Current state of play of private equity structures and the use of partnerships

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Part I: Current trends in PE structures

General overview

- The application of Tax Treaties to Collective Investment Vehicles and Private Equity (PE) Structures:
  - Tax residence
  - Beneficial Ownership
  - Principal Purpose Test

- The application of the Directive on dividends (PSD) and on interest and royalties (IRD) to PE structures
  - The anti-abuse clause in the PSD
  - The Beneficial Ownership clause in the IRD: the Danish Cases.
- PPT vs. PSD vs. ATAD anti-abuse clause.

- The use of partnerships and hybrids: pitfalls and opportunities for PE structures

Art. 1 PSD as amended by EU Directive 2015/121

2. Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements which, having been put into place for **the main purpose or one of the main purposes** of obtaining a tax advantage that defeats the object or purpose of this Directive, are **not genuine** having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

3. For the purposes of paragraph 2, an arrangement or a series of arrangements shall be regarded as **not genuine** to the extent that they are **not put into place for valid commercial reasons which reflect economic reality**.

4. This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse.

Art. 6 EU Directive 2016/1164 (ATAD)

1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for **the main purpose or one of the main purposes** of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are **not genuine** having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as **non-genuine** to the extent that they are **not put into place for valid commercial reasons which reflect economic reality**.

3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, **the tax liability shall be calculated in accordance with national law**.

Art. 7 MLI (minimum standard)

1. Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was **one of the principal purposes** of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.

4. Where a benefit under a Covered Tax Agreement is denied […] the competent authority of the Contracting Jurisdiction that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to **different benefits** with respect to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement. The competent authority of the Contracting Jurisdiction to which a request has been made under this paragraph by a resident of the other Contracting Jurisdiction shall consult with the competent authority of that other Contracting Jurisdiction before rejecting the request.

ECJ, C-116/16 and C-117/16, Danish Cases (PSD)

75. […] the principle that **abusive practices are prohibited** nonetheless constitutes a **general principle of EU law** which applies irrespective of whether the rights and advantages that are abused have their basis in the Treaties, in a regulation or in a directive […].

77. Whilst Article 1(2) of Directive 90/435 provides that the directive is not to preclude application of the domestic or agreement-based provisions required for the prevention of fraud or abuse, that provision cannot be interpreted as excluding the application of the general principle of EU law, noted in paragraphs 70 to 72 above, that abusive practices are prohibited. […]

79. To permit the setting up of financial arrangements whose **sole aim is to benefit from the tax advantages resulting from the application of Directive 90/435** would not be consistent with such objectives and, on the contrary, would undermine the effective functioning of the internal market by distorting the conditions of competition. As the Advocate General has, in essence, observed in point 51 of her Opinion in Case C-116/16, that would also be the case even if the transactions at issue do not exclusively pursue such an aim, as the Court has held that the **principle that abusive practices are prohibited applies**, in tax matters, where the **accrual of a tax advantage constitutes the essential aim of the transactions** at issue […].

81. Whilst the pursuit by a taxpayer of the tax regime most favourable for him cannot, as such, set up a general presumption of fraud or abuse […], the fact remains that such a taxpayer cannot enjoy a right or advantage arising from EU law where the transaction at issue is **purely artificial economically** and is designed to **circumvent the application of the legislation** of the Member State concerned […].

89. Nevertheless, even if it were to transpire, in the main actions, that national law does not contain rules which may be interpreted in compliance with Article 1(2) of Directive 90/435, this — notwithstanding what the Court held in the judgment of 5 July 2007, *Kofoed* […] — could not be taken to mean that the national authorities and courts would be prevented from refusing to grant the advantage derived from the right of exemption provided for in Article 5 of the directive in the event of fraud or abuse of rights […].

97. As is clear from the Court's case-law, proof of an abusive practice requires, first, a **combination of objective circumstances** in which, despite formal observance of the conditions laid down by the EU rules, the purpose of those rules has not been achieved and, second, a **subjective element consisting in the intention to obtain an advantage from the EU rules by artificially creating the conditions** laid down for obtaining it […].

