

SUBMITTED ELECTRONICALLY

June 17, 2015

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Head, Tax Treaties,
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Re: Comments on the New Discussion Draft on BEPS Action 6: Preventing Treaty Abuse

Dear Madam:

The Private Equity Growth Capital Council (the “PEGCC”) is pleased to submit these comments on the *Revised Discussion Draft on BEPS Action 6: Prevent Treaty Abuse* released by the OECD on 22 May 2015 (the “Revised Draft”). 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. For further information about the PEGCC and its members, please see our website at www.pegcc.org.

In September 2014, the OECD released its report in respect of the OECD/G20’s BEPS Project *Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (the “2014 Report”). The 2014 Report made a number of recommendations aimed at curtailing treaty abuse, including introducing in treaties (i) limitations-on-benefits provisions that would limit the availability of treaty benefits to certain “qualified persons” within the relevant jurisdiction (the “LOB rule”), and (ii) a more general anti-abuse rule based on the principal purpose of transactions or arrangements (the “PPT rule”). Following the release of the 2014 Report, the OECD released the *Public Discussion Draft Follow-up Work on BEPS Action 6: Preventing Treaty Abuse, 21 November 2014* (the “Discussion Draft”), which invited comments on particular issues, including (i) the issues that the proposed LOB rule created for collective investment vehicles (“CIVs”) and non-CIV funds, including private equity funds, and (ii) how the PPT rule would operate in relation to the non-tax motivated use of special purpose vehicles by investment funds. The PEGCC submitted comments on the Discussion Draft in January 2015.

The Revised Draft includes a simplified alternative LOB rule intended to be used in combination with the PPT rule. The simplified LOB rule broadens the derivative benefits provision so that an entity in which more than 75% of the direct or indirect investors are equivalent beneficiaries may be entitled to treaty benefits. The Revised Draft also treats certain CIVs as “qualified persons” eligible for treaty benefits under the LOB rule. It offers additional examples involving holding companies intended to clarify the scope of the PPT Rule. None of these examples, however, relates to non-CIV funds.

While the Revised Draft acknowledges the economic importance of non-CIV funds and discusses their entitlement to treaty benefits, it declined to make the changes recommended by the PEGCC regarding the application of the LOB rule to non-CIV funds and the PPT rule. In the Revised Draft, the OECD working group identified two issues of concern to governments in relation to granting benefits to non-CIV funds: (i) that such funds may be used to provide treaty benefits to investors that are not themselves entitled to treaty benefits and (ii) that such funds may allow investors to defer recognition of income on which treaty benefits have been granted.

The PEGCC believes that its comments in relation to the Discussion Draft remain applicable to the Revised Draft. In particular, as described in more detail below, the PEGCC believes that the LOB rule as it stands in the Revised Draft would still substantially and inappropriately limit the ability of private equity funds and their affiliated entities to claim treaty benefits. As a result, the PEGCC continues to support treating private equity funds and their affiliated investment entities as “qualified persons” under the LOB rule.

The PEGCC continues to believe that a properly tailored PPT rule is a better method of addressing potential treaty-shopping concerns with respect to private equity funds than an LOB rule. As it stands in the Revised Draft, however, the PPT rule looks to whether *one of the* principal purposes of an arrangement or transaction is to obtain treaty benefits, which is overly broad and likely to be applied inconsistently across jurisdictions. The PEGCC recommends that the PPT rule be drafted to apply in cases where it is determined that “*the* principal purpose” of an arrangement or transaction is to obtain the benefits of a tax treaty.

In addition, the PEGCC believes that the two key concerns raised by the OECD working group in the Revised Draft (i.e., that non-CIV funds may be used by investors for the purpose of treaty shopping and that granting treaty benefits to non-CIV funds would result in the deferral of income for investors) are substantially mitigated in the context of private equity funds, for the reasons discussed below.

Private equity funds are not vehicles for treaty shopping

Private equity funds do not present the treaty-shopping concerns that the 2014 Report seeks to curtail. Private equity funds are closed-end investment vehicles formed for the purpose of pooling capital of a broad base of investors and investing that capital in portfolio companies. As outlined in our prior comments, private equity funds share many of the characteristics of other CIVs as described in the OECD’s 2010 report on *The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles*. Notably, similar to CIVs, private equity funds generally have a broad investor base, invest in a broad range of jurisdictions and industries and are subject to substantial regulation.

