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Structuring Private Equity and Credit Funds in 2024 – challenges and opportunities in portfolio companies, holding companies, fund vehicles, managers, carry holders and for LPs of private equity and credit funds

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Spain

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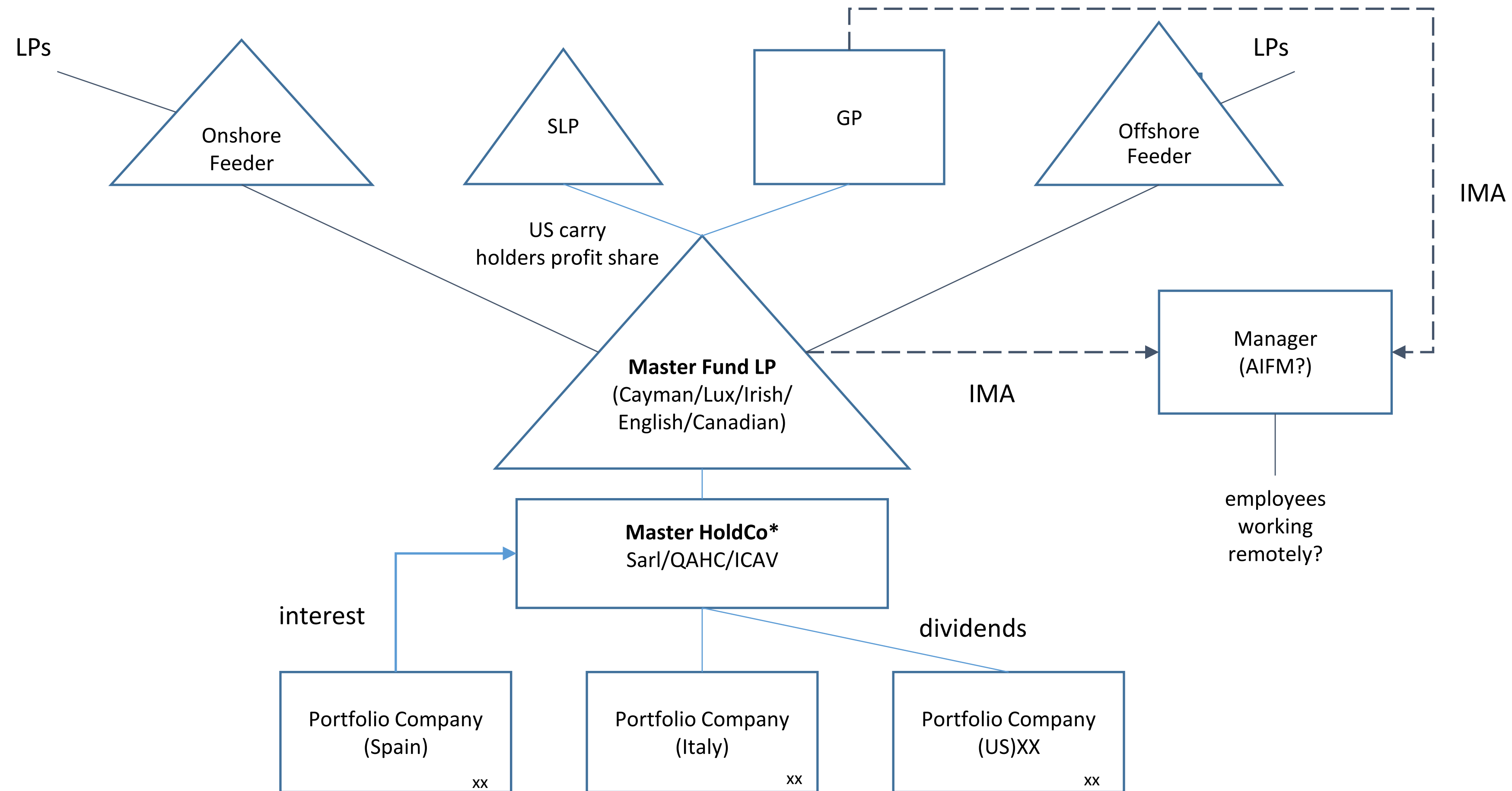
Typical (Simplified) Example of a Private Equity and Credit Fund Structure



* May be multiple Holdcos or master Holdco

xx Normally generally a stack of holdcos for interest deductability, lender security package.

Trends at
Portfolio Company Level

Trends at Portfolio Company Level: minimizing withholding taxes & non-resident capital gains tax

Trends at Portfolio Company Level

Spain

Private equity investments: tax treatment of dividends ex Art. 14.1.h) NRIT Law – P/S Directive-.

- **Exempt dividends paid to EU/EEA residents**.
  - Requirements: basically, at least 5% interest during a minimum holding period of 1 year.
- **Anti-abuse clause** (where **majority of voting rights ultimately controlled by non-EU shareholder**) applicable to **dividends and royalties** under the scope of their respective P/S Directives:
  - Not applicable "where the formation and operations of the recipient of the dividend or royalty are based on **valid economic grounds and business reasons with substance**".
- **Supreme Court has confirmed that the anti-abuse clause in the Law is contrary to the P/S Directive** as the abuse is presumed. The burden of proof of the abuse must be on the tax authorities (STS 771/2023 of June 8 –Global Noray case- and STS 827/2023 of June 21 –Iberdrola case-).

