



Funds in Focus 2019

Private Funds Annual Review Conference

Global Tax Update:
US Tax Reform and the View
from Europe

**Robert Gaut, Arnold May,
David Miller, Catherine Sear**

Proskauder»

Tax Reform – Two Years Later

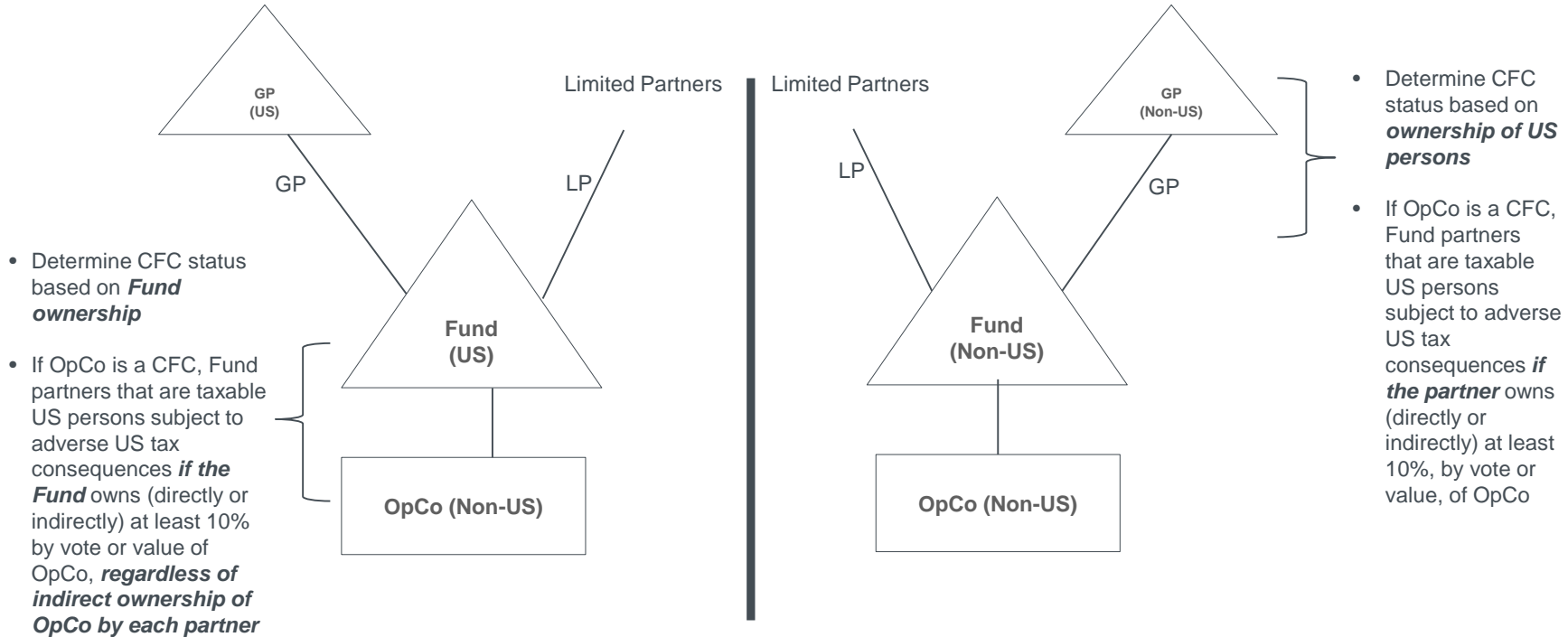
- Offshore vs Onshore Fund Jurisdiction
- Carried Interest Considerations

Offshore vs Onshore Fund Jurisdiction

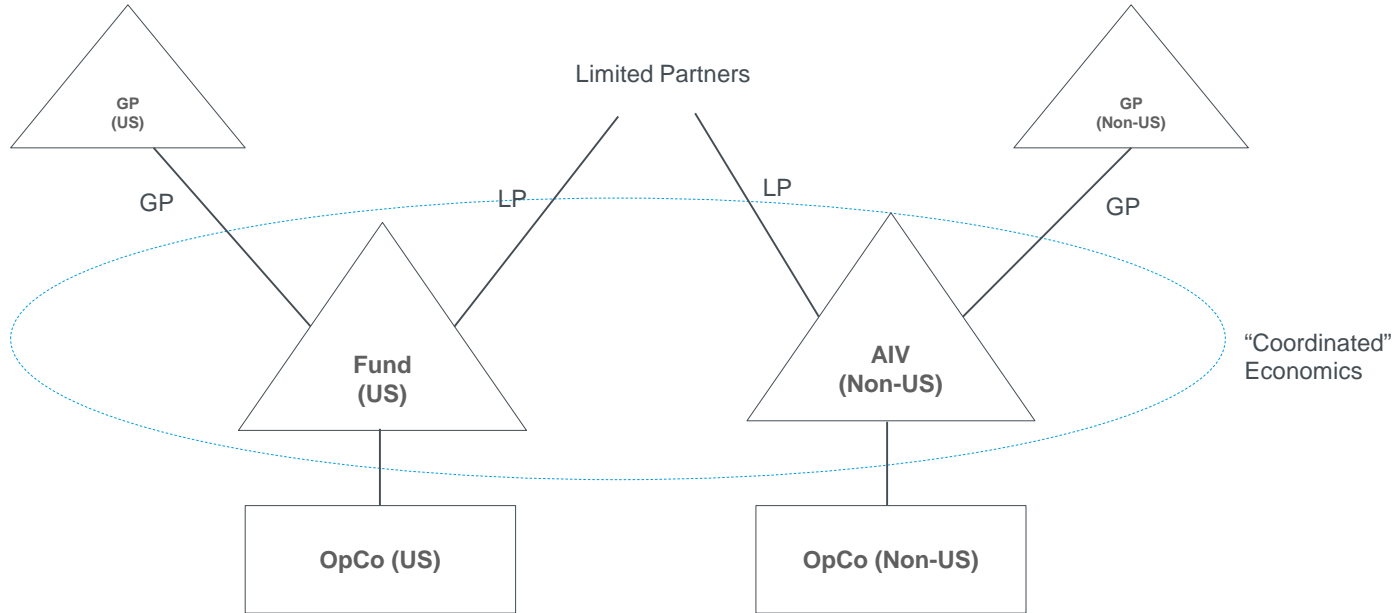
Fund Jurisdictional Issues

- Historical considerations
- Non tax considerations
- Tax considerations: Non-US Investments
 - Subpart F and Section 956
 - GILTI
 - Dividend recharacterization (Section 1248)

