IBA 11th Annual Finance & Capital Markets Tax Conference

FUNDS UPDATE

4 March 2022

AGENDA

1. **Latest developments in fund structuring**
   - Impact of Pillar 2, ATAD 3
   - Impact of ATAD 2 on Irish investment vehicles
   - UK's new AHC regime
2. **Structuring of funds investing into Spain and Italy**
3. **New trends in investment strategies and unique tax issues**

Panel

- **Alish Finnerty** *Arthur Cox, Dublin*
- **Paolo Giacometti** *Chiomenti, Milan*
- **Rafael Calvo Salinero** *Garrigues – Madrid*
- **Ron G. Nardini** *Vinson & Elkins LLP, New York*
- **Thierry Lesage** *Arendt & Medernach, Luxembourg*
- **Session Chair: Brenda Coleman** *Ropes & Gray, London*

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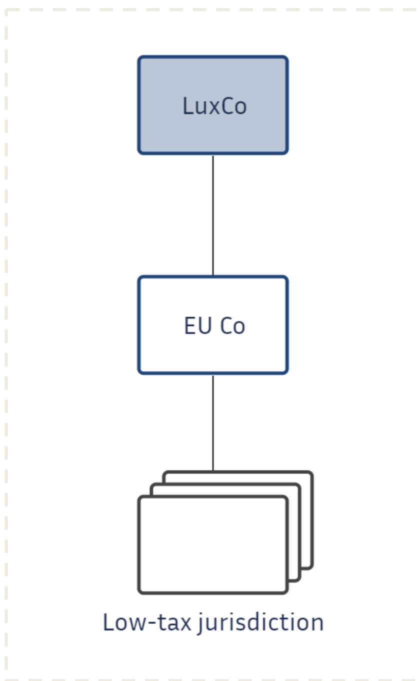
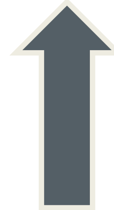
Draft EU directive implementing OECD Pillar 2 - New set of rules



MNE Group

Additional amount of tax (Top-up tax)



Effective tax rate (ETR) in the subsidiaries' jurisdiction <15%

Draft EU directive implementing OECD Pillar 2 - Scope

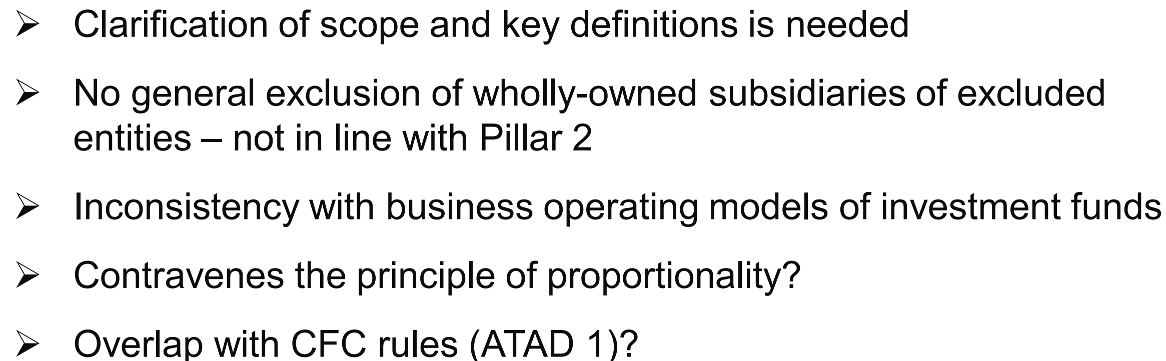
Constituent entities	▪ Entities located in the EU, members of an MNE group or large-scale domestic group with annual consolidated revenue > €750 million in at least 2 of the last 4 consecutive FY
Excluded entities	▪ Pension funds, investment funds and real estate investment vehicles that are ultimate parent entities ▪ Governmental entities, international organisations, non-profit organisations ▪ Certain entities owned by these excluded entities that hold assets or invest funds, or only carry out ancillary activities, or that mostly derive excluded income

➢ To be considered: exclusions not applicable in specific situations

Unshell/ATAD 3 draft EU directive – Focus on applicable carve-out

Carve-out

- Companies with listed transferable securities
- EU regulated financial undertakings (incl. UCITS, AIFs and AIFMs)
- Same country undertakings with holding activities
- ≥ 5 FTE employees



