BVCA

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By email: taxtreaties@oecd.org

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Dear Sirs

Re: BVCA response to revised discussion draft on BEPS Action 6: Preventing treaty abuse

Introduction

I am writing to you on behalf of the British Private Equity and Venture Capital Association (the "BVCA"), which is the industry body and public policy 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. 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 discussion draft

We are pleased that the discussion draft, the third issued so far in relation to Action 6, recognises the importance of non-CIV funds to the global economy. With this letter we have responded to each of the discussion drafts and also attended the meeting in January. It is clear from the discussion draft that significant effort is still required in order to finalise the work, highlighted by the fact that the discussion draft is not a consensus document. We remain committed to working with the OECD to provide insight into the private equity investment model, in order that the OECD can achieve its aims under Action 6 without doing disproportionate harm to the private equity funds market.

We remain concerned that if a workable solution cannot be found for the issues related to treaty access for non-CIV funds then it may well result in a reduction in i) returns for the investors in such funds; and ii) the availability of finance for businesses across the world. With pension funds being a key investor group and private equity contributing to the development of businesses, the detrimental impact on the real economy and individuals would be significant. With this in mind we note that the Working Party considers that the suggestions made by the BVCA and others in response to the previous discussion draft and also those made at the January meeting did not sufficiently take account of treaty shopping concerns. We understand that these concerns are twofold: i) that non-CIVs may be used to provide treaty benefits to investors that are not themselves entitled to treaty benefits and ii) that investors may defer recognition of income on which treaty benefits have been granted (which is, of course, not a treaty concern).

These two concerns are misplaced in the context of private equity funds for reasons explained previously and reiterated below. Should these concerns persist following the responses to the current discussion draft then we would welcome an opportunity to discuss with the OECD the source of their concerns and the reasons why previous responses – both in respect of explaining why the concerns may be misplaced and also suggesting ways forward – have not been accepted, as without this insight it is difficult to make proposals which the Working Party could accept. Taking the two concerns separately:

Non-CIVs may be used to provide treaty benefits to investors that are not themselves entitled to treaty benefits

- Private equity funds are closed ended investment vehicles formed for the purpose of investing in, broadly, unlisted securities in operating businesses. They are not formed for the purpose of delivering treaty benefits or any other form of tax avoidance. Indeed the constitutional documents of private equity funds prevent the manager from acting in a way which would favour one investor over another. However, that said, private equity funds do invest via intermediate holding companies but this is not purely for tax avoidance purposes. Instead, holding companies are used for a variety of commercial, legal and tax reasons including facilitating third party leverage, co-investment, management incentivisation, administrative convenience and consistency, and legal liability protection. In considering the location of such companies tax is of course considered, as it would be for any other business, but this does not mean that the use of a holding company indicates treaty abuse.

  As set out in our January 2015 submission, the vast majority of investment into private equity funds comes from investors who would generally be able to avail themselves of the benefits of tax treaties entered into by their jurisdictions of residence, including pension funds, sovereign wealth funds and high net worth individuals. Moreover, at present the majority of investment in private equity funds is generally derived from jurisdictions with wide treaty networks including the United States, the United Kingdom, Germany and Canada.

- Private equity funds are subject to significant regulation as well as commercial and reputational pressure. They do not operate in an environment which would facilitate these arrangements to be marketed for the purpose of tax avoidance.

- As discussed in our January 2015 submission, the commercial and regulatory environment in which private equity funds operate means that in some respects they are no different to CIV funds (in the sense that their managers are regulated and the funds are diversely held); fund managers already comply with extensive requirements under anti-money laundering and know your client procedures, and have extensive reporting obligations under FATCA and similar regimes such as the Common Reporting Standard.

Investors may defer recognition of income on which treaty benefits have been granted.

- Private equity funds are generally structured both legally and commercially to ensure that cash from distributions and exit proceeds received by the fund is distributed to investors as soon as practically possible. Typically there are very limited circumstances in which a fund can re-invest proceeds from the disposal of an investment, and these will be defined in the fund documentation. There may be no ability to re-invest proceeds at all.

- In addition to the protections afforded by the fund documentation, two related commercial features of private equity further highlight that funds are simply not designed to defer cash distribution. Firstly, investors will measure the performance of a fund (and allocate capital to subsequent funds) based on an internal rate of return calculation. Secondly, the carried interest model which incentivises the fund executives, is calculated on an internal rate of return basis. Together these are compelling reasons why a fund manager would not seek to defer the return of cash to investors.

- Beyond the reasons above, the nature of the investors into private equity funds – being largely pension funds and similar institutions – means that investors do not need to leverage their investments. As a result they have no requirement for regular distributions with which to service debt.

- Whether investors recognise income which is distributed to them is not within the control of the fund and should not be a relevant consideration in this discussion. It is not a treaty abuse issue. However, it is relevant to note that the vast majority of investment into private equity funds is ultimately sourced from pension funds, sovereign wealth funds and similar institutions which are typically exempt from tax, and for whom, therefore, deferral should not be a relevant concern.

