Via electronic submission:

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To Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division,
OECD/CTPA

Response to the Organisation for Economic Cooperation and Development's (OECD) Public Discussion Draft on the Treaty Entitlement of Non-CIV Funds.

Dear Sir/Madam

Introduction

The Institutional Limited Partners Association (ILPA) appreciates the opportunity to respond to the Public Discussion Draft issued by the OECD on 24 March 2016, in order to address the outstanding issues relating to the treaty entitlement of non-collective investment vehicle (CIV) funds.

About the ILPA

The ILPA is a global organisation dedicated to the interests of institutional investors into private equity (PE) funds worldwide (known as Limited Partners), and one that is committed to promoting tax transparency and fairness in the operating practices of its member firms. We therefore support the broad objectives of the OECD's Base Erosion and Profit Shifting (BEPS) project.

Our membership comprises more than 3,000 investment professionals from 32 countries around the world across 333 organisations, ranging from insurance companies, pension funds, public sector funds, foundations and endowments, collectively representing more than €1 trillion in PE assets under management globally. The ILPA's membership constitutes approximately half of all institutional capital being invested into private equity globally.

As a representative body, we speak exclusively on behalf of Limited Partners from around the world, and are very happy to now be presented with the opportunity to provide feedback on this latest consultation under Action Point (AP) 6 of the BEPS project on Treaty Abuse.

We intend to pitch our comments at a high level in this context, as we do not fundamentally disagree with any of the technical representations made by industry to date, such as in past submissions made by Invest Europe[1] and the Private Equity Growth Council[2], both of which were summarized in the Revised Public Discussion Draft as of 22 June 2015.

We hope that our input will be of use to the OECD in its work to find a suitable compromise that maintains the integrity of the BEPS process, while ensuring that the ILPA's members can continue to invest into non-CIVs, and consequently, the real economy in a competitive fashion.

Our response

We will not address each and every question posed by the OECD in this latest Public Discussion Draft, instead focussing on the key issues as we see them for the ILPA membership.

If it would be helpful for the OECD to discuss any of the points raised here in further detail please do not hesitate to get in touch, as we would be delighted to provide further elaboration in person if you should so require.

Kind regards,

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[1] Invest Europe (formerly EVCA) (2015) Response to the Public Consultation on Draft BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances - http://www.investeurope.eu/media/394038/150617-PAE-Response-on-OECD-Action-6-Treaty-Abuse.pdf

[2] PEGCC (2015) Comments on the New Discussion Draft on BEPS Action 6: Preventing Treaty Abuse - http://www.pegcc.org/news-and-policy/comment-letters/comments-on-the-new-discussion-draft-on-beps-action-6-preventing-treaty-abuse/

OECD Public Discussion Draft on the Treaty Entitlement of Non-CIV Funds

We believe it appropriate to first provide some commentary on each of the two points of principle the OECD is seeking to address in the context of non-CIVs under AP6.

Page 3 of this latest OECD Discussion Draft states that Member States have two general concerns here:

- First, that non-CIV funds may be used to provide treaty benefits to investors that are not themselves entitled to them; and,
- Second, investors may defer recognition of income on which treaty benefits have been granted.

Private equity (PE) funds exist to provide patient capital committed for the long term (the average holding period of a standard PE-backed portfolio company is usually between three and seven years), which complements the availability of debt finance typically offered by banks in the economy. This supports economic growth, financial stability, and security for those businesses and individuals who rely on a steady income stream, particularly retirees holding policies with pension funds or insurers providing an annuity.

In order to achieve this, PE funds channel institutional money – whether it is coming from potentially tax-exempt Limited Partners such as pension funds, charities etc., or those that are subject to domestic tax such as insurers or family offices – into growing companies that in turn generate for investors and their ultimate beneficiaries a meaningful return. As of December 31 2015, PE and venture capital (VC) investments into European privately held companies generated for institutional investors 10-year returns of 11.74% on average, compared with 5.3% and 3.2% returned in the public markets over the same period, according to the MSCI World and MSCI Europe indices respectively.[3]

From the ILPA's perspective, it is not the purpose of non-CIVs to provide treaty benefits to those investors who are not eligible to receive them, rather it is to provide a mode for investors to channel capital into undervalued and/or high growing companies in Europe and elsewhere, regardless of where that individual investor may sit, in a way that maximizes the return on their investment, and preferably without adding undue tax liability beyond which they are not otherwise subject in their home jurisdictions.