Private equity funds represent an important source of capital in the global economy, including in emerging markets. In order for private equity funds to continue to operate effectively in cross-border situations, it is essential that an investor’s participation in a fund does not result in a lower level of treaty entitlement than would have been accorded to such investor investing directly.

Investors that participate in private equity funds typically 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 and family offices. Such investors often would be entitled to treaty benefits in their own rights if they invested directly in the underlying investments of the fund. If investing in private equity funds were to curtail such investors' entitlement to treaty benefits, we believe that it would adversely affect the private equity industry's ability to attract capital from investors and to invest capital effectively on a multi-jurisdictional basis.

Private equity funds are not vehicles for deferring the recognition of income by their investors

The concern that granting treaty benefits to private equity funds may allow investors to defer recognition of income on which treaty benefits have been granted is misplaced. Corporate pension plans, public retirement plans, foundations, university endowments and sovereign wealth funds typically make up a large portion of the investors in private equity funds.¹ Such investors are typically exempt from tax, and do not benefit from income deferral.

Even for investors who are subject to tax in their jurisdiction of tax residence, private equity funds are not vehicles for deferring the recognition of income on investments. Private equity funds are organized most frequently as fiscally-transparent limited partnerships in order to achieve tax neutrality and the flow-through of the characteristics of the underlying income realized by the fund. Consequently, taxable investors in such a fund generally are subject to tax currently on their proportionate share of the fund's income, even if no distribution is made by such fund. Since investors are subject to tax on income at the time such income is realized by the fund, these fund structures generally do not provide the opportunity for investors to defer tax.

In addition, private equity funds typically hold investments for periods of between three and seven years prior to exit. The partnership agreements or other governing documents of private equity funds generally do not permit capital to be reinvested except under very limited circumstances, and typically require that amounts received by the fund from the sale of an investment be distributed promptly to the investors in the fund.

Furthermore, the private equity fund model typically penalizes fund sponsors that do not distribute investment proceeds at the earliest opportunity. The performance of a fund and the remuneration of its sponsors are typically measured by reference to the fund's internal rate of return, which takes into account both the timing and the quantum of investment returns.

¹ According to Preqin, in 2015, corporate pension funds (14%), public pension funds (29%), foundations (6%), endowment plans (7%), sovereign wealth funds (14%) and government agencies (5%) collectively invested 75% of the aggregated capital currently invested in private equity. Source: 2015 Preqin Global Private Equity & Venture Capital Report, Fig 7.2, at p.77.

Accordingly, private equity funds are incentivized for both marketing and remuneration reasons to return investment proceeds to investors promptly.

Finally, a private equity fund is a limited duration investment entity with a typical term of ten years (subject to extension for up to two or three years if needed). This limited duration reduces opportunities for deferral. Following the termination of the fund, any remaining proceeds are distributed to investors.

The LOB Rule

While we appreciate that the LOB rule, and in particular the derivative benefits provision, has been broadened in the Revised Draft, we continue to believe that the LOB rule would make it extremely difficult, if not impossible, for most private equity funds and their affiliated investment entities to qualify for treaty benefits when making cross-border investments.

Most private equity funds and their affiliated investment entities would not qualify for treaty benefits under the “qualified person” test because (i) such funds and their investment entities generally are not publicly traded, and (ii) investors in private equity funds typically represent multiple jurisdictions and, in many cases, more than 50% of a private equity fund’s investors would not be representative of any particular jurisdiction or jurisdictions. Most private equity funds and many of their affiliated investment entities would also not qualify for treaty benefits under the “trade or business” test as their activities are limited to making investments and they do not otherwise carry on an active trade or business.

The application of the “derivative benefits” provision of the LOB rule to private equity funds presents administrative and practical difficulties that would frequently prevent the funds (or their affiliated investment entities) from accessing treaty benefits even in cases where the vast majority of their investors qualify.

