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Key tax issues for private equity funds

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Over the recent past there have been a number of wide-reaching developments to tax legislation and regimes, both in the UK and worldwide. These have led to a new tax landscape when private equity funds are considering new investments or which may need to be taken into account for existing investments. And these issues are not only relevant to the investments being made, or transactions being entered into, but also to the structure or the management of the fund itself.

In this climate of complex tax legislation and heightened tax authority scrutiny, it is especially important to be aware of the tax points in relation to transactions and investments, and any interplay with the fund's own position, so that you are not ambushed by the latest raft of changes to tax rules. This note seeks to highlight some of the issues that relate to investments made by private equity funds, and provides accompanying high level commentary.

If you are at all concerned in relation to your fund's tax position, or in respect of any investments, then please do not hesitate to get in touch with us.

We look forward to working with you in the future.

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Tax deductibility of interest on senior/mezzanine debt

The "anti-hybrids" rules, introduced by the Finance Act 2016, may apply to disallow the deductibility of interest where it is paid to, or by, a "hybrid entity". The rules apply equally to shareholder debt as they do to other debt, but given that shareholder debt is often assumed to be non-deductible, these rules may have a more material impact on senior/mezzanine debt.

Why is this relevant?

- These rules introduce a material risk of deductions not being available on mezzanine/senior debt which would normally have been assumed to be deductible in the bank model.
- These rules are relevant for funds that have:
  - invested in groups hit by a disallowance under these rules, and/or;
  - provided their own mezzanine/senior funding.
- If the disallowance applies to existing borrowing it can cost a lot of money and hit cash flow.
- This is a live issue because any borrowing companies affected will likely have recently filed/will shortly be filing tax returns which have to deal with this issue for the first time.

When is disallowance most likely to arise?

- A disallowance of a deduction is most likely to arise where at least one of the following is involved:
  - mezzanine/senior debt is provided by a lender who is in the same "control group" as the borrower. Broadly this may be in issue where the lender is a shareholder and/or a warrant holder;
  - debt is provided by a debt fund rather than a high street bank, although if the debt fund is not also a shareholder/warrant holder in the borrower, and is a third party lender lending on commercial terms, then HMRC guidance suggests the rules may not apply;
  - the borrowing group includes companies which have been elected to be treated as partnerships or pass-through entities for US tax purposes, rather than corporates, under the US "check-the-box" rules; and/or
  - the borrowing group includes "hybrid instruments" (for example a loan that is treated as a debt in one jurisdiction but equity in another).

What happens if the rules apply?

- Deductions for all or some of the interest accruing or paid on third party debt from 1 January 2017 will be disallowed. The lost deduction may mean that the amount of the interest is subject to UK corporation tax (currently at a rate of 19%).
- If the group has incorrectly assumed deductions are available, there may be historic unpaid cash tax liabilities.
- To file its returns, a borrower may need information from the lender, although this may be confidential and/or not available.

What should I be thinking about?

- Thinking about the potential for disallowance at the start of a new deal will be important, particularly where the lender takes warrants or equity interests.

Increased focus on substance

Scrutiny over the substance of holding companies has significantly increased over recent years.

What's new?	• The EU has published a set of rules that certain non-EU countries are required to comply with in order to avoid being branded as "non-cooperative". Accordingly, there are impending rule changes around substance requirements as offshore jurisdictions seek to comply with the EU rules. Jersey, Guernsey and BVI are among the jurisdictions to enact legislation, which came into force in January 2019. • The OECD's multilateral instrument (initially proposed by the BEPS project) has now been implemented in the UK, amending from 1 October 2018 certain double tax treaties (where the other jurisdiction has also implemented the instrument). These changes include restricting access to treaty benefits where the obtaining of that benefit was the principal purpose of the arrangement.
What are the potential consequences?	• If the residence/substance of a holding company isn't carefully managed you could end up with: - significant problems on an exit where the buyer will identify the risk of materially increased tax liabilities; and - holding companies may not have access to treaty benefits (for example to knock out withholding taxes) which they had been assuming were available, affecting investor returns.
What should I be thinking about?	• Careful thought should be given to ensuring that holding companies in investment structures are properly managed and controlled in the intended territory and that any substance rules are properly considered. • You may need to think carefully about the substance of holding companies in the context of your own fund structure. • Where treaty provisions are relied upon, consideration should be given to whether those benefits would still be available.

Luxembourg structures

What's new?

- Similarly to the UK, Luxembourg are also implementing their own new legislation as a response to the BEPS project and the EU's Anti Tax Avoidance Directives. This includes new rules in relation to hybrid mismatches, which apply where financial instruments are treated differently for tax purposes in different jurisdictions.

What should I be thinking about?

- You will need to consider these rules in relation to any Luxembourg structures where either:
  (i) check-the-box elections have been made over entities, such that they are treated differently for US tax purposes as from Luxembourg tax purposes; and/or
  (ii) debt instruments are used which are treated differently for tax purposes in Luxembourg as compared to other jurisdictions.