ECJ, C-115/16, C-118/16, C-119/16 and C-299/16, Danish Cases (IRD)

84. […] the concept of 'beneficial owner of the interest', which appears in Article 1(1) of Directive 2003/49, **cannot refer to concepts of national law** that vary in scope.

86. The scope of Directive 2003/49, as defined in Article 1(1) of the directive, thus concerns the exemption of interest and royalty payments in their source Member State, provided that the beneficial owner is a company established in another Member State or a permanent establishment situated in another Member State belonging to a company of a Member State […].

88. The concept of 'beneficial owner of the interest', within the meaning of Directive 2003/49, must therefore be interpreted as designating an entity which **actually benefits from the interest** that is paid to it. Article 1(4) of the directive confirms that **reference to economic reality** by stating that a company of a Member State is to be treated as the beneficial owner of interest or royalties only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person.

89. […] the term 'beneficial owner' concerns not a formally identified recipient but rather the entity which **benefits economically from the interest received** and accordingly has the **power freely to determine the use** to which it is put. […]

90. […] the directive draws upon Article 11 of the OECD 1996 Model Tax Convention and pursues the same objective, namely avoiding international double taxation. The **concept of 'beneficial owner', which appears in the bilateral conventions** based on that model, and the successive amendments of that model and of the commentaries relating thereto are, therefore, **relevant** when interpreting Directive 2003/49.

92. It is clear from the development — as set out in paragraphs 4 to 6 above — of the OECD Model Tax Convention and the commentaries relating thereto that the **concept of 'beneficial owner' excludes conduit companies** and must be understood not in a narrow technical sense but as having a meaning that enables double taxation to be avoided and tax evasion and avoidance to be prevented.

95. - 124. Similar to the corresponding paragraphs (68. - 97.) of the decision, C-116/16 and C-117/16, Danish Cases (PSD)

US Trends in Private Equity structures

- **PE Issues with Hybrids**
  - **US Investors**
    - Restrictions on US Entity Classification
      - ✓ Unrelated business taxable income
      - ✓ Unrelated debt financed income
      - ✓ Phantom income
      - ✓ Blockers
  - **US Targets**
      - ✓ Entity Classification for US Tax
      - ✓ CFC Rules

US Trends in Private Equity structures

- **Recent Significant Changes Impact US PE Investors**
  - Taxation of Carried Interest
  - CFC Attribution Rules under Section 958(b)(4)
  - Anti-Hybrid Regulations
- **Recent Significant Changes Impacting US Targets**
  - Deal Financing: Section 163(j) Limitations
  - Anti-Hybrid Regulations
- **Potential Changes in Tax Law Impacting US PE Investors**
  - Capital Gain and Ordinary Income Equalization
- **Potential Changes in Tax Law Impacting US Targets**
  - Increasing Corporate Rates
  - Revisiting Interest Limitations

UK Trends in Private Equity

- **Issues at fund level**
  - Use of partnerships in PE structures
    - partnerships common in the UK and very familiar to UK investors. Very unusual for a private equity fund to not be structured as a partnership
  - Substance
  - Anti-hybrid rules

- **Issues at investment level**
  - General comment – no big changes in UK structures as a result of ATAD
  - Substance
  - Limits on deductibility of interest costs (corporate interest restriction and anti-hybrid rules)

UK Trends in Private Equity – use of shareholder debt

- **Two sets of rules which have impacted the use of shareholder debt in PE deals**
  - The corporate interest restriction rules (apply from 1 April 2017)
  - UK anti-hybrid rules (apply from 1 January 2017)
- **The corporate interest restriction**
  - Rules operate to restrict the tax deductibility of interest and other financing amounts
  - Starting position - tax deductibility of net interest expenses is restricted to 30% of EBITDA, subject to the application of a "modified debt cap“ (special rules for groups with high levels of 3rd party debt)
- **The anti-hybrids rules**
  - Rules disallow the deductibility of interest where interest is paid by or to a hybrid entity, or under the terms of a hybrid financial instrument
  - If there are hybrid instruments or entities within the fund structure, it may be necessary for the Target Group to consider whether this could result in the disallowance of deduction for interest on shareholder debt.
- **Practical implications**
  - Rules above mean that tax is less of a driver for use of shareholder debt in UK PE deals
  - Who bears the cost of denied interest deductions under anti-hybrid rules?