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Interest paid to and capital gains obtained by EU resident tax payers (Art. 14.1. c) of NRIT Law)

- **Full exemption of interest paid and capital gains on movable property obtained by resident taxpayers in the EU or EEE** without a permanent establishment in Spain.
- Exception applicable to capital gains related to the transfer of shares in companies where the main assets are directly or indirectly real estate (potential EU discrimination as domestic participation exemption applies to similar cases in domestic context).
- Although the Spanish law does not contemplate the beneficial ownership as an anti-abuse rule, **does beneficial ownership have to be inferred from this law?**
- **Practical considerations:**
  - Shadow banking (EU funds)
  - Private equity exits and tax treatment of capital gains.
  - EU AIFs vs foreign and the proof of residence.

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Proof of tax residence of EU AIFs

- 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 the case of a **transparent entity**, the management company can also certify the percentage of EU resident interest-holders. In the 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.

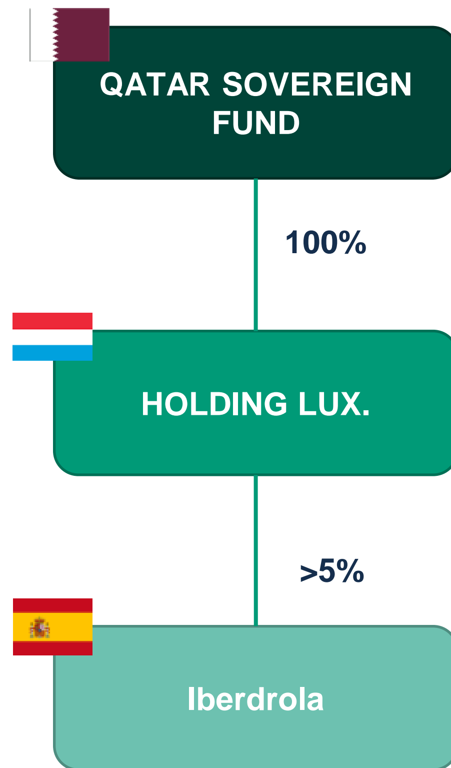
Tax audit climate

- Taxation of dividends, interest, royalties and capital gains obtained by non-residents and application of related anti-avoidance measures are in the focus of the published Annual **Tax** and Customs **Control Plans** of the Spanish Tax Agency (AEAT). Funds industry strongly impacted by the Plans.
- Genuine structures must meet a "triple test":
  - Substance (some hints in AEAT abuse of law report nº 4 December 16, 2021).
  - Existence of valid economic reasons.
  - Beneficial ownership.
- Most common issues addressed in Spanish tax audits:
  - WHT on dividends and interest (special relevance in credit funds) and taxation of capital gains.
  - Remuneration of executives of the fund (carried interest / equity-based remunerations).
  - Application of anti-abuse regulations, with special emphasis on substance and beneficial ownership.
  - The limits of the burden of proof on B.O. by the taxpayer.
  - Not acceptance of look-through regime of funds domiciled in blacklisted countries (i.e. Cayman and Jersey Funds). Is it contrary to Spain-US Tax Treaty? To OECD MLI – Action 2 hybrid entities-? To EU free movement of capital?

Beneficial ownership

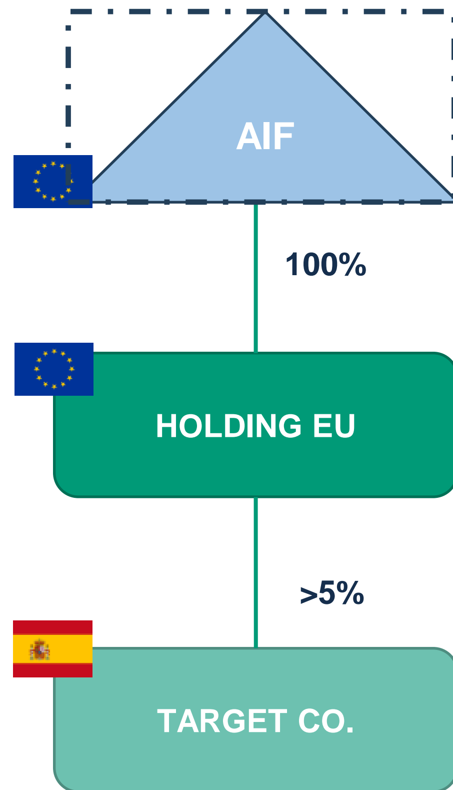
- Not defined in Spanish Tax Law.
- STS 1196-2020 of September 23, 2020 – Colgate case-: The beneficial ownership clause *"is not a meta-legal or natural law rule that must always be imposed at all costs in the agreement itself"*. Same approach in N.A. June 18, 2021 –Acciona case-.
- AEAT abuse of law report nº 4 December 16, 2021, does not directly apply beneficial ownership as a separate anti-abuse clause, but as an element of the abuse of law.
- STS 827/2023 of June 21 – Iberdrola case- deals with the B.O. concept in the context of the P/S Directive on dividends: Investment platform.
- AEAT in current tax audits always addresses the B.O. issue. Factual approach. Focus on money flows, irrespectively of underlying legal concepts (i.e. equity combined with debt / hybrid debt on top).

