SUBMITTED ELECTRONICALLY

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Dr. Achim Pross
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Re: Comments on Public Discussion Draft on BEPS Action 4: Interest Deductions and Other Financial Payments

Dear Dr. Pross:

These comments are submitted by the Private Equity Growth Capital Council (the "PEGCC") and the Public Affairs Executive (the "PAE") of the European private equity and venture capital industry.

The PEGCC, based in Washington, DC, is an advocacy, communications, and research organization established to develop, analyze, and distribute information about the private equity and growth capital (together, "private equity") industry and its contributions to the U.S. and global economy. The members of the PEGCC represent a broad cross-section of the private equity industry in the United States and include many of the world's largest and best known private equity firms, as well as leading small and medium-sized private equity firms. The PEGCC's members are united by their commitments to growing and strengthening the businesses in which they invest. Many of the PEGCC's members invest globally and market their funds to professional investors throughout the world. For further information about the PEGCC and its members, please see our website at www.pegcc.org.

The PAE speaks on behalf of the representative national and supranational European private equity (including venture capital) bodies. The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy. The European Private Equity & Venture Capital Association's (the "EVCA") 700 members cover the full range of private equity activity, from early-stage venture capital to the largest private equity firms, and funds investing in infrastructure. The EVCA also represents institutional investors such as pension funds and insurance companies, which are a key source of long-term financing in Europe and invest in private equity and venture capital funds. For more information, please see www.evca.eu.

In December 2014, the OECD released its Public Discussion Draft on *BEPS Action 4: Interest Deductions and Other Financial Payments* (the "Discussion Draft"). The Discussion

Draft explores several important issues relating to deductible payments such as interest and payments economically equivalent to interest, in both inbound and outbound investment scenarios. Among the issues examined and questions posed in the Discussion Draft are the optimal design of general interest limitation rules, whether to aggregate or exclude certain entities when applying such rules, linking interest deductibility to fixed ratios, and targeted interest limitation rules to address specific base erosion and profit shifting ("BEPS") risks.

The PEGCC and the PAE appreciate the opportunity to submit these comments, for consideration by OECD Working Party No. 11, in response to the OECD's invitation for comments in the Discussion Draft concerning interest deductibility as such concerns apply to private equity firms, the private equity funds that they manage and advise, and the portfolio companies in which such funds invest. By way of summarizing our recommendations in this letter, we respectfully submit the following suggestions:

- the full deductibility of interest on business debt, as it exists under current law in most OECD countries, should be maintained;
- portfolio companies owned or controlled by the same fund should not be treated as "connected parties," with each other or with their fund, for purposes of imposing limitations on interest deductibility; and "group" leverage tests should not apply to such portfolio companies and their fund;
- in cases in which a private equity fund structured as a partnership lends to its portfolio company, no "related party" ownership tests should apply, and if any do apply, they should be computed at the partner level, not the partnership level;
- any rules limiting interest deductibility should grandfather existing debt facilities and any new debt incurred to refinance existing debt;
- disallowed deductions should be permitted to be carried forward to future taxable years by the borrower; and
- private equity funds and their portfolio companies should not be subject to any targeted rules.

I. Overview of Private Equity Firms, Funds and Portfolio Companies

To provide important context for our responses to certain of the questions posed in the Discussion Draft, we provide a brief description of the structure and operations of private equity firms and private equity funds as well as some comments on portfolio company leverage.

A. Private Equity Firms

1. Typical Structure; Lines of Business. Private equity firms sponsor, manage, and advise private equity funds (which are described below). Private equity firms or their owners typically own and control their funds' general partners (or equivalent controlling entity), which make investment decisions for the funds ("GPs"). Private equity firms may have one or several lines of business. Many private equity firms organize a single private equity fund that pursues a particular investment strategy and, once that fund is largely invested, will organize a successor fund to continue that investment strategy. Other private equity firms may organize several different funds to pursue different strategies or to invest in different geographies.