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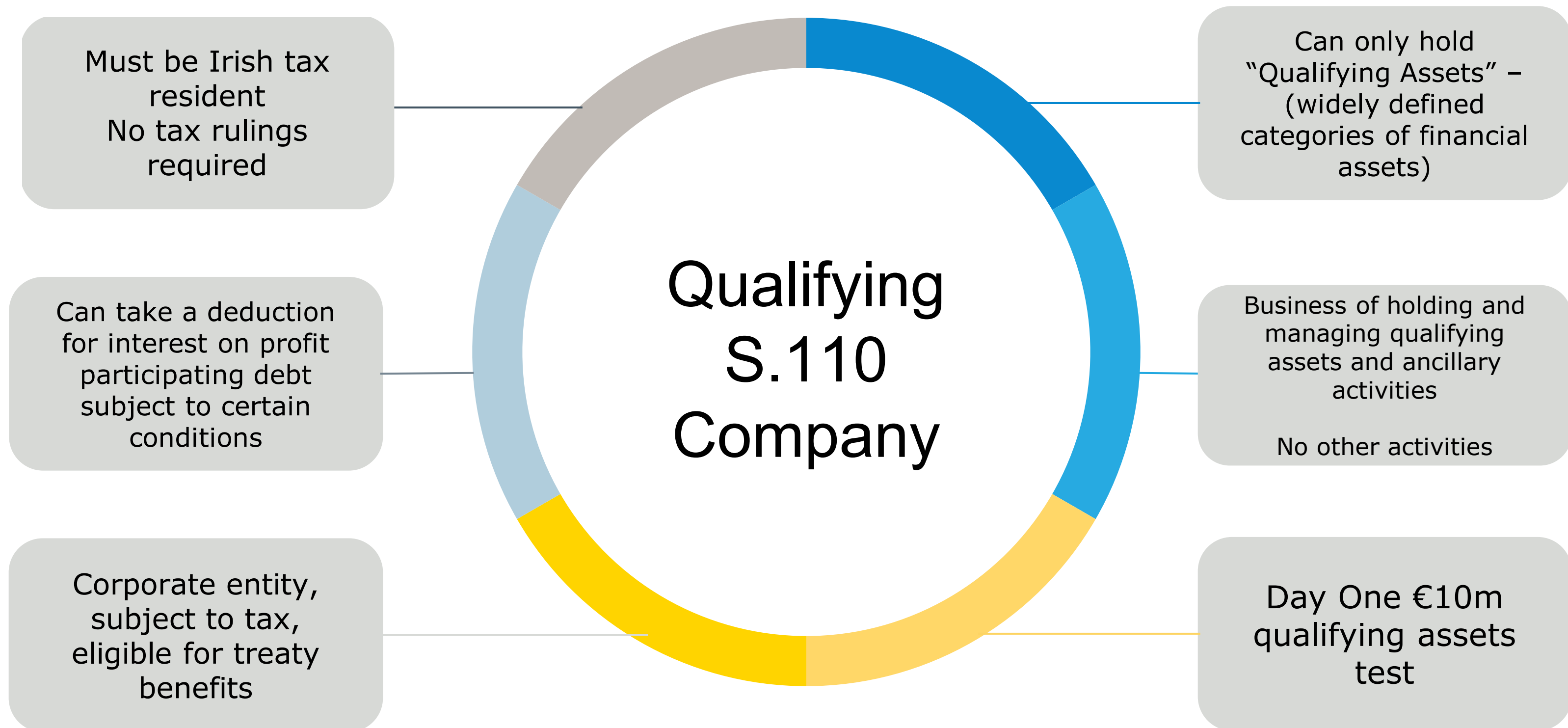
Typical Irish structures for PE investment

Irish Vehicle is typically structured as a Section 110 company or a QIAIF ICAV

- **Section 110 Company.** Unregulated and easy to establish but requires careful structuring to achieve a tax efficient outcome.
- **QIAIF ICAV.** Regulated, more expensive to establish and maintain but has the benefit of being tax exempt in Ireland and respected as a treaty resident for Ireland/US Tax Treaty purposes.
- **Combination.** ICAV may hold Section 110 company for treaty eligibility, or Section 110 company may hold ICAV for US treaty purposes, if required.