UK Trends in Private Equity - substance

- **Substance generally less of an issue for UK PE deals because may not need to rely on DTT**
  - No withholding tax on UK dividends
  - Withholding tax on UK interest but possible to mitigate through domestic exemption
- **But, general focus on substance**
  - PE managers are generally required to put adequate substance into their headquarters for both regulatory and tax compliance purposes
  - UK Managers operating pan-European funds and deal structures aware that they need to establish substance in the various jurisdictions in which they have legal entities
  - Trend towards Managers locating holding companies in same jurisdiction as the fund

Brazilian Trends in Private Equity related to anti-abuse

- **Use of investment fund (FIP) by investors in Brazil**
  - **Exemption of FIP capital gains.** Two requirements must be met:
    1. No investor can have more than 40% of the FIP; and
    2. Investor cannot be in a black list jurisdiction.
  - **FIP** – limitations:
    1. Cannot pay interest or dividends;
    2. Can only invest in Brazilian corporations; and
    3. Needs a Brazilian third party to manage the FIP.

- **Substance/Beneficial Ownership**
  - **Who is the investor in applying the FIP capital gains tax exemption?**
    - Non Brazilian-fund?
    - Intermediary entities that invest directly into Brazil?
    - Ultimate beneficial owner of the foreign fund?

Luxembourg Trends in Private Equity (issues at fund level)

- **Use of partnerships in PE structures**
  - for pan European alternative funds within the framework of the Alternative Investment Fund Manager Directive (AIFMD) Luxembourg partnerships are gaining a tremendous popularity for EU and non EU sponsors who are looking for investing in the EU and / or raising capital within the EU
  - Luxembourg company law in relation to limited partnerships has been redesigned making them one of the most flexible in Europe
- **Substance**
  - No substance requirements for the LPs; holding structures need to meet the PPT (MLI and EU Directives) and the transfer pricing requirements; documentation is key
  - Asset managers based in Luxembourg can reconcile regulatory and tax requirements

Luxembourg Trends in Private Equity (issues at fund level)

- **Anti-hybrid rules**
  - Reverse hybrid issues need to be addressed (applicable from 01.01.2022 on)
  - The tax treatment of transparent entities in and outside the EU is very disparate
  - Luxembourg holding companies are potentially hit by ATAD 1 and 2
  - Specific measures for investment funds regarding « acting together » concept (de minimis rule) and the reverse hybrid rule (CIV exemption)
  - Alternative structuring involving regulated funds and holding companies both based in Luxembourg
  - Who bears the cost of denied interest deductions under anti-hybrid rules?

Italian Trends in Private Equity related to anti-abuse

- **Entitlement to (EU Directives, DTCs or domestic) tax reliefs on dividends, interest and capital gains**
  - specific/general anti-abuse provision
  - beneficial ownership
    - interest: requirement not met in case of back-to-back structure
    - dividend: requirement not met in case of obligation to transfer the dividend cashed (e.g. dividend washing arrangements); should be met if dividend is used for fulfilling contractual/legal obligations from other sources (*e.g.* payment of interest on acquisition debt)
    - beneficial ownership as a general principle of international tax law (Italian Supreme Court No. 25281/2015, No. 10792/2016 and Nos. 24287 and 24291/2019): does it apply to capital gains too?
  - substance of intermediate investment vehicles
    - indicators of lack of substance (Circular Letter No. 6/2016):
      - conduit entity: “light” structure (in terms of personnel, premises and equipment), lack of managerial autonomy
      - conduit arrangement: pass-through structure
      - how much substance for a holding? Consistency with its functions (Italian Supreme Court No. 27113/2016; CJEU, cases C-504/16 and C-613/16, *Deister Holding and Juhler Holding*)
  - possible use of look-through approach for investment funds (see CJEU, Danish Cases-IRD, par. 94): proof is very burdensome