2. Many Possible Investment Strategies. Private equity firms organize funds that pursue a wide range of investment strategies—including buyout, growth capital, venture capital, real estate, distressed, and debt investing—and those funds invest in a broad range of industries and geographies. While an individual private equity fund may hold a limited number of investments, and while some private equity firms or funds may have a geographic or industry focus, private equity funds in the aggregate are diversified across multiple geographies[1] and industries[2] and thus lack concentrated exposure to any single region or sector.

B. Private Equity Funds

1. Typical Structure. Private equity funds are closed-end[3] pooled investment vehicles usually organized as limited partnerships (and thus tax transparent) that invest in operating businesses ("portfolio companies"). As described above, a private equity fund is sponsored, managed and advised by an affiliated private equity firm. The fund is controlled by its GP, which makes investment decisions for the fund and, as noted above, is typically affiliated with the private equity firm that manages and advises the fund. The GP or an affiliate makes a significant capital commitment to the fund, *i.e.,* a contractual agreement to contribute capital from time to time over the term of the fund, generally when needed by the fund to make investments and pay expenses. The private equity fund also obtains capital commitments, at the beginning of its term in private placement transactions, from investors that agree to become the limited partners (or members or shareholders in a non-partnership structure) of the fund ("LPs").

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1 In the past ten years, the private equity industry invested at least U.S. $4.4 trillion in OECD member states through over 48,000 transactions, based on public sources. Source: PitchBook database. In fact, using a proprietary method to calculate unreported investment values, PitchBook estimates that the private equity industry has actually invested more than U.S. $6.3 trillion in OECD member states in the past ten years. Source: PitchBook research. OECD member states are home to the overwhelming majority of private equity investment conducted in the world.

2 From 2009 to 2013, for example, buyout investment in a sector as a percentage of total buyout investment was as follows: for consumer-related companies, 21%; for business services, 21%; for information technology, 16%; for energy, 14%; for financial services, 13%; for healthcare, 10%; and for materials & resources, 5%. Source: PitchBook and Preqin, *Private Equity Explained*, analysis performed by the PEGCC.

3 Because of the long-term, illiquid nature of their investments, private equity funds do not offer (and are not able to offer) early redemption rights to their investors. Indeed, a private investment fund is not considered a private equity fund if its investors are permitted to redeem their interests in the fund during the term of the fund. Private equity funds also do not allow their limited partners to transfer their interests in the fund without the consent of the GP.

2. Limited Partner Investors. LPs of private equity funds include corporate pension plans, public retirement plans, foundations, university endowments, sovereign wealth funds, insurance companies, banks and, to a lesser extent, high-net-worth individuals, family offices and private investment funds managed by unaffiliated management companies (*e.g.*, funds of funds).[4] Private equity funds have an international investor base, and LPs from many different jurisdictions may invest in a single private equity fund. Except in very limited circumstances, the LPs are not involved in the management or control of the fund or its portfolio companies.

3. Long-Term Funding; Long-Term Illiquid Investments. As noted above, the GP and LPs contribute capital to a private equity fund over the fund's term, generally as and when needed by the fund to make investments and pay expenses. The term of a private equity fund is typically 10 years, and new investments are usually made only during the first three to six years of the fund's term. Whatever the investment strategy or focus of a private equity fund, that fund usually invests capital in highly illiquid securities (*i.e.,* securities not tradable on a securities exchange)—whether common equity, preferred equity or debt—of operating businesses.[5] A private equity fund tends to hold each of its investments for three to seven years. In each case the private equity firm works on the fund's behalf to improve the value of the business in which the fund has invested so that, eventually, the business may be sold at a gain.

4. Limited Borrowing. Although, as discussed below, portfolio companies frequently borrow, private equity funds (other than certain real estate and debt funds, and other than short-term debt used to bridge capital calls) typically have little to no leverage. Indeed, (*a*) many fund governing documents limit the amount of borrowing that a fund may incur and (*b*) most private equity funds have little or no current income to service debt even if they are permitted to borrow.[6]

5. No Cross-Collateralization, No Cross-Guarantees. The obligations of a private equity fund (if any) typically are not guaranteed by, or secured by pledges of the assets of, another private equity fund. Similarly, a private equity fund managed by a private equity firm

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4 Investors such as foundations and university endowments are more prevalent in the U.S. than in Europe, whereas in Europe, insurance companies, for example, invest relatively more capital in private equity funds. Source: 2013 European Private Equity Activity: Statistics on Fundraising, Investments & Divestments, May 2014, p. 15.