US vs Non-US Jurisdiction: Historical Rule



Alternative Investment Vehicle



New Rule

- ***Proposed regulations:*** Same “look through” rules applicable to Non-US partnerships *generally* apply to US partnerships for purposes of determining GILTI/Subpart F/Section 956 consequences
 - Proposed regulations are not applicable to dividend recharacterization under Section 1248
- But some limitations on ability to rely on proposed regulations

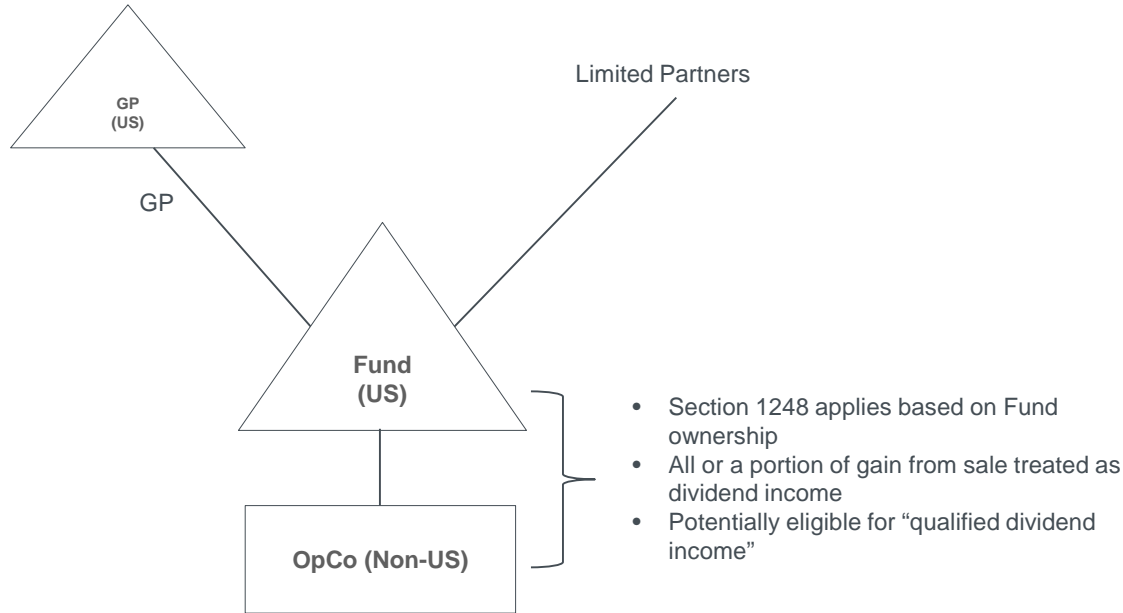
US vs Non-US vs AIV



Tax considerations: Non-US Investments

- ~~Subpart F and Section 956~~
- ~~GILTI~~
- Dividend recharacterization (Section 1248)

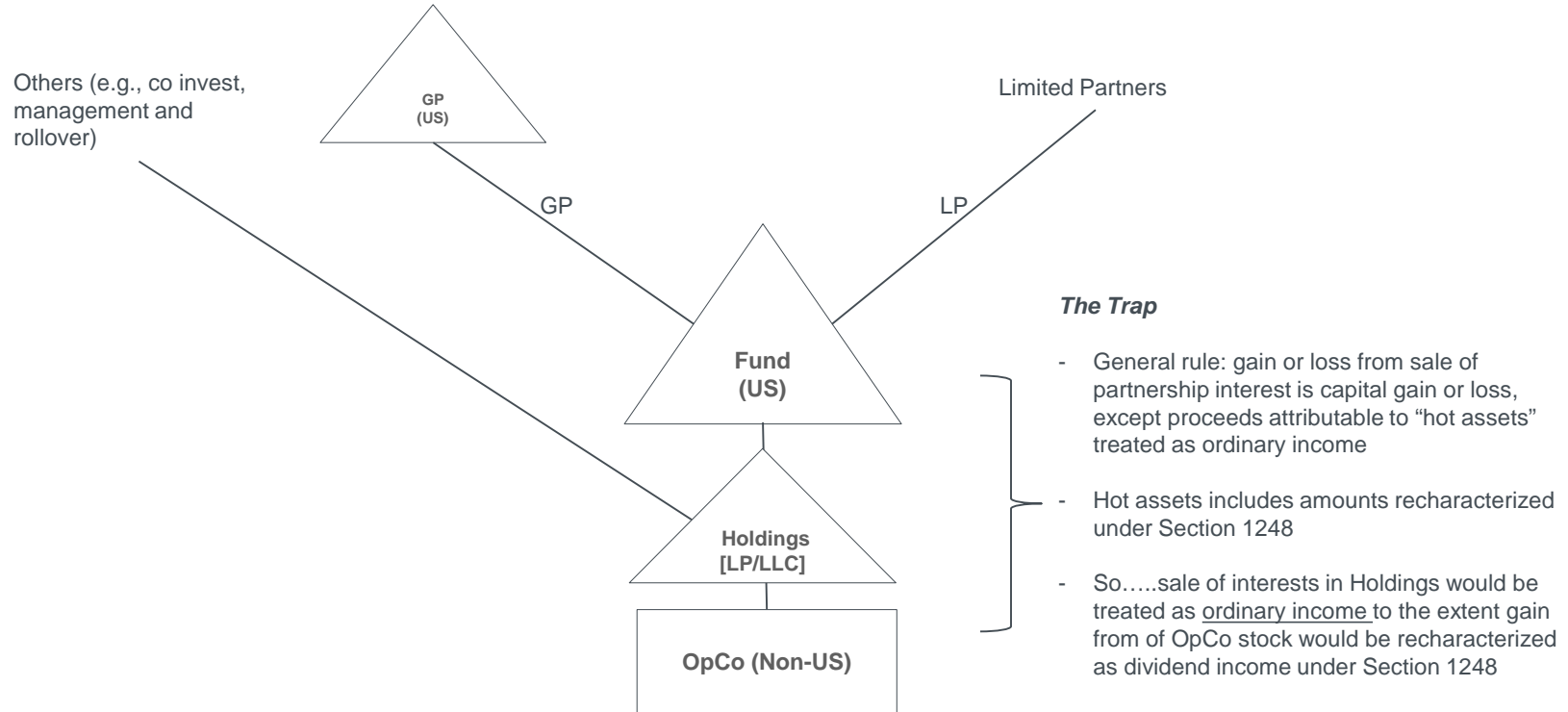
Section 1248 Recharacterization



Section 1248 Recharacterization



US Fund



The Takeaway

- New proposed regulations significantly reduce the need for Non-US Fund or AIV
- Some issues with ability to rely on guidance before finalized
- No relief from Section 1248
 - Are dividends eligible for “qualified dividend income”?
 - Special considerations if Non-US OpCo will be held through a partnership