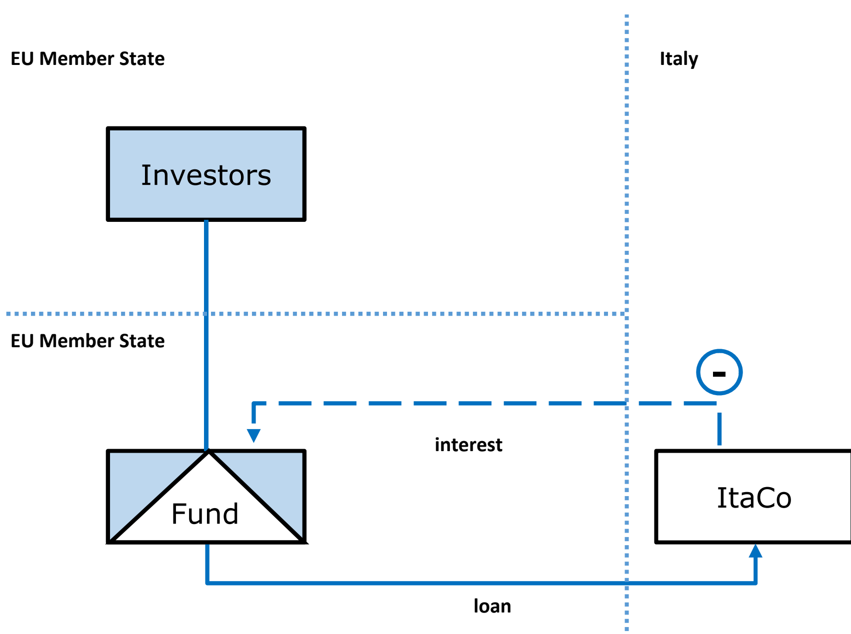
Italian Trends in Private Equity related to anti-abuse

- **Domestic WHT exemption on interest**
  - lenders: EU banks and insurance companies or white list foreign institutional investors subject to regulatory supervision
  - borrowers: Italian-resident enterprises
    - UCITS are out of scope (see Ruling No. 98/2019)
  - loans: medium-long term (> 18 months)
  - no beneficial owner analysis (Ruling No. 423/2019; Resolution No. 76/2019)

- **Interest/notional interest deduction**
  - post-ATAD interest deduction rule: cap to 30% tax EBITDA
  - Notional interest deduction (ACE): specific anti-abuse rules applicable also to foreign-source equity contributions

- **Anti-hybrid rules**
  - Foreign UCITS tax opaque for Italian tax purposes and generally tax transparent in the jurisdiction of establishment: a reverse hybrid mismatch could arise (D/NI) → Italian target should not deduct interest expenses as a primary response (applicable from 1.1.2022 onwards)

Italy: payment to a foreign reverse hybrid



- **Case**
  - Fund transparent in its State of establishment/opaque for the Investors' State (reverse hybrid)
- **Effects**
  - ItaCo deducts interest paid to Fund
  - Fund does not tax interest received from ItaCo
  - Interest is not taxed in the hands of the Investors, since their State of residence considers Fund as tax opaque
- **Mismatch**: D/NI (Art. 4(9)(b) of ATAD; Art. 6(1)(r)(3) of Decree No. 142/2018)
- **Response** (Art. 9(2) of ATAD; Art. 8(2)(a) of Decree No. 142/2018)
  - Primary: Italy must deny interest deduction
  - Secondary: the State where the Fund is established must include interest in taxable income

