

24TH ANNUAL

U.S. AND EUROPE TAX PRACTICE TRENDS

HOTEL BAYERISCHER HOF
MUNICH, GERMANY

Investment Funds: Taxation of Carried Interest and Management Fees

12 April 2024



Panelists

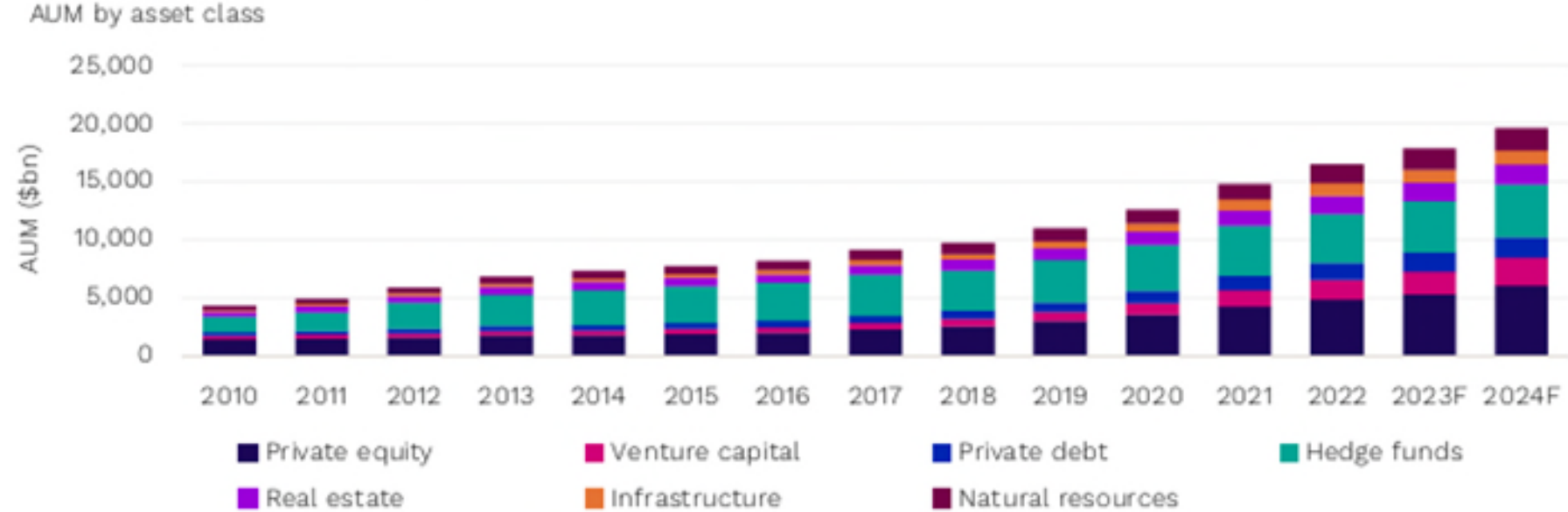
- Co-Chairs
 - Torsten Engers, Flick Gocke Schaumburg, Frankfurt am Main
 - Morgan Klinzing, Troutman Pepper, Philadelphia, PA
- Panelists
 - Paul Kraan, Van Campen Liem, Amsterdam
 - Antti Lehtimaja, Krogerus, Helsinki
 - Mathilde Ostertag, GSK Stockmann, Luxembourg
 - Veronika Polakova, Debevoise & Plimpton LLP, London
 - Karin Spindler-Simader, Wolf Theiss, Vienna

Overview

- Background on Private Funds and Fund Economics
- Carried Interest
 - Issuance
 - Liquidity Events
- Management Fees
 - Taxation Generally
 - VAT Implications
 - Waivers

