Private Equity Report

WHAT'S INSIDE

"Who can we talk to about global investing?"

From the Editors

As we enter the last quarter of 2017, we continue to see strong investor interest in private equity. The year appears on track to set records for fundraising, particularly with the closing of a number of very large funds this year. The challenge remains for fund managers to deploy their dry powder in a period marked by high valuations.

One trend we have witnessed is the resurgence of the use of "special purpose acquisition companies," or SPACs. The popularity of SPACs waned after the financial crisis, as a result of uncertainty in the equity capital markets and a decline in M&A activity. PE sponsors are now increasingly using SPACs to supplement the traditional PE investment model and tap into public markets for a permanent source of equity. In this issue, we take a closer look at the benefits to PE of the SPAC model and explain how the SPAC offering process works.

We also explore four other recent developments impacting PE fund structuring and compliance programs:

- A potentially game-changing US tax decision that could affect how non-US investors invest in US funds
- Developments in Brexit and European regulatory changes
- Regulatory scrutiny on the financial services sector and increased global coordination in the enforcement of anti-bribery/anti-corruption laws
- BEPS – the global move towards new base erosion and profit shifting rules that will impact fund structures

We wish you good reading!

This report is a publication of Debevoise & Plimpton LLP.

PE Jumps into the SPAC Markets

"After a period of diminished fundraising, SPACs are back with a vengeance, and a number of them are backed by private equity sponsors."

Raising capital through special purpose acquisition companies, or SPACs, hit its peak around 10 years ago. After a period of diminished fundraising, SPACs are back with a vengeance, and a number of them are backed by private equity sponsors.

What Is a SPAC?

A SPAC is a company formed for the purpose of acquiring one or more operating companies pursuant to a business combination. Prior to having a specific target for the business combination, the SPAC raises the funds through a public offering of the SPAC's equity securities, with the private equity sponsor retaining 20% of the post-IPO SPAC.

Appeal to Private Equity Sponsors

SPACs have a number of benefits that have led private equity sponsors to use them to raise capital.

- SPACs provide a potential permanent capital solution for sponsors through access to public markets, which allows for more open-ended private equity investments.
- The private equity sponsor retains 20% of the post-IPO SPAC, providing an outright ownership position, which increases the potential upside in the post-business combination entity.
- SPACs can serve as co-investment vehicles, allowing private equity sponsors to do side-by-side transactions with less leverage and more equity.
- SPACs allow the pursuit of larger acquisition targets and targets in industries that fund documents would prohibit.
- SPACs provide greater liquidity certainty for sellers who receive SPAC equity in the transaction, as compared to an illiquid interest in a private portfolio company.

Despite these benefits, sponsors need to consider the potential downsides in seeking to set up a SPAC. For example, sponsors will need to explain the product to existing limited partners, who may be concerned about potential competition for deal opportunities between the SPAC and the existing fund. They might also be concerned that the private equity sponsor employees involved in the SPAC will be distracted from core fund investment activity.

Continued on page 3

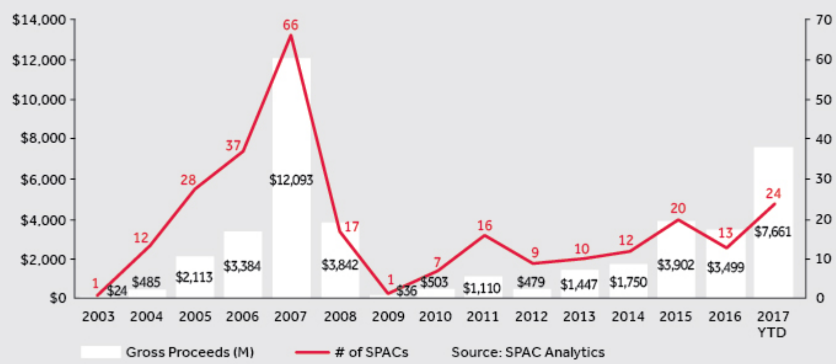
Continued from page 2

SPAC Deal Trends

There has been a significant resurgence in the SPAC IPO market since the financial crisis.

SPAC Capital Raising 2003-2017

- Significant resurgence in SPAC IPO market since financial crisis
- SPACs are becoming a more mainstream structure



Private equity sponsors that have completed IPOs of SPACs in 2017 include Riverstone, The Gores Group, TPG and Thomas H. Lee Partners. In addition, SPACs sponsored by TPG (acquisition of Playa Hotels & Resorts), Centerview (acquisition of Atkins Nutritionals, Inc.) and Chinh Chu, formerly a Blackstone partner (acquisition of Fidelity & Guaranty Life), have either signed or completed business acquisitions in 2017.

SPAC IPO Process Overview

Prior to the IPO, the founders of the SPAC invest a small amount of initial capital to form the SPAC and hold all of the pre-IPO equity. A SPAC will typically sell units consisting of one class A common share and 1/3 of a warrant in the IPO at a price of $10.00 per unit. The market custom is that only units are tradeable for the first 52 days after the IPO, after which the class A common shares and warrants trade separately. The founders retain their 20% equity ownership through class B common shares, which are commonly referred to as "founder shares."