Qatar - Iberdrola (STS 827/2023 of June 21)



- Anti-abuse clause art. 14.1 h) NRIT Law and NA Court judgment of May 21, 2021 (Global Noray – CLH case). Adoption of Equiom EU case law.
- **Triple test**
  - **Substance test**. Economic activity of holding company: **portfolio management** and necessary substance.
  - **Beneficial ownership test**.
    - Although this was not a key element of the judgment, the Supreme Court accepted that the parent company was the beneficial owner of the dividends, because it was an **investment platform** which, in part, reinvested the profits obtained in other investments.
  - **Valid economic reasons:** State Tax Agency has not proven otherwise.

Potential (new) Fund structures – The use of AIFs



- **Exemption of interest and capital gains** under art. 14.1.c) NRIT Law, subject to the proof of residence (EU tax resident) of the Fund (special rules favoring proof of residence in the case of AIFs).
- **Substance test**: Is the regime foreseen in the Directive 2011/61/EU on Alternative Investment Fund Managers enough to prove substance?
- AIF and Holding in the same EU country.
- **Still a challenge**:
  - **Exemption of dividends**: triple test at the level of the Intermediate holding company.
  - **Beneficial ownership**: is that rule implicitly included in article 14.1. c) NRIT, affecting interest and capital gains? How this rule will be interpreted in the context of the private equity industry, in the divestment cycle of a fund?
- To avoid using feeders in Spanish blacklisted countries.
- In case of use of transparent AIFs / fund structures, get ready to identify ultimate owners and apply the merits of art. 14.1.c) NRIT Law and the relevant Tax Treaties to ultimate investors.

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Trends at Portfolio Company Level
France

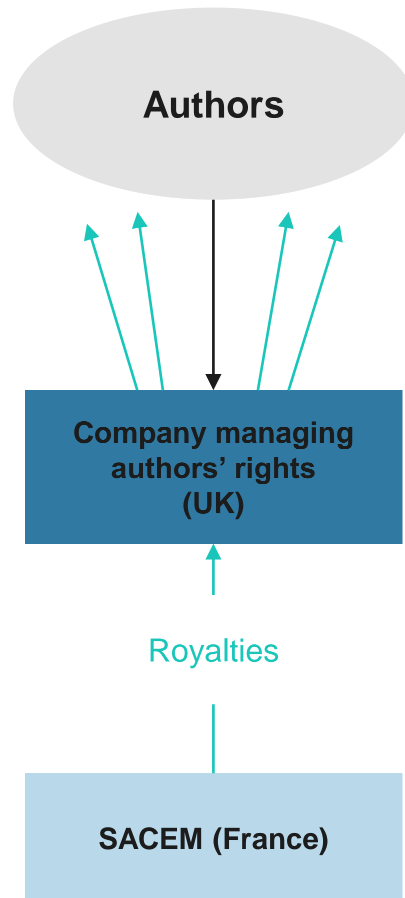
Background

- **No withholding tax on French source interest** (except where interest paid into a so-called non-cooperative jurisdiction) but **withholding tax on fees** => issue for credit funds which cannot claim treaty benefits

- **Dividend withholding tax** of typically 12.8% for dividends paid to individuals / 25% for entities save treaty relief or domestic exemption

- **Non-resident capital gains tax of 25%** for anyone having held 25% or more of the financial rights in the sold entity at any time during the 5 years preceding the sale save treaty relief or domestic exemption

Beneficial ownership (1/2)



- The French tax authorities can deny the benefit of a withholding tax relief granted under a tax treaty if the recipient of the income claiming this benefit is not the beneficial owner of that income without needing to argue that the transaction is abusive (*Conseil d'Etat*, 5 February 2021, n° 430594, Performing Right Society Ltd)

- Case law has however also confirmed that the actual beneficial owners could claim the benefit of relief under the tax treaty between France and their own country of residence (*Conseil d'Etat*, 20 May 2022, n° 444451, Sté Planet)

=> Possibility to look through intermediate holding vehicles up to the ultimate owners to determine what relief (treaty or domestic?) they could benefit from?