Carried Interest

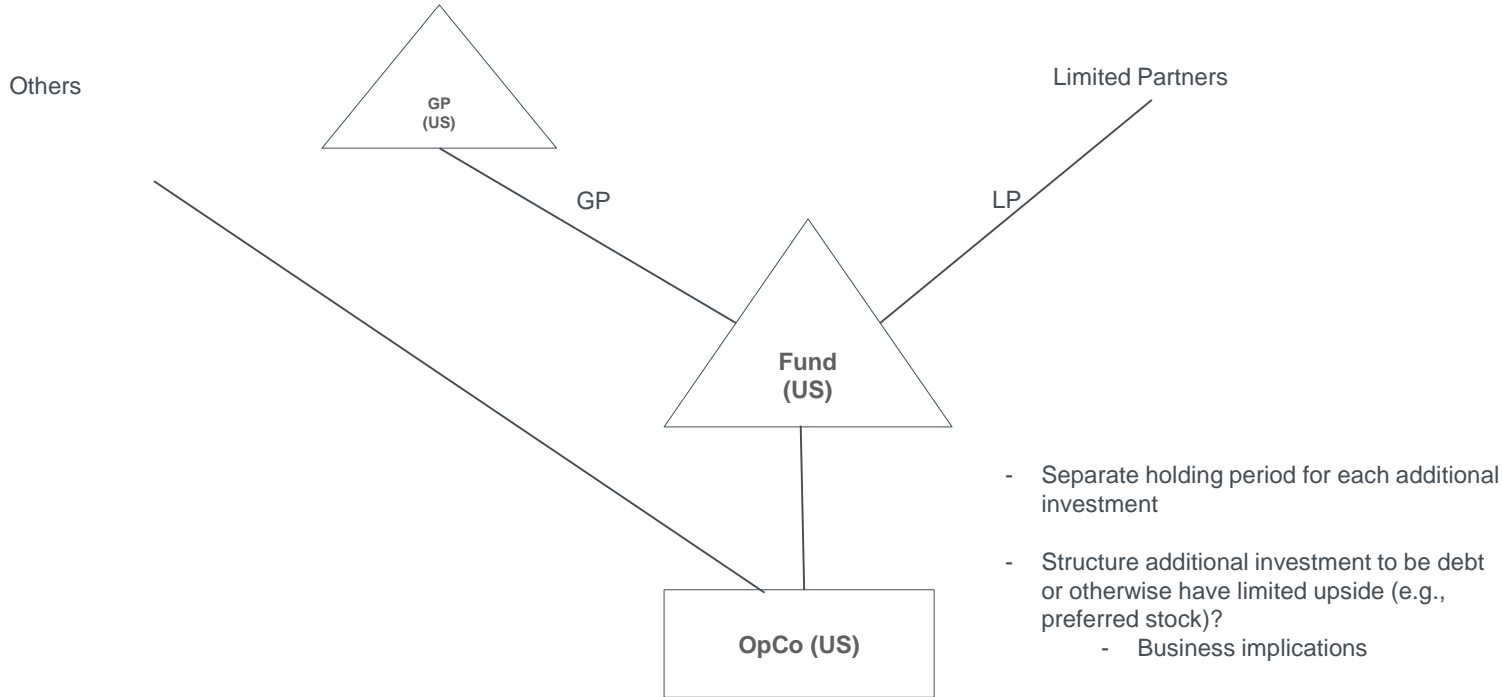
Carried Interest – Refresher

- Gain potentially treated as short-term capital gain if holding period is not more than 3 years
- Limited exclusion for gain commensurate with the amount of capital contributed
- Not applicable to “Section 1231” gains

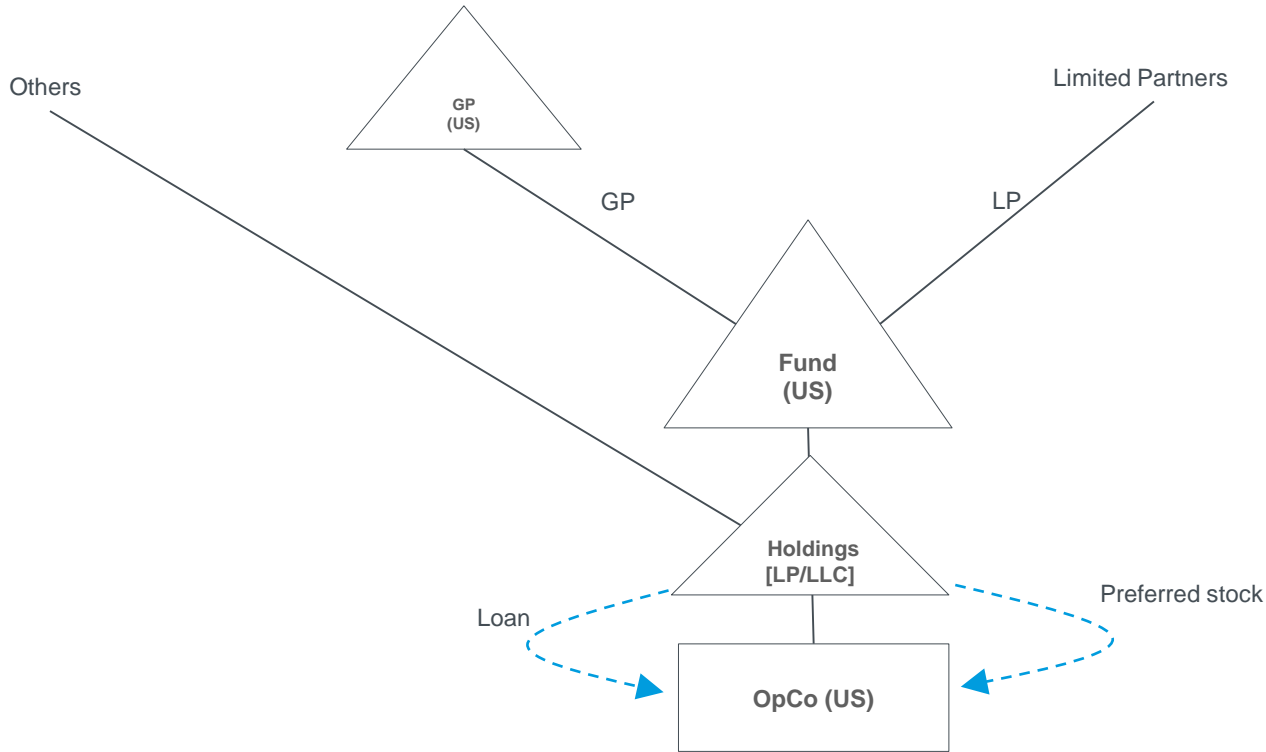
Carried Interest – Planning Strategies

- Hold for more than 3 years
 - Distributions in kind
 - Non tax considerations
- Exit structures
 - Dividend income
 - Section 1231 gains
 - Distributions in kind
- Waive allocation of carried interest and GP made whole in the future
 - Economic risk to the GP
 - Ability to do unilaterally
 - Identification of tax items to include in the “catch up”