Only the founder shares are entitled to vote on the election of directors prior to the initial business combination, which allows the founders to retain control of the SPAC until it becomes an operating business. Most SPACs list on Nasdaq, which has favorable listing requirements for SPACs. However, Nasdaq rules subject SPACs to similar corporate governance requirements as are imposed on operating companies, so SPACs will have an audit committee made up of independent directors and a majority independent board of directors.

Nasdaq rules require that at least 90% of a SPAC's IPO proceeds be placed in a trust account to fund the business acquisition, but in practice, SPACs typically place the full amount of the IPO proceeds into the trust account. The trust account invests the proceeds in US government bonds. The underwriting discount for a SPAC IPO is typically 5.5%, with 2.0% paid at the time of the IPO and an additional 3.5% paid when the SPAC successfully completes an initial business combination. Typically, the underwriting discount is paid for through a private sale of warrants to the founders.

The IPO process typically takes between ten and twelve weeks. Many SPACs make their first registration statement filing confidentially with the SEC, which allows the founders to advance the IPO process with the SEC without having to announce it to the public until closer to the time of the IPO. Since SPACs qualify as "emerging growth companies," the founders can take advantage of certain accommodations, including reduced disclosure requirements and exemptions from certain Sarbanes-Oxley requirements.

SPAC Business Combination Process Overview

Nasdaq rules require that a SPAC complete a business combination within 36 months of an IPO; this time frame is typically 24 months in a

Continued on page 4

SPAC's organizational documents. If a SPAC is unable to meet the deadline, each holder of class A common shares is entitled to its pro rata portion of the assets in the trust account, while holders of founder shares and warrants (including the founder warrants purchased to finance the underwriting discount) are not entitled to any such assets.

Under Nasdaq rules, the fair market value of the target business must exceed 80% of the value of the assets in the trust account. Once management identifies and agrees to a business combination with a target, Nasdaq rules require that the business combination be approved by a majority of the SPAC's independent directors. If required by state law, a SPAC may have to submit the business combination to a vote of the class A shareholders. In many cases, however, a shareholder vote can be avoided. Further, the approval of the class A shareholders is usually obtained if needed because of the shareholders' redemption option discussed below.

Whether or not a shareholder vote is required, Nasdaq rules require that each shareholder be given an opportunity to redeem its class A shares for a pro rata portion of the trust account. If a shareholder vote is not held, the SPAC may offer this opportunity to redeem class A shares pursuant to a tender offer. This may lead to a situation in which a shareholder threatens to redeem a large position in order to extract value from the SPAC. Many SPACs attempt to mitigate this risk by limiting redemptions for any individual investor to 20% of the total outstanding class A shares.

The shareholders' ability to redeem their shares can also create significant uncertainty for the sellers, as it can be unclear whether the SPAC will have enough assets to complete the business combination. Some recent SPACs have addressed the uncertainty caused by the redemption process by entering into a forward purchase agreement with the SPAC's founders, which obligates the founders to purchase additional units from the SPAC in the event additional capital is needed to complete the initial business combination. A forward purchase arrangement can not only fill any gap that is created by redemptions, but can also provide additional capital for the SPAC in the event that the target business costs more than the value of the assets in the trust account and available debt financing. Alternatively, SPACs can seek a PIPE (private investment in public equity) deal, where additional capital is raised through a private offering to a selected investor or group of investors. A potential PIPE transaction, however, lacks the certainty of a forward purchase agreement entered into at the time of the IPO.

> "Nasdaq rules require that a SPAC complete a business combination within 36 months of an IPO; this time frame is typically 24 months in a SPAC's organizational documents."

Conclusion

Although SPACs are complicated structurally, they can provide private equity sponsors with a number of benefits in terms of transaction targets, structure and returns on investment. The SPAC IPO market has seen significant demand in recent years, which has further encouraged private equity sponsors to take advantage of SPACs. Private equity sponsors should consider whether a SPAC will provide them with benefits that will justify the time and cost of establishing a SPAC and differentiating their investment strategy from that of the sponsors of other funds.

Matt E. Kaplan
mekaplan@debevoise.com

Kevin M. Schmidt
kmschmidt@debevoise.com

Steven J. Slutzky
sjslutzky@debevoise.com

Christopher Anthony
canthony@debevoise.com

Kevin R. Grondahl
krgronda@debevoise.com

A Taxpayer Win May Be a Game Changer for Operating Partnership Investments

"While it may be too early for private equity funds to change the blocker structures offered to non-US investors when investing in Operating Partnerships, non-US blockers may be a good solution for an Operating Partnership with the right tax profile."

Private equity funds have long had to deal with non-US (and to a lesser extent, tax-exempt) investors' concerns about the adverse tax consequences of investing in operating US LLCs or other pass-through entities (Operating Partnerships). On July 13, 2017, the US Tax Court ruled that a foreign corporation did not have to pay US federal income tax on certain gain realized on the redemption of its interest in an Operating Partnership.[1] The ruling rejected the IRS's long-standing position that a non-US partner's gain on the sale of an interest in an Operating Partnership is income effectively connected with a US trade or business (ECI) and subject to US federal income tax.