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Beneficial ownership (2/2)

- While beneficial ownership has been an area of more acute scrutiny in recent tax audits, a recent decision of the French Supreme Court reminds the French tax authorities that the beneficial ownership requirement cannot be implicit in a purely domestic legal provision:

  - French law provides for a withholding tax on dividends “benefitting” non-residents.
  - The French tax authorities had interpreted this provision as meaning that dividends paid to French tax residents but on-paid to non-resident “beneficial owners” were subject to the withholding tax.
  - The French Supreme Court rules that this interpretation is incorrect and that this provision of domestic law does not contain an implicit “beneficial owner” condition. If the French tax authorities want to apply the withholding tax in this case, they need to be able to set aside the interposition of the French recipient by relying on GAAR. (*Conseil d’Etat, Plénière*, 8 December 2023, n° 472587, Fédération Bancaire Française)

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Relief available to “funds” under French domestic law

- **French source dividends:** The domestic dividend withholding tax exemption was introduced following the CJEU decision in the *Santander* case and is available to funds located in the EU or other countries having signed a tax treaty with France containing an administrative assistance provision which have “characteristics similar” to those of French funds

- **French source capital gains (other than real estate):** The domestic capital gains tax exemption was introduced in August 2021 following a formal notice from the EU Commission and is available to the same funds although, for non-EU funds, only, based on the wording of the law (which may still be open to challenge…) to the extent they do not effectively participate in the management or control of the relevant portfolio company.

- **Guidelines have been published by the French tax authorities:** Those guidelines list the criteria required for funds to be comparable

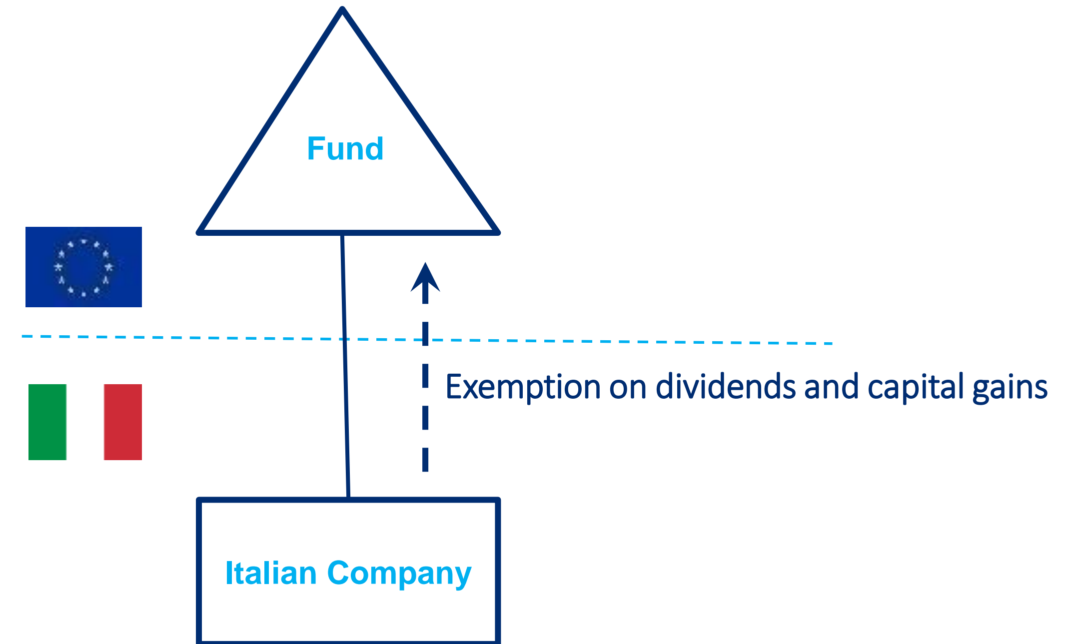
- **Can Luxembourg RAIFs and SCSps be regarded as comparable?** Private rulings issued

Trends at Portfolio Company Level

Italy

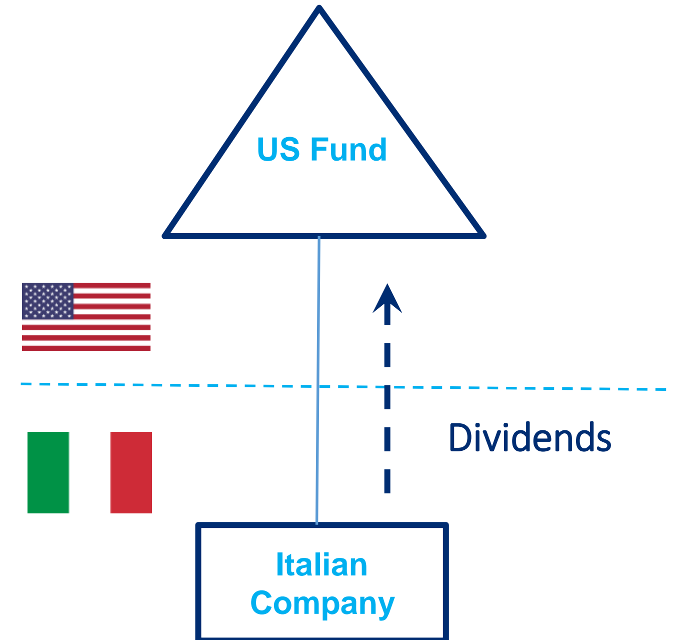
Italy – exemption for EU/EEA regulated funds