Section 110 Qualifying Criteria



Recent Developments

Anti-Hybrid Rules

Deduction on PPN denied if:

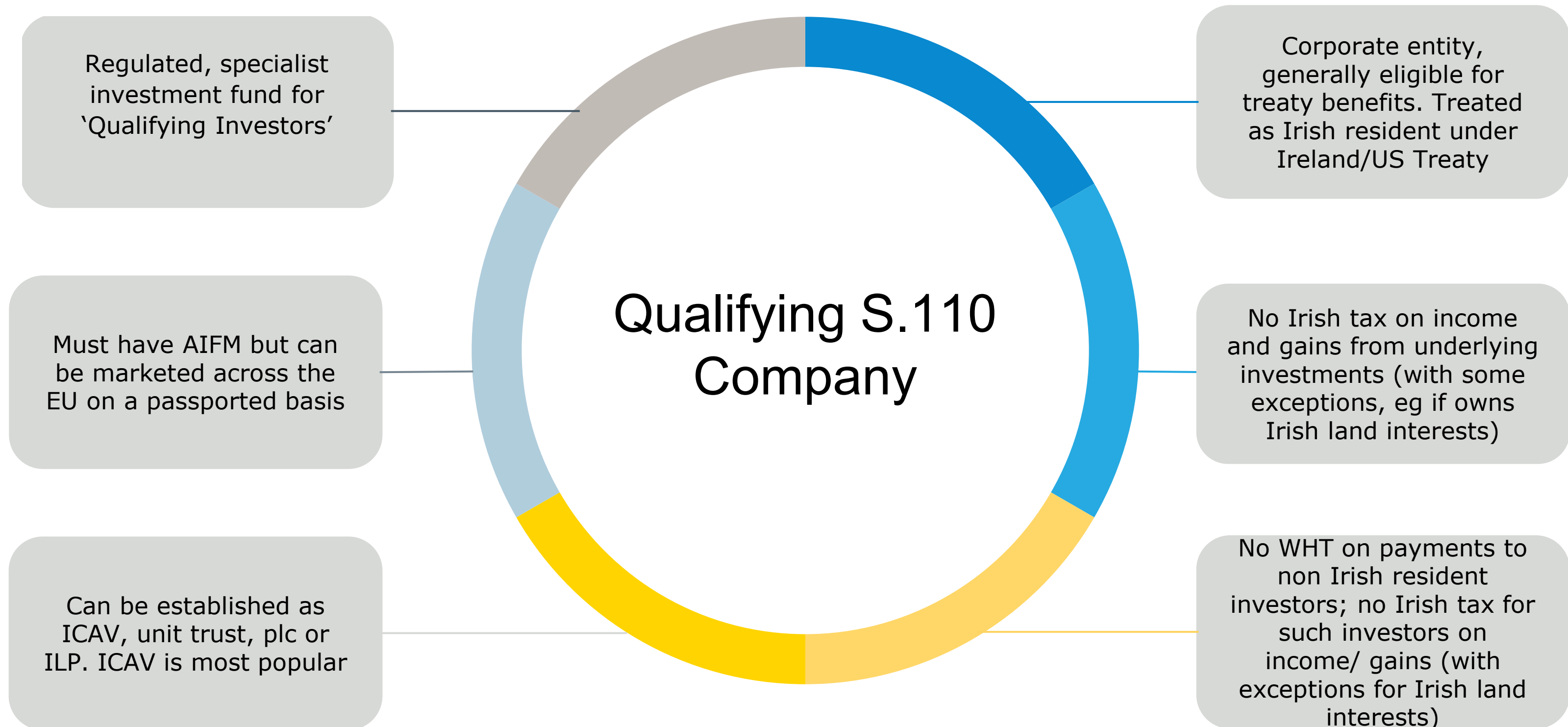
- Notes give rise to deduction without inclusion mismatch outcome (i.e. treated as equity
- Noteholder is an "associated enterprise" (consolidates/ board representation)
- No inclusion at noteholder level

Deduction also denied if "structured arrangement" (mismatch outcome priced into terms / arrangement designed to give rise to a mismatch outcome)

