PRIVATE EQUITY UPDATE

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Welcome

Welcome to the spring edition of Private Equity Update.

According to the Financial Times, the key theme coming out of the SuperReturn conference in Berlin was too much money chasing too few assets. According to Preqin, European buyout firms have $300bn to invest: a historical high. The FT also points out that fees are down, returns are down and there is more competition.

In other words…Private Equity is a maturing industry! So perhaps it is appropriate that in this edition we look at the prospect of Private Equity funds having access to retail investors. We also focus on how Luxembourg is expanding its treaty network and give an update on FATCA.

We are less than 100 days away from the UK General Election. A change in Government always creates uncertainty and this election is particularly interesting as there is no indication of the likely outcome. For our clients this may shape the timing of an exit or put investment on hold.

We will be watching the developments closely and no doubt discussing the implications in further editions of Private Equity Update.

I hope you enjoy reading this edition.

Chris Merry
Chief Executive, Ipes

ELTIF proposal offers private equity the prospect of accessing retail investors

By Simon Witney and Brian O'Neill

In the summer of 2013, the European Commission unveiled a proposal for a new type of fund: the European Long Term Investment Fund, or ELTIF. The aim was to create a vehicle that could be easily marketed to both professional and retail investors, facilitating investment by smaller European investors in long-term, illiquid assets. It was potentially an important development for the private equity and venture capital industry, whose funds are not normally accessible to individual retail investors, and one that could open up a new pool of capital.

The Commission's idea was that ELTIFs could, in exchange for more regulation, be marketed to retail investors by managers authorised under the Alternative Investment Fund Managers Directive (AIFMD). These funds could then invest in infrastructure projects, real assets (such as intellectual property, machinery and immovable property but with limits on commercial property and a ban on commodities), unlisted companies or listed small and medium-sized enterprises, as well as other specified types of investment fund. Since mid-2013, work has been underway to agree the rules governing ELTIFs, and late last year a final text was agreed which paves the way for implementation of the new regime.

Initially, proposed restrictions on structures, redemptions and geographic diversification made it hard to envisage that ELTIFs would be used by private equity and venture capital fund managers. But the European Private Equity & Venture Capital Association (EVCA) worked with policy-makers to identify these issues, and the final proposal now allows partnership structures to be used, does not require liquidity mechanisms unless the manager chooses to offer them, includes more reasonable rules on the timing of divestments, and does not include a requirement to invest a certain percentage of the fund in the EU. That means that ELTIFs could prove to be very useful for a number of fund managers.

Some limitations do remain: for example, only EU funds managed by EU managers may be used, so vehicles based in the Channel Islands or other non-EU jurisdictions are not permitted. And although managers based outside the EU may in future be able to opt in to AIFMD, this is

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not currently contemplated for ELTIFs, reflecting their European focus. As well as the investments mentioned above, ELTIFs will be permitted to invest in certain other funds: EuVECAs (the lighter touch regime designed for certain European venture capital funds), other ELTIFs and European Social Entrepreneurship Funds. But their use as funds of funds will be restricted: they won't be able to invest in other AIFs that do not fall into one of these three categories.

The price for a pan-European passport to market to retail investors is, naturally, increased regulation. The marketing documents will need to comply with the requirements of the Prospectus Directive and be accompanied by a "key information document" as prescribed under the Packaged Retail Investments Products (PRIPS) legislative package. The depositary of the ELTIF will be subject to certain provisions of the pending UCITS V Directive and, if the life of the ELTIF exceeds 10 years, an appropriate, written warning must be made to retail investors that the fund may not be suitable for them. The fund manager will also have certain other obligations designed to protect retail investors.

It is currently expected that interested managers will have to wait until (at least) late 2016 for the opportunity to launch an ELTIF, and it is not clear how many will be tempted to do so. The additional regulatory requirements already laid out – and the many more to be included in the final regulations – will mean a different approach to fundraising for most managers, and that will put many off. But the prospect of accessing this large new source of capital will encourage many more to look at ELTIFs very seriously.