- Effective from 1 January 2021
- Dividends from Italian companies and capital gains from the sale of shares in Italian companies are exempt from Italian taxation
- Eligible funds:
  - Non-Italian undertakings for collective investment compliant with the UCITS Directive established in EU or EEA member states that allow an effective exchange of information
  - Non-Italian undertakings for collective investment established in EU or EEA member states, managed by a regulated fund manager under the AIFM Directive
- Investment through an intermediate vehicle



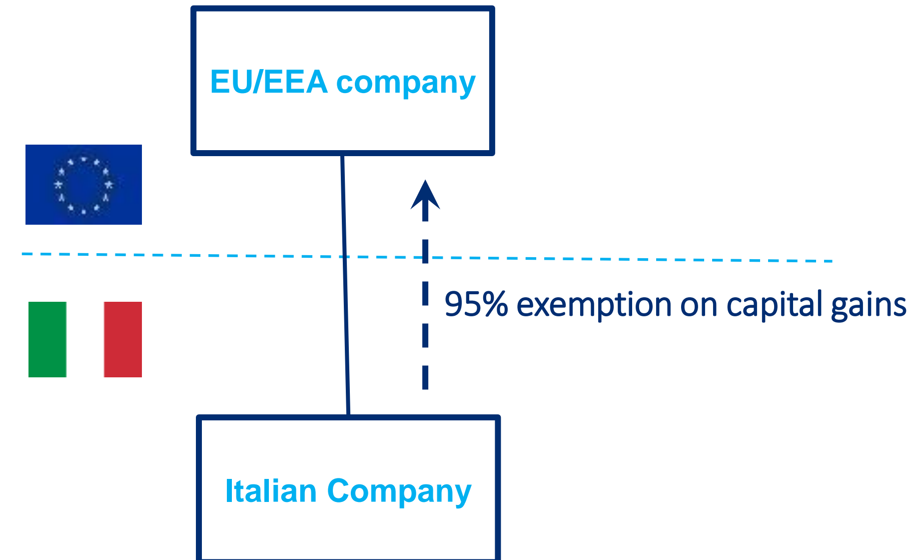
Italy – Non-EU funds

- Possible discrimination
  - Under current rules, Italian funds are not subject to any taxation on dividends
  - Non EU-funds are not eligible for the exemption on dividends and capital gains
- Italian Supreme Court (decision No. 21454 of 6 July 2022):
  - US fund received dividends subject to 15% Italian WHT under the US/Italy tax treaty
  - US fund claimed the refund of the difference between the WHT applied and the tax treatment applicable *ratione temporis* to resident funds
  - Violation of the EU principle of the free movement of capital: non-EU funds should be subject to the same tax treatment applicable to Italian funds



Participation exemption available to EU/EEA companies

- In principle, capital gains from the sale of shares in Italian companies realized by non-Italian shareholders are taxable in Italy (26%), unless a tax treaty applies.
- Following 2023 case law of the Italian Supreme Court which recognized that the denial of the participation exemption regime (available to Italian resident companies) with respect to non-resident shareholders was incompatible with the EU freedoms, the 2024 Budget Law has extended the scope of the participation exemption.
- Effective from 1 January 2024, capital gains realized by EU/EEA companies from the sale of shares in Italian companies may benefit from the Italian participation exemption regime (95% exemption) provided that the relevant conditions are met
- Possible discrimination versus non-EU shareholders