Spanish Trends in Private Equity related to anti-abuse

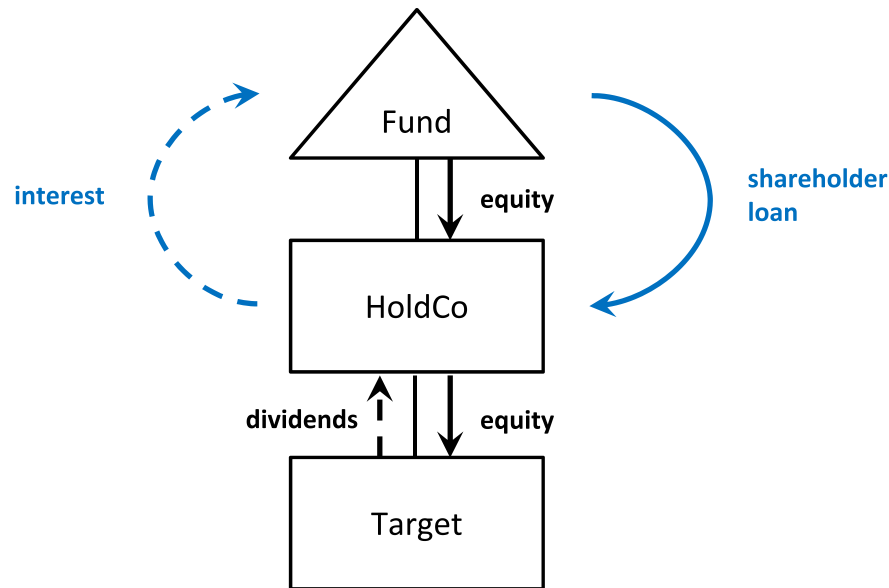
- **Beneficial ownership**
  - Not an anti-abuse concept included in domestic law (only Tax Treaties and PSD)
  - Administrative Court (TEAC) October 8, 2019 (two resolutions), adopts doctrine of CJEU on Danish cases in connection with the exemption on interest paid to EU resident (art. 14.1 c) NRIT Law) and dividends (PSD – art. 14.1.h) NRIT Law).
  - Is beneficial ownership principle applicable to exemption to third party interest and capital gains on sale on substantial participations obtained by EU residents?
  - Supreme Court sentence of September 23, 2020 (Colgate case) concludes in a case of royalties paid to Switzerland, where art. 12 of Tax Treaty does not include the B.O. anti-abuse clause, that the B.O. clause cannot be inferred from the Tax Treaty unless expressly included. Potential extension of the reasoning of Colgate case into domestic law.
- **Proof of residence for EU AIF (subject to AIFMD) for the purpose of art. 14.1 c) NRIT Law (exemption on interest paid to and capital gains on sale of shares obtained by residents in the EU)**
  - The management company can certify whether the entity is fiscally transparent or non-transparent. In case of a **transparent entity**, the management company can also certify the percentage of EU resident interest-holders. In case of a **non-transparent entity**, the entity is resident for tax purposes in the EU.
  - Tax treatment of dividends will depend on the entity being resident or not within the meaning of a Tax Treaty with Spain.
  - Is the AIF beneficial owner of the income received?

Spanish Trends in Private Equity related to anti-abuse

- **Tax transparency of foreign entities / partnerships**
  - Non resident entities qualify as transparent in Spain if their legal nature is identical or substantially similar to the one of Spanish transparent entities (art. 37 NRIT Law):
  - Spanish tax authorities had bend from giving more weight to legal features until 2015 to the tax treatment given by the country of incorporation (2015 onward), with the aim of avoiding hybrids.
  - General Tax Directorate (DGT) *Resolution of February 6, 2020 on qualification of non resident entities as transparent entities incorporated abroad* only test tax features in the country of incorporation:
    - Not subject to CIT.
    - Attribution of income to its partners when the income has been generated (disregarding whether distributed or not).
    - Maintenance of same qualification of the income for the partner.