Increasing Private Investment

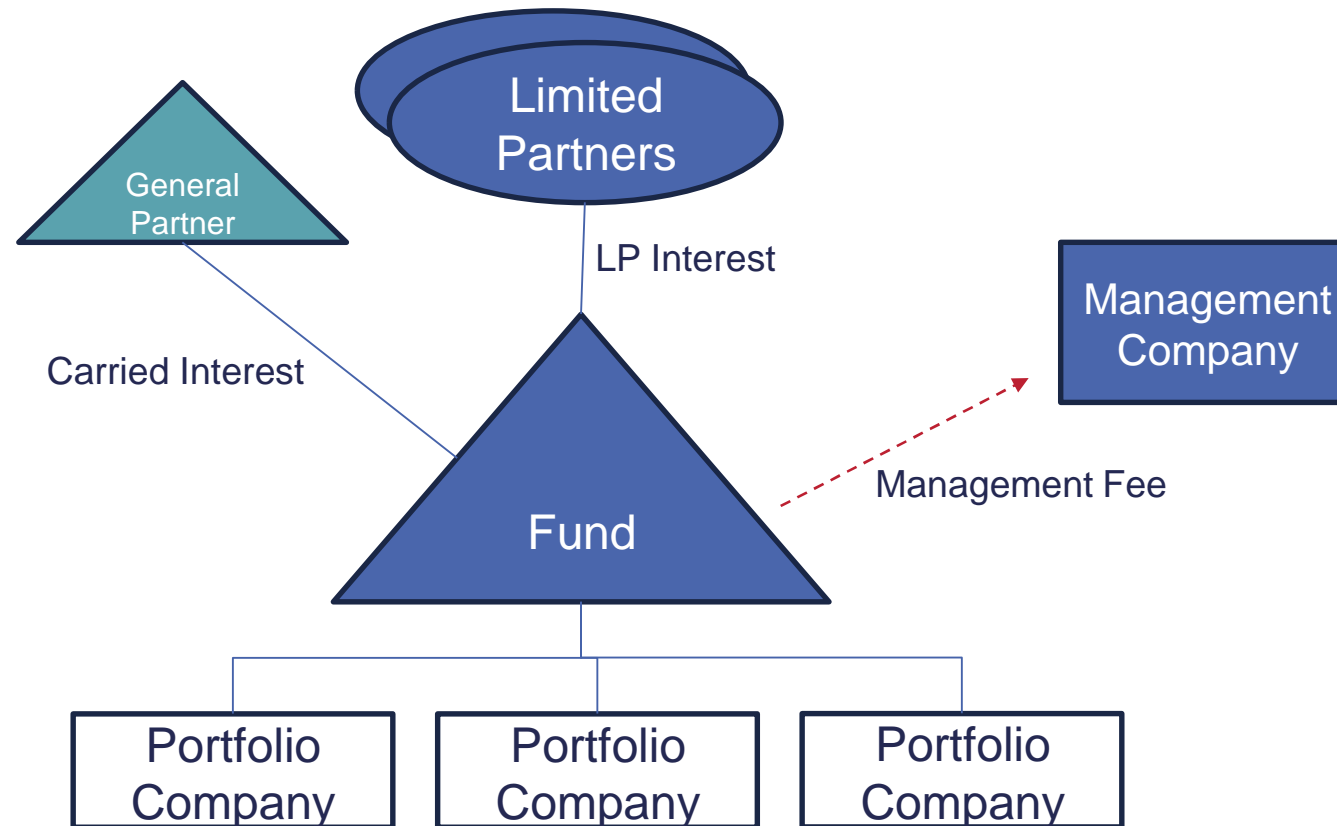
Fig. 3: Private capital and hedge funds AUM to near \$20tn in 2024



*AUM figures excludes funds denominated in Yuan Renminbi

Source: Preqin Pro

Simple Private Fund Structure



Waterfalls Generally

- Define the way in which a fund will make distributions to its limited and general partners.
- Broadly, two models:
 - European Waterfall
 - American Waterfall

European Waterfall

- Manner in which distributions are made is determined on a whole fund basis.
- Each distribution reflects overall performance of the fund, and not just the performance of the investment that gave rise to the distribution.
- Distributions:
 - Return of All Capital;
 - Preferred Return;
 - 80% to LPs and 20% to General Partner.