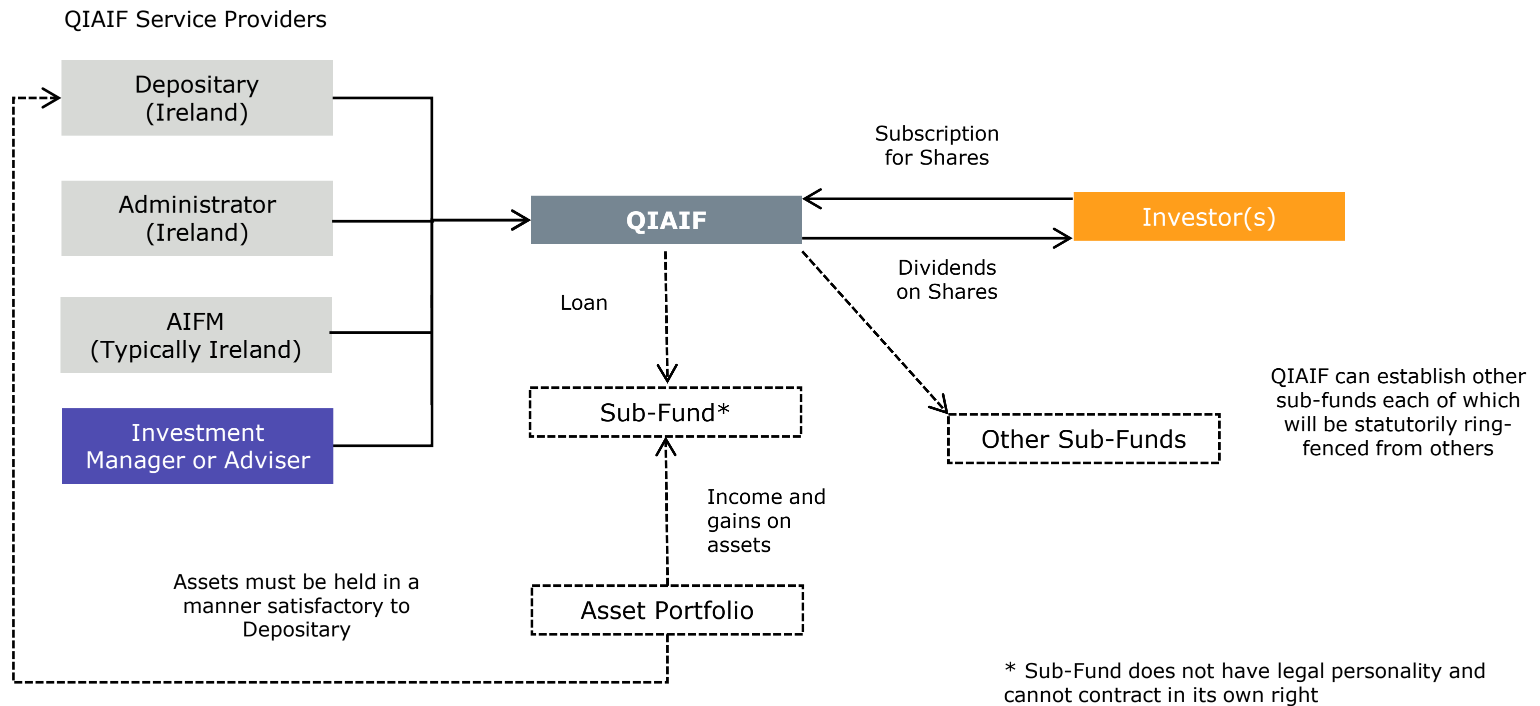
Interest Limitation Rules

- Applies from 1 January 2022
- Restricts deductibility of net interest expense to 30% of EBITDA
- Exemptions include:
  - "Single company worldwide group" – conditions:
    - not a member of a consolidated group (for accounting purposes)
    - no "associated enterprises" hold debt
  - PPN issued before 17 June 2016
  - Net interest is less than €3 million per year