Carried Interest – Investment Structure



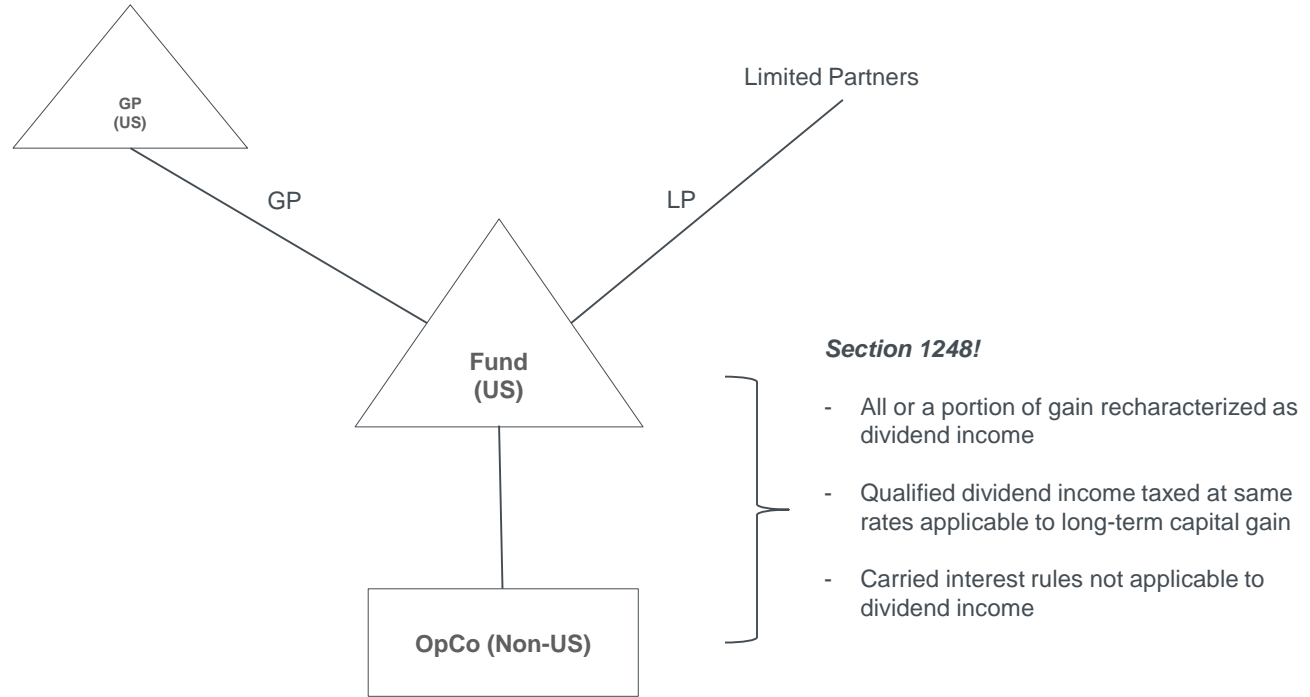
Carried Interest – Investment Structure



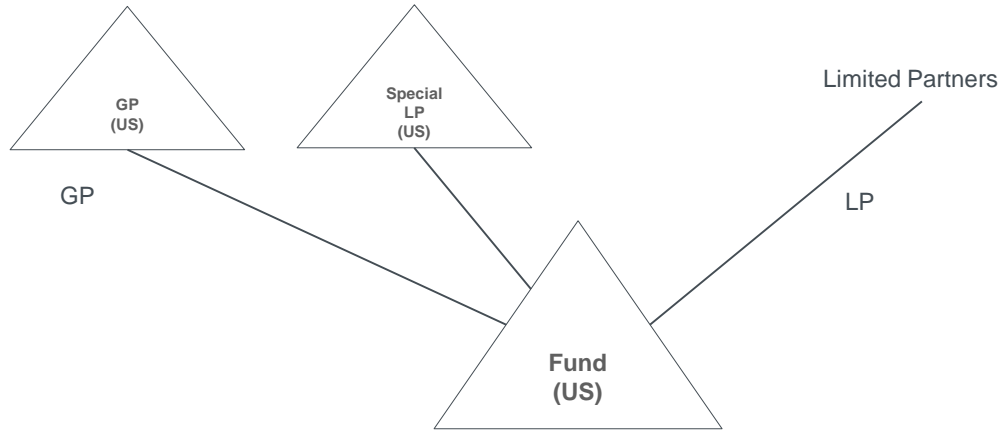
Carried Interest



Carried Interest – Dividend Treatment




Carried Interest – GP Structure



Bifurcate GP Interests:

- Capital through one entity and carried interest through the other entity
- Result: holding period for carried interest entity begins when fund is closed

European Fund Structure Developments



The View from Europe

- A period of rapid change in international tax
- OECD BEPS 15 Action Points
- Final reports issued in 2015
- Implementation phase across Europe continues
- Unilateral legislation and EU Directives
- ATAD and ATAD2
- Hybrid mismatches – BEPS Action 2 – particularly complex