5 Since private equity funds employ long-term "buy and hold" strategies, rather than trading strategies, and tend to purchase illiquid securities, they typically do not hedge for speculative purposes, purchase commodities or derivatives, or invest in hedge funds or publicly traded securities (except in connection with a going-private transaction).

6 In addition, certain U.S. investors in private equity funds are sensitive to the incurrence of "unrelated business taxable income" for U.S. tax purposes, which could be caused by fund-level borrowing.

generally does not guarantee or pledge its assets to secure the obligations of the private equity firm, or *vice versa*.

C. Portfolio Companies

1. Simplified Buyout Structure; Leverage. Some private equity funds, such as buyout funds, purchase companies using equity (from the fund and, where necessary, third-party co-investors) and debt (usually from banks and other institutional lenders). As noted below, the funds themselves almost never guarantee that debt. In a leveraged buyout transaction, a buyout fund may, for example, incorporate an acquisition vehicle and make an equity investment; the acquisition vehicle then uses the capital from the fund along with cash from borrowings to purchase the target company, with repayment of at least a portion of the debt being secured by a lien on the assets of the target company and a pledge by the fund or a holding company of the shares of the target company. The degree of leverage in a buyout can vary significantly from one transaction to another, depending on the analysis done by the private equity firms and lenders involved of the amount of debt that the business to be acquired can service.

There are many variations on this simplified buyout structure, but all leveraged acquisitions have this in common: when the acquisition is complete, the fund owns an equity stake in an operating business that, like almost all operating businesses, has some degree of leverage on its books that the company (not the fund) is obligated to repay from its earnings[7]; and if the business fails, the lenders and other creditors of the company will be repaid before the fund or other equityholders are entitled to any return of or on their equity investments. In any event, lenders have no recourse to the assets of the private equity fund (except for any shares of the target portfolio company that were pledged by the fund to secure the borrowing), of any other portfolio company, or of the private equity firm.

2. No Cross-Collateralization, No Cross-Guarantees. Except perhaps for a pledge by a private equity fund of the shares of a portfolio company that it owns as security for the company's borrowings, the borrowings or other obligations of that portfolio company are not guaranteed by, or secured by pledges of the assets of, the fund or any other portfolio company. Therefore, the failure of one portfolio company does not impact the fund's other portfolio companies. The fund and its investors may lose their investment in the failed portfolio company, but such loss would not affect other investments held by the fund.

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[7] The average gross leverage ratio for U.S. private equity deals in 2014 was 1.68:1, although some portfolio companies may be materially more or less leveraged. Source: Standard & Poor's Q4 2014 Leveraged Buyout Review. In other words, on average U.S. private equity deals in 2014 were financed with 37.31% equity and 62.69% debt. Source: Id. These private equity purchases on average held a debt/EBITDA ratio of 5.75x. Source: Id. Similarly, on average EU private equity deals in 2014 were financed with 41.27% equity and 58.73% debt. These private equity purchases on average held a debt/EBITDA ratio of 5.14x. Source: Id.

II. General Comments on Interest Deductibility

As the OECD considers various measures designed to ensure the coherence of corporate income taxation at the international level, we note the importance of interest deductibility to corporate capital structures. In most countries, interest cost is treated as a tax-deductible expense,[8] and the Discussion Draft recognizes as a basic policy aim that "in general groups should still be able to obtain tax relief for an amount equivalent to their actual third party interest cost."[9] We support this basic policy, recognize the benefits of this policy as discussed below, and are deeply concerned about the harms that limitations on interest deductibility mentioned below could inflict.