Taxation of carried interest in the UK and the US

What's new?

- Legislation came into force in the UK in April 2016 which sought to tax carried interest at income tax rates, rather than capital gains tax rates, unless the holding period for the fund's investments were sufficiently long (broadly 40 months).
- These rules do not seek to apply to individuals that are already employees (or treated as such for UK tax purposes).
- The US have introduced their own similar set of rules, and for US carry holders to secure the lower rate of tax, an investment has to be held for at least 3 years.

Why is this relevant?

- Although the UK rules have now been in force for a couple of years now, they continue to be a focus for many funds given the significant effects they can have on the returns to carry holders.
- Deal-by-deal carry models should be especially closely considered given how the tests for the length of the holding periods operate (although the rules should equally still be considered for whole-fund carry models).

What should I be thinking about?

- We are continuing to monitor developments in this sphere as the new rules bed in, and we would be happy to discuss any aspects of these rules with you.

New US withholding tax

What's new?

- New rules have been introduced in the US which require a 10% withholding tax rate to be applied on the gross consideration on a disposal by any non-US person of any entity that is a partnership or has elected to be treated as a partnership for US tax purposes, where that entity generates any income "effectively connected" to the US ("ECI").
- No withholding is required, however, if the transferor, or the underlying general partner, can provide an adequate affidavit that either:
  - the transferor is a US entity; or
  - the relevant entity does not generate any ECI.

Why is this relevant?

- Where a company is incorporated to be used as a vehicle for an acquisition, it may have made a check-the-box election to be treated as a partnership for US tax purposes (most often the case where the fund has a US investor, or if a previous owner had US investors, or to assist with US valuation analysis for US management teams). In such a case the withholding tax could apply to the consideration on a disposal of the company on an exit.
- Providing the affidavit referred to above may not be straightforward. If it cannot be provided, then an IRS notice has set out some limited exclusions from the withholding applying, but it is unclear to what extent these may be relied upon.
- These rules may also be relevant where partnership interests are being transferred at

What should I be thinking about?

- Careful consideration should be given to whether these rules could apply to any entities in acquisition structures that have made "check-the-box" elections, or whether such elections should be made in respect of any new acquisition structures to be established in the future.
- Carrying out adequate due diligence on a transaction to ascertain whether there is any ECI in the target group, and considering whether appropriate affidavits may be made, or whether any of the exemptions in the IRS guidance may be relied on.
- Since these are new US rules that the market is only just familiarising itself with, we would recommend seeking appropriate tax advice if you are concerned with the position in relation to a transaction.

Trump tax reforms

What's new?

- As part of the Trump tax reforms, new "global intangible low taxed income" (GILTI) provisions have been introduced.

Why is this relevant?

- Funds which hold investments in groups with both US and non US companies need to think carefully about the impact of the GILTI provisions.
- The measures are meant to target US corporates that own "controlled foreign companies" for US tax purposes, but these rules have wide ranging and counter intuitive implications which can result in inadvertently triggering unfunded tax charges for investors.
- We anticipate that most funds will already have been considering these provisions, however the impact of bolt-ons in triggering these provisions may be less well known. We have come across circumstances where the bolt-on of a US entity into an existing investment can create unexpected and material tax charges for the US fund investors. The ensuing tax charges have been linked to the value of and level of US profit in the US entity.

What should I be thinking about?

- Steps can be taken to mitigate the risk of such a charge provided the potential problem is identified in advance of completion of the bolt-on acquisition
- It's worth considering what information rights you have to ensure you can take appropriate steps to manage this point if these US tax provisions are relevant to your fund.

EU rules on disclosure requirements

What's new?

- The Sixth EU Directive on Administration Cooperation has introduced a new mandatory reporting regime in respect of reportable cross-border arrangements.
- The Directive has already come into force and is relevant to things you are doing now.

Why is this relevant?

- The new rules are aimed at combatting tax avoidance but are in fact drawn much more widely, and are expected to catch many standard transactions that you may be working on now.
- If you fall within the regime, then details of the deal you are working on, including the names of relevant shareholders and a summary of the deal and deal value, may need to be disclosed to HMRC (and shared with the tax authorities of relevant EU member states).
- It is unlikely that Brexit will prevent the rules from coming into force in the UK and the rules will also apply to the remaining EU Member States.

Will disclosure be seen as a 'badge' of tax avoidance?

- An EU working group have clarified that if a transaction includes one of the "hallmarks" of the rules, this does not automatically constitute a finding of tax avoidance, but instead identifies the arrangement as one which tax authorities may wish to examine more closely. However there is still some concern that disclosures of this sort may be implicitly treated as a sign of involvement with tax avoidance involvement notwithstanding any such high level assurances.

What should I be thinking about?

- The first disclosures will be made in August 2020 but will cover the period from 25th June 2018 onwards so you need to have a system in place now to capture all relevant information in relation to transactions which may be affected.
- We are closely monitoring the development of these rules and their implementation, with one of our tax partners on a key working group in connection with their implementation, and we would be happy to discuss these rules with you in more detail.

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