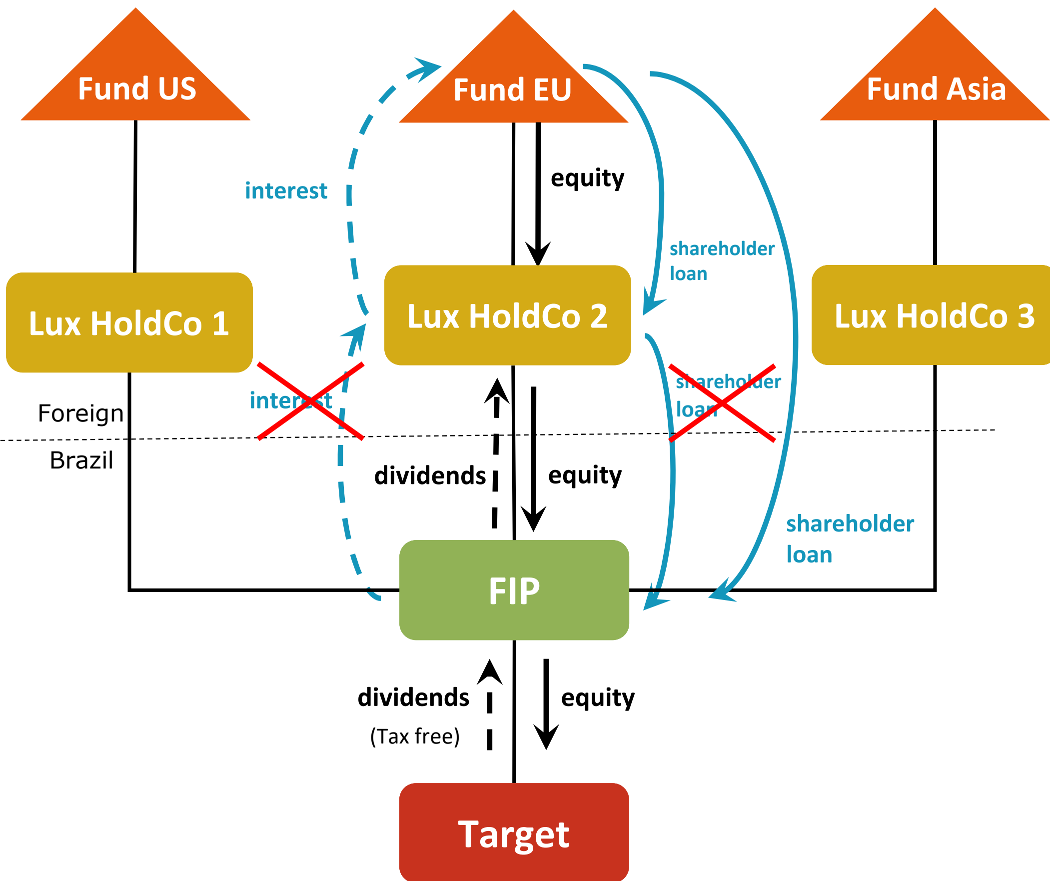
Part II: Case studies

Sample case 1: Private equity investment



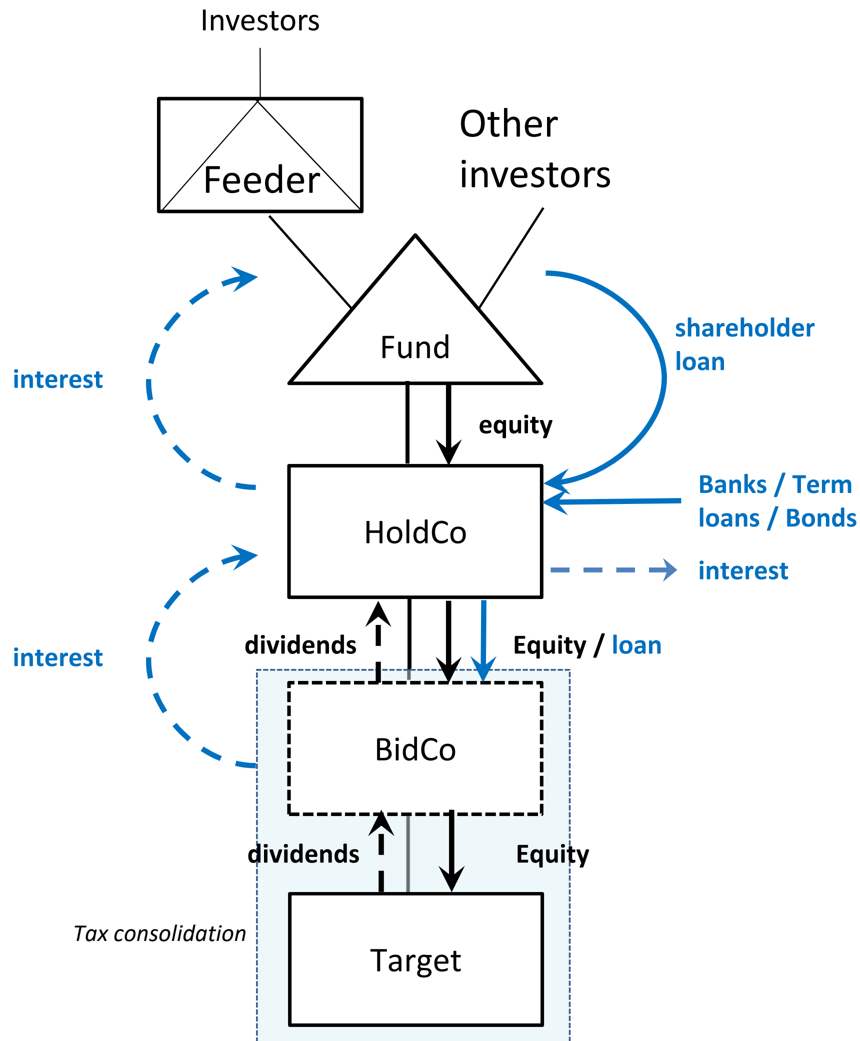
- Is “substance” enough to validate the structure?
- Are there any valid economic grounds and substantive business reasons to have HoldCo?
- Who is the beneficial owner of the dividends received by HoldCo? (reaction to the Danish cases)
- Are the principles above similarly applicable to capital gains?
- Would this sample case lead to different conclusions depending on:
    - The Fund being non-transparent vs. transparent
    - The Fund being off-shore or within EU and subject to 2011 AIFM Directive
    - HoldCo being funded only with equity vs. equity plus debt?