A. Benefits of Debt and Interest Deductibility

Corporate debt is an essential tool used by businesses, small and large alike, to grow and finance operations. According to the U.S. Small Business Administration, four in five small businesses in the United States use debt in their capital structure. A recent study found that 75% of start-ups finance their activities with some type of debt, with 44% using business debt and 24% using trade debt.[10] According to the OECD, small and medium-sized enterprises and entrepreneurs across OECD countries continue to face greater vulnerability to credit market conditions due to their heavy reliance on bank credit.[11] Debt is a fundamental part of a typical company's capital structure and is often used to finance day-to-day operations and essential business activities such as meeting payroll, buying raw materials, making capital expenditures, building new facilities, and financing asset acquisitions. All these financed expenditures are incurred in the ordinary course of a trade or business, and the interest on these loans is therefore tax-deductible.

In most countries, the tax law is symmetric with respect to debt. Generally, each dollar of interest deducted from the borrower's income is a dollar included in the creditor's taxable income. Debt creates an environment of fiscal discipline as lenders carefully examine business plans prior to lending and keep a close watch on the progress and growth of the borrower's business. Debt can also provide greater security than equity through payment seniority,

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8 Discussion Draft, ¶32.

9 Discussion Draft, ¶10.

10 Cole, Rebel A., and Tatyana Sokolyk. "How Do Start-Up Firms Finance Their Assets? Evidence from the Kauffman Firm Surveys." (March 1, 2012) SSRN. http://sites.kauffman.org/efic/resources/How-Do-Start-Up-Firms-Finance-Their-Assets.pdf.

11 "Financing SMEs and Entrepreneurs 2014: An OECD Scoreboard," available at http://www.oecd.org/cfe/smes/financing-smes-scoreboard-2014.htm.

collateral in the form of physical or intangible assets and, sometimes, guarantees by parties related to the borrower.

The ability to access debt capital creates options for business owners and investors looking to finance a new business or engage in a capital expansion. Debt permits business owners to raise capital and finance growth without having to relinquish control or decision-making authority in their companies. This is particularly important for start-up enterprises whose entrepreneurs often have a defined vision and may not want to dilute their authority by being forced to issue equity (and equity financing will not always be readily available).

B. Concerns About Limitations on Interest Deductibility

Limiting interest deductibility would significantly increase the marginal effective tax rate on new investment and could stifle growth in OECD member states imposing these limitations, undermining an oft-stated goal of corporate tax reform. Changing the traditional rules of capital formation by limiting or eliminating the ability to deduct interest on corporate debt would simply make any OECD member state that adopted this policy a less attractive place for business and job creation. For instance, a study conducted by Ernst & Young in 2013 determined that in the U.S. context, a revenue-neutral 1.5 percentage point reduction in the corporate income tax rate financed by a 25% across-the-board limitation on corporate interest expense would in the long run decrease U.S. economic output by U.S. $33.6 billion and investment by U.S. $6 billion.[12] Likewise, we believe that limitations on the deductibility of corporate interest would have negative effects on output and investment in OECD member states because OECD companies' returns on investment would decrease, even taking into account the benefits of any corresponding reduction in corporate income tax rates. Overall, this would make OECD member states less attractive destinations for business investment.

Limiting interest deductibility would especially penalize enterprises that lack easy access to equity and instead rely on external financing to create jobs or invest in plant and equipment. Early-stage and innovative companies would be disproportionately impacted because they often have particularly high costs of equity and therefore rely on debt financing to fund growth initiatives.

We believe that the OECD's effort to address legitimate BEPS issues need not be inconsistent with the goal of encouraging more competitive tax codes to benefit OECD member states. Tax reform and the BEPS process should not sacrifice fundamental tax principles that are essential to the conduct of business throughout the OECD. Limiting the ability to deduct ordinary business expenses, or changing the longstanding definition of those expenses to exclude

[12] "Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses," Ernst & Young LLP, July 2013.

interest, would have a negative impact on capital formation and growth. We encourage the maintenance of the full deductibility of interest on business debt as it exists under current law in most OECD countries.

III. Recommendations on Selected Questions and Topics from the Discussion Draft

The Discussion Draft examines various scenarios, at pp. 19-20, and considers the extent to which they present BEPS risks: (*1*) companies and other entities in a group; (*2*) connected parties (including cases where a "fund or trust exercises control over the entities")[13] that are not part of a group, but are under common ownership or control; (*3*) payments made to related parties (including "significant shareholders and investors" that hold a 25% or greater investment in the payor); and (*4*) standalone entities.