LOB and alternative simplified LOB

The May discussion draft presents an alternative simplified LOB rule intended to be used in conjunction with the PPT. The alternative LOB rule includes an expanded derivative benefits provision which allows entitlement to treaty benefits to a non-qualified person whose direct or indirect owners are made up of more than 75% 'equivalent beneficiaries' (broadly individuals or entities who themselves would have access to the relevant treaty if participating in the relevant relationship directly).

While we welcome the broadening of the LOB concept, as currently drafted it does little to address our concerns around treaty access for non-CIV funds. Our fundamental concern is that the rules create a situation whereby it is no longer commercially sensible for a treaty qualified investor to make an investment through a private equity fund compared to making that same investment directly. Such a situation could well arise either where i) investing through a fund leads to that investor suffering foreign tax they would not otherwise have suffered, ii) there is uncertainty as to whether its share of investment returns should be subject to foreign tax or iii) where the investor's share of fund running costs is large enough to offset the benefits of investing in a managed vehicle.

As discussed below, the structure of the simplified LOB rule along with inherent practical difficulties in determining whether it is applicable mean that as currently drafted there is a risk that each of i) to iii) above will be realised.

Structure of the rule

The strict 'in or out' nature of the expanded derivative benefits provision means that it is possible that a treaty qualified investor investing through a fund could suffer foreign tax on investment returns from an underlying asset by virtue of the fund being made up of 75% or less equivalent beneficiaries. If such an investor were eligible for treaty benefits on a direct investment in the same asset then they are arguably putting themselves in a worse position by pooling capital through the fund to make that investment.

As it stands it would be difficult both from a constitutional and practical standpoint for the funds industry to solve this problem structurally by say segregating classes of investors into different vehicles depending upon their treaty status e.g. by grouping 'good' treaty investors in one vehicle and 'bad' treaty investors in another. Private equity funds often invest across a range of geographies and in a mix of assets (equity, loan notes, etc) potentially giving rise to numerous treaty qualification permutations across the investor base. In such a scenario there is no such thing as a 'good' treaty investor thus making it practically impossible for the fund manager to offer a product which gives investors any certainty that their foreign taxation position is in line with what it would have been had they invested directly, or indeed any degree of certainty on their foreign tax position generally.

Practical issues

The simplified LOB rule would create numerous practical challenges for private equity funds as explained below:

- Private equity funds typically have a wide investor base with many of the ultimate beneficiaries of returns participating in the fund through other fund or pooling vehicles.

- While private equity funds collect and retain information on entities which invest directly in the fund it will generally be unlikely that they will know about changes in the ultimate investor base of say a fund of fund investor (as they, rather than the private equity fund, will have to comply with the know your client and anti-money laundering obligations).

  Identifying the ultimate beneficial owners of interests in a private equity fund would require a level of inquiry which is beyond that required by other regimes which seek to identify beneficial owners of income (for example under FATCA a fund is generally not required to collect information on the beneficial owners of an investor fund). Further, it will be the case with many funds that their constitutional documents mean they have no legal right to request such information.

- For many funds even if it were possible to access the required information, the collection and analysis process would be an extremely costly task. Where these costs are passed on to investors it will increase the cost of pooling capital making investment in a fund less attractive.

We note the comment made during the OECD Webex of Monday 8 June that adoption of the TRACE package for CIV funds would go some way to addressing the issues around treaty access for non-CIV funds. We are concerned that the TRACE package was developed with no consideration given to non-CIV funds (as they were defined as being out of scope). Furthermore, a significant difference between the CIV and non-CIV fund markets is the role of the intermediaries which would operate the TRACE package in a CIV fund context; private equity funds do not commonly use intermediaries and to require them now to do so with no commercial benefit would increase costs and decrease returns for investors. It is not clear to us that this would be proportionate, given that no evidence of treaty abuse by non-CIV funds has been presented.

Given all of the above we reiterate the recommendation made in our January submission that private equity/non-CIV funds should be explicitly excluded from the LOB work under Action 6 such that their ability to access treaty benefits is not compromised. If this is unacceptable, then we recommend that further consideration is given to our alternative proposal that the definition of qualified person is expanded to include non-CIV funds meeting certain conditions which could be demonstrated by the fund manager using information already under their control, so as to not increase costs for investors. In the meantime we would request that the OECD makes a clear recommendation that treaty access for private equity funds is in principle to be maintained until the conclusion of the further work contemplated by paragraph 24 of the document.