Trends at Portfolio Company Level

Austria

General and Withholding tax

General

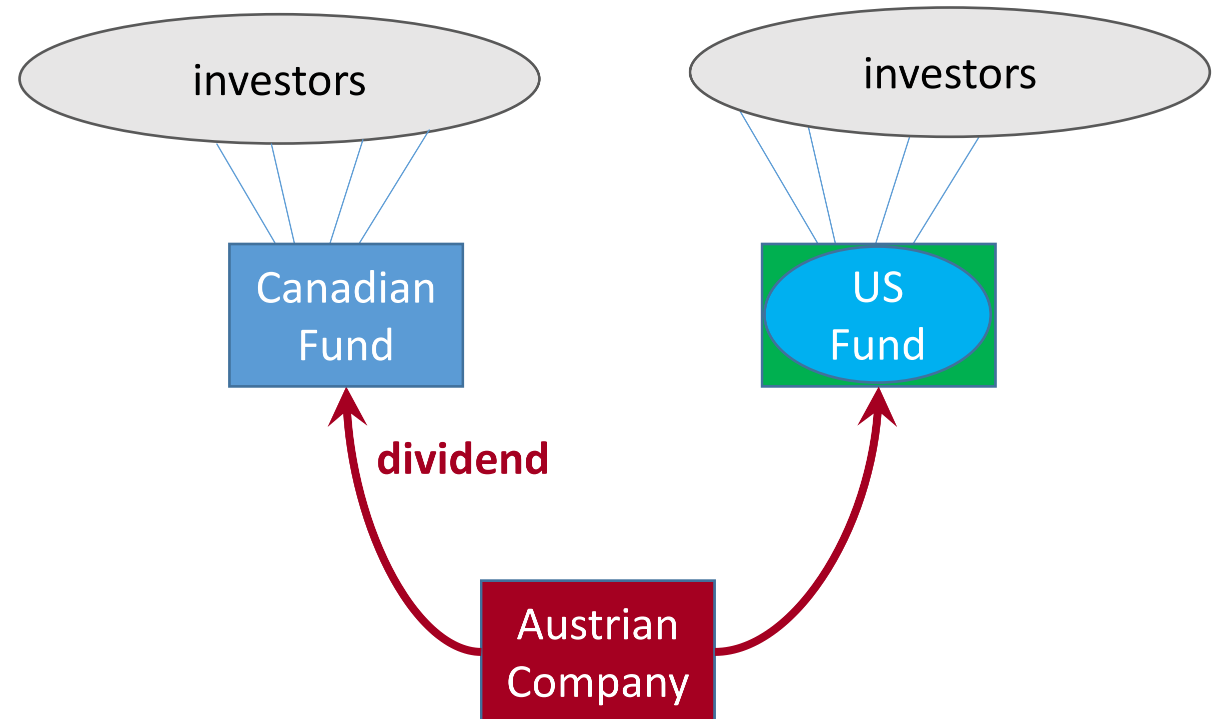
- The provision that establishes the Austrian GAAR was not amended when the PSD's GAAR was changed, but it was amended in light of ATAD.
- For Austrian withholding tax purposes regarding dividend payments, a **reduction at source** is only possible if **substance** is fulfilled.
- For the question of **beneficial ownership**, a **valid economic function** is decisive.
- Recently the highest Austrian tax court ruled on a number of cases concerning beneficial ownership: the main criteria were substance and function.

Withholding Taxation

- Austrian domestic law foresees no withholding tax on **interest payments** or on **capital gains** if neither is paid through an Austrian paying agent
- For **dividend payments** a reduction of the Austrian wht rate of generally 23% or 27.5% to the treaty rate is possible (1) at source (in case of investors that are corporations if substance is given) or (2) by way of a refund procedure.
- Regarding substance, a debate arose (a) whether substance needs to be fulfilled in the direct ownership chain or if substance higher up in the corporate group suffices and (b) whether it makes a difference that substance is given within the EU or within the same country.

Reduction of Dividend WHT to 0%

- Austrian wht on dividend payments made to foreign corporations might be reduced to 0% by way of applying for a refund if the recipient cannot credit the Austrian wht.
- While this reduction originally only applied within the EEA, a court ruling extended it to any corporate shareholder worldwide with the only requirement that a comprehensive exchange of information is in place.
- Currently a preliminary ruling request is pending at the ECJ which was submitted by the highest Austrian tax court. It concerns the application of the reduction to 0% to a US fund.



Trends at Portfolio Companies Level

United States

Corporate Alternative Minimum Tax & Stock Buyback Excise Tax

- **US Corporate AMT**
  - From 2023, the US corporate alternative minimum tax (“CAMT”) regime imposes a 15% minimum tax on certain large corporations
  - CAMT generally applies to large corporations with average annual financial statement income (“AFSI”) exceeding $1 billion
  - Significant problems stem from the different policies that underlie the calculation of “book” income (generally captured by the CAMT regime) vs. taxable income (historically the base for US corporate tax)
  - IRS notices have provided taxpayers with some guidance, but there is significant uncertainty requiring further clarification
- **Section 4501 Excise Tax**
  - Section 4501 imposes a new 1% excise tax on certain corporate share repurchases by publicly traded domestic companies (subject to applicable exceptions for *de minimis* repurchases, reorganizations, etc.)
  - Generally designed to target and tax publicly traded corporations that would use cash on hand to repurchase stock
  - Potential significant concerns for special purpose acquisition company (“SPAC”) deals

Trends at Holdco Level

Separate presentation

Jurisdiction of Holdco

- Luxembourg, UK, Ireland
- Use of QAHCs in the UK

Trends at Fund Structure Level

Factors impacting Jurisdiction of Fund

- Regulatory
- Substance
- VAT
- Reputational/Domestic Exemptions impacting tax havens
- Reverse Hybrid Rules (Luxembourg)

Reverse hybrid rules in Lux:

Do investors in your jurisdiction see a Lux SCSp as transparent or opaque?

Spanish tax transparent entities (*Entidades en Régimen de Atribución de Rentas – ERAR-*). Characterization rules

- Non-resident entities qualify as transparent in Spain if their legal nature is identical or substantially similar to that of Spanish transparent entities (art. 37 NRIT Law):
  - Tax transparency in the country of incorporation is one feature amongst others (Rulings Dutch CV V0037-03, German KG V1631-14, UK LLP V1319-05 V6306-14 and UK LP V0012-2011).
  - Tax transparency in the country of incorporation is the main feature (Dutch CV V3557-15)
- **DGT Resolution of February 6, 2020, on characterization of non-resident entities as transparent entities incorporated abroad.**
  - Main (purely tax) features to consider in the country of incorporation:
    - Not subject to CIT.
    - Attribution of income to its members/owners when the income arose (disregarding whether distributed or not).
    - Same characterization of the income is retained to the member/owner.
  - DGT Resolution perspires conclusions on Action 2 on Hybrid entities (transparent entities).
- In practice, tax administration does not accept ERAR where the entities are domiciled in blacklisted countries (i.e. Cayman Islands, Jersey), even if investors' Treaty jurisdiction treats the entity as transparent (against Action 2 commentaries?).