The Discussion Draft then considers various limitations on interest deductibility, such as group-wide leverage tests. Various types of leverage tests and thresholds, including debt-level (*e.g.*, balance sheet) tests and earnings-based (*e.g.*, interest as a percentage of EBITDA) tests, are examined. In addition, the Discussion Draft inquires about potential mitigating rules, such as carryforwards of disallowed interest deductions, in cases in which a limitation on deductibility is imposed.

A. Who Should a Rule Apply To? (Questions 4 and 22)

We believe that, in the vast majority of cases, borrowing incurred by portfolio companies of private equity funds would fall under scenario 4 above (standalone entities) because the lenders are third parties unrelated to the portfolio company. (This is also usually true of the limited borrowings incurred by the funds themselves.) We do not believe that portfolio companies owned or controlled by the same fund should be treated as "connected parties" that fall under scenario 2, and we do not believe that it would be appropriate to apply any "group" leverage tests to such portfolio companies.

As discussed above, the borrowings of a portfolio company are generally not guaranteed by the fund and are almost never cross-collateralized with the assets of other portfolio companies owned by that fund. Each portfolio company is an independent investment, which is bought and sold separately from all the others, and has a standalone debt facility. The portfolio company

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[13] The Discussion Draft proposes that "*collective investment vehicles* under the control of the same investment manager should not be treated as connected parties if there is no other connection between them" (emphasis added), at p.19. However, it does not make a similar statement with respect to *portfolio companies* under the control of the same collective investment vehicle. Instead, it suggests that connected parties would include "entities controlled by the same individual or by a private equity fund" at p. 44.

relies on the strength of its own credit to obtain loans from third parties in arm's-length transactions.

In most cases, portfolio companies are not consolidated with the fund that owns them or with each other for accounting purposes. Even in the rare cases when consolidation is required, the portfolio investments are separate businesses that generally do not engage in cross-chain lending or other transactions with each other or with the fund. Indeed, a typical debt facility contains strict limitations on "affiliate transactions" between such parties. We also note that portfolio companies almost always have minority shareholders in the form of co-investors or management. A fund cannot cause one portfolio company to lend to another portfolio company solely in order to benefit the tax position of the borrower, given the duties owed to minority shareholders of each portfolio company; any such lending (to the extent it occurs at all) must be done at arm's-length.

In the uncommon cases where the portfolio company's creditor is the shareholder fund itself, and scenario 3 could be applicable, we would urge caution in evaluating any restrictions on interest deductibility. First, the loan by the fund is usually not motivated by tax concerns implicating BEPS. The fund may simply be making a short-term bridge loan to the portfolio company as part of its initial capitalization (pending receipt of third-party loans) and is structuring it as debt to facilitate prompt future repayment by the portfolio company without the need to declare a dividend and to benefit from the superior protections that debt provides to investors. Often, structuring the instrument as debt also helps the fund minimize withholding taxes on the subsequent repayment, especially with respect to the principal amount. While the latter is a tax-driven motive, it is caused by tax concerns at the fund and investor level, not a desire to maximize interest deductions or minimize taxable income at the portfolio company level.

Second, a loan from the fund to the portfolio company should not give rise to a net tax reduction among the related parties to the extent that the fund's investors are taxed on the interest income.[14] In that regard, it is important to specify the level at which "relatedness" or tax avoidance is tested where, typically, the lending fund is itself a fiscally transparent entity but its ultimate investors are not. In general, we do not believe that applying "related party" targeted rules in such cases is warranted. Where the lender is fiscally transparent, we believe that, to the extent any related party test is applied at all, the 25% threshold for considering a lender related to the borrower should be tested at the partner level, not the partnership level. Only in rare cases does a single fund investor hold a 25% indirect interest in a portfolio company, and even then such an investor may have little to no involvement in the management or control of the fund or the portfolio company.