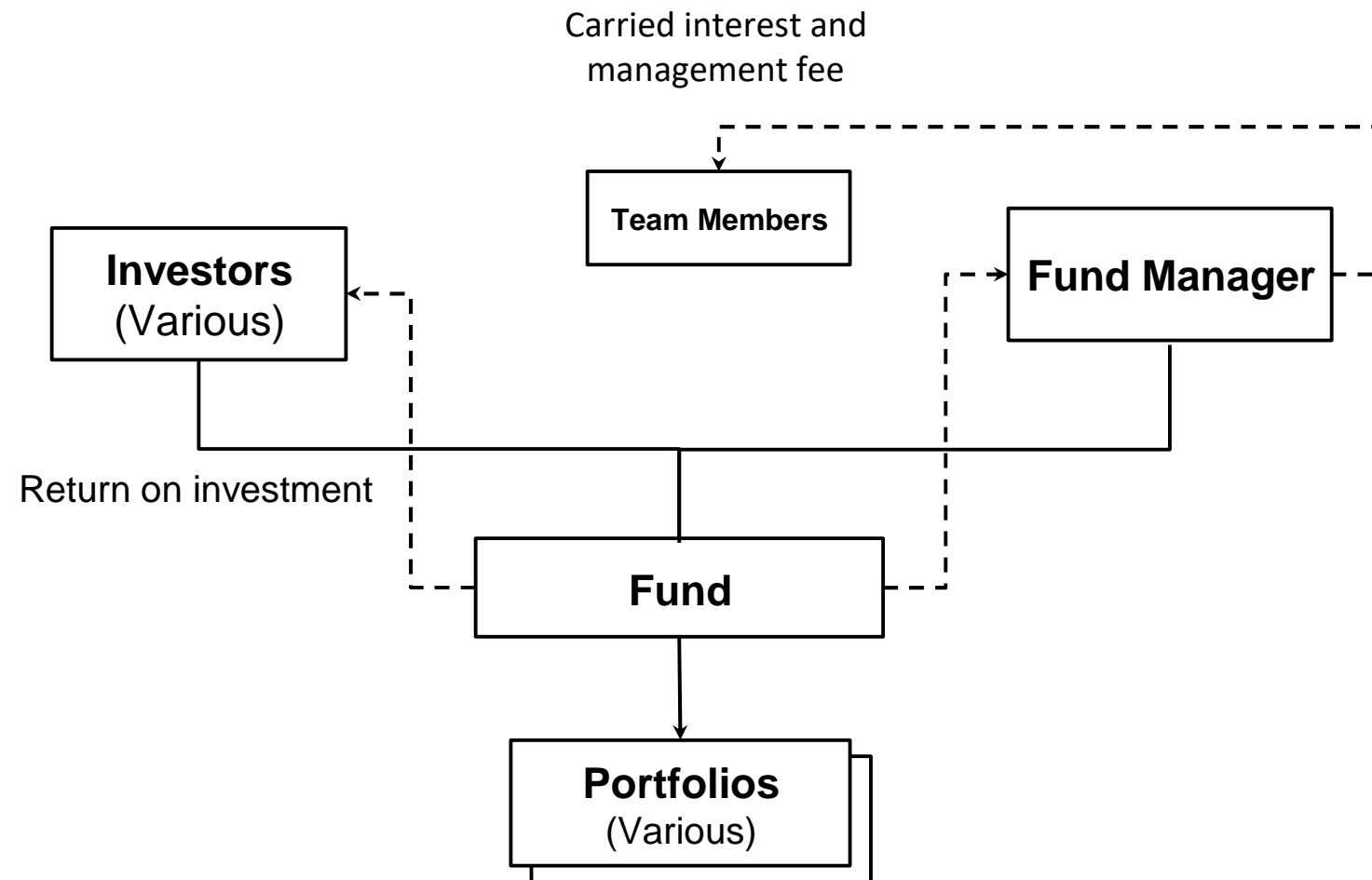
American Waterfall

- Proceeds are distributed on a deal-by-deal basis.
- GPs can receive a disproportionate share of distributions earlier in the life of the fund.
- Distributions:
 - Return of Capital with respect to that Investment;
 - Preferred Return on that Investment;
 - 80% to LPs and 20% to General Partner.