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Luxembourg expands its treaty network

By Jean-Michel Chamonard and Samantha Schmitz-Merle

Luxembourg continues to expand its Double Tax Treaty (DTT) network and has recently ratified a new double tax treaty with the three Crown dependencies: Jersey, Guernsey, and the Isle of Man. In the following article, we will present the main features of the Double Tax Treaty with Guernsey. This Double Tax Treaty, which generally follows the provisions of the OECD Model Tax Convention, entered into force on 8 August 2014 and became applicable on 1 January 2015.

DTT benefits for collective investment funds

The Protocol to the DTT includes a specific provision on Collective Investment Funds (CIVs). Under the DTT, body corporate Collective Investment Funds (CIVs) are considered as residents and beneficial owners of the income they receive while CIVs in other forms are considered as individual residents and beneficial owners of the income received.

When applied to Luxembourg investment funds, this means that Luxembourg SICAVs/SICAFs are able to claim treaty benefits and as such, benefit on their investments in Guernsey from the same reduced withholding tax (WHT) rates as ordinary fully taxable Luxembourg companies (maximum of 5% WHT on dividends), while Luxembourg FCPs, since they are tax transparent, are subject to the WHT rate applicable to individuals (which is higher under the DTT: maximum of 15% WHT).

However, for investments performed by Luxembourg CIVs, this distinction is currently irrelevant since the internal tax rules currently in force in Guernsey do not subject dividend distributions to WHT. As a result, there is no need for a Luxembourg CIV to claim the application of the treaty rates.

Nevertheless, the fact that Luxembourg now almost systematically includes CIV-specific provisions in its new DTTs in order to clarify treaty benefits is positive as it will most probably increase the number of situations in which Luxembourg CIVs will be able to benefit from reduced DTT WHT rates when they invest abroad.

Maximum withholding tax rates

The maximum WHT rates applicable under the DTT are as follows:

As far as dividends are concerned, the standard maximum WHT rate is 15% and a reduced WHT rate of 5% applies in case of a company holding at least 10% in the company distributing the dividend. These are the maximum WHT rates that Luxembourg and Guernsey may levy on dividend distributions. However, since Luxembourg grants a WHT exemption under certain conditions and since Guernsey does not subject dividends to WHT, there will be no need to claim the application of the DTT rate in many cases.

As far as interest payments are concerned, they are not subject to WHT and are only taxable in the country of residence of the recipient.

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As far as royalty payments are concerned, they are also not subject to WHT and are only taxable in the country of residence of the recipient.

Capital gains from real estate companies

The DTT deviates from the OECD Model Tax Convention in its current form because it does not provide for a land rich clause. This means that gains derived from the disposal of shares in real estate companies are treated as gains upon the sale of movable property and are therefore only taxable in the country of the seller (whereas under a land rich clause, these gains would be only taxable in the source country, i.e. the country in which the real estate is located).

If the seller is a Luxembourg company, gains will only be taxable in Luxembourg. Additionally, the Luxembourg company realising the gain may be able to benefit, under certain conditions, from the domestic exemption regime.

Avoidance of double taxation

Guernsey applies the credit method. Luxembourg applies the exemption method and as an exception, the tax credit method in respect to dividends.

In addition, Luxembourg is required to exempt dividends received from a company resident in Guernsey if the Luxembourg company holds at least 10 % of the distributing company from the beginning of the year and if the distributing company is liable to a corporate income tax comparable to Luxembourg corporate income tax. The exemption remains applicable even if the subsidiary is exempt or taxed at a reduced rate, as long as the dividends are derived from activities in industry, agriculture, infrastructure or tourism in Guernsey.

Exchange of information

The provisions of the DTT on exchange of information are in line with the OECD provisions regarding exchange of information upon request.