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France

- **Concept of « transparency » not well known in France**

- When dealing with a non-French entity, French courts will typically try to identify the closest French equivalent based on its legal – rather than tax – features. Limitation of liability will typically be one of the important features.

- Because a French investor will be a limited partner in the SCSp, it should view the SCSp as more likely opaque

- Case law is however still developing on this subject and the fact that a French investor would view the SCSp as opaque would not necessarily mean that this investor could claim the benefit of participation-exemption on income received from the SCSp (Paris Administrative Court of Appeal, 10 November 2023, n° 22PA03675, Sté Invest Conseils)

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Austria

- Austrian tax law treats a Luxembourg SCS as a transparent entity, i.e., the same as an Austrian KG (which is an LP)
- However, Austrian tax law might see an issue if the Luxembourg SCS is considered having a PE in Luxembourg from an Austrian tax law perspective, while from a Luxembourg perspective it does not

United States – Audit Activity

- **Increased IRS Enforcement efforts for 2024 and beyond following Inflation Reduction Act (IRA) funding**

- IRS enforcement actions expected to adopt an increased focus on high net-worth (HNW) individuals and large complex partnerships (including hedge, private equity and other investment fund vehicles that have historically been difficult for IRS to audit)

- New “special pass-through organization” to be established by IRS within the Large Business and International (LB&I) division with a focus on large or complex pass-through entities (including partnerships and S-corporations)

- IRS expected to utilize Artificial Intelligence (AI) tools to identify compliance risks among complex partnerships with cross-border tax structures

- Coupled with recent procedural simplifications to the audit process for large partnerships under the BBA, there is expected to be **significantly increased** entity-level audit coverage for investment fund vehicles treated as flow-throughs for US tax purposes

Trends at Manager Level

What tax issues arise for the FUND when a US manager of a PE fund or credit fund sets up an office in your jurisdiction?

Austrian Aspects, or rather: Austrian key questions

Taxation of manager

- For the question of how the manager is ultimately taxed, the tie breaker rules are key
- New development: full progression even if Austria is not the resident state
- Other important questions for the taxation: is the manager an employee or self-employed, are bonuses paid while the manager spends time in Austria (for work done from Austria), which economic benefits are received by the manager under which contracts (e.g., a carried interest).

Taxation of fund or fund operating company

- Is a permanent establishment in place because of the manager’s presence in Austria?
- If self-employed, does the manager have a power to conclude agreements for the fund or the fund operating company?
- If an employee, which function does the manager fulfill?

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Italy – Investment manager exemption (1/2)

- Introduced by 2023 Budget Law
- No Italian permanent establishment of foreign investment funds deriving from management activities in Italy
  - The management activities carried out in Italy are deemed to be activities of an independent agent.
  - The Italian office is not considered a fixed place of business through which the business of the foreign investment fund is wholly or partly carried on.
- Requirements
  1. The investment fund and any intermediate holding companies are based in a White List country
  2. The investment fund satisfies certain independence requirements to be set forth in a ministerial decree
  3. The managers who carry out management activities in Italy (i) are not directors of the fund or of any controlled companies and (ii) do not hold a participation in the economic results of the fund higher than 25%
  4. The remuneration of the management activities in Italy is supported by specific documentation.

Italy – Investment manager exemption (2/2)

- Public consultation on draft implementing decree (closed on 3 November 2023). Decree not issued yet.
- Highlights:
  - the safe harbour includes advisory companies;
  - UCITS funds and funds managed by a manager regulated under AIFMD are deemed to be “independent”;
  - undertakings for collective investment or other entities are regarded “independent” if they are subject to vigilance and independently managed (no investor holds more than 20% with respect to other entities);
  - independence of the manager:
    - the requirement not to be a director is limited to the foreign fund and the non-resident controlled companies (i.e. it does not apply to Italian companies) and it applies solely with respect to the other entities (i.e. it does not apply with respect to UCITS fund and funds managed by an AIFMD manager as well as to undertakings for collective investment subject to vigilance)
    - for the purposes of the 25% threshold of the participation in the economic results, also carried interest is computed.

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France

- **Ruling issued to France Invest (then called AFIC) in 2012**: confirmed that the management of a non-French fund by a French management company did not result in the creation of a French PE for the fund nor in the taxation in France of capital gains realised by the fund.

- **The questions typically looked at when setting-up an office in France will be**:
  - transfer pricing
  - income tax and social security treatment of individual employees and availability of impatriate regime for those possibly relocating to France
  - tax treatment of carried interest
  - recoverability of input VAT
  - salary tax

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Carried Interest

Spain. New regulation. Law 28/2022, of December 21 to promote the ecosystem of start-ups.

