Connecting Fund Managers with Impact Investors' Tax Principles

Co-written by FMO and BII (Co-Promoters) and published as a resource for GPCA

Context

The purpose of this article is to initiate communication between multilateral and bilateral development finance institutions (''DFIs") and private equity fund managers ("FMs") that seek to attract DFI funding for investments in countries within the mandate of DFIs. This is with the intention of equipping FMs with an upfront understanding of responsible tax standards typically imposed by DFIs when investing in FMs.

The expectation is that such understanding over time is mutually beneficial to the FM and the DFIs as it should have the consequence of markedly reducing the time that is currently spent on due diligence and side letter negotiations to find an agreement on the responsible tax principles to be adopted by the FM, for both fund investments and fund manager tax practices.

The circulation of this article to the GPCA community is intended to invite interested FMs to further discussion outside the pressure of funding deadlines and an upcoming workshop on Monday, March 27, around the GPC Conference in New York to share views, experiences and needs of both FMs and DFIs.

This article will describe the tax principles commonly seen with DFIs and the need for transparency by FMs as well as a core set of principles that can be used as a framework.

Introduction

In response to the unique political and investment climate in which we operate, and the pace at which international tax laws continue to develop, most DFIs have developed responsible tax principles which should be adopted by their investees to restrict aggressive tax practices and maximize the overall societal impact of its investments.

The most important principle that can be drawn from DFI tax policies relates to the use of entities in so-called non-cooperative jurisdictions, but effectively also entities established in low tax jurisdictions. Other principles reflect the OECDs BEPS project items relating to aggressive tax structures (treaty shopping, transfer pricing and hybrid mismatches).

PE Fund Investment Structures

How do those principles relate to PE funds' investment structures?

a) <u>The Fund Structure Itself</u>
   It is generally accepted that FMs establish the fund vehicle in jurisdictions that are familiar to investors and have a well-established and investor-friendly legal and regulatory framework. We also

accept that the fund vehicle should not be established in a manner which unnecessarily adds an additional layer of tax for the investors or the investees.

Notwithstanding, DFIs look to invest through countries which meet internationally accepted standards of tax transparency and information exchange. Typically, DFIs are not able to invest in funds established in jurisdictions which have been designated as "non-cooperative for tax purposes" by the EU and / or not adhering to international tax transparency standards set by the OECD. This should be borne in mind by the FM when promoting and offering structures for DFIs to invest into.

b) Structuring Fund Investments by the FM

DFIs operate in an environment where its stakeholders do not differentiate between structures implemented because of a direct investment and those where we invest in an intermediate structure. As such, DFIs require FMs to, as far as is practicable, adhere to the responsible tax standards of the DFI which can be a key component of side letter negotiations on a DFI-by-DFI basis. The most relevant principles, consistent across the majority of DFIs are:

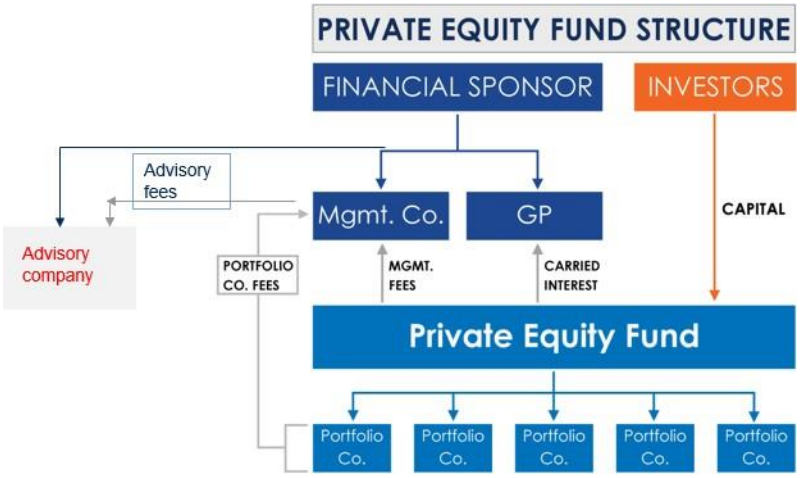
i) *Treaty shopping*: It is often the case that an FM may desire to set up an intermediate SPV through which an investment in a portfolio/target company is made. The rationale behind setting up the SPV should not be with the primary purpose of reducing exit taxes and withholding taxes in the investee's country of operation. The non-tax reasons for establishing an SPV need to be substantiated, documented and aligned with commercial and operational reality. When there is a compelling non-tax reason for an SPV, it is technically a free choice to establish the SPV in a beneficial jurisdiction; however, there needs to be a consistency of approach. As an example, FMO has recently adopted the principle that for an FM to support that the SPV is not established solely for tax, the FM cannot choose different jurisdictions for different investments. Such behavior can be deemed as cherry picking and can be more likely to lead to enquiries around treaty shopping.