Economics of private equity fund

Economics of private equity fund

- Private equity strategies generally provide for carried interest model with hurdle rate, commonly 5% to 8%
- 80%/20% carried interest split is most common model
- Clawback if determined fund manager received > 20% of profits



A. Carried Interest

General rules applicable to issuance



- **Section 83** of the US tax code governs the taxation of property transferred in connection with the **performance of services**
 - Under section 83(a), service provider realizes **taxable ordinary income** at the earliest time that the property is
 1. substantially vested

OR

 2. freely transferable
 - Amount of the tax equals the FMV of the property over the amount paid for the property
- **Election to accelerate** under section 83(b) to **time of transfer**
- Prior to 1993, applicability of section 83 to carried interest unsettled

Revenue Procedures on “profits interests”



- IRS provided some **clarity** through two Revenue Procedures:

1. Revenue Procedure 93-27

- Receipt of **profits interest for the provision of services to or for the benefit of a partnership** in a partner capacity or in anticipation of being a partner not taxable
- **Profits interest** = not a capital interest
- **Capital interest** = interest that entitles partner to a share of the embedded value of partnership’s assets (if they were sold at FMV and then proceeds were distributed in a complete liquidation of the partnership)

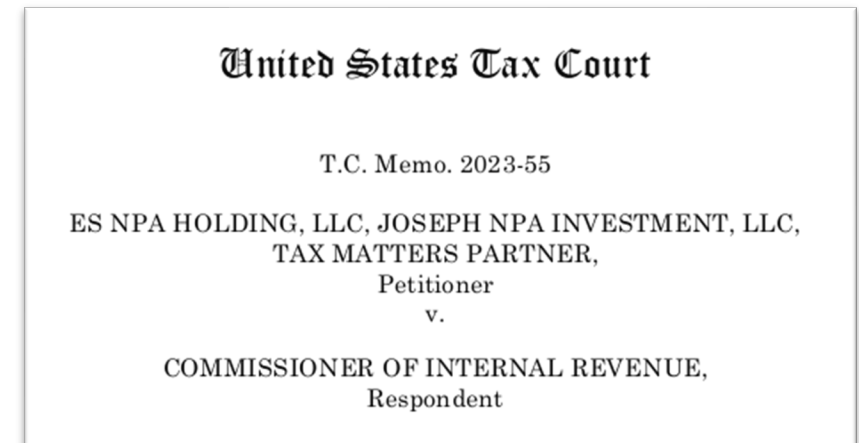
2. Revenue Procedure 2001-43

- Clarified that service provider is treated as receiving profits interest at time of grant even if substantially non-vested at that time
- Nonetheless, **protective section 83(b) elections** recommended

Guidance from recent US Tax Court case



- Rare US Tax Court case addressing partnership profits interests decided in May 2023: *ES NPA Holding, LLC v. Commissioner*
- Key takeaways:
 1. Decision favors **expansive** reading of service requirement under Revenue Procedure 93-27
 - Services provided “to or for the benefit of” a partnership
 2. Expert valuation not necessary for “profits interest” characterization
 - Affirms long-held market position





- Austria has a separate tax regime for (domestic and foreign) funds, including AIF, irrespective of the legal form
 - Transparent treatment
 - Income is directly attributed to the investor
 - Distributed income, deemed income and capital gains realized upon a sale of units are taxable at investor level
 - Non-residents are only taxable on Austrian-source income of the fund; capital gains from the sale of fund units are not taxed
 - White (notifying) v. black (non-notifying) funds with lump-sum taxation of deemed income or necessary proof by investor

Carried interest: Issuance - Austria



- Austria does not have special rules for carried interest taxation
- The issuance of carried interest is generally not a taxable event
- A linear profit shares are generally accepted
- They reflect the (in kind) participation of the investors
- Carried interest may also be issued to the service provider
- Tax consequences could arise in case of under-value issuance of shares in a carry vehicle to employees of the service provider