Sample case 1: Private equity investment (Brazil)



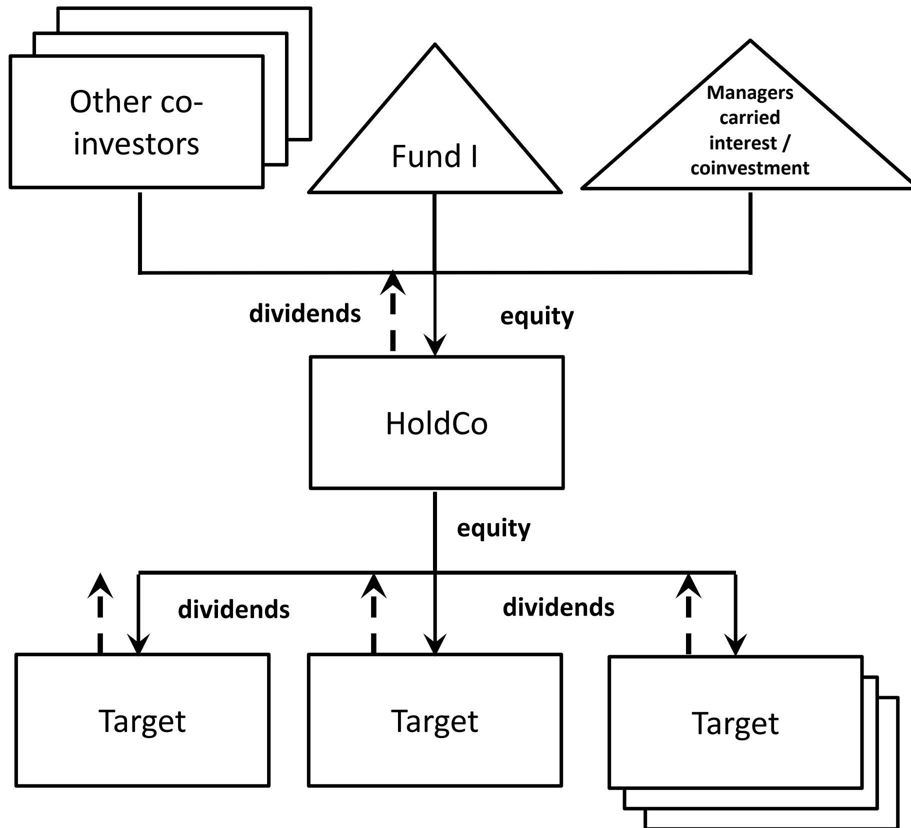
- Is "substance" enough to validate the structure?
- Are there any valid economic grounds and substantive business reasons to have HoldCo?
- Are the principles above similarly applicable to capital gains?