As with CIVs, private equity funds may have hundreds of investors and these investors often invest through tiered entities, including other funds. Identifying the ultimate beneficial owners of interests in a private equity fund, including interests that are held indirectly through upper-tier entities would require a level of inquiry that is substantially beyond what is required by currently applicable regimes, including the US FATCA rules. This inquiry would require access to information with respect to indirect investors that the private equity fund may not be able to identify and with which it has no legal relationship.

A private equity fund may also make investments in numerous different jurisdictions, each with different treaty rules. The precise jurisdictions in which a fund will invest are often not known at the time investors invest in the fund, especially for funds with multi-jurisdictional investment strategies. It will often be impractical, if not impossible, for a fund to determine which of its direct and indirect beneficial owners are eligible for benefits in respect of a particular item of income under the treaty of each jurisdiction in which the fund invests and to monitor eligibility on an on-going basis. Even if this level of inquiry were feasible as a practical matter, it would be a time consuming and daunting process, particularly for funds with large numbers of investors,

and would impose substantial additional compliance costs upon funds and their investors. See *Example 1* in the *Appendix*.

Moreover, under the derivative benefits provision's "all or nothing" approach, a private equity fund relying on the derivative benefits provision would be denied treaty benefits entirely if it fails to meet the more than 75% ownership by equivalent beneficiaries test - in other words even if 75% of its investor base consists of investors that are equivalent beneficiaries and are legitimately eligible for treaty benefits. Such investors making an investment in a private equity fund and otherwise eligible for treaty benefits may find themselves in a worse position by pooling capital through the fund to make investments in portfolio companies than they would have been had they invested directly in the underlying portfolio companies. In addition, as private equity funds generally have limited or no control over changes in the tax status or eligibility for treaty benefits of their investors, there could be no assurance that a particular fund would continue to be eligible for treaty benefits, thereby creating substantial uncertainty for private equity fund investors. See *Example 2* in the *Appendix*.

For private equity funds, identifying and monitoring the ultimate beneficial owners of interests on an ongoing basis is administratively complex and commercially impractical. Furthermore, the rule's "all or nothing" approach has disproportionate consequences for private equity funds, due to the frequency with which investors participate in funds indirectly. Accordingly, we do not believe that the derivative benefits provision of the Revised Draft provides an effective avenue for private equity funds to access treaty benefits in relation to cross-border investment. For this reason, the PEGCC reiterates its recommendation that private equity funds and their affiliated investment entities be treated as "qualified persons" under the LOB rule. Our proposed approach would not require a look through to the treaty status of any investor in the fund and would not subject the fund to a reporting regime regarding the identity of direct or indirect investors in the fund.

The PPT Rule

The PEGCC believes that treaty-shopping concerns are better addressed through a general anti-abuse rule. The current PPT rule applies to arrangements and transactions with respect to which "one of the principal purposes" is obtaining treaty benefits. We believe that the PPT rule, as currently proposed, is overly broad and imprecise and that it invites a subjective analysis in which different countries may reach different conclusions in applying the PPT test to the same set of facts and circumstances. Such a subjective standard creates uncertainty as to how the rule will be applied from jurisdiction to jurisdiction and frustrates the purpose of tax treaties, which is to promote bona fide cross-border investment. To address these concerns, we reiterate our recommendation that the PPT rule be revised to apply in cases where it is determined that "*the* principal purpose" of an arrangement or transaction is obtaining the benefits of a tax treaty rather than the more subjective standard of "*one of the* principal purposes". Formulating the PPT rule based on the principal purpose of a transaction or arrangement will result in a more objective analysis and will minimize the opportunities for varying interpretations of the same set of facts and circumstances across jurisdictions.

We are particularly concerned that the subjective standard of the PPT rule may make it difficult for private equity funds to be certain that their affiliated investment entities will not be disqualified from the benefits of tax treaties. Private equity funds frequently form investment vehicles in order to make, hold, and finance their investment activities. The reasons that such vehicles are formed include (i) to ensure that fund investors have limited liability in respect of the fund's investments, (ii) to allow co-investment with management or other investors, (iii) to allow borrowing in relation to the making of an investment to be secured against the property being acquired, and (iv) to provide flexibility for future disposition of the investment or in the case the investment becomes insolvent. In selecting a jurisdiction for incorporating such a vehicle, a fund will consider a range of factors, including the local legal and regulatory environment, the cost of establishing and maintaining the vehicle, and the management expertise available in such a jurisdiction. Depending on the vehicle's purpose, they may also consider any applicable tax treaties. The PEGCC believes such consideration is appropriate, because the availability of treaty benefits for such vehicles will often serve to put investors in a private equity fund in the same position in which they would have been had they invested directly and is consistent with the objectives of tax treaties. Accordingly, we believe that the commentary to the PPT rule should make clear that the rule is not breached simply because, in establishing an affiliated investment entity as a holding vehicle for the fund, the fund considers the availability of tax treaties before selecting a jurisdiction. See *Example 3* in the *Appendix*.