- Issuance of carried interest:
 - No specific rules in Finland
 - Arm's length principle is generally applied



- Generally taxed under general partnership tax principles
 - Carried interest recipient is required to pay tax on his “**distributive share**” of partnership profits each year whether or not he receives any cash distributions
- **2017 Trump tax reform** introduced section 1061
 - Imposes a **3-year holding period** requirement for a partner to recognize long-term capital gain with respect to a partnership interest received in exchange for the performance of certain services
 - Top tax rate of **37%** (short-term) vs. **20%** (long-term)
- Periodic attempts at additional reform
 - So far unsuccessful



Carried interest: Payout - Austria

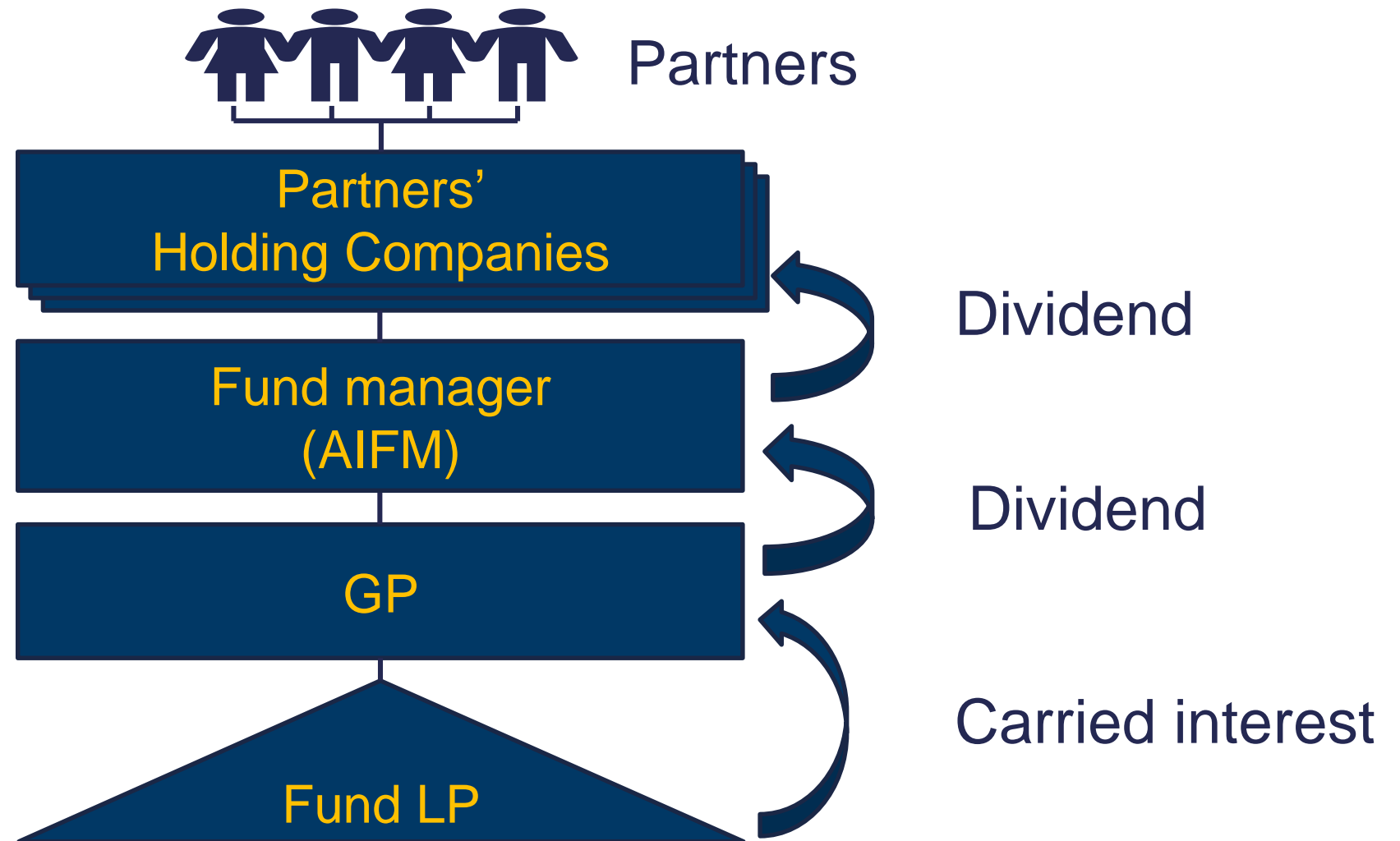


- Carried interest is taxed as capital income, just like any other participation in the fund's profits
- It is considered to be a preferential share in the fund's income
- Generally subject to tax rate for capital income (27.5%) in the case of an exit from underlying investments in the form of shares
- Carried interest does not constitute expenses (of the other investors)



- No specific legislation exists on taxation of carried interest
- Generally, carry income is taxed based on its civil law nature (usually dividend)
- Finnish Tax Administration has been trying to challenge the prevailing practice
 - Treatment of carry as earned income (taxed at progressive rate up to approx. 56%)?
- One published advance tax ruling exists on taxation in a “safe harbour” carry-structure (Central Tax Board 2016:51)

Carried Interest - Finland



Carried interest - Sweden



- No specific legislation exists on taxation of carried interest
- Historically, disputes regarding the nature of carried interest for tax purposes since early 2010s
 - If salary, social security payments (31%) assessed to advisory firms
 - If GP treated as “closely held company” carried interest taxed partly as salary and partly as capital gain