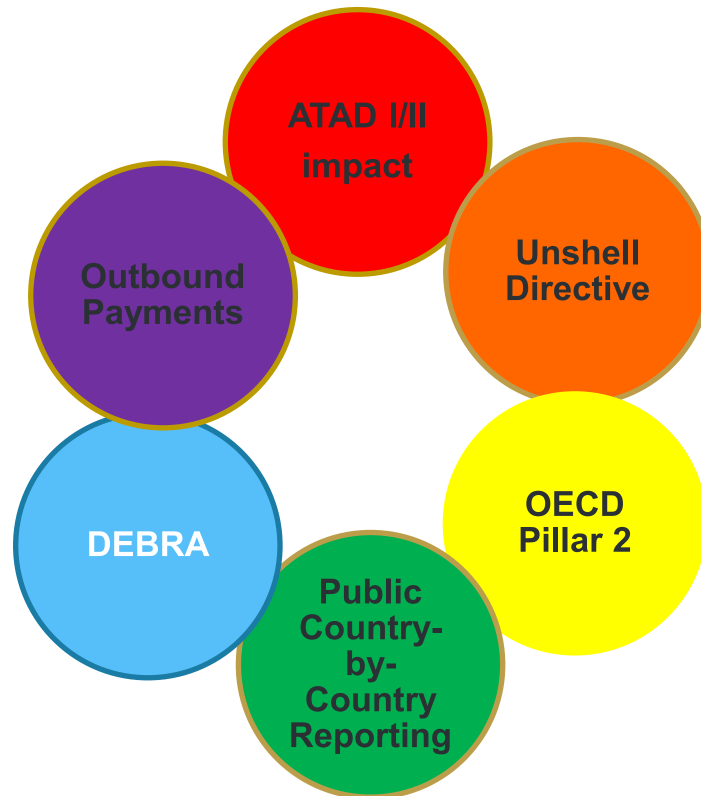
QIAIF ICAV



QIAIF – Structure Diagram



Tax developments on the horizon for fund structures



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New Asset Holding Company regime

- **HM Treasury review of UK funds regime – tax and regulatory**
  - Object to make the UK a more attractive location to set-up, manage and administer funds
- **Qualifying Asset Holding Companies regime**
  - Introduced with effect from April 2022.
  - Entry by election for existing fund to become an AHC.
  - Regime entry MV disposal entry charge, subject to exemptions (including SSE).
- **Ownership condition**
  - 70% owned by diversely owned funds, charities, long-term insurance businesses, sovereign immune entities and certain pension schemes and public bodies.
- **Activity condition**
  - Mainly carry out investment activity (with only insubstantial ancillary trading permitted)
  - No acquiring listed securities.

Debt Funds

- **Treaty access**
  - UK substance from existing UK operations / London financial infrastructure.
  - Outside current proposed scope of ATAD III, although the EU has indicated there will be additional proposals to tackle non-EU shell entities
- **Interest receipts and deductions**
  - UK withholding tax on interest disapplied for payments from QAHCs to investors
  - Several provisions to synchronise receipts and deductions to maintain a stable taxable margin.
  - Connected creditor loan relationships (LRs) taxed on fair value basis where used to fund loans taxable on fair value basis (distressed debt investments).
  - LRs provisions on late paid interest and deeply discounted securities switched off.
- **Transfer pricing margin**
  - Indications transfer pricing margin will be internationally competitive.

PE Funds

- **Treaty access**
  - As for debt funds
- **QAHC tax treatment**
  - QAHC business ring-fenced from group relief and other tax consolidation with subsidiaries. Acquisition structures will often wish to put debt into non-AHCs in order to utilise group relief for interest deductions
  - Automatic exemption from charge on gains (not subject to SSE) without holding period or minimum stake requirement. Allows opportunistic flips and minority stakes
- **Returns to investors**
  - Availability of capital returns to investors on share buybacks.
  - UK withholding tax on interest disapplied for payments from QAHCs to investors

ROPES & GRAY

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Taxation of Funds Spain as Target Country

Overview

- **Domestic Funds**

- Regulated collective investment institutions ("CIVs"), whether UCITs or AIFs, benefit from a reduced taxation at a special 1% tax rate for Corporate Income Tax (“**CIT**”) purposes if certain conditions are met
- Private Equity funds and Venture Capital entities are subject to the general CIT rate (25%) but can apply the participation exemption regime on dividends and gains regardless of the –normally applicable- minimum shareholding percentage and holding period. Distributions to foreign investors are out of the scope of Spanish taxation
- Spanish REITs (SOCIMIs) are generally subject to a 0% CIT rate in respect of all qualifying income (but taxed at distribution)