The implications of the Tax Court's decision are far-reaching for private equity funds and non-US investors. While it may be too early for private equity funds to change the blocker structures offered to non-US investors when investing in Operating Partnerships, non-US blockers may be a good solution for an Operating Partnership with the right tax profile. In addition, private equity fund sponsors may see certain non-US investors that are not averse to filing US tax returns decline blocker structures offered by the fund and, instead, invest unblocked into Operating Partnerships. Private equity funds with Cayman feeders and non-US investors that have reported ECI from the sale of their interests in Operating Partnerships should consider filing tax refund claims with the IRS for all open tax years.

Tax Court Ruling

Grecian Magnesite Mining, Industrial & Shipping Co., S.A. (GMM), a foreign corporation, owned an interest in a partnership engaged in the business of extracting, producing and distributing magnesite in the United States In 2008, the partnership redeemed GMM's interest, resulting in $6 million of gain, which GMM did not report as ECI. The IRS claimed that the gain was ECI and therefore taxable. In response, GMM filed a petition with the Tax Court.

The IRS's controversial position regarding the sale or redemption of an interest in an Operating Partnership is articulated in a 1991 Revenue Ruling (Rev. Rul. 91-32). Rev. Rul. 91-32 holds that a non-US partner's gain on the disposition of an interest in an Operating Partnership is ECI and subject to US tax to the extent attributable to property of the Operating Partnership that is used or held for use in its US trade or business. The IRS arrived at this result by stating that the US office of an Operating Partnership is treated as a US office of its partners and

Continued on page 6

1. *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (July 13, 2017), *available at* https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11322.

Continued from page 5

that gain realized by a non-US partner from the sale of an interest in such Operating Partnership is attributable to that US office.

Commentators have criticized Rev. Rul. 91-32 since its publication, questioning in particular whether the ruling is supported by law or simply reflects IRS policy. Notwithstanding this criticism, the IRS has consistently applied its position, which remained essentially unchallenged during the 25 years since Rev. Rul. 91-32's publication. The Obama administration also indicated support for the ruling's position by proposing to codify its holding.

> "With the Tax Court's ruling, however, structuring investments in Operating Partnerships through non-US blockers may become more appealing, especially in cases where an Operating Partnership does not have significant FIRPTA assets or has significant non-US assets."

All of this changed with the GMM case. The Tax Court did not follow Rev. Rul. 91-32, finding that GMM's gain on the redemption of its partnership interest was better characterized as gain from the sale of an "indivisible capital asset," rather than from the partnership's underlying assets. The Tax Court noted that the look-through approach advanced by Rev. Rul. 91-32 was not supported by the Internal Revenue Code (Code) or regulations. It further found that GMM's gain was not attributable to the partnership's office and therefore improperly treated as ECI. In support of its ruling, the Tax Court pointed to the FIRPTA rules (US real property tax rules), which have a specific look-through to treat as ECI any gain attributable to a partnership's US real property interests; under the IRS's position, such rule would be unnecessary.

What Does This Mean for You?

By rejecting the controversial analysis in Rev. Rul. 91-32, the Tax Court's decision, if sustained on appeal or acquiesced to by the IRS, may significantly change how private equity funds structure investments in Operating Partnerships for non-US investors. Of course, most non-US investors will continue to want blocker structures to avoid any direct US tax or tax return obligations. Historically, private equity funds have used US blocker corporations for non-US (as well as tax-exempt) investors when making investments in Operating Partnerships. This preference was due in part to the IRS's position in Rev. Rul. 91-32. In addition, using a US blocker can make it possible to sell the blocker tax-free, albeit at a discounted price.

With the Tax Court's ruling, however, structuring investments in Operating Partnerships through non-US blockers may become more appealing, especially in cases where an Operating Partnership does not have significant FIRPTA assets or has significant non-US assets. Indeed, there may be little down-side risk in using non-US blockers. Both US and non-US blockers are essentially taxed the same way on current income (both are taxed at the same rates and can be capitalized using blocker leverage to minimize the impact of current taxation). Moreover, while only non-US blockers are subject to the branch profits tax, the branch profits tax generally would not apply to a non-US blocker on the sale of an Operating Partnership. It may also be possible to manage the branch profits tax leakage on current income similarly to the way in which dividend withholding tax leakage is managed today in the case of a US blocker.

Continued on page 7

Continued from page 6

So Why Are We Suggesting Caution?

At this time, the issue remains unsettled. The IRS has not yet indicated whether it will acquiesce to or appeal the Tax Court's decision. If the IRS appeals, it may win. Perhaps more importantly, the IRS may seek to overturn the Tax Court's decision by issuing new regulations consistent with its position in Rev. Rul. 91-32, such as clarifying what it means to be "attributable" to a US office. Another possibility is that Congress will adopt changes to the Code to codify the holding in Rev. Rul. 91-32. One thing that does seem certain is that we have not heard the last of this issue.

During this time of uncertainty, before deciding on using a non-US blocker, fund sponsors should think carefully about the impact a reversal of the Tax Court's decision will have on unwinding a non-US blocker structure. In general, selling a non-US blocker is likely to be materially more difficult than selling a US blocker. US strategic investors in particular may be adverse to buying a non-US blocker because of integration issues.