- In 2017 a load of cases were decided in administrative court of appeals – in most of those cases closely held company treatment
- Current trend of the Tax Agency is to try to apply the salary treatment, especially if carry not structured through the GP

Do carry rules apply to co-investment?



- Exception from section 1061 for partner's **capital interest**
 - Allocations in respect of carry recipients' capital interest to be determined and calculated in a manner **similar to allocations made to other significant (5% or more) unrelated partners** in respect of their capital interest
 - Allocations must be **clearly identified** under both the carry vehicle's partnership agreement and in the carry vehicle's books and records (reflected contemporaneously) **as separate and apart** from allocations with respect to such recipient's carried interest
- Capital interests funded through certain **loans** from (or guaranteed by) the sponsor **may be disqualified** from the exception

Timing mismatch for UK-resident US citizens



- Potential for double taxation as a result of a **timing mismatch** between UK and US tax systems
 - UK generally taxes carried interest on an “**arising basis**”
 - US rules complex, but attempt to reflect the **overall economic arrangements** (e.g., the details of the waterfall), taking into account the cost of investments in the ground, rather than following any particular cash distribution.
- UK government introduced new **accruals basis election**
 - **s103KFA** permits individuals to elect, on a fund-by-fund basis, to be subject to UK tax on their carried interest on an accruals basis, rather than arising basis
 - Intention is that UK-resident US citizens use more of their UK tax charge on carried interest to reduce their US tax liabilities under US foreign tax credit rules



Taxation of carried interest → ‘lucrative’ interest provisions

- Shares, receivables or rights with similar economic characteristics (‘leverage’)
- Granted with intention to form remuneration for services rendered (link to management goals)