Hybrid mismatches

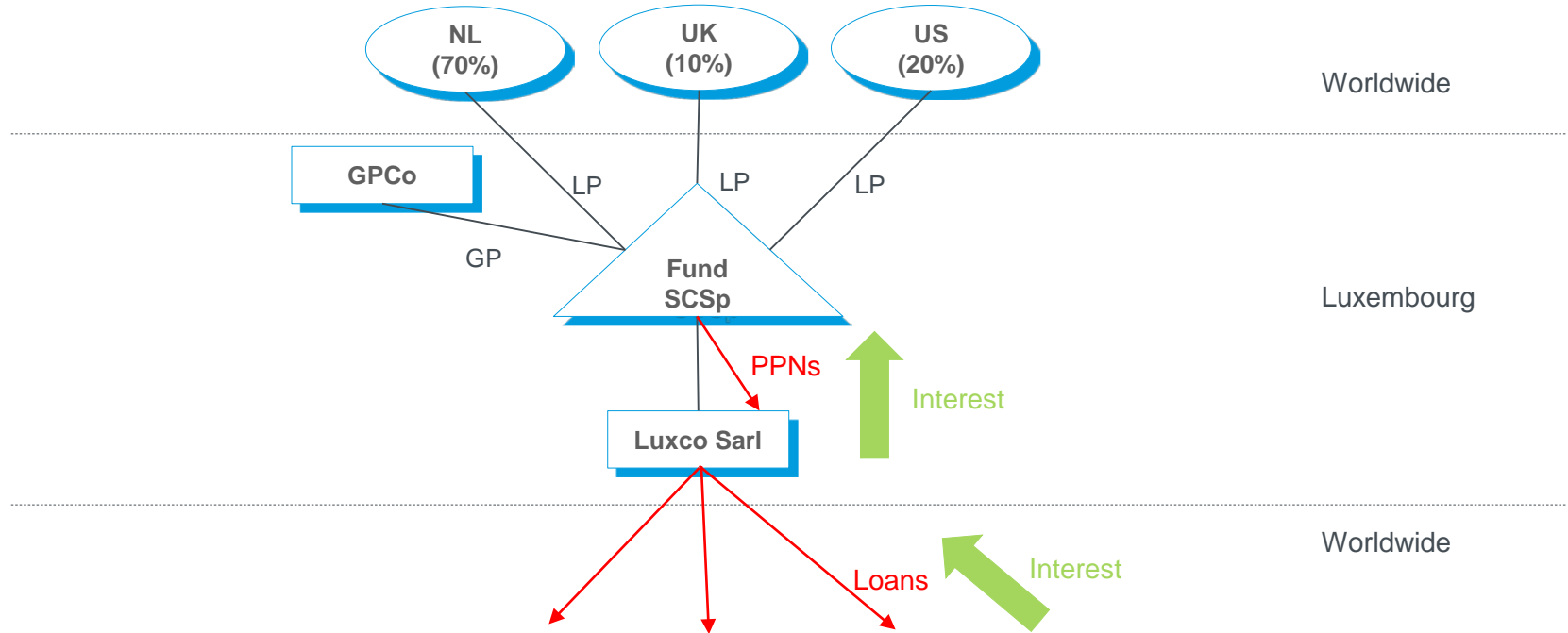
- Hybrid mismatches “exploit differences between tax systems to achieve double non-taxation”:
 - double deduction
 - deduction without inclusion
 - non-taxation without inclusion
- Different characterisation by two countries of an entity, payment or business activities.
- Hybrid payer, hybrid payee, hybrid instrument

ATAD/ATAD2

- Within Europe, the anti-tax avoidance directive (ATAD) required EU Member States to introduce legislation to counter hybrid mismatches in relation to arrangements within the EU. Rules needed to be in force from 1 January 2019.
- ATAD2 amended ATAD and extends the rules to arrangements with third countries. Most rules need to be implemented by EU Member States w/e/f 1 January 2020; reverse hybrid rules w/e/f 1 January 2022.
- UK has implemented all rules except “reverse hybrid”
- Luxembourg and Netherlands have draft rules to implement ATAD2
- These slides focus on the Luxembourg rules, given the popularity of Luxembourg fund structures involving SCSps.

Debt Funds

Hybrid mismatches – debt funds



Luxembourg draft law

- Draft law published in July 2019 to implement ATA2 w/e/f 1 January 2020 (2022 for “reverse hybrids”).
- Several potential effects on fund structures
- Examples:
 - Payment of interest on PPN by Luxco to the fund SCSp could be a “hybrid entity mismatch” with denial of deductions for the interest in Luxembourg
 - The PPNs could be hybrid instruments if not treated as debt for non-Luxembourg tax purposes (with potential denial of deductions).
 - The SCSp itself could be treated as a Luxembourg reverse hybrid taxable entity from 1 January 2022

Luxembourg draft law – hybrid entity

- Payment of interest on PPN by Luxco
 - If one or more limited partners treat the SCSp as tax opaque there is a hybrid mismatch, and the PPN interest will be treated as paid to a hybrid payee.
 - Needs to be a payment:
 - between associated enterprises; or
 - under a “structured arrangement”.
 - Assuming there is no “structured arrangement” where the parties are sharing the benefit if the hybrid mismatch treatment, the question is whether the limited partners and the Luxco are “associated enterprises”.

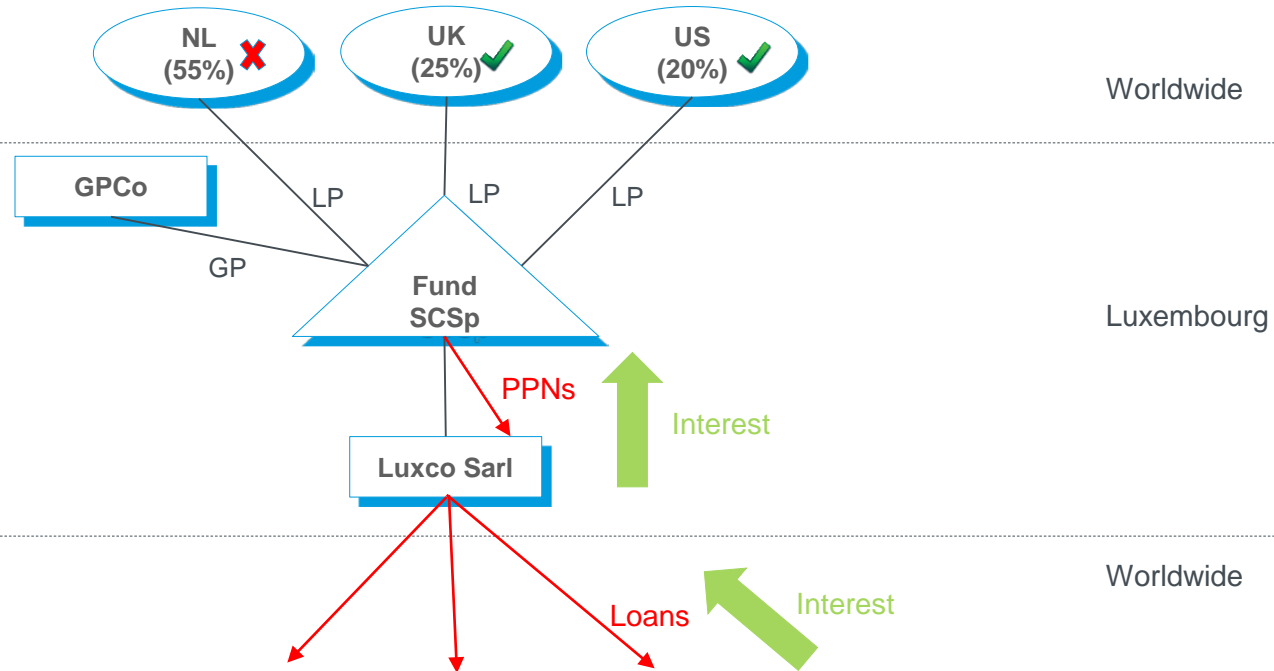
Luxembourg draft law – hybrid entity (cont'd)

- Must have 50%+ votes or capital or entitlement to profits
- All investors that effectively act together are aggregated (but, helpfully, in the context of an investment fund, investors that each own under 10% of votes/capital/entitlement to profits presumed not acting together with the other investors)

Hybrid entity mismatch?