> "During this time of uncertainty, before deciding on using a non-US blocker, fund sponsors should think carefully about the impact a reversal of the Tax Court's decision will have on unwinding a non-US blocker structure."

Of course, if the IRS ultimately loses the issue or acquiesces, selling non-US blockers would be unnecessary because gain from the sale of an Operating Partnership would generally not be ECI. If the IRS ultimately wins or changes the rules of the game, however, selling US blockers will be back on the table. Fund sponsors using non-US blockers may at that point be able to convert them into US blockers, but some tax leakage is likely and delay in selling the US blockers may be necessary. Unfortunately, there will not be any way to unwind any sales of Operating Partnerships by non-US blockers made in the interim.

Takeaways for Fund Sponsors

The Tax Court case is a game changer. Fund sponsors should keep in mind, however, that this is just the start of the game and that the IRS has many cards it can play in response. Fund sponsors thinking about how best to serve their non-US investors should pay careful attention to the IRS's next move. Fund sponsors should also discuss the pros and cons of using US versus non-US blockers with their tax advisors. Managing the branch profits tax and having the ability to unwind a non-US blocker structure in the event of a reversal will be key elements to any blocker structure analysis.

Rafael Kariyev
rkariyev@debevoise.com

Gary M. Friedman
gmfriedman@debevoise.com

Lena E. Smith
lesmith@debevoise.com

FCPA Enforcement: Financial Services Sector Under Scrutiny

"2016 was a record year for FCPA enforcement. The SEC and DOJ brought a combined 27 corporate actions, collecting approximately $2.4 billion in disgorgement, penalties and fines."

Enforcement of the Foreign Corrupt Practices Act (FCPA) reached record levels in 2016, with more than $2.4 billion in disgorgement, penalties and fines. Although the first half of 2017 was comparatively quiet, enforcement is again on the rise, with the United States, Sweden and the Netherlands announcing a global $965 million settlement with Swedish telecommunications giant Telia on September 21. Given the US government's recent focus on FCPA compliance in the financial services sector, now is a good time for asset managers to take stock of their compliance programs and assess their FCPA risk.

The FCPA in a Nutshell

The FCPA prohibits the offer, promise or payment of anything of value to foreign government officials in order to obtain or retain business or obtain an unfair business advantage. It also requires public companies to maintain accurate financial records and have an adequate system of internal controls.

The anti-bribery provisions of the FCPA apply to conduct anywhere in the world and extend to:

- Companies that are publicly traded in the United States, as well as their officers, directors, employees, stockholders and agents
- Private US companies, as well as their officers, directors, employees, stockholders and agents
- US nationals
- Any foreign national who violates the FCPA while in the United States

Both the US Department of Justice (DOJ) and the US Securities & Exchange Commission (SEC) have dedicated units that enforce the FCPA. Violations of the FCPA can result in civil and criminal charges, disgorgement of profits, penalties or fines, and jail time for individuals.

Record Enforcement Levels in the United States

2016 was a record year for FCPA enforcement. The SEC and DOJ brought a combined 27 corporate actions, collecting approximately $2.4 billion in disgorgement, penalties and fines. The cases spanned a wide variety of industries, ranging from pharmaceutical and life sciences to technology, oil and gas, manufacturing, and even the food and beverage industry. The pace continued into 2017, with five cases each brought by the SEC and DOJ in early 2017.

Although there was a slowdown in cases through the spring and early summer of 2017, this may have been due to a combination of senior staff turnover and a regrouping period after the frenetic activity of 2016 and early 2017. Enforcement

Continued on page 9

Continued from page 8

activity picked up in July, with the DOJ bringing action against two private US companies, Linde Group and CDM Smith Inc., and the SEC taking action against two-time violator Halliburton Company. And on September 21, the DOJ and SEC announced a global settlement resolution with Telia Company that included actions by the Netherlands and Sweden. The $965 million global resolution places Telia among the top ten largest FCPA cases ever brought.

> "Other countries are increasingly adopting US-style enforcement techniques."

Increasing Attention on the Financial Services Sector

US authorities signaled a continued focus on the financial services sector, with two major enforcement actions:

- In November 2016, JPMorgan paid $264 million to settle charges that it violated the FCPA by offering internships to relatives of Chinese government officials in exchange for business opportunities. Investment bankers at JPMorgan's subsidiary in Asia created a client referral hiring program that bypassed the firm's normal hiring process and rewarded job candidates referred by client executives and influential government officials with well-paying, career-building JPMorgan employment. The SEC announced at the time that this was the first case to come out of an enforcement sweep examining referral hiring in Asia. Interestingly, the Federal Reserve also brought charges against JPMorgan for this conduct, marking the first time that the Federal Reserve has taken action in this space.
- In September 2016, Och-Ziff Capital Management settled charges that it paid tens of millions of dollars in bribes through intermediaries to government officials in Libya and Africa in order to obtain investments and other business.

  In addition to paying more than $400 million in disgorgement of profits, penalties and fines, a subsidiary of the firm pled guilty, and the firm was required to retain a compliance monitor for three years. The firm's founder and CEO, Dan Och, and the former CFO settled charges that they ignored red flags and corruption risks and permitted the illicit transactions to proceed. This was the second case to come out of the SEC's enforcement sweep examining firms' interactions with sovereign wealth funds (the first was a case against BNY Mellon the prior year) and the first action brought against a hedge fund for FCPA violations.