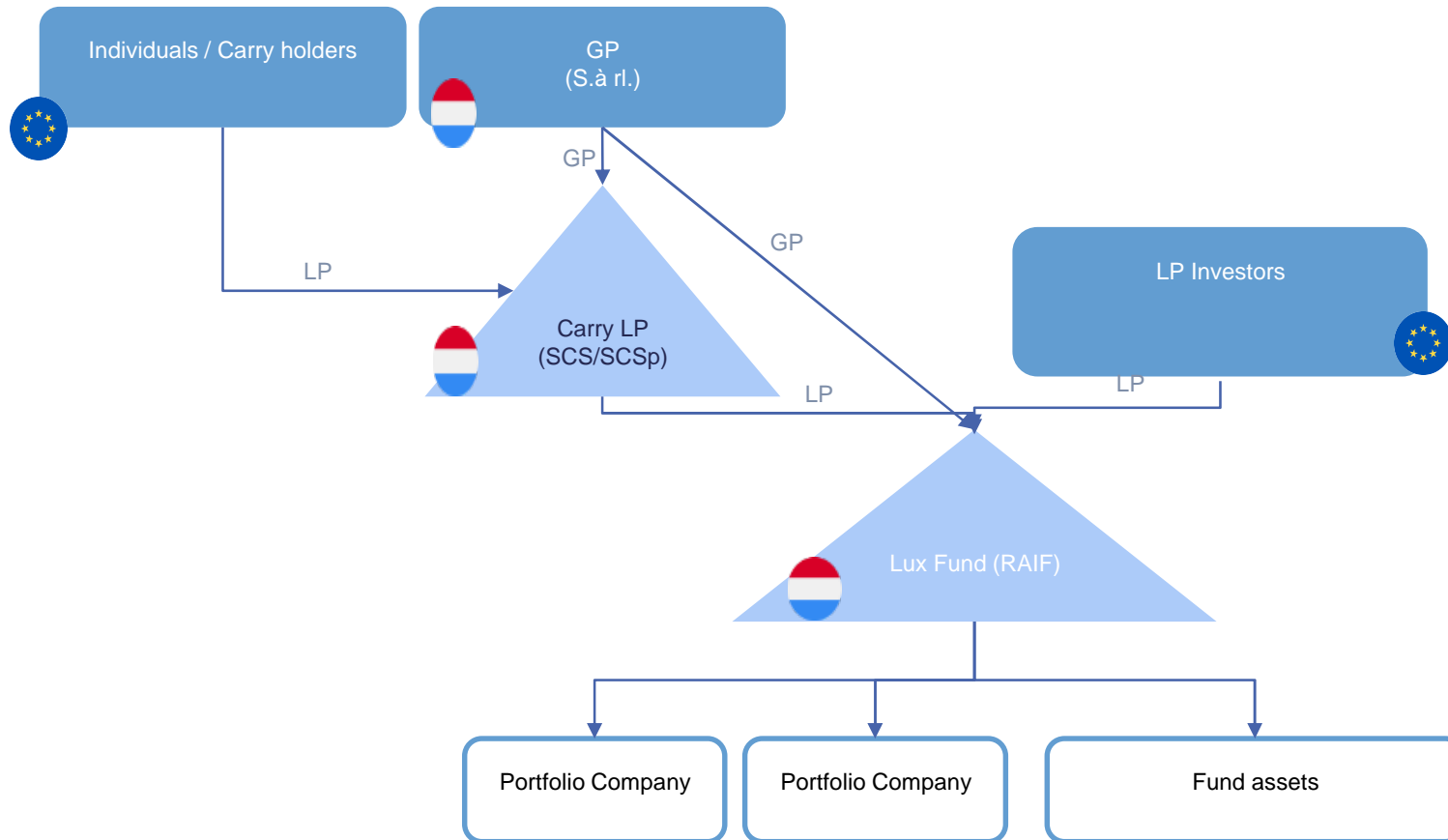
Taxation of lucrative interest

- Lucrative interest (Box 1) → taxable against progressive rates up to 49.5% for income from a business or employment
- Substantial interest (Box 2) → taxable against rates up to 33.0% for income from (roughly) shareholding $\geq 5\%$
- Structuring lucrative interest as substantial interest (by interposing entity) reduces tax on carry by 16.5% provided conditions are met
- Taxation expectation value upon grant → employment income

Carried Interest – Luxembourg



Typical Luxembourg fund structures



- Luxembourg funds are not subject to income tax
- GP is merely used to hold the GP interest in the fund + carry vehicle
- Fund management team co-invests in the Fund
- Carried interest pooled in a Luxembourg partnership
- Provides for privacy, flexibility in the LPA
- Carry is typically structured via capital gains