Sample case 2: Private equity investment (third party finance)



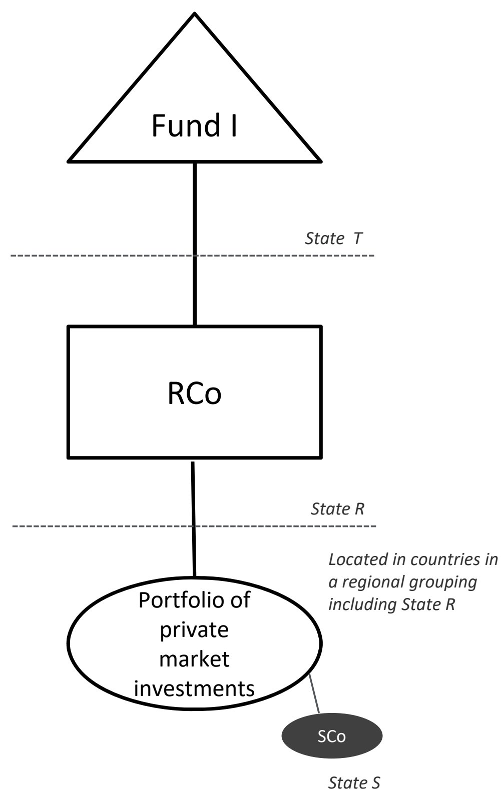
- Would the conclusions on beneficial ownership change if the finance comes totally / partially from third parties (either banks, funds or bonds)?
- What if the investment in the target jurisdiction is streamed through a local SPV (BidCo) used to push-down debt to Target?
- How can anti-hybrid rules limit the deductibility of interest at Bidco and Holdco levels?

Sample case 3: Private equity investment (co-investors / multi-country platform)



- Does being HoldCo an investment platform who invest in different jurisdictions help in connection with the application of PSD anti-abuse clause and PPT in Tax Treaties?
- Likewise having co-investors at HoldCo?
- How having co-investors impact the CFC analysis for US investors?

Sample case 3 – application of the PPT to non-CIV (art. 29 MCOCDE comm. 182 example K)



DTT State R/State S, WHT on dividends reduced from 30% to 5%
DTT State S/State T, WHT on dividends is 10%

Regional investment platform

RCo, a company resident of State R, is a wholly-owned subsidiary of Fund, an institutional investor that is a resident of State T and that was established and is subject to regulation in State T. RCo operates exclusively to generate an investment return as the regional investment platform for Fund through the acquisition and management of a diversified portfolio of private market investments located in countries in a regional grouping that includes State R

- **Decision for establishing the regional investment platform in State R driven by**
  - The availability of directors with knowledge of regional business practices and regulations
  - The existence of a skilled multilingual workforce
  - The State R's membership of a regional grouping
  - The extensive tax convention network of State R, including its tax convention with State S, which provides for low withholding tax rates
- **Substance in State R**
  - RCo employs an experienced local management team to review investment recommendations from the Fund and performs various other functions which, depending on the case, may include approving and monitor investments, carry on treasury functions, maintain RCo's books and records, and ensure compliance with regulatory requirements in States where it invests
  - The board of directors of RCo is appointed by the Fund and is composed of a majority of State R resident directors with expertise in investment management, as well as members of the Fund's global management team RCo pays tax and files tax returns in State R.
- **Standpoint**
  - The intention of tax treaties is to encourage cross-border investment
  - It is necessary to consider the context in which the investment was made, including
    - ✓ The reasons for establishing RCo in State R ; and
    - ✓ The investment functions and other activities carried out in State R
- **Conclusion**

  It would not be reasonable to deny the benefit of the State R-State S tax convention to Rco in the absence of other facts or circumstances showing that RCo's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention.

Part III: Conclusions