- **Foreign Funds**

- EU UCITS (Directive 2009/65/EC) are subject to the special CIT rate of 1%
- Non-EU comparable UCITS are subject to general nonresidents’ tax of 19% (or DTT rates) but are claiming equal treatment in the Spanish courts under the free movement of capital principle
- Both EU and non EU AIFs are subject to the general nonresidents’ tax of 19% (or DTT rates) but are claiming equal treatment in the Spanish courts under the free movement of capital principle
- Foreign Private Equity funds are subject to general nonresident’s tax regime, but are normally eligible to DTT and EU benefits
- Tax transparent entities are subject to a look-through approach, so the status of (first opaque) investors has to be analyzed

Standard Investment Schemes

- The above situation (funds are either transparent or taxed at standard rates) normally lead foreign funds to invest in Spain through intermediate holding companies in the EU

- In general, EU and EEA entities fulfilling certain requirements are tax exempt in Spain on:
  - Dividends on qualifying Spanish shareholdings (>5% and one year): The CIT Law provides with a SAAR excluding the exemption if the EU/EEA parent company is ultimately controlled (directly or indirectly) by natural or legal persons with their tax residence outside the EU or the EEA, unless the incorporation and operations of the parent respond to valid economic reasons and a substantial business purpose
  - Interests: There is no SAAR in connection with this exemption nor does it require to meet further conditions, but GAAR and beneficial ownership requirements are normally at stake when ultimate lenders are out of the EU/EEA
  - Capital gains on the transfer of shares in Spanish companies, unless (i) the participation exemption requirements (>5% and one year) are not met; or (ii) the majority of the assets of the Spanish entity consist mainly (directly or indirectly) of real estate property located in Spain.

- Historically, PE funds have been focused on equity divestments, capital gains not being subject to tax under domestic law and DTTs. DTT benefits have been hardly contested so far by the Spanish Tax Authorities, but the MLI (entering into force for most DTTs in 2022) and the ATAD 3 proposal may increase the scrutiny.

- On recent times, minority shareholdings on large Spanish corporations (whether listed or not) have brought the attention over the dividend exemption and the related beneficial ownership discussion that followed the ECJ judgments on the "Danish cases"

- Therefore, and despite some legal defensive arguments, EU intermediate holding companies must be in position to justify their business/economic/finance rationale and its beneficial ownership condition. New risk management strategies covering withholding agents' position are now in place

- Luxembourg is the preferred location for holding entities investing in Spain (DTT and EU Law protection plus easier physical and economic –JV, pan European investment platform, security package, etc.- substance)

Real Estate

- With some exceptions (The Netherlands, Italy, likely to be amended in the near future), DTTs normally allow Spain to tax capital gains on Spanish real estate entities
- Furthermore, the domestic capital gains exemption to EU and EEA investors does not apply to shareholdings in Spanish real estate entities. This can be deemed as contrary to EU Law, as Spanish investors would be generally entitled to apply the participation exemption regime in similar circumstances
- Notwithstanding, the above restrictions have led real estate investments to be usually channeled through a Spanish holding company (the so-called HoldCo-PropCo structure), which requires the Spanish holding company to justify its business/economic/finance rationale and its beneficial ownership condition on the investment structure (i.e. enough substance to manage the investments in the PropCos)
- Special attention must also be paid to the underlying investment (PropCo) not to be qualified as a passive-asset holding entity (i.e. enough human and material resources to manage the leasing activity)

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Taxation of Funds - Italy

Overview

Main tax issues for funds investing in Italy

- UCITs: withholding tax on dividends (however now partially solved)
- PE funds: repatriation of profits/exit strategies (taxation of dividends and gains)
- Credit funds: withholding tax on interest
- RE funds: taxation of gains on disposal of assets

Various exemptions are available subject to certain conditions; crucial proper structuring to avoid tax inefficiencies and potential challenges by Italian tax authorities, who have been particularly aggressive in recent years

UCITs

- Dividends received by EU/EEA UCITS are exempt from domestic WHT as from 1 Jan 2011
- New rules in response to EU Pilot case from the Commission. Previously, clear discrimination against foreign UCITSs and infringement of EU fundamental freedoms, as dividends paid to Italian funds were fully exempt from tax since 2011
- Discrimination still remains for non-EU/EEA funds (including UK funds).
- Massive amount of refund claims still pending for past years.
- A very recent decision (7 February 2022) from the competent Tax Court has eventually upheld that dividend withholding taxes suffered by a Luxembourg SICAV contrast with the EU freedom of establishment and free movement of capital
- Litigation route needed to obtain refunds