How do LP jurisdictions treat Lux SCSp?

✗ = opaque
✓ = transparent

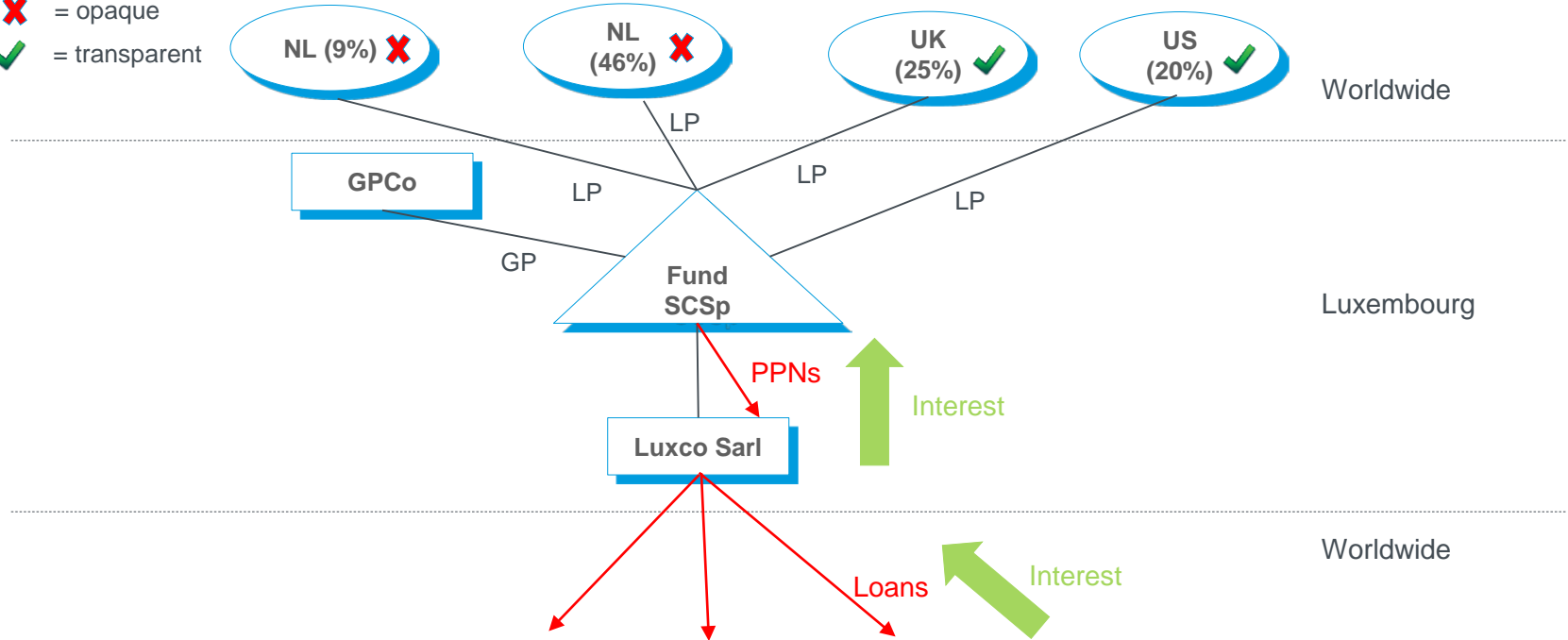


Hybrid entity mismatch

- Denial of 55% of interest deduction at Luxco level

Hybrid entity mismatch?

✗ = opaque
✓ = transparent



Luxembourg draft law

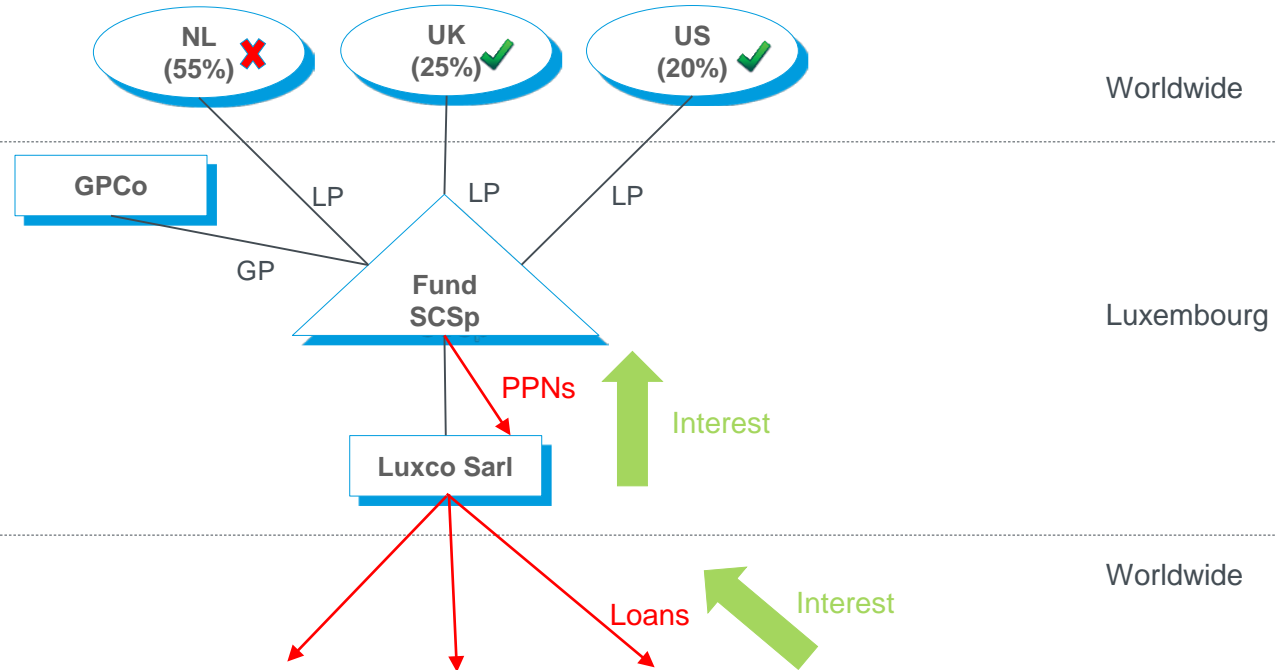
- No denial of interest deduction at Luxco level, unless NL investors are actually acting together in fact (so both investors have an effective control over the investments made by the fund)

Hybrid instrument?

