Mitigating tax leakage

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Bastien Voisin and Laura Charkin consider the latest tax considerations in structuring Luxembourg private equity funds for investors from the UK, the US and the EU

Key Points

What is the issue?

The tax structuring generally used by private equity funds to reduce administrative burdens for investors is now caught up in the widespread and comprehensive changes underway in the global tax landscape arising from the Base Erosion and Profit Shifting project.

What does it mean for me?

It is critical for investors that their commitment to investing with a fund manager does not expose them to additional tax costs that they would not suffer if they invested directly into companies.

What can I take away?

Sponsors and investors should carefully assess the potential impact of recent legislative changes in international taxation, especially when investing in Europe. The complexity of these new rules is such that it requires a comprehensive tax analysis.

Private equity investments have traditionally been associated with a high degree of flexibility in terms of structuring and tax optimisation of the investment platform. The investor base of such funds is made up to a large extent of tax exempt investors. It is critical for these investors that their commitment to investing with a fund manager does not expose them to additional tax costs that they would not suffer if they invested directly into companies. In the past, the EU has recognised the specific needs and difficulties faced by these investors in investing across Europe, looking at ways of removing barriers to cross-border investment. However, the tax structuring generally used by private equity funds to also reduce administrative burdens for investors is now caught up in the widespread and comprehensive changes underway in the global tax landscape arising from the Base Erosion and Profit Shifting project. The key area is Action 6 of the 15 actions, covering Treaty Shopping.

Indeed, there has recently been multiple legal changes across Europe which operate to limit the tax efficiency of certain international investment structures. As a result of broadly drafted and far-reaching legislation, private equity investors and sponsors now have to consider a wider spectrum of tax considerations. These new rules are not targeted at tax exempt institutional investors, but neither are they designed to cater to their particular needs. Efforts being made to curb perceived potential tax avoidance can lead to increasingly complex structuring considerations that create barriers for private funds.

This article will consider the main tax drivers applicable to different investors across a range of jurisdictions and examine the key tax considerations – and how Luxembourg has usually become the ‘go to’ jurisdiction for private equity funds to address these matters.

Investor objectives

Regardless of the jurisdiction of incorporation of the fund vehicle or of its target acquisitions, investors all share certain key expectations. The fund vehicle must be able to guarantee limited liability for the investor and protect the investor to the extent possible against unfavourable regulations in their countries of residence, whilst not distorting that investor's tax position.

Sponsors should carefully choose a jurisdiction with a favourable tax regime. Investors are keen to minimise any local tax liabilities that may arise in the countries where the fund is located and from which it is managed, as well as where the fund ultimately makes its investments. A further key objective is to reduce any withholding taxes on interest and distributions from the country where an investment is located, and to do so without subjecting investors to potentially onerous tax filing or reclaim obligations.

As a practical matter, advisers should also carefully plan for the tax issues that arise upon disposal of the acquisition target. An efficient exit from an investor's point of view involves efficient upfront tax planning, the mitigation of certain additional costs and the reduction of phantom income risk.

Different types of investors can have varying tax objectives when investing in a fund. Given the specific and occasionally conflicting demands of investors, care is needed during the process of admitting investors to the fund not to agree to demands that will hamper the sponsor when it comes to structuring and implementing its investment strategy.

Sovereign investors

Sovereign investors, investing in a state-owned investment fund, will generally be interested in mitigating tax leakage in the fund structure on the basis that, had they invested in the underlying asset directly, their sovereign immunity would have protected them from any such leakage. Sovereign investors that use their immunity for US investments can be extremely sensitive to deriving commercial activities income, which can jeopardise their sovereign immunity for US tax purposes. Commercial activities income is generally any income derived, directly or indirectly, from the conduct of a commercial activity other than through an entity that is treated as a corporation for US federal income tax purposes. Such investors often require some level of commitment to block them from receiving any such income.