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[14] Although some investors in private equity funds are tax-exempt entities, many others are taxed on interest income at the high marginal rates applicable to ordinary income.

Finally, while we oppose limiting interest deductibility, we also believe that if any such limitation were adopted it should, at a minimum, contain grandfathering provisions for existing loan agreements (and for debt incurred to refinance existing debt), as it is ordinarily very difficult, if not impossible, for companies to revise their existing leverage structures on account of unanticipated changes in tax laws.

B. Whether Interest Deductions Should Be Limited with Reference to the Position of an Entity's Group (Questions 7-23)

For the reasons discussed above, we believe it is not appropriate to group together various portfolio companies owned by the same private equity fund (or other funds sponsored by the same private equity firm) for purposes of any group-wide limitation on interest deductibility. The Discussion Draft acknowledges that such grouping may "lead to undesirable results, particularly where the two [portfolio companies] operate in different sectors and have different funding needs."[15] We strongly oppose any "connected party" grouping for portfolio companies merely because they share the same large shareholder (the fund), where each portfolio company has its own standalone debt funded by third parties. Obviously, to the extent a portfolio investment itself consists of a consolidated group of companies, and that group engages in intercompany lending such that scenario 1 above is applicable, a group test may be appropriate – but solely within the confines of such group.

C. Additional Technical Comments

The Discussion Draft also includes certain technical questions about how a limitation rule should be designed and administered. While most of these questions do not implicate issues peculiar to private equity, we offer the following observations for the OECD's consideration.

- *Carryforwards of disallowed interest deductions (Questions 21 and 33)*. We strongly believe that any disallowed deductions should be permitted to be carried forward to future taxable years by the borrower.[16] In addition, we note that a carryforward is often an inadequate remedy. Many jurisdictions impose limitations on the use of loss carryforwards after a change of control. As described above, private equity funds invest in portfolio companies with a view toward strengthening their management and profitability and ultimately selling them at a gain. A portfolio company is typically held for a period of three to seven years and then sold. It is often difficult to persuade a buyer to pay the seller for deferred tax assets of the target company, especially if tax attributes will become limited in the hands of the target company after the sale. Accordingly, we

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15 See Discussion Draft, at p. 45.

16 As discussed below, carryforwards would be especially important if fixed ratio rules based on earnings are adopted.

recommend that carryforwards of disallowed interest deductions become eligible for current deductibility upon a change of control of the portfolio company. We also oppose any limitations on carryforwards, such as an expiration date.

- *What practical issues arise in applying fixed ratio rules based on asset values or earnings? (Questions 5 and 24).* In general, we highlight the concern already noted in the Discussion Draft, at p. 24, that a test based on asset values, such as a debt-to-equity ratio, raises valuation issues. Valuation becomes more difficult in the case of a private equity fund's portfolio company, which will usually be closely held and not publicly traded. Presumably, the valuation reflected on a fund's financial statements would be given some deference, but it may not represent a full-blown appraisal. On the other hand, an earnings-based test may produce uneven results for a portfolio company that requires extensive restructuring costs immediately following its acquisition, or that is a start-up business. In both cases, earnings may be negative in the early years of the fund's investment, only to improve significantly toward the end of the fund's holding period; we believe this is another reason carryforwards of disallowed deductions should be permitted.

- *Would a fixed ratio rule pose particular problems for entities in certain sectors? If so, which sectors would be affected and how could this be addressed? (Question 27).* As noted in the Discussion Draft, at p. 49, an EBITDA-based test may be preferable for a company engaged in a capital-intensive business. First, write-downs and amortization of capitalized costs would be excluded from the calculation. Second, an asset-based test could be detrimental to companies in industries that require high levels of leverage.

- *Which situations do you think would need to be covered by targeted rules? (Question 31).* For the reasons set forth above, we do not believe that private equity firms, private equity funds or portfolio companies should be subject to any targeted rules. Portfolio companies almost always borrow on a standalone basis, and the funds themselves generally do not incur significant leverage.

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We would be delighted to discuss this letter or any other issues relating to the private equity industry, if that would be helpful to you.

Respectfully submitted,

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