Given the announced sweeps by the SEC and recent activity by the US government in connection with potential corruption at Malaysia's state investment fund 1MDB, it seems likely that the DOJ and SEC will continue to investigate potential corruption involving financial services firms. This should keep investment advisers' attentions focused on managing their anti-corruption risks.

International Enforcement on the Rise

2016 began an unprecedented level of global enforcement, with countries ranging from Brazil, the United Kingdom, Canada, the Netherlands and Switzerland announcing enforcement actions against companies that violated their anti-corruption laws. Moreover, six of the largest corporate FCPA enforcement actions since February 2016 have involved coordinated global resolutions between the United States and other countries, including first-ever actions with Brazil, the Netherlands and Sweden:

- In February 2016, the United States and the Netherlands announced a global settlement with Vimpelcom. The Netherlands-based telecommunications provider agreed to a $795 million global settlement to resolve its alleged violations of the FCPA to win business in Uzbekistan.
- In October 2016, Brazilian-based aircraft manufacturer Embraer agreed to pay $205 million to settle charges by the United States and Brazil that it violated the FCPA to win business in the Dominican Republic, Saudi Arabia, Mozambique and India.
- In December 2016, Braskem, the Brazilian-based petrochemical

Continued on page 10

Continued from page 9

manufacturer, pled guilty and agreed to pay $957 million in a global settlement with the United States, Brazil and Switzerland for concealing millions of dollars in illicit bribes paid to Brazilian government officials to win business.

- Also in December, Odebrecht, a global construction conglomerate based in Brazil, pled guilty and agreed to pay a combined total penalty of at least $2.6 billion to resolve charges with authorities in the United States, Brazil and Switzerland arising out of its schemes to pay hundreds of millions of dollars in bribes to government officials around the world.
- In January, UK-based conglomerate Rolls-Royce agreed to an $800 million global resolution with US, UK and Brazilian authorities in connection with allegations of a long-running scheme to bribe government officials in exchange for government contracts.
- In September 2017, Sweden-based telecommunications provider Telia agreed to pay $965 million in a global settlement with the United States, the Netherlands and Sweden to resolve alleged violations of the FCPA to win business in Uzbekistan.

Although in the past the United States took the lead in any anti-corruption enforcement action, this is no longer always the case. Indeed, in two recent actions, other countries took the lead, with a majority of the settlement amounts going to them. In the Odebrecht/Braskem set of cases, 80% of the recovery went to Brazil, with the remaining 20% split between the United States and Switzerland. In the Rolls-Royce case, more than three-quarters of the recovery was paid to the United Kingdom, with most of the remaining amount going to the United States and a small amount to Brazil.

A senior DOJ official recently indicated that they expect to see these global resolutions continue in the future.

Global Enforcement, US-style

Other countries are increasingly adopting US-style enforcement techniques. For example, the United Kingdom adopted a framework several years ago for bringing deferred prosecution agreements (DPAs) and has now brought four DPAs, including its recent DPA in the $800 million action against Rolls Royce. Brazil has made extensive use of cooperating witnesses and leniency agreements in the Operation Carwash investigation. Australia recently announced a proposed model to implement DPAs. Further, multiple countries have announced the creation of dedicated anti-corruption units.

Takeaways for Asset Managers

- *Make sure your compliance policy is up-to-date.* If you haven't looked at your anti-corruption policy with an eye towards the recent enforcement actions, now is the time. Pay particular attention to your use of introducers, placement agents and other third-party agents. Make sure that you have a mechanism in place to track third-party usage and ensure that they receive the appropriate due diligence.
- *Broaden the definition of "anything of value."* Non-cash benefits, such as gifts, travel or entertainment expenses, must be considered reasonable and related to a legitimate business purpose. For internships or other offers of employment, make sure that all candidates go through your normal hiring process and are qualified for your program under their own merits.
- *Do your pre-acquisition due diligence.* When considering an investment, assessment of anti-corruption risks is an important part of a firm's pre-acquisition due diligence. Thorough pre-acquisition assessments of portfolio companies, joint venture opportunities or other investments will help accurately price a target, plan post-acquisition integration and avoid successor liability. Make sure that the deal team has the information it needs to accurately evaluate the risk.
- *Regular risk assessments are key.* A periodic review of your entire portfolio can help you determine your overall corruption risk and identify portfolio companies and other investments that should be flagged for additional follow-up.
- *Get help in difficult situations.* Experienced counsel can help you determine the right approach to managing FCPA risk.

Kara Novaco Brockmeyer
kbrockmeyer@debevoise.com

Jil Simon
jsimon@debevoise.com

What You Need to Know About Structuring Your Fund in the BEPS Era

"Over 100 countries, including the United States and most European countries, are collaborating in implementing some or all of the BEPS Project, meaning every fund is likely to be touched by the changes in some way."

To misquote *Star Trek*, "It's life, Jim, but not as we know it." And so we must think of the global tax landscape as we head into a BEPS (base erosion and profit shifting) era. The BEPS Project, the brainchild of the OECD and the G20, is aimed at preventing tax avoidance caused by base erosion and profit shifting by multinationals. Over 100 countries, including the United States and most European countries, are collaborating in implementing some or all of the BEPS Project, meaning every fund is likely to be touched by the changes in some way (see our implementation tracker at http://beps.debevoise.com that follows the progress made by each of the United Kingdom, France, European Union and the United States).