- Depending on their terms, the PPNs could be treated as either debt or equity for US tax purposes.
- If the PPNs were treated as equity for US tax purposes, they would be considered hybrid financial instruments for Luxembourg tax purposes.
- It is possible that the Luxembourg anti-hybrid mismatch rules with respect to hybrid financial instruments could disallow the Luxembourg tax deduction for the interest paid on the PPNs to US investors, possibly including tax payments to exempt investors, but this remains subject to further clarification during the legislative process.
- PPNs should be structured as debt for US tax purposes.

Reverse hybrid rules from 1 January 2022

✗ = opaque
✓ = transparent

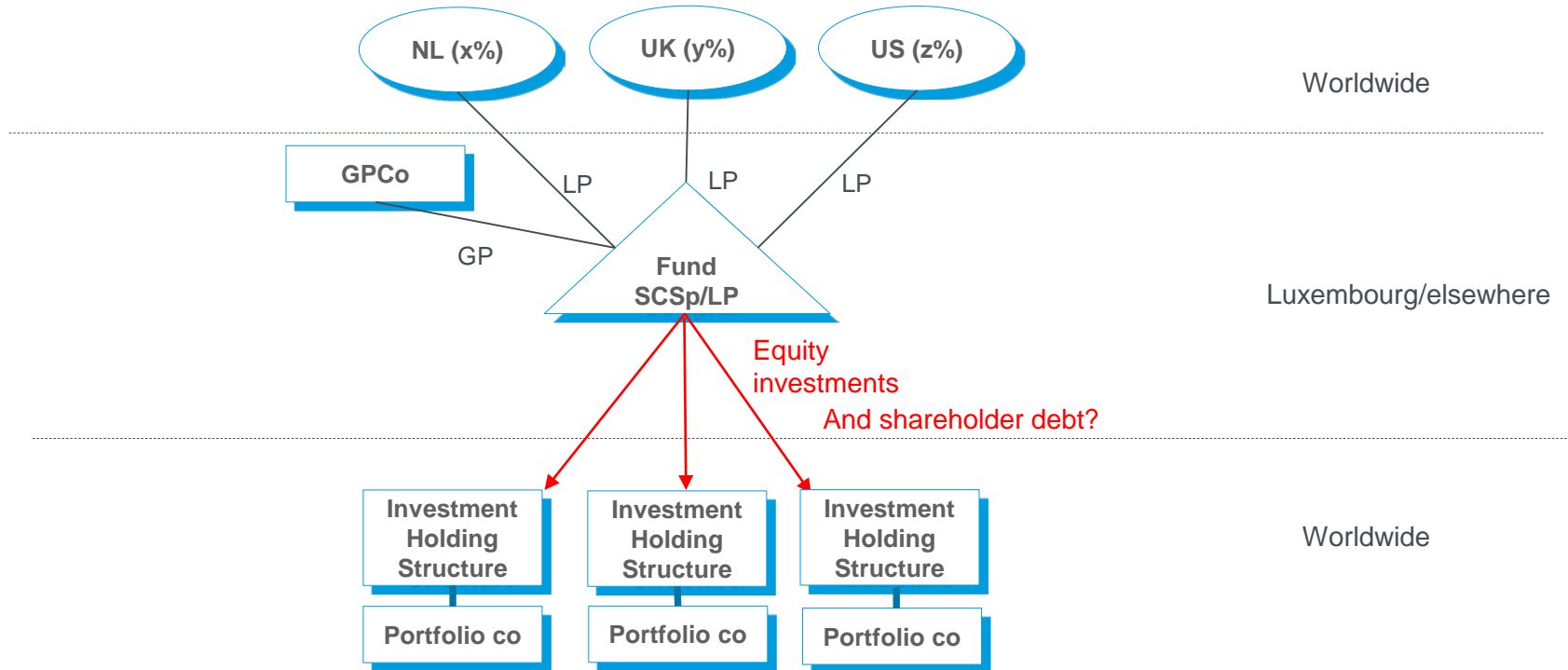


Reverse hybrid rules

- 50%+ of the voting rights, capital interests or profits rights held by limited partners in jurisdictions that view SCSps as tax opaque.
- SCSp will then be subject to Luxembourg CIT, to the extent of those limited partners' interests.
- Not applicable to “collective investment vehicles”:
 - RAIFs/SIFs
 - widely-held AIFs that
 - hold a diversified portfolio of securities
 - are subject to investor-protection regulation

Private Equity Funds

Hybrid mismatches – private equity funds



Buy Out funds

- Deal structuring question to be looked at case by case (generally, no equivalent of the Debt Fund lending Luxco Sarl)
- Hybrid entity mismatch – hybrid payee rules may apply to shareholder debt
 - Look at rules applicable in borrower jurisdiction – not necessarily Luxembourg
 - However:
 - Deductions for interest on shareholder debt typically unavailable or available only to limited extent (interest cap introduced by BEPS Action 4 or transfer pricing)

Buy Out funds

- However: (cont'd)
 - Shareholder debt may have been replaced by preference shares (not in scope because no deduction sought)
 - So typically hybrid payee rules unlikely to be critical, generally more a compliance concern
- Reverse hybrid rules from 1 January 2022 – same considerations as Debt Funds

Venture and Growth funds

- Venture:
 - No holding structures generally
 - Reverse hybrid rules considerations only
- Growth:
 - Depends on holding structures
 - Profile may be like Buy Out or like Venture or a mix

Practical implications

Impact on fund structuring and documents

- ***Structuring***

- Increased use of Reserved Alternative Investment Funds (“RAIF”s) as fund vehicles or feeders for debt funds?
 - Luxembourg tax-exempt vehicles, except subscription tax of 0.0% of NAV per annum
 - Block hybrid issues but maybe also reduce treaty benefits for investors

Impact on fund structuring and documents (cont'd)

- **Documents**

- *Subscription Document:* More detailed questions may be asked by GPs in subscription documents about how the fund vehicles are treated in the country of tax residence/establishment of the prospective LP.
- *LPA/Subscription Document:* More comprehensive provisions for LP to provide information to GP during the life of the fund.
- *LPA:* Broad provisions to allow the GP to allocate costs (e.g., of non-deductibility of interest in Luxco) to “bad” investors.
- *LPA:* Discretion may be built into LPA to allow GP to move investors into parallel vehicles/feeders or convert partnerships during the life of the fund to address hybrid issues.