Non?US tax exempt investors

Investors that benefit from a tax exemption by reference to their status similarly want to mitigate any tax leakage that they would not have suffered themselves on a direct investment. They may prefer to invest in transparent structures, such that they can more robustly rely on their own tax status or available treaty relief.

In the event that the status of any other investors results in tax costs within the fund structure, tax exempt investors may require assurance that the fund is able to properly allocate the burden of those costs to those investors that caused them. Perhaps most important to some tax exempt investors is prevention from exposure to certain types of income such as trading income (to which their tax exemption may not apply), which may require blocking arrangements. In addition, tax exempt investors can be especially sensitive to tax filing obligations as they often do not have any internal tax capabilities. Any degree of tax administration can be a significant burden to them.

Tax paying investors

Tax paying investors may also benefit from treaty relief and will want to mitigate against double taxation on returns, so may have a preference for a transparent structure giving access to tax credits.

On the other hand, they will also be keen to avoid dry tax charges, in particular any for which credit cannot be obtained. Local controlled foreign company rules may also play a part in the fund structuring concerns of tax paying investors, and they may have a preference for certain types of returns if they benefit from an exemption in this regard.

US investors

US taxable investors, the bulk of whose income is derived from the sale of investments, generally seek to generate income that will be treated as long-term/capital gain – generally subject to reduced rates of taxation.

US tax-exempt investors are generally exempt from US federal income tax on investment income, such as dividends and interest, as well as gain from the sale of capital assets. Such investors are, however, generally subject to US federal income tax on their unrelated business taxable income, which includes operating income from businesses operated in pass-through form rather than corporate form for US federal income tax purposes. They are also subject to unrelated debt-financed income, which generally refers to income from an investment with respect to which there is or has been within the past 12 months 'acquisition indebtedness'. As a result, US tax-exempt investors often prefer to avoid investments in operating entities that are held as pass-through investments or want to have such investments made through entities that are treated as corporations, referred to as 'blockers'. In addition, if a private equity fund incurs fund-level debt to make investments, they may prefer to invest through a non-US entity treated as a corporation for US federal income tax purposes, which would allow those investors to avoid a tax liability generated solely as a result of debt financing.

German investors

German tax-exempt investors may prefer to invest in a fund which is not a 'deemed trading' partnership so that their tax status is not jeopardised. The involvement of a so-called 'managing limited partner' can often be a solution to this. On the other hand, German taxable investors may prefer to invest in a deemed trading partnership because the income derived from such a partnership is not subject to German trade tax. A possible solution is to a have a 'deemed' trading partnership in which the German taxable investors invest directly together with a tax transparent blocker, such as a vehicle which qualifies as an investment fund for German tax purposes, through which the tax exempt investors invest in the deemed trading partnership.

Further, German investors typically request certain tax information from the fund to be able to comply with their tax filing and reporting obligations. If several German residents are invested in a foreign partnership fund, German tax law requires that a special tax return is prepared and filed which stipulates the income attributable to those German investors.

French investors

As a general rule, tax optimisation is not the key driver for French investors when considering an investment in a private equity fund. However, they expect that the total burden of tax suffered will not be higher than if they were to make the same investments directly. Notwithstanding, French investors may also be less reluctant than others when it comes to possibly having to file tax returns or pay taxes in non-French tax jurisdictions.

In such cases, sponsors are expected to assist them in accomplishing the corresponding formalities.

French investors are becoming increasingly focused on how sponsors intend to navigate through the various anti-abuse provisions and new tax disclosure obligations. Sponsors must explain the internal processes that they have put in place to assess and, importantly, ensure compliance with such rules.

Global tax changes affecting funds

Private equity funds invest mainly through holding companies and other legal entities located in jurisdictions which offer certain tax treaty advantages and respond to the demands of investors.

However, the global tax landscape has changed in recent years, affecting both multinationals and investors which have sought to use so-called treaty shopping structures.

BEPS

The base erosion and profit shifting project (BEPS) has been adopted by 137 countries globally – the BEPS Inclusive Framework. The BEPS action plan aims to neutralise tax benefits in a number of different circumstances, which can impact the way in which a fund finances its investments, as well as the fund manager's own internal operating model.