PE Funds

- In general (i) dividends received by foreign PE funds are subject to 26% WHT; (ii) capital gains are subject to a 26% CGT (self assessment)
- Given their tax status, in principle PE Funds do not benefit from domestic and PSD exemptions on dividends, nor from DTT exemption on gains
- Further, significant issues for recognition of tax transparent structures
- Traditionally, PE funds have structured their Italian investments via intermediate EU holding companies, with exit strategies focused on equity divestment to benefit from domestic and DTT exemptions.
- However, in most recent years Italian Tax Authorities started challenging said structures under Italian GAAR and substance/BO principles, and the landscape is likely worsening due to Unshell
- **The good news**: since 1 Jan 2021 qualifying AIFs benefit from a specific domestic exemption on both dividends and capital gains
- For qualifying AIFs, if investing directly is a viable option businesswise, the use of intermediate holding may not be necessary, and the increasing risk of challenges based on alleged abuse of EU Directives and/or DTTs may be removed.
- Increasing trend of investment via qualifying AIFs, also as "sub-funds" of non-AIFM compliant master funds and with umbrella compartments to avoid commingling and channel possible co-investors in specific assets

RE Funds

- For foreign RE funds investing in Italy, there are two typical structures:
  - the use of local corporate entities, with issues similar to those of PE funds (unless the fund is a qualifying AIF)
  - The use of typical master-feeder structures, with an Italian AIF having a foreign qualified AIF (often a LUX Raif) as single unitholder
- The Raif/AIF is extremely efficient, as the Italian AIF if fully exempt on any income or gains, and no WHT applies upon distribution to the Raif.

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General

Investment Strategies that have been a focus of capital raises in 2021 and are expected to continue into 2022 include:

- Loan Origination
- Real Estate
- Infrastructure (specifically digital and energy transition related)
- Digital Currencies
- Shipping/Aircraft (aircraft, vessels and/or engines)
- Music/Film Libraries
- Secondary Fund Interests

Loan Origination

- Credit Fund have been very popular for the last 7 years. However, the new trend is that the credit funds invest in units of both debt and equity of the borrower and/or debt issued by other private equity funds at the end-tail of their life.
- Credit funds create unique tax issues. In particular, if the funds originate the loans (i.e., source and negotiate the terms) as opposed to purchase the loans on the secondary market. Such origination activity may create a taxable nexus for the funds in the jurisdictions where the management company operates from (subject to domestic exemptions). The equity component has its own tax issues (around dividends, PFIC/CFC classifications, ECI, UBTI and CAI, portfolio interest and real estate rich companies).
- Some structures include:
  - Use of a mutual fund in a treaty jurisdiction (usually an Irish ICAV) and structuring the relationship between the fund and the manager as a relationship of principal and independent agent.
  - Use of a leveraged blocker (i.e., typically the interest barrier laws do not apply to blockers that earn interest income).
  - Use of a U.S. mutual fund (usually a US BDC), although not as efficient for foreign sourced interest.
  - Season and sale (and its variations).
  - Separation between the loan side and the equity side.

Real Estate

- Funds that are focused on investments in U.S. and European real estate become larger and larger portion of the segment. In particular, industrial real estate (like warehouses), multi-family housing (which include asset portfolios that are leased on a short-term rental services like Airbnb) and movie studios.
- Real estate funds create unique tax issues. In particular, in most jurisdictions rental income and gain from the sale of real estate assets is subject to full tax on a net basis.
- Some structures include:
  - Use of levered blockers
  - Use of REITs (especially domestically controlled REITs or REITs where no one SWF is over 50%)
  - Use of a treaty entity on top of a REIT

Infrastructure (digital, energy transition)

- Funds that are focused on investments in U.S. and European infrastructure, which typically includes carbon credits, decarbonization technology, renewable energy (solar and/or wind on the generation side and chemical or mechanical batteries on the storage side) and digital infrastructure (data centers, cellular towers).
  - For example, Apollo just announced that they intend to deploy $100B by 2030, via their Sustainable Investing Platform, towards financing and investing in energy transition and decarbonization of industry.
- Infrastructure funds create unique tax issues. In particular, whether the underlying infrastructure projects are treated as "real estate" and, thus, subject to a different tax regime. Many times such determination is based on whether the equipment can be treated as "machinery" as opposed to tangible assets attached to real estate.
- Some structures include:
  - Use of levered blockers
  - Use of REITs (especially domestically controlled REITs or REITs where no one SWF is over 50%), if the asset class is "REITable".
  - Use of a treaty entity on top of a REIT and/or bloker