Changes to the EU participation exemption regime

Amendments introduced to stop the use of certain hybrid instruments creating situations of double non-taxation.

The Parent Subsidiary Directive 2011/96/EU has been amended by Directive 2014/86/EU of 8 July 2014 in order to challenge certain hybrid financial instruments and consequently remove situations of so-called double non-taxation in an EU context. The new Directive has to be implemented by the EU member states by the end of 2015 at the latest.

Hybrid instruments are instruments which are given a different tax qualification by two different jurisdictions: for example, the jurisdiction of source (jurisdiction of the subsidiary) qualifies the instrument as a debt instrument and therefore treats the payment made under this instrument as a tax-deductible interest payment. The jurisdiction of the parent company qualifies the instrument as equity investment and therefore treats the payment received by the parent company as a dividend which can benefit from a tax exemption under certain conditions. This mismatch in the tax treatment can create a situation of so-called double non-taxation, i.e. no taxation in both the jurisdiction of source and the jurisdiction of residence of the parent company.

To avoid this, the EU Parent-Subsidiary Directive has been amended in such a way that if a payment made is tax deductible in the EU member state of the subsidiary, i.e. in the country of source, it will have to be taxed by the EU member state of the parent company. In other words, the EU parent company will only be able to obtain a dividend exemption under the participation exemption regime of the EU Directive if the payment made by its EU subsidiary is not tax deductible in the jurisdiction of the subsidiary. This restriction applies only to distributions/payments taking place between 2 EU companies, meaning that no such restriction applies in the case of payments/distributions between non-EU companies.

Introduction of a General Anti-Abuse Rule

An additional change to the EU Parent-Subsidiary regime has been introduced more recently with Directive 2015/121 of 27 January 2015 amending Parent Subsidiary Directive 2011/96/EU. The new Directive introduces a “de minimis” General Anti-Abuse Rule (GAAR) in the EU Parent-Subsidiary regime (“de minimis” meaning that EU member states can apply stricter national rules, as long as they meet minimum EU requirements).

According to the amendment, there will be no dividend exemption under the amended Directive in case of arrangement or series of arrangements that, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage which defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances. “Not genuine” means that they are not put into place for valid commercial reasons which reflect economic reality.

The new GAAR, as most GAARs generally do since they are a matter of many various interpretations, will create some legal uncertainty and will have to be defined more precisely by the European Court of Justice of the EU, which will most probably require some time. In the meantime, to reduce at maximum the chances of application of the GAAR, taxpayers will have to pay a lot of attention to economic substance when structuring their investments.

Implications

Given these two changes which the EU member states will be required to integrate into their internal law by the end of 2015 at the latest, and considering the ongoing BEPS work which will most probably require the adoption of similar measures at a global level in the near future, multinationals should now review their investment structures carefully and remain particularly prudent, seeking the advice of their tax advisor when structuring new investments.

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FATCA – What to do now

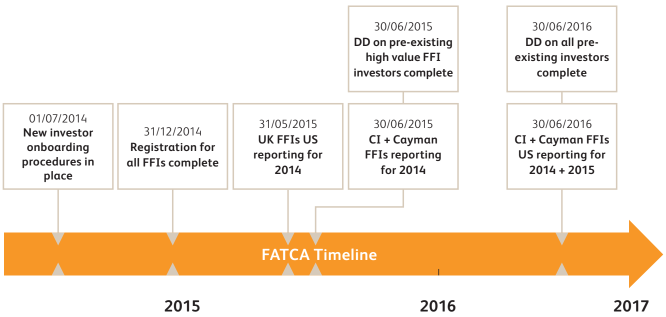
By Tim Andrews, Service Development Director

Foreign Account Tax Compliance Act (FATCA) Reporting is due by mid 2015 and is here to stay. Fund Managers should beware of some pitfalls in the process and, like Alternative Investment Fund Managers Directive (AIFMD) Reporting, ensure that they minimise its impact on investors and cost.