Monitoring

- Luxembourg guidance expected late 2019
- In particular, keep watching brief on:
 - Acting together rules and the <10% exclusion
 - Reverse hybrid rules CIV (collective investment vehicle) exemption
- Other EU jurisdictions also finalising laws in the coming weeks
- UK reverse hybrid rules

Qualified Opportunity Funds

Tax Benefits of Investing in a Qualified Opportunity Fund (“QOF”)

1

- **Temporary deferral** of tax on eligible capital gains from the sale of property to an unrelated person reinvested in a QOF within 180 days after the sale.
- Gain is deferred until the earlier of a disposition of the QOF interest or December 31, 2026.

2

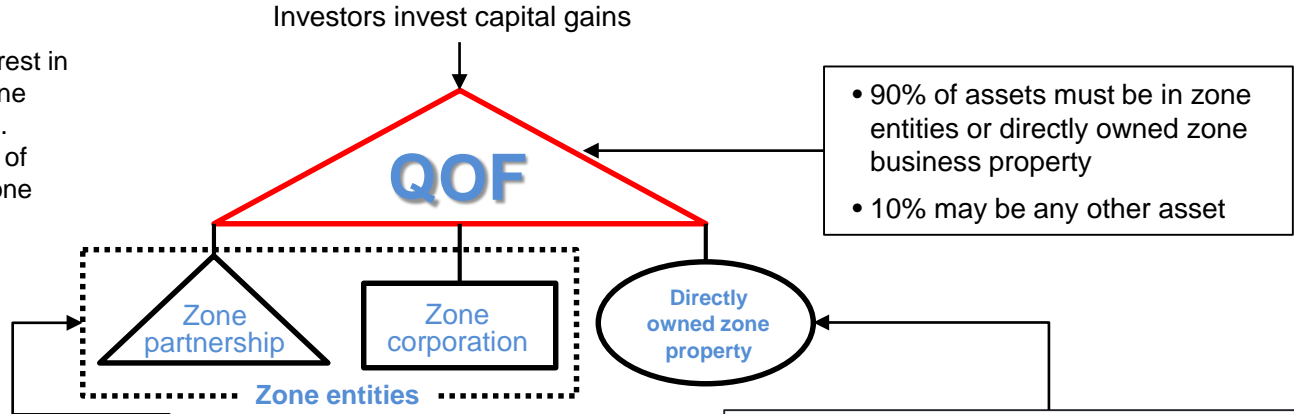
- **Up to 15% reduction in tax** for eligible capital gains reinvested in a QOF and held for a specified period of time (10% after 5 years; 5% more after 7 years).
- Reduces the amount of tax at the end of the deferral period.

3

- **Permanent exclusion** of tax on any new gain from sale or exchange of an appreciated interest in a QOF held for at least 10 years.

Summary of QOF Requirements

- QOF must acquire the interest in the zone entity from the zone entity in exchange for cash.
- The only trade or business of a zone entity must be a “zone business” by meeting the requirements (i) through (v) below



For “substantially all” (at least 90%) of the zone business’s holding period:

- At least 70% of the tangible property owned or leased by the zone business must be zone business property,
 - At least 50% of the gross income of the entity must be from the active conduct of the zone business,
 - A “substantial portion” (at least 40%) of the intangible property of the zone entity must be used in the active conduct of the zone business,
 - Less than 5% of the basis of the zone entity’s property may be attributable to “nonqualified financial property” (stock, debt, etc.) unless the property qualifies for the “working capital safe harbor”, and
 - The zone entity cannot operate a “sin business”.
- Five-Year Grace Period: Tangible property that ceases to be zone business property remains zone business property for five years.

Directly owned zone property must be “zone business property”:

- it must be tangible property used in a trade or business,
- it must be acquired by purchase from an unrelated person after December 31, 2017,
- either the original use of the property in the zone must begin with the fund or the fund must invest at least the amount of the purchase price to improve the property during the 30-month period after the date of purchase, and
- during substantially all (at least 90%) of the holding period for the property, “substantially all” (at least 70%) of the use of the property is in the zone as part of a trade or business.

QOF as a Fund Manager

- Arnold organizes a “qualified opportunity fund” (QOF) partnership to be the manager and general partner of a new private equity fund. The QOF will lease space in a “qualified opportunity zone” (QOZ) from an unrelated lessor for fair market value.
- David and Catherine are first year analysts who will each work in the zone for 40 hours/week. Arnold will work 40 hours/week, but outside the zone.
- Arnold has \$200,000 of unrelated capital gains, which equals the combined annual salary of David and Catherine and the first year of rent. Arnold contributes the \$200,000 to the QOF, which is used by the QOF to prepay salary and rent.

QOF as a Fund Manager (cont'd)

- All of the management fees earned by the QOF that are not used to pay future salary and rent are distributed to Arnold. After ten years, Arnold sells the QOF for \$1 billion.
 1. The QOF satisfies the hours test because more employees work in the QOF than out.
 2. Arnold can defer \$200,000 of capital gains and avoid tax on \$30,000 (15%) of that gain.
 3. After ten years, Arnold can sell the QOF and avoid all tax (unlimited exclusion).

An “Internal” QOF

- A publicly-traded national retail chain has stores in several opportunity zones.
- Periodically, the stores are renovated.
- The chain sets up an “internal” QOF owned by the parent and a subsidiary.
- The parent earns unrelated capital gains and contributes them to the QOF. The QOF uses the cash to buy the fixtures and other improvements for the stores in the opportunity zone and leases the improvements to the stores.
- This structure allows the chain to defer tax on the capital gains until 2026 and avoid 15% of the tax on the capital gains.

Contacts



Robert Gaut

+44.20.7280.2064

rgaut@proskauer.com



Arnold May

+1.617.526.9757

amay@proskauer.com



David Miller

+1.212.969.3006

dmiller@proskauer.com



Catherine Sear

+44.20.7280.2061

csear@proskauer.com

Proskauer's Global Presence





The information provided in this slide presentation is not intended to be, and shall not be construed to be, either the provision of legal advice or an offer to provide legal services, nor does it necessarily reflect the opinions of the firm, our lawyers or our clients. No client-lawyer relationship between you and the firm is or may be created by your access to or use of this presentation or any information contained on them. Rather, the content is intended as a general overview of the subject matter covered. Proskauer Rose LLP (Proskauer) is not obligated to provide updates on the information presented herein. Those viewing this presentation are encouraged to seek direct counsel on legal questions. © Proskauer Rose LLP. All Rights Reserved.