BEPS appears frequently in private equity news and is commonly asked about by investors during fundraising and beyond. This article aims to provide readers with a working understanding of the BEPS Project and its potential impact on fund structures. You may also wish to view our 2.5-minute animated explainer video at http://beps.debevoise.com/#video1.

Key Terminology

Base Erosion

An entity's tax base is the income, profits or gains (or other determining factor) against which tax is charged. At a basic level, corporate tax is calculated by:

[tax base] x [tax rate]

Base erosion is the process of reducing an entity's tax base. This can obviously occur simply by not being profitable, but the base erosion targeted by the BEPS Project is erosion that has been "aimed for" or structured.

Profit Shifting

Profit shifting is the practice of moving a multinational group's profits from one (typically high tax) country to another (typically low/no tax) country (for example, through royalty payments or intercompany debt).

The BEPS Project Framework

The BEPS Project consists of a 15-point Action Plan. The Actions are wide-ranging and consider, among other things, hybrid entities and instruments, interest deductibility, double tax treaty abuse, permanent establishment status and transfer pricing.

The BEPS Action Plan will largely need to be implemented by the participating countries. This means that, although there may be a multinational consensus as to the general approach that needs to be taken, the actual BEPS rules may change

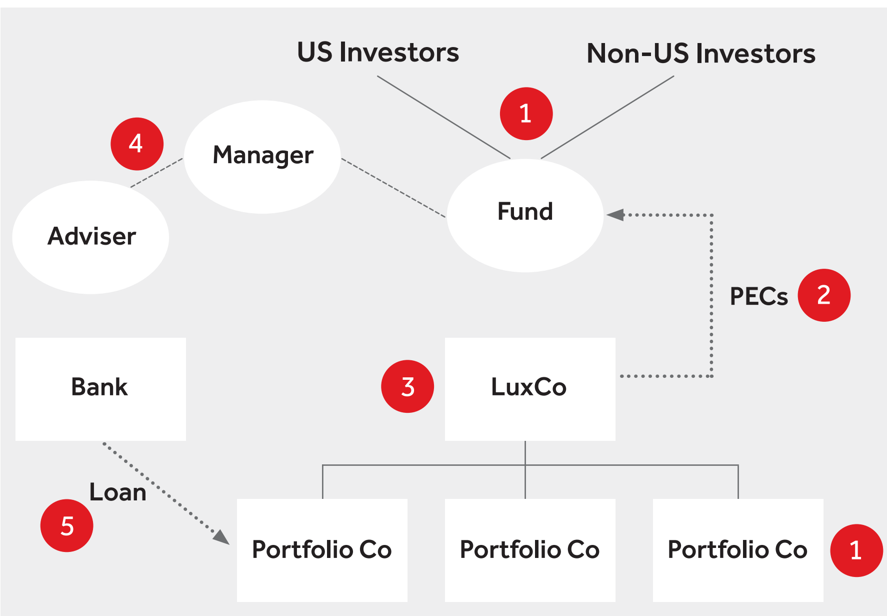
Continued on page 12

Continued from page 11

from country to country. The European Union has published its own response to BEPS in an Anti-Tax Avoidance Package and seeks to implement many of the BEPS Actions. This should bring some uniformity into how the 28 member states (27 following Brexit) will implement the BEPS Action Plan. In addition, the United States has already implemented some parts of the BEPS Project and may implement more (see our implementation tracker at http://beps.debevoise.com).

Impact on Funds

Set out below is a simple fund structure, highlighting some of the areas that may be impacted by the BEPS Project.



1 Hybrid Entity

Action 2 aims to neutralize tax benefits that hybrid entities enjoy due to mismatched treatment by various tax jurisdictions. If a check-the-box election is made with respect to either a company or a partnership, this will make it a hybrid entity and therefore potentially subject to the Action 2 anti-hybrid rules. For a fund that is a partnership, these rules may be applicable if (i) the fund is checked to be treated as a corporation for US tax purposes, or (ii) there are certain investors in the fund for whom the fund is treated as opaque. If the Action 2 anti-hybrid rules apply, the investors may become subject to deemed taxable income. Alternatively, if there is an interest payment at the portfolio level in a participating country, the deductibility of this interest payment may be compromised. For a short animation explaining the anti-hybrid rules, see http://beps.debevoise.com/#video2.

2 Hybrid Instrument

A Preferred Equity Certificate (PEC) is typically treated as debt in Luxembourg but equity in the United States and is therefore a hybrid instrument. The anti-hybrid rules proposed under Action 2 may apply to disallow a portion of the interest deduction in LuxCo (or, surprisingly, could even impact interest deductibility at a portfolio company level). This may be the case even if the US investors are US tax exempt. For more on this, see http://www.debevoise.com/insights/publications/2017/06/the-anti_hybrids-rules_pe-fund-structures.