FATCA in 2014 – Classification and Registration

FATCA, the attempt to eradicate tax evasion by US tax residents using foreign accounts through information sharing between jurisdictions and the US, rose up the agenda of Fund Managers in 2014 as it was transposed into the law of most developed countries under Inter-Governmental Agreements (IGAs). It therefore applies to all Foreign Financial Institutions (FFIs) both within and outside the United States, irrespective of whether they transact in US Dollars, have US Investors or own US portfolio companies.

In practice, FATCA is a 4 stage process whereby Managers must classify each entity in their Funds into a number of 'buckets' which determine whether the entity must be reported to the local tax authority. If an entity is to be reported then the manager had to obtain a Global Intermediary Identification Number (GIIN) by 31 December 2014.



FATCA has been applied in practice by multiple Regulators, each with their own guidance, systems and legislation. As with AIFMD, most European authorities have scrambled to adapt their systems to accept the required reports in XML format and have published and updated their guides – not always in English.

Recently HM Revenue and Customs (HMRC) clarified that the top holding company in an investment structure should not be classified as reportable. This has long been a discrepancy with other Model 1 IGA countries such as Guernsey and Luxembourg and now leaves some managers deregistering some holdcos that no longer have to report. Some jurisdictions, such as Luxembourg, require nil returns on the basis that if you do not report, how can the authorities ensure compliance? Other jurisdictions, like the UK, do not require nil returns, at least for now. Overall, remaining compliant is harder than it should have been.

FATCA in 2015 – Due Diligence and Reporting

Having classified their structures and obtained their GIINs, many Managers are in the midst of reviewing their CDD on existing investors against the indicia specified under FATCA. Funds must determine whether their investors are reportable under FATCA as US taxpayers or, if the Fund is domiciled in the UK or Crown Dependencies, under 'UK FATCA' as UK taxpayers. Getting this decision wrong exposes the board of the General Partner to risks of non compliance or to the inadvertent reporting of investors to the tax authorities.

Short term, many houses have relied on paper systems to obtain and evaluate the required information. This has led to a wide array of paper forms which can leave investors uncertain. A systemised and standardised approach is clearly necessary across the industry to reduce duplicative effort. Managers should also ensure that each investor self certifies the accuracy of the information that they provide so as to limit their own exposure.

Reporting – Another XML Submission

Once the due diligence on each investor has been reviewed, those that are reportable as US taxpayers need to be reported to the tax authority in the domicile of the fund by 30 June 2015. Under 'UK FATCA' reporting will be due by 31 May and will begin in 2016 on data from both 2014 and 2015. Managers therefore face a calendar of tax reporting alongside the AIFMD Reporting that many have had to begin submitting recently.

While, like AIFMD, FATCA is a prescribed reporting format, the experience of multiple user guides and interpretations suggests that significant variation will emerge in both content and submission method over time.

In a bid to set a standard for legislation and reporting, the OECD recently published the Common Reporting Standard (CRS) which will be in place by 2017. More than 90 countries have signed up to the CRS of which 58 will adopt it in 2017 and the remainder in 2018. The tax information exchange that started with FATCA is therefore here to stay and will become increasingly global over the coming years.

What to do now:

1. If you have not started classifying and registering it is not too late in practice. Do it now to ensure that you remain compliant with local legislation.
2. Ensure that you or your provider has an efficient, systematic process to minimise cost, investor hassle and risk of error.
3. Ask questions. This process is new for tax authorities, service providers and managers alike. There is no such thing as a silly question.
4. Embed the process. FATCA will apply to all new Funds and investors and should be built into Fund documents, due diligence and the reporting cycle.
5. Look ahead. The CRS requirements are similar but not identical to FATCA. Ask the questions from investors now to avoid repeating the process in future.

There is a lot of confusing content out there. If you would like to discuss FATCA or AIFMD Reporting in greater detail we would be happy to talk further.

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