PE funds are dependent upon raising capital from a wide variety of institutional investors in different jurisdictions around the world, in order to achieve requisite economies of scale. Of course, the respective treaty eligibility status of each of the investors that allocates capital to the fund – which is then available to the manager for draw-downs and subsequent portfolio investments – is not uniform (although a majority would typically be able to access treaty relief had they allocated directly to an end investment).

This state of affairs should not prevent treaty access however and was in effect, recognized by the OECD as part of its 22 May 2015 Revised Discussion Draft on Treaty Abuse, via the notion of an expanded derivative benefit provision under a simplified Limitation on Benefit (LOB) test[4].

[3] Sources: ILPA/Cambridge Associates LLC and MSCI Inc. The ILPA Private Markets Benchmark is an end-to-end calculation based on data compiled from 3,413 funds formed between 1981 and 2015. Figures indicate pooled end-to-end return, net of fees, expenses and carried interest as of 30 September 2015.

[4] "A resident of a Contracting State that is not a qualified person shall nevertheless be entitled to a benefit that would otherwise be accorded by this Convention with respect to an item of income if persons that are equivalent beneficiaries own, directly or indirectly, more than 75 per cent of the beneficial interests of the resident."

Although we welcome the direction of policy travel towards a more accommodating stance by the OECD, it remains the view of the ILPA and its membership that it would represent a considerable burden of compliance for non-CIV managers to meet the criteria of such a test. The additional cost this would inevitably generate would then be passed on to institutional investors and their ultimate beneficiaries. While reporting does naturally take place under existing regulatory frameworks including the US Foreign Account Tax Compliance Act (FATCA), and forthcoming regimes such as the OECD's own Common Reporting Standard, neither extends to recording the treaty eligibility status of **all** investors. Mandating the collection of such information would represent a disproportionate compliance burden for both non-CIV managers and LPs, and one that in practical terms would be very difficult to meet.

It is for this reason that greater flexibility is needed in the context of the LOB test, while we would request more clarity insofar as the General Anti-Abuse Rule (based upon a Principal Purpose Test) is concerned so as to maintain tax neutrality for institutional investors allocating to non-CIVs.

The ILPA believes that the alternative – tax exempt investors facing undue taxation when allocating via a non-CIV, and LPs that do have a domestic tax liability exposed to the prospect of double taxation – would be excessive and could have a cooling effect on institutional investor interest in circumstances where such risk of undue or double taxation were present.

We also feel it is of use to stress that since the financial crisis of 2007-8 and subsequent sovereign debt crisis in Europe, the spotlight of public scrutiny on the tax affairs of all parts of the financial services industry has intensified considerably.

The PE industry is no exception, and as such the reputational risk of engaging in any sort of activity that could be construed as aggressive tax avoidance, while far from palatable prior to the last economic shock, is even less so now.

Finally, PE funds are actively incentivized to deliver accrued returns to institutional investors, a state of affairs we believe limits the possibility of non-CIVs being used in this regard to defer recognition of income. Institutional investors into PE funds rely on distributions from these investments to smooth their overall returns, and contribute to their ability to fund their ongoing liabilities, whether that means payouts on benefits to retirees or to policyholders, or for the operational funding of educational or charitable institutions. As such, the precise terms around the timing and conditions for distribution of net cash owed to investors are laid out in the fund agreements. It is unthinkable that investors would tolerate returns generated on the basis of their invested capital, and which are contractually owed to them, to be artificially warehoused in offshore vehicles for the tax benefit of the managers of these non-CIVs.

In fact, the ILPA has recommended that all capital returning to the fund from the harvesting of investments be distributed back to institutional investors until all called capital has been returned, inclusive of any offset fees or fund expenses, and the hurdle rate of return has been met. Only then should General Partners retain their share of excess returns above the hurdle rate, known as carried interest, generated by the capital invested via the non-CIV.