PPT

The BVCA broadly supports the concept of a PPT as a workable approach to addressing treaty abuse concerns. However, the formulation of the draft PPT will exacerbate an existing barrier to international investment, being the lack of consistency between how individual jurisdictions apply treaty provisions in practice, a problem frequently encountered by private equity funds. This risk of inconsistency is further highlighted by the fact that the discussion draft is not, at this late stage, a consensus paper; treaty access is clearly a complex issue which invokes a range of different perspectives amongst stakeholders. Given that one of the objectives of the OECD is to promote consistency between jurisdictions we consider that an objective of the Action 6 work ought to be to minimise inconsistency, in the sense of minimising the likelihood of particular jurisdictions interpreting identical fact patterns in different ways. Providing examples in the commentary to the model treaty will not fully address this concern. We therefore reiterate our recommendation that the PPT is drafted so as to be a test of the (single) principal purpose of an arrangement. This, combined with appropriate commentary examples, would maximise consistency without defeating the aims of Action 6.

Notwithstanding the above we have set out two examples in the Appendix to this letter setting out our view of how the PPT, as currently drafted, could apply to common private equity holding structures.

Conclusion

Private equity funds are not vehicles for treaty shopping or any other form of tax avoidance. They exist solely to meet investor appetite for pooled investment in a particular class of asset. As noted in our previous submissions, such funds provide an important investment option for key institutions such as governments and pensions and play an important role in channelling capital to where it can most efficiently be deployed and in the global financial system generally.
In order for such funds to remain available to investors it is vital that investing in a private equity fund does not worsen a participant's treaty position (either in terms of tax suffered or simply uncertainty) in comparison with them making a direct investment and that the costs of investing in a fund are not prohibitively high. As set out above our concern is that the current drafting over the LOB and PPT rules creates uncertainty in this area.

Therefore while this representation is short the points made are fundamental to our principal goal which is to ensure that the asset class remains a viable proposition for investors. To this end we also endorse the views set forth by the Private Equity Growth Capital Council and the European

Private Equity and Venture Capital Association in their submissions in response to the discussion draft.

Further work

We welcome the commitment made in the discussion draft to explore solutions to the issues related to the treaty entitlement of non-CIV funds. We would welcome an opportunity to continue our engagement on this issue beyond September 2015 and to contribute to further working party discussions. We consider that further dialogue to identify the source and validity of the working party's concerns about treaty abuse and income deferral for non-CIV funds would be constructive.

Yours faithfully,

David Nicolson
Chairman of the BVCA Taxation Committee

Appendix

Example 1

A private equity fund is established with the intention of investing into a portfolio of unrelated trading businesses. Twenty investors of different types and treaty characteristics commit to providing capital to the fund, which will be managed by an entity subject to regulation under the Alternative Investment Fund Managers Directive. The fund is structured as a limited partnership, which due to its fiscal transparency is not resident in any state.

Bank finance is used to leverage the investors' capital and make investments. The bank providing this finance requires that funds are lent into a group holding company in order to gain good security over the portfolio of assets. The fund must therefore establish a holding company for the investment portfolio into which the bank can lend and over which the bank can take security. The fund manager considers a range of potential jurisdictions for the holding company and as part of this process considers the legal regime, political stability, investor familiarity, flexibility to extract exit proceeds from piecemeal sales of the portfolio and tax considerations such as certainty around the taxation position of the holding company on disposal of its investments. The treaty position of each of the target entities is taken into account as part of the decision but this is one factor in a range of considerations.

In these circumstances, the set-up of the holding company is mostly driven by legal, commercial and tax reasons. Obtaining treaty benefits should thus not be considered as being one of the main purposes of the arrangements.

Example 2

A private equity fund also structured as a limited partnership, which due to its fiscal transparency is not resident in any state, intends to invest into a single trading business in a jurisdiction which imposes withholding tax on interest and dividend payments.

Through the information gathered in order to satisfy existing anti-money laundering and similar requirements at the inception of the fund, the fund manager is satisfied that a majority of the investors are likely to be entitled to treaty relief at source in respect of payments from the underlying investment.

Whilst the fund manager is not expecting significant ongoing interest and dividend flows from the investment (like most private equity funds the vast majority of returns will come via sale proceeds at exit) in structuring the acquisition the decision is made to acquire the investment through an entity located in a jurisdiction which has a favourable treaty with the target jurisdiction. The reason for this decision is to avoid imposing an administrative and potential cash flow burden upon the majority of the fund's investors by requiring them to each make individual treaty claims with respect to interest and dividend payments from the investment. Were this to be required, there would be an additional administrative burden on the fund manager (which of course carries with it staff and cost implications), and the fund may be considered to be less desirable from an investor perspective, given the additional administration put upon the investors.

In these circumstances the set up of the holding company is driven by a desire to reduce the administrative burden for the majority of the fund’s investors and avoid investor relations difficulties for the fund manager. Potentially accessing treaty benefits for the small proportion of the investor base whose treaty position is uncertain is not a key driver behind the decision in comparison with managing the position for the majority of investors. Obtaining treaty benefits should thus not be considered as being one of the main purposes of the arrangements.