The project prevents the movement of taxable profits to low-tax jurisdictions, notwithstanding economic activity being undertaken elsewhere. In practice, this means practitioners will need to show sufficient substance (in other words, a greater degree of operational activity) in the home country of a vehicle for it to be able to claim taxing rights over, and benefits in respect of, income generated. From the private equity sponsor's perspective, this means additional costs as it implements an appropriate decision making process and enters into various service agreements, including with potential third party providers.

ATAD

Following the BEPS project, participating countries have accepted change to combat tax avoidance practices. The European Union, for instance, adopted separate anti-tax avoidance directives: Directive 2016/1164 and Directive 2017/952/EU ('ATAD'). ATAD implements mandatory BEPS Actions, as well as some additional EU-specific changes. ATAD aims to prevent hybrid arrangements arising from different characterisation of the same entity or instrument by different jurisdictions, thereby creating a mismatch in taxation.

From a private equity fund's perspective, this has significantly complicated structuring to 'block' certain types of income used for US tax purposes in particular, and the fund's constitutional documents must carefully document and deal with the consequences and potential liabilities which may be incurred should there be tax leakage in connection with the investor base. Increasingly, fund managers find that they must ask investors for information regarding their jurisdiction of residence or organisation and tax status, as well as the treatment and characterisation of certain instruments and entities in investors' home countries.

Investor disclosure rules

An important issue which has been subject to increased international scrutiny is that of beneficial ownership. The concept of beneficial ownership looks set to play an important role in this new tax environment, with there being a movement towards tax systems operating on a more granular basis, looking through structures to the ultimate beneficial owners. It is therefore important for the sponsor that limited partners in a private equity fund can be required to provide certain information about their beneficial owners.

It is likely to be increasingly the case that common holding structures will need to either demonstrate economic activity and enjoyment of the income received, or alternatively disclose beneficial ownership information, in order to claim benefits under certain tax treaties and EU directives.

The Luxembourg fund platform

With €4.718 trillion of assets under management as at 31 May 2020, Luxembourg is by far the largest investment fund centre in Europe. This is mainly due to the great variety and corporate flexibility of its investment vehicles, as well as its tax efficiency as a holding platform when it comes to structuring investments. While a Luxembourg regulated fund is exempt from corporate tax and benefits from a VAT exemption on management services, a Luxembourg holding company generally held under the fund as a regional investment platform will allow investors to benefit from the wide network of Luxembourg tax treaties and an attractive participation exemption regime.

The type of Luxembourg fund vehicle with which international investors are most familiar is the Luxembourg special limited partnership (SCSp) – which is substantially similar to an Anglo-Saxon limited partnership and commonly used for fundraising. The SCSp is a flexible tax transparent entity, which means that non-resident investors, and the investment vehicle itself, are not subject to local Luxembourg taxes.

A recent trend has seen the use of the Luxembourg corporate partnership limited by shares (SCA), sometimes in combination with the traditional SCSp. Indeed, an SCA should not in principle create an issue with respect to the new anti-hybrid rules to the extent that it is considered for tax purposes as a corporation (versus a partnership) in Luxembourg and also in the investor countries most of the time, which avoids any tax qualification mismatch. This is not necessarily the case with a SCSp, which qualifies as a partnership in Luxembourg but which can sometimes be considered a corporation in certain investor jurisdictions. An SCA with the Reserved Alternative Investment Fund regime can still offer investors the corporate tax exemption they benefit from with an SCSp in Luxembourg.

Conclusion

Sponsors and investors should carefully assess the potential impact of all these recent legislative changes in international taxation, especially when investing in Europe. The complexity of these new rules is such that it requires a comprehensive tax analysis. Fund structures are evolving to better accommodate these changes and adjustments may be needed to many tried and tested structures. As such, it is now critical for sponsors to have access to a well-integrated and experienced international tax team when operating in the investment fund sector.

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