Concerns related to the Limitation on Benefits (LOB) provision

The ILPA recognises the majority of concerns flagged by the private equity industry to date in regards to the draft LOB provision.[5]

The LOB rule as worded in previous OECD drafts would be essentially impossible for a PE fund to meet. Of course, the form of the final provision remains the topic of discussion here, and we welcome the fact that the OECD still appears to be considering all options in a bid to find a palatable solution for non-CIVs.

As stated above, we are appreciative of the OECD's willingness to sanction the introduction of greater freedom into the model treaty in this regard, but must stress that even a simplified LOB would represent a considerable administrative challenge. The ILPA would therefore encourage the OECD to continue with the direction of travel started with the simplified LOB, originally floated back in mid-2015 and introduce further flexibility that caters for non-CIV access to international taxation treaties while still respecting the integrity of the BEPS initiative.

More generally, an excessively restrictive approach in this field could have an extremely detrimental effect on the attractiveness of PE as an asset class for international Limited Partners. The commensurate reduction in capital flows could have significant knock-on effects for both the companies that rely on such equity investment, and for example, individuals that hold policies with institutional investors such as pension funds and insurers. The ILPA's members in these two categories manage invested capital totalling EUR575 billion in private equity backed companies globally, EUR100 billion of which has been invested by European insurers and pension funds.

General Anti-Abuse Rule

While in principle we welcome the more qualitative approach offered by a General Anti-Abuse Rule or PPT, we do remain concerned that the final wording remains overly broad, and may lead to uneven implementation into national taxation treaties.

In regards to "Discretionary Relief", the OECD's Final Report on AP6 from October 2015 stated the following:

> "A resident of a Contracting State that is neither a qualified person nor entitled under paragraph 3 or 4 to a benefit that would otherwise be accorded by this Convention with respect to an item of income shall nevertheless be entitled to such a benefit if the competent authority of the Contracting State from which the benefit is being claimed, upon request from that resident, determines, in accordance with its domestic law or administrative practice, **<u>that the establishment, acquisition or maintenance of the resident and the conduct of its operations are considered as not having as one of its principal purposes the obtaining of such benefit</u>** *[emphasis added]*. The competent authority of the Contracting State to which such request has been made by a resident of the other Contracting State shall consult with the competent authority of that other State before rejecting the request."

[5] See previous reference to prior submissions by the Private Equity Growth Capital Council and Invest Europe.

We note that the specific wording highlighted here – particularly "one of its principal purposes" – is already being adopted around the world, with the European Commission's Recommendation on the Implementation of Measures against Tax Treaty Abuse[6] from January 28 2016 containing essentially the same text.

At this point the ILPA would simply like to highlight that both international Limited Partners and the fund managers to which they allocate consider a whole host of factors when deciding upon every step of an investment; thorough due diligence is a hallmark of the industry and a requirement for investors in fulfilling their fiduciary obligations. A failure to scrutinse each investment could jeopardise returns. A high-level analysis of taxation treaty network may well be one of many considerations taken into account by a PE fund manager when considering when and where to make a transaction but this does not mean it is a "principal purpose", let alone **the** principal purpose.

Discretion is granted to Competent authorities when it comes to interpreting this provision, but it would be very helpful if the OECD were to provide additional clarification so as the competitive reality of PE investments is not threatened by a broad PPT.

Conclusion

As has been well documented, the OECD confirmed in October 2015 in its Final Report on AP 6 that it "recognises the economic importance of these funds [non-CIVs] and the need to ensure that treaty benefits be granted where appropriate"[7].

We hope our input will prove useful to the OECD in terms of finding a workable compromise in this area that will enable non-CIVs, particularly PE funds, to continue making this valuable economic contribution.

For the purposes of clarity, please see below a list of our key concerns in this context:

- We at the ILPA hope that a balance can be found by the OECD that prevents institutional investors from being placed in a competitively worse-off position from a tax perspective when allocating to a PE fund, than if they had invested directly in its underlying assets.
- We believe the avoidance potential of PE non-CIVs is limited, and therefore encourage the OECD to review the LOB test in particular in a bid to ensure legitimate investment activity in this regard can continue.
- It is the view of the ILPA's membership that an excessively restrictive approach could have a chilling effect on international flows of investment.

[6] European Commission (2016) Recommendation on the Implementation of Measures against Treaty Abuse - http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/anti_tax_avoidance/c_2016_271_en.pdf

[7] OECD (2015) Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report - http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en#page18