Digital Currencies

- Funds that are focused on crypto and digital currency investments.
- The main challenge with these funds is that the tax law in this area is still not developed enough to allow universal structuring solutions. In particular, in the United States, it is not clear whether a trading activity with respect to crypto can rise to a level of a US trade or business and whether such activity can fall within the "commodities" trading safe harbor.
- Some structures include:
  - Splitter between "good income" and "bad income"
  - Foreign blockers
  - Use of management teams sitting outside the United States

Shipping/Aircraft

- Funds that are focused on shipping and aircraft assets and/or loans.
- Income from international transportation typically is eligible for special tax regimes and such funds are structured to bolster their entitlement to such special regimes. The tax issues rise typically in the context of domestic transportation income (e.g., lease payments on U.S.-to-U.S. ports) and scrapping.
- Some structures include:
  - Splitter between “good income” and “bad income”
  - Treaty structures

Music/Film Royalty

- Funds that focus on the purchase of music and/or film libraries.
- The main tax issues arise from activities of the fund to enhance the IP (i.e., negotiations regarding the use of works in film or video games, publishing work) and the fact that in most jurisdictions, royalties are subject to tax on a gross basis (so effective tax on a net basis can be very high).
- Some structures include:
  - Splitter between "good income" and "bad income" (using a blocker to get netting on the bad income)
  - Treaty structures
  - Separation between the "active" side (i.e., publishing) and the passive side (i.e., ownership of the IP).

Secondaries Funds

- A major trade in recent years are fund designed to purchase fund interests on a secondary basis.
- Private funds are inherently an illiquid asset class, with investors required to commit capital for ten years or more. In addition, private funds are typically structured as investment vehicles with a close-ended date, resulting in managers unable to focus on capital appreciation without a time barrier. The secondaries market provides liquidity to private equity investors, allowing them to sell positions in private equity funds, and via the use of continuation funds or other GP-liquidity tools like preferred equity, tender offers, NAV financings or fund restructurings. GP-liquidity solutions is particularly appealing to managers as they allow managers to gain extra time to increase value in underlying portfolio companies that would not otherwise be permitted in a typical closed-end vehicle with a fixed end date.
- Preqin estimates that AUM of secondaries funds as of December 2020 exceeded $300 billion and that secondary players currently hold about $127 billion of dry powder. Large secondary fund closes in 2021 include Coller Capital ($9 billion), LGT Capital Partners ($4.5b billion), Whitehorse Liquidity Partners ($4 billion), and Hamilton Lane ($3.9 billion) (Secondaries Investor, Looking back: Top 5 fund biggest closes of 2021).
- Unique tax issues arise from the lack of transparency, matching of tax status between the selling LPs and secondary fund and built-in blocker taxes.

Investment Strategies through Irish Vehicles

Strategy	Structure
Credit Funds / Loan Origination	Typically structured through an Irish ICAV but can also work via an Irish Section 110 company if no anti-hybrid issue (eg. widely held or no hybridity). Should yield only interest income so ILR generally not an issue.
Real Estate	Typically structured through Irish ICAV structures if a direct real estate holding and, provided not Irish land, ICAV benefits from Irish tax exemption. Real estate loan portfolios usually structured through Irish Section 110 companies.
Life Settlements	Typically structured through an Irish ICAV (treated as Irish resident under Irish/US Treaty) but can also work via an Irish Section 110 company if no anti-hybrid issue (eg. widely held or no hybridity) and ILR exception available (eg. single company worldwide group if no consolidation and related party debt)
Music/Film Royalties	Typically structured through an Irish ICAV (treated as Irish resident under Irish/US Treaty) but can also work via an Irish Section 110 company if no anti-hybrid issue (eg. widely held or no hybridity) and ILR exception available (eg. single company worldwide group if no consolidation and related party debt).
Aviation	Increasingly structured through Irish trading vehicles (treaty access and typically eliminates hybrid and interest limitation considerations).