ii) *The use of 'shareholder' loans*: FMs can choose to invest through a loan by the fund alongside the equity investment. We appreciate and understand that there can be many commercial drivers for doing this depending on the desired yield profile of the investment. If interest bearing, such interest payments will likely not be taxable at the fund vehicle level, making this a hybrid mismatch (deduction at portfolio company, no taxation at fund level) if the fund vehicle is opaque. In such circumstances, we would expect that the FM confirms that such interest payments are subject to withholding tax in the investee country. Strategies to aggressively avoid this withholding tax is not within the responsible tax appetite of DFIs. Reporting of such withholding tax paid is strongly recommended.

(iii) Responsible tax behavior by investee/target: the FM will be involved (in most cases) in the strategy of the investee. DFIs consider it the responsibility of the FM to ensure the investee has no aggressive tax structures in place and would expect evidence of aggressive tax structures to be uncovered and unwound as part of the diligence process with conditions imposed in the legal agreement to specifically prohibit aggressive tax avoidance strategies, i.e. aggressive transfer pricing being implemented by the investee.

PE Fund Manager

How do those principles relate to fund manager structures?



Structuring of Management Fees and Carried Interest by the FM

PE fund agreements generally allow the fund to pay the FM a management fee (usually 2% of commitments as a starting point). Investors or Limited Partners of a PE fund, therefore, effectively pay the FM a fee. The fee is a remuneration for the FM team. In our experience, the legal structuring of such fees generally takes the following form:

i) The fund vehicle pays a management fee to the FM, who in most cases is established in the same (offshore) jurisdiction as the FM. The FM typically has no actual staff, but the fee functions as liability protection for its formal decision-making function.

ii) The FM sub-contracts its obligations to a fund advisor which typically houses employees / staff in one of the jurisdictions in which the fund invests or in the headquarters office.

iii) Further, the carried vehicle is located in the fund vehicle's low tax jurisdiction. This common structure embeds the opportunity for the FM to leave part of the management fees offshore as untaxed income[1]. DFIs can require transfer pricing documentation to substantiate the remuneration basis implicit to this situation, but increasingly, DFIs want to ensure that
a) all staff are being paid in the country where they operate/reside and that relevant (wage or income) taxes, social security and pensions are being paid
b) keypersons / partners of the FM profit share or other remuneration is taxed in the country where they reside
c) the residual profit on management fees received by the FM is allocated to where activities take place (onshore), and lastly,
d) all beneficiaries of the carried interest pay their relevant taxes in the country of residence.

[1] We also have seen PE funds not located in low tax jurisdictions, where the management fee structure was altered in such a manner as to achieve the same untaxed situation by fees being transformed into tax-exempt distributions and subsequent contributions.

Getting transparency on points a-d have proven to be difficult and require unreasonable time from both investors (DFIs) as well as FMs. It is, however, relevant for DFIs to have this transparency, because as payers of the fees, they cannot support the risk that those incomes remain untaxed[2].

Conclusion

DFIs would like to recommend that FMs develop (and adhere to) a responsible tax policy as addressed in this article.

Through the topics raised in this article, we have aimed to provide context for the recurring questions that DFIs raise with FMs during the DD phase. As a next step, we would like to invite FMs to respond to this article with their perspective on the use of loans, SPVs and complex vehicles and their ability to transpose responsible tax behavior on the investee companies.

We also are working with GPCA to provide an opportunity for FMs to attend a workshop on Monday, March 27 on this topic, which will be held in conjunction with the annual GPC Conference in New York. Register here.

We are committed to working with FMs to find commonality of approach, please contact via FMO through Yvonne Bol at Y.Bol@fmo.nl or via GPCA through Holly Radel at hradel@gpcapital.org, who can aggregate and anonymize questions for the GPCA DFI Council.

[2] An interesting note: fund documentation often requires investors/LPs to make advances to the FM for potential tax liabilities on their carried interest share, without providing documented proof of the actual tax liability. (Note: in practice such advances have rarely been made.)