3 Treaty Abuse

One of the reasons many funds invest through a holding company is because of the treaty benefits offered by such holding company's jurisdiction (*i.e.*, the elimination of withholding tax on interest and distributions). BEPS Action 6 aims to prevent the granting of treaty benefits in inappropriate circumstances. Applying the anti-abuse provisions to a fund is tricky. One approach, the Limitation-on-benefits (LoB) rule, involves tracing through to all of the beneficial owners to establish whether they are obtaining better treaty benefits by investing through the fund. The other approach, the Principal Purpose Test (PPT) rule, tests whether one of the principal purposes of the arrangements is to obtain treaty benefits. Applying the LoB rule to a widely-held fund is administratively burdensome, and applying the PPT rule is technically challenging and will require a large degree of professional advice. The greater the holding company's substance, the easier the analysis will become. For a short animation explaining the anti-treaty abuse provisions, see http://beps.debevoise.com/#video4, and for further analysis on this area, see http://www.debevoise.com/insights/publications/2017/07/treaty-benefits-in-a-fund-context.

Continued on page 13

Continued from page 12

4 Transfer Pricing

The transfer pricing guidelines have been updated significantly in response to a number of BEPS Actions and have put more pressure on the analysis of payments for services between related parties. The amount of management fees that each of the manager and the adviser(s) are allocated may need to be reviewed, with particular focus on the activities undertaken by people in each relevant jurisdiction and the functions that such people perform. This will be of particular relevance to sponsors with an offshore manager supported by a substantive onshore adviser. Further, Action 13 seeks to introduce a requirement for multinational enterprises (MNEs) to produce transfer pricing documentation on a country-by-country basis. This will require MNEs to provide high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations. A detailed "local file" will be needed in each country of operation. Large MNEs will also be required to file a Country-by-Country (CbC) Report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax, and income tax paid and accrued. These MNEs must also report their numbers of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, the CbC Report requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities in which each entity engages.

> "One of the reasons many funds invest through a holding company is because of the treaty benefits offered by such holding company's jurisdiction. BEPS Action 6 aims to prevent the granting of treaty benefits in inappropriate circumstances. Applying the anti-abuse provisions to a fund is tricky."

5 Interest Deductibility

Action 4 seeks to limit "base erosion" through interest deductions, setting out a fixed ratio rule that will limit the deductibility of net interest costs to a percentage of EBITDA. Amounts above the fixed ratio may still be available to deduct for companies forming part of a worldwide group, where net interest expense will be deductible up to a level equal to the worldwide group's net interest/ EBITDA ratio. Related-party debt, or debt that would not ordinarily benefit from interest deductibility, is likely to be excluded from the group net interest calculation. For a short animation considering interest deductibility, see http://beps.debevoise.com/#video3.

Conclusion

If you want to know more, please visit our BEPS resource website www.debevoise.com/BEPS, which has a series of short animations and practical articles aimed at unpacking the issues in more detail. BEPS is here to stay and has real implications for funds. Changes will be needed and serious thought given to many tried and tested structures for both existing and new funds. BEPS represents the new now, and we have every expectation that, with care, the private equity industry should, in the (correctly attributed) words of Mr. Spock, "Live long and prosper."

Richard Ward
rward@debevoise.com

Cécile Beurrier
cbeurrier@debevoise.com

Ceinwen Rees
crees@debevoise.com

Brexit and European Financial Services Regulation

"Even if (as seems more likely than not) a transitional arrangement can be agreed upon, there is still likely to be some short-term disruption for private equity fund managers."

Following the United Kingdom's decision to leave the European Union last year, many private equity and venture capital fund managers are in limbo—they are planning for all contingencies, while still anxiously awaiting a concrete indication of the eventual relationship between the United Kingdom and the rest of the European Union.

Meanwhile, with the United Kingdom likely to leave the European Union in March 2019, regulators across Europe have also been thinking about the consequences of Brexit. For them, the task has been to forestall some of the anticipated regulatory competition that may ensue as the remaining European Union member states seek to attract London's migrating asset managers—making it even harder for fund managers to plan their post-Brexit structure.

However, although Brexit discussions will defer consideration of some regulatory initiatives, including the scheduled review of the Alternative Investment Fund Managers Directive and introduction of a third country passport, regulators have also been progressing other, more positive, reforms—some of which are aimed at improving access to private equity and venture capital across the European Union.

This short update considers some of the most important developments in recent months.

The New UK/EU Deal

It remains hard to predict how Brexit will affect the regulatory position of private equity fund managers and advisers based in the United Kingdom. It is now clear that the United Kingdom will seek to maintain the status quo, to the extent possible, for a transitional period after March 2019, but it will want any such transitional arrangement to end within 2-3 years. Whether the rest of the European Union will agree to such an arrangement, however, remains uncertain, and how much of the status quo can be preserved during this interim period will be a subject for negotiation.

Even if (as seems more likely than not) a transitional arrangement can be agreed upon, there is still likely to be some short-term disruption for private equity fund managers. For example, accessing funding from the European Investment Bank is already proving tougher for funds based in, or making significant investments in, the United Kingdom—a particular issue for venture capital and growth equity funds. At the same time, there may be questions about the continuation of the full marketing and management passport for alternative investment funds during any transitional period, unless the United Kingdom agrees to implement regulatory reforms coming from Brussels during that period.

