role of these investors is more akin to a passive shareholder in a company rather than a consumer of services.

### **Fund management Returns (whether day-to-day or performance linked) are best characterised as routine profit or non-reallocable non-routine profit**

Third, the value provided by fund management services reflects time spent by investment professionals in their home jurisdiction (and is not based, for example, on the use of digital





technology or intellectual property held outside of the home jurisdiction to enable remote selling) and so profits received for such services should be taxed there.

Fund managers are very much linked to their home jurisdiction. They will be subject to stringent regulatory requirements there, including the need for regulatory capital and sometimes pay regulation. The team identify investment opportunities and then help to deliver operational improvements to portfolio companies in order to secure investor returns. These people-driven, geographically confined activities mean that the profits arising from fund management services are best characterised as routine profits or non-re-allocable non-routine profits not targeted by the new taxing right.

### **Risk that local taxpaying results in wider compliance or regulatory burdens**

Fourth, the strict regulation of fund management means that fund managers are very careful not to carry out regulated activities outside of their jurisdiction(s) of regulation. If the Pillar One regime were to mean that fund managers have a taxable presence in other jurisdictions, this would potentially put pressure on regulators in such other jurisdictions to start regulating fund managers. This risks adding costly and duplicative layers of regulation in an already highly regulated industry. In addition, even if no further regulation is introduced, fund managers may be disincentivised from carrying out activities outside their home jurisdiction out of concern that, if they have a taxable presence there, they will need to incur time and resource getting advice as to why such presence does not require regulation.

A corollary of the second and third points above is that were fund management to be within the scope of the Pillar One, in practice this would raise little or no revenue susceptible to the new taxing right but would generate a significant tax compliance burden for the fund management industry.

If no general exemption for financial services is provided or, contrary to our recommendation, such exemption does not include fund management, then it will be crucial that the definition of the term "consumer" makes it clear that sophisticated individuals acting as investors in PE/VC funds are not considered consumers of the funds' fund managers.

### **E. Threshold**

We consider that aligning the Pillar One threshold closely with that applying to CBCR would be a sensible outcome. Certainly, given the compliance burden which the new taxing right will generate, we do not consider it appropriate to apply it to enterprises falling below that revenue threshold.

### **Questions 2 – 7 of consultation document**

We have discussed above the characteristics of funds and their managers and why we believe the should not be within the scope of the new taxing right. However, we would make the following points about the operation of the new rules more generally.

#### **2. Nexus**

As noted above, transactions involving funds should not be within scope of the new rules. It is critical that the legislation is crafted such that asset management is either exempt from Pillar One or, at a minimum, confirmation is given that investors in a fund are not "consumers", rather their interest is more akin to that of a passive shareholder.

Provided our recommendations above are followed, no specific nexus considerations should apply to funds and/or their investors. However, for completeness of response, we would note that significant complexities would arise in particular if investors or a sub class of investors were brought into scope.

Primarily, the concept of creating a taxable nexus for an Asset Manager in respect of transactions with all or a subset of its investors, in particular where those investors constitute a small proportion of their committed capital, would create significant compliance costs which could create disincentive for Asset Managers in seeking investment from investors in territories in which they have no physical presence. The disincentive for Asset Managers would clearly be harmful and create market distortions.

Where businesses are in scope setting appropriate revenue thresholds will be key to reduce complexity and compliance costs for MNEs. If territorial revenue thresholds are set at too low a level this would create significant compliance cost for businesses selling into those territories that are disproportionate to their revenues.

### **3. Calculation of Group profits**

In respect of the calculation of profit we agree with the approach outlined in the consultation document proposing consolidated accounts as the starting point for this calculation. As noted above a key issue here will be ensuring that the MNE group is defined appropriately to avoid aggregation of separate portfolio companies.

In addition we would note that:

- Whilst we agree in principle with the use of consolidated accounts of an MNE group, this approach is likely to give rise to significant complexity. For example a group could have a consolidated profit whilst the company in the home territory could be loss making on a stand alone basis.
- Likewise, any segregation of a business into stand alone business lines will inevitably need to be industry specific which will lead to complexity and inconsistency. Clear guidelines will be needed outlining how such segregation will take place and who will be responsible for deciding what segments should exist within the MNE.
- Detailed discussions around what adjustments are required to accounting profits to cover matters such as depreciation, deferred tax, interest costs, employee incentives etc. will be needed. Adjustments of this nature could lead to MNE groups incurring tax costs which are not representative of economic profit.
- Certain businesses are subject to significant fluctuations in their business profits – how should such business profits be smoothed to mitigate the impacts of these variations? Should an average over a number of years be taken?

### **4. Determination of Amount A**

There are a number of complexities here in understanding not only how routine and residual profits should be identified but in determining what constitutes a market, what allocation keys are used to distribute those profits, how you identify the surrendering and home territory and how losses should be dealt with.

We see a significant potential risk for taxpayers as it would make them vulnerable to contest from countries on both calculation and allocation. This would lead to not only more uncertainty for taxpayers as to their tax position but an inevitable increased compliance cost for MNEs.

#### **5. Elimination of double taxation in relation to Amount A**

As discussed, a fundamental concern with the Pillar One proposals is ensuring that all businesses within scope should not be subject to double taxation on the same profit. The structure and operation of existing domestic double taxation relief rules and the network of double tax treaties utilised by MNEs are unlikely to function in this respect.

In addition, it will be imperative that the mechanism for filing and collecting of any tax, particular in countries where the MNE has no existing presence, is as simple as possible. One possible solution would be to require the home territory to report tax due under Amount A to its local tax authority together with the calculation of how it should be reattributed. The local tax authority would then share the reattributed amounts with the tax authorities in the consumer jurisdiction rather than this filing being done by the business – effectively building on the tax authority sharing model that has already been introduced in the context of CRS.

#### **6. Amount B**

We see a clear need to better understand what constitutes marketing/distribution, particularly in the context of an a fund management business which may operate a mixture of both closed and open ended funds.

#### **7. Amount C/dispute prevention and resolution**

It is imperative that any dispute resolution mechanisms put in place in respect of the Unified Approach Proposal apply not only in relation to Amount C but all aspects of the new taxing right. As highlighted in our comments above, Amount A is open to scrutiny/disagreement not only in how it should be calculated, but how that amount should then be allocated. It is unlikely that existing mechanisms will be sufficient to deal with the complexities of the proposal.