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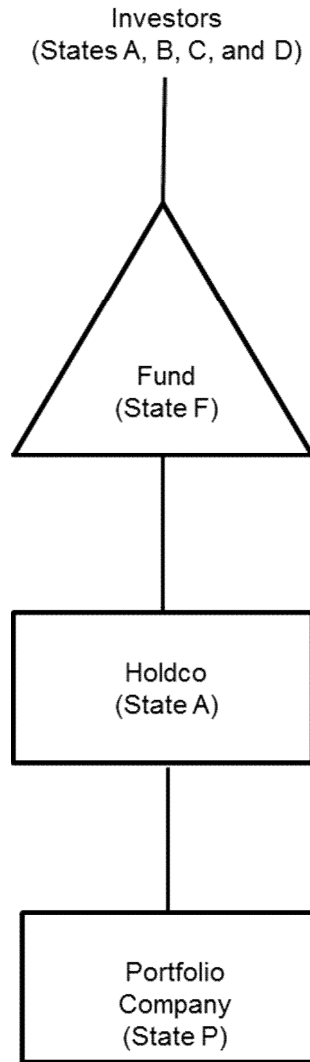
We would welcome the opportunity to discuss any of the points raised in this letter with you.

Respectfully submitted,

Steve Judge
President and CEO
Private Equity Growth Capital Council

APPENDIX

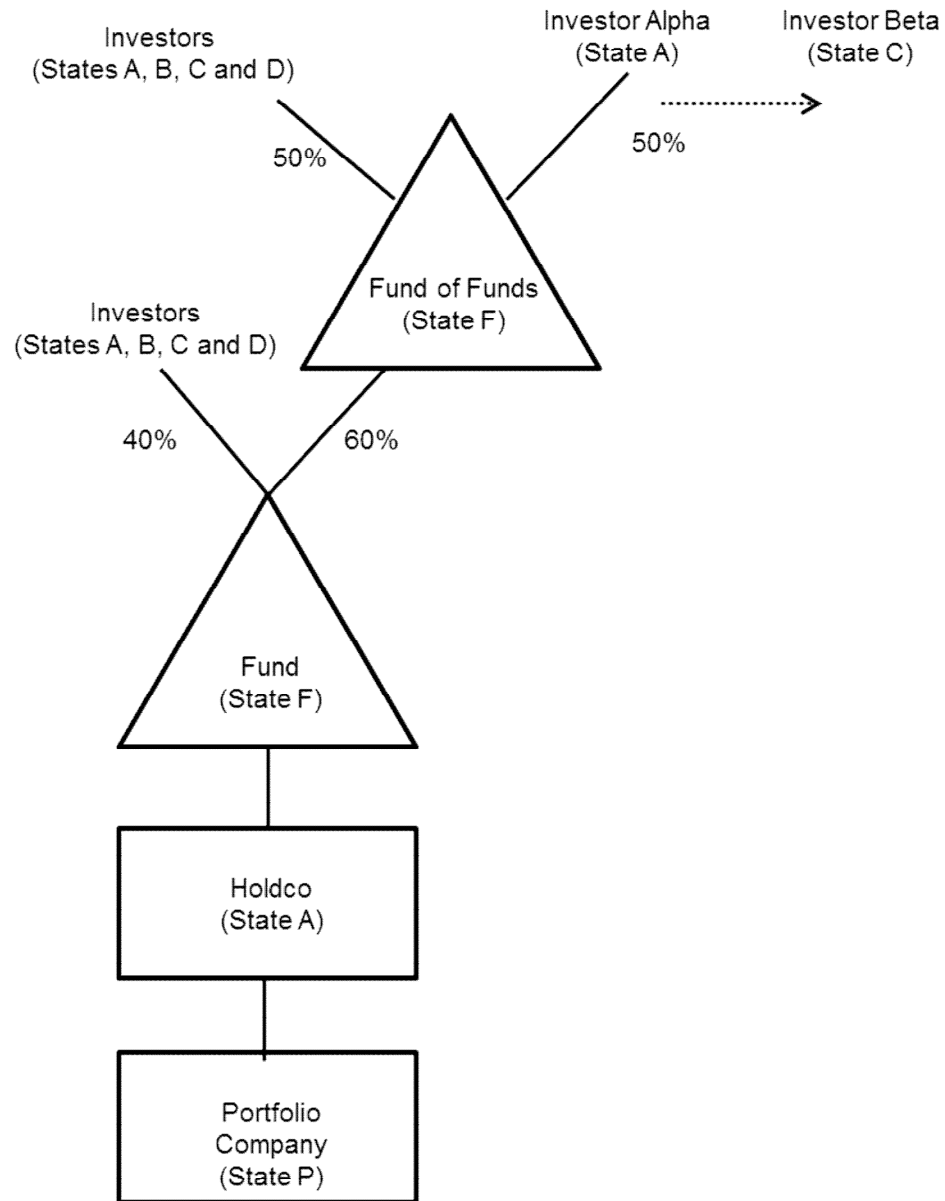
Example 1



- **Facts:** Fund is a limited partnership organized in State F. Fund has numerous investors, many of which are other entities that themselves have numerous beneficial owners. All of the direct and indirect investors in Fund are tax-resident in States A, B, C and D and are eligible for treaty benefits in relation to a direct investment in State P.
- **Facts:** Fund will invest in Portfolio Company, which is organized and resident in State P. For non-tax business reasons, Fund has established a holding company (“Holdco”) in State A, which has a tax treaty with State P. The treaty between State A and State P includes the simplified LOB rule outlined in the Revised Draft. Holdco does not meet the qualifications of paragraph 2 or paragraph 4 of the LOB rule of the treaty between State A and State P, since it is not publicly traded and does not conduct a trade or business. All of the direct and indirect investors in Fund are equivalent beneficiaries for purposes of the LOB rule in the treaty between State A and State P, so that Holdco should be entitled to treaty benefits in respect of income derived from Portfolio Company.

- Comments: In order to claim treaty benefits under the derivative benefits provision of paragraph 3 of the LOB rule in respect of an item of income derived from Portfolio Company, Holdco would need to establish that more than 75% of its investors (directly or indirectly) qualify as equivalent beneficiaries. While Fund may make inquiries to its investors, it has no direct contractual relationship with indirect investors that hold their interests in Fund through other entities. As a result, we expect it would be extremely difficult to establish Holdco's entitlement to treaty benefits under the treaty between State A and State P. If, given the administrative complexity, Fund is not able to timely confirm the status of 25% or more of its investors (directly or indirectly) as equivalent beneficiaries in respect of an item of income derived from Portfolio Company, Holdco will not qualify for treaty benefits for such income even though 100% of its indirect investors would have been eligible for treaty benefits if they had invested directly in Portfolio Company. In that case, all of the investors in Fund, including those that provided confirmation as to their treaty status to Fund, will be tax-disadvantaged in relation to their investment in Portfolio Company because they invested through Fund rather than directly. This would frustrate the principle of tax neutrality, according to which investors should not be in a worse position in relation to tax treaty benefits if they pool capital to make an investment than if they invest directly. For this reason, we believe it is appropriate for Fund and Holdco to be treated as a "qualified person" under the LOB rule.