- **Definition of carried interest**: income derived directly or indirectly from shares or other rights, including success fees, giving rise to special economic rights to directors or employees of management entities of qualifying funds.

- **Qualifying funds**:
  - AIFs according to Directive 2011/61/EU which fall within following categories:
    - Spanish private equity funds (Law 22/2014).
    - European venture capital funds (EU Regulation 345/2013).
    - European social entrepreneurship funds (EU Regulation 346/2013).
    - European long-term investment funds (EU Regulation 2015/760).
  - Other similar CIV.

- **Characterization as employment income, with a 50% exemption subject to**:
  - The obtention by the investors of a minimum return threshold.
  - The shares or the economic rights must be held at least for five years, unless *mortis causa* transfer or settlement of the rights due to a change of management company by the fund.

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Italy

- Carried interest is subject to 26% tax (instead of 43% + 10% in certain cases) if three requirements are met:
    1. Minimum investment of 1% of the net equity/fund commitments
    2. Subordination: the multiple applies only if the other investors have obtained the capital invested and a minimum return (hurdle rate)
    3. Minimum holding period of 5 years except for change of control

- If any of the three requirements is not met, 26% taxation can still be achieved
    - Relevant elements (guidelines of the Italian tax authorities)
        - Amount of the investment
        - Risk of loss of the capital invested
        - Leavership clauses
        - Adequate remuneration of the managers
        - Subscription of the same financial instruments also by other investors
    - Tax ruling recommended

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France

- **Capital gains tax treatment (30% flat tax) subject to conditions**:
  - one class of carry
  - minimum investment by carry holders of 1% of total fund commitments up to €1 billion, 0.5% above
  - 5-year lock-up period
  - individuals employed by the management company or by an entity which provides management services to the fund
  - individuals otherwise receiving market compensation

- **If conditions not met => 79% tax for carry holders** (regular progressive income tax + 30% social contribution)

- **Regime strictly only applicable to EU PE funds**

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Austria

- A Carried Interest is taxed as income from capital (e.g., as capital gains) if it constitutes the payment made on a partnership agreement or, stated differently, if it is not the payment for services or employment.
- Whether the payment is made based on a partnership agreement is determined by applying an economic and legal analysis.
- The fact that the amount of the Carried Interest is linked to the performance of the underlying portfolio is not necessarily harmful.

United States

- **Carried Interest**
  - Typically structured as “profits interests” in a partnership, allowing for pass-through treatment of income, gain, loss, deduction and credit
  - Generally preserves character of underlying income earned by the partnership (subject to the Section 1061 regime)
  - Potential for non-US carry recipients to become exposed to underlying US trade or business issues (mitigation techniques include, but not limited to, use of blocker vehicles)

- **Section 1061**
  - Three-year holding period generally required for favorable long term capital gain treatment
  - Certain income is excluded from the Section 1061 regime (e.g., Section 1231 trade or business property, regulated futures and other contracts marked to market under Section 1256, qualified dividend income (QDI))
  - Capital interest allocation issues (clear identification requirement in partnership agreement as well as books and records)

Trends at LP Level

United States

- **Fund Structuring for US Limited Partners**
  - US Taxable Limited Partners:
    - Individual US citizens and residents, US trusts/estates and US corporations
    - Generally sensitive to investment through local holding companies treated as corporations from a US tax perspective and typically prefer to invest on a "pass-through" basis
    - Passive Foreign Investment Company (PFIC) and Controlled Foreign Corporation (CFC) regimes may apply
      - Recent changes to PFIC regime, including how Qualified Electing Funds (QEF) elections are made, may create increased compliance burdens for non-US funds with US investors up the chain
    - No one-size-fits-all approach. US taxable investors may prefer to invest in certain asset classes (e.g., fee-heavy non-US real estate deals) via local holding companies treated as corporations and that are QEFs

United States – continued

- US Tax-Exempt Limited Partners :
  - US charitable organizations, hospitals/research institutions, university endowments, pension plans (private and public)
  - Exempt from US tax on investment income (interest, dividends, capital gains, royalties), but subject to tax on operating income (classified as “UBTI”) or income that is debt-financed (classified as “UDFI”)
  - Generally able to invest in non-US deals via local holding companies treated as corporations for US tax purposes, but analysis is more nuanced for US-deals or deals with significant withholding tax drag

United States – continued

- **US Rules Impacting US Limited Partners in Non-US Holding Structures**
  - Proliferation of local holding companies treated as CFCs post-TCJA
  - Global Intangible Low-Taxed Income (“GILTI”) regime takes on increased significance

- **Common Side Letter Issues/Requests for US Limited Partners in Non-US Funds**
  - PFIC reporting
  - Tax audit notification, consultation or “modification” provisions (e.g., accounting for investor tax-exempt status)
  - Covenants regarding minimization of UBTI
  - Covenants regarding minimization of local withholding taxes (especially for investors of special status, such as US tax-exempts)

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