Continued on page 15

Continued from page 14

Beyond any transitional arrangement, the ultimate outcome is still far from clear. Firms therefore have to plan their future fund structures on a conservative basis, and most are now actively doing that.

Relocation Following Brexit

Any such planning was made even more complicated when the European Securities and Markets Authority (ESMA) published its views on Brexit this summer in an attempt to prevent EU regulators from engaging in a "race to the bottom." ESMA's opinions focused on the position of UK investment firms and managers (AIFMs) seeking to relocate to a remaining EU member state after, or in anticipation of, Brexit. In practice, however, ESMA's guidelines will also impact investment firms and AIFMs that are already based in, and remain in, another EU country. It appears that ESMA is using this opportunity to push for more stringent rules and establish supervisory standards for matters such as corporate governance, substance and delegation throughout the European Union.

The main thrust of the opinions is that an AIFM's choice of location should be objectively justified. Accordingly, ESMA suggests that a competent national regulator should refuse a license application if it thinks that the applicant opted for its jurisdiction in order to evade stricter standards in another member state. ESMA also stipulates that a minimum of two senior managers should be required to obtain an authorization, that the use of any third-party services (including from affiliates) will be considered a delegation, and that, for each fund the AIFM manages, portfolio and risk management may not be delegated to an extent that substantially exceeds the retained, internally-performed functions. When engaging advisors, for example, in relation to portfolio management decision-making, ESMA stresses that the AIFM must have sufficient competence to review the substance of the advice.

> "Accordingly, ESMA suggests that a competent national regulator should refuse a license application if it thinks that the applicant opted for its jurisdiction in order to evade stricter standards in another member state."

While ESMA's opinions are not binding, they carry significant weight and are likely to have a particular impact on post-Brexit planning. (Further details are available at http://www.debevoise.com/insights/publications/2017/07/esmas-guidelines-on-relocations.)

The European Commission has subsequently gone even further, proposing to increase ESMA's oversight of AIFMs that seek to delegate functions outside the European Union. If these proposals are endorsed by Europe's co-legislators, it will signal a desire to move even further towards a centralized system of financial supervision, making regulatory arbitrage even harder. (More information is available at http://www.debevoise.com/insights/publications/2017/07/esmas-guidelines-on-relocations.)

MiFID II

Regulatory developments already in progress will continue and will be implemented in the United Kingdom even as it prepares to leave the European Union. The most notable example is the new Markets in Financial Instruments Directive and corresponding regulation (MiFID II), which will take effect across the European Union in January 2018 (more information is available at http://www.debevoise.com/insights/publications/2017/07/mifid-ii-reshapes-fundraising). The new regime will add complexity to the launch and marketing of investment funds and other financial products to investors in Europe, including new rules designed to ensure that financial products sponsored or recommended and marketed to investors in the European Union are tailored to the

Continued on page 16

targeted investor base. There will also be requirements to record certain communications with clients, as well as increased disclosure requirements. Adjustment to the new rules will be moderately painful.

However, MiFID II will also make it easier for non-EU financial intermediaries to provide regulated services to clients in Europe. Indeed, the introduction of a passport for non-EU investment firms could help some UK firms following Brexit. The cross-border model will allow some firms to conduct business from their home country on a cross-border basis in the European Union.

"Indeed, the introduction of a passport for non-EU investment firms could help some UK firms following Brexit."

Reducing Barriers to Cross-border Distribution of Investment Funds

Meanwhile, in an effort to improve the cross-border distribution of funds within the European Union, the European Commission is seeking to improve the EU marketing passport regime, in particular, by easing burdensome registration and administration procedures and making marketing requirements more consistent across member states. Further legislation is therefore expected and likely to cover, among other things, the definitions of marketing and pre-marketing and the charging of fees by national regulators. This legislation will hopefully improve the passport process, which, with its long blackout and waiting periods that often hold up closings, is currently burdensome and poorly adapted to negotiated private funds.

Other Developments

Against this big picture backdrop, European fund managers continue to face a number of significant regulatory changes in specific areas. For example, this past June saw the deadline to implement the 4th Anti-Money Laundering Directive, which introduced a risk-based approach to customer due diligence and monitoring and mandated a transparency register in each EU member state. Although the United Kingdom already had similar rules, some modifications were necessary to conform to the new EU Directive. The differing approaches to implementation of these regulatory changes in different countries will inevitably pose challenges for compliance professionals. (More information on the UK implementation is available at http://www.debevoise.com/insights/publications/2017/06/uk-implements-new-anti-money-laundering-rules.)

Heralding another change that will pose challenges for UK-based firms, the UK regulator, the Financial Conduct Authority, recently confirmed that it will roll out its Senior Managers & Certification Regime to all UK-authorized firms (further information available at http://www.debevoise.com/insights/publications/2017/07/uk-financial-conduct-authority). This marks a break with the actions of other EU regulators, who tend to focus on technical competence rather than conduct. Undoubtedly, the United Kingdom's new approach to the regulation of individuals who work in private equity funds will require some organizational changes, or at the very least, greater clarity on individual responsibilities.

Patricia Volhard
pvolhard@debevoise.com

Simon Witney
switney@debevoise.com