Example 2

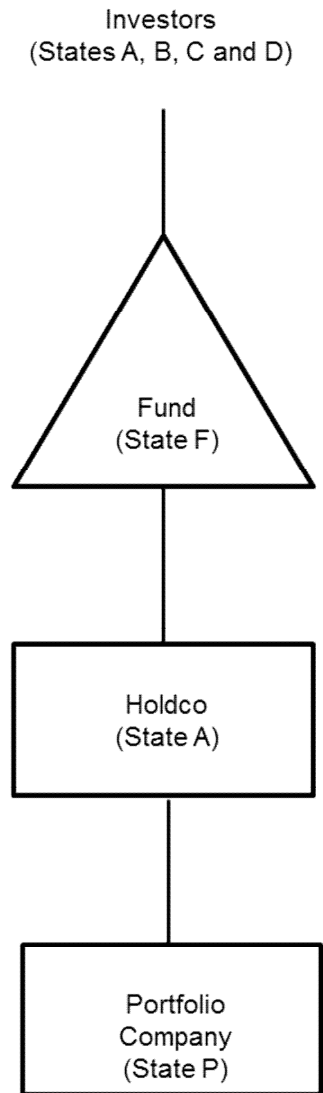


- **Facts:** The facts are the same as *Example 1* above, except that in this case 60% of Fund is owned by “Fund of Funds” (a private equity fund that invests in other private equity funds). For purposes of illustration, assume that 50% of Fund of Funds is owned by Investor Alpha, which is eligible for treaty benefits under the treaty between State A and State P. (Such concentrated ownership would be very unusual, since typically private equity funds have large numbers of investors).
- **Facts:** The treaty between State A and State P includes the simplified LOB rule outlined in the Revised Draft. Holdco does not meet the qualifications of paragraph 2 or paragraph 4 of the LOB rule of the treaty between State A and State P, since it is not publicly traded and does not conduct a trade or business. All of the direct and indirect investors in the Fund are equivalent beneficiaries for purposes of the LOB rule in the treaty between State A and State P, so that Holdco should be entitled to treaty benefits in respect of income derived from Portfolio Company. At the time of the investment in Portfolio Company, Fund is able to

establish that Holdco qualifies for benefits under the derivative benefits provision of the treaty between State A and State P.

- **Facts:** At some point in time following the investment, for some non-tax business reason, Investor Alpha transfers its interest in Fund of Funds to Investor Beta. Investor Beta is eligible for benefits under the treaty between State C and State P and is an equivalent beneficiary for purposes of the LOB rule in the treaty between State A and State P.
- **Comments:** Fund has no control over Investor Alpha's transfer of its interest, since it has no direct contractual relationship with Investor Alpha. Even though the indirect ownership of Fund has changed, Holdco should remain eligible for treaty benefits under the treaty between State A and State P. However, since Holdco has no direct contractual relationship with Investor Alpha or Investor Beta, it may be a difficult or impossible task for Fund to establish that Investor Beta is an equivalent beneficiary in its own right, so as to demonstrate that Holdco continues to meet the more than 75% ownership requirement by equivalent beneficiaries contained in the LOB rule and, consequently, that Holdco continues to qualify for treaty benefits in relation to income derived from Portfolio Company. If Holdco is unable to obtain timely information from Investor Beta and establish that it continues to qualify for benefits under the treaty, the investors in Fund and in Fund of Funds (including Investor Beta) will be tax-disadvantaged in relation to their investment in Portfolio Company because they invested through Fund rather than directly. This creates uncertainty for investors making an investment in Fund that they would not have if they invested directly in Portfolio Company, and is inconsistent with the principle of tax neutrality. For this reason, we believe it is appropriate for Fund and Holdco to be treated as a "qualified person" under the LOB rule.

Example 3



- Facts: The facts are the same as in *Example 1* above.
- Facts: Fund intends to borrow funds to finance the acquisition of Portfolio Company. For non-tax business reasons, Fund is required to establish Holdco to hold its shares in Portfolio Company. Fund has shortlisted three jurisdictions, including State A, for Holdco, each of which are similarly advantageous from a regulatory, financial, legal and management perspective. After considering the fact that State A is the only one of these jurisdictions with which State P has a tax treaty, the decision is made to establish Holdco in State A.
- Comment: In such circumstances, where an investment entity is established for reasons not related to tax, but the availability of treaty benefits is one criterion considered in selecting which jurisdiction is used, the PPT rule should not apply to deny treaty benefits to Holdco. In addition, to address a concern that subjective interpretation of the PPT rule would deny treaty benefits to Holdco, we reiterate our recommendation that the PPT rule be revised to apply in cases where it was determined that the principal purpose of a transaction or arrangement was to obtaining the benefits of a tax treaty, which we believe will result in more objective analysis.