Carried Interest – Luxembourg

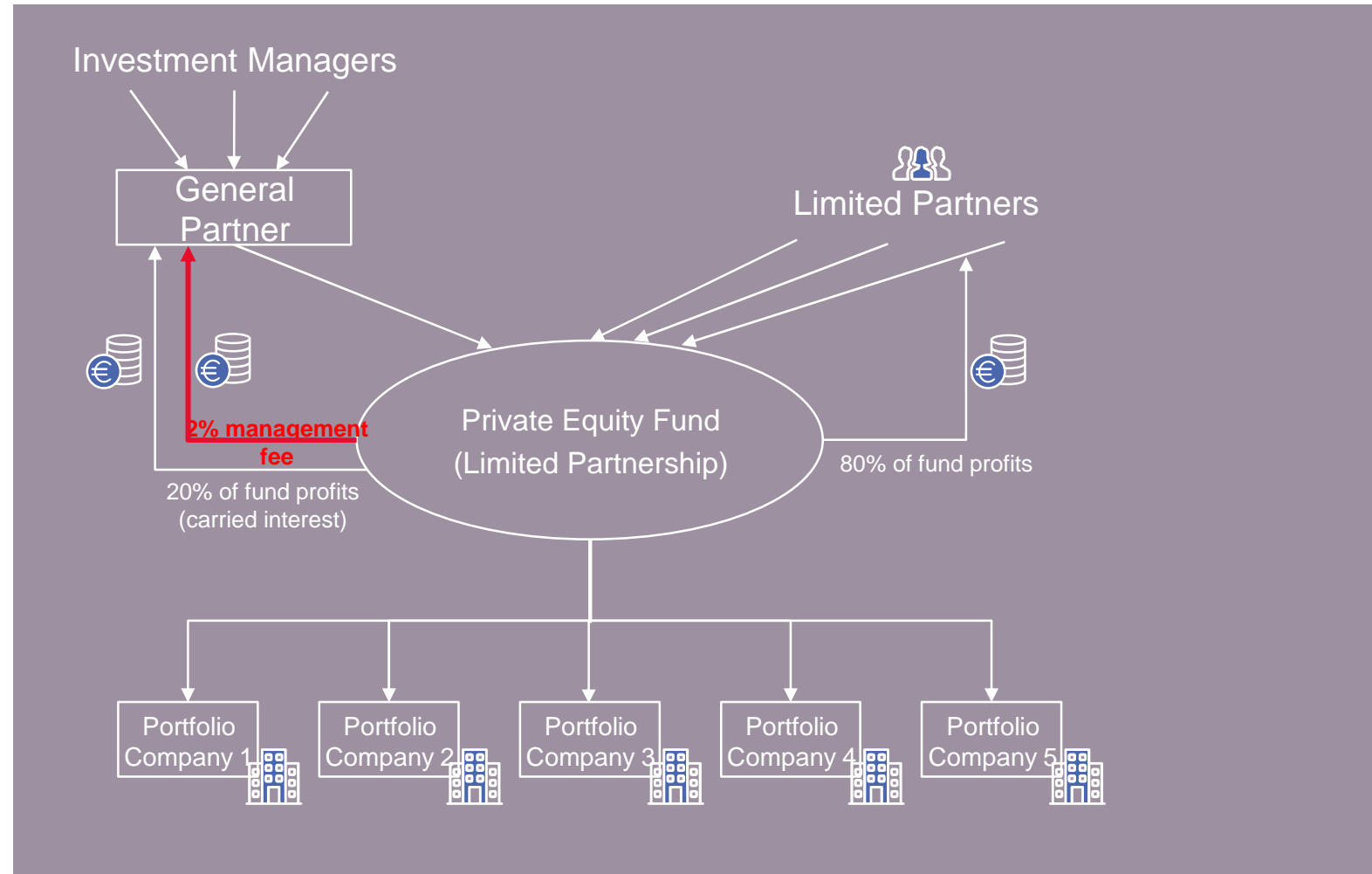


- Taxation of carried interest upon grant: if the carry holder is an employee or director -> employment benefit
- No taxation upon vesting
- No favorable carried interest taxation regime
- Taxation of the carried interest will depend on the tax status of the Fund and/or the nature of the underlying asset
- Typically, repurchase of Fund units -> capital gains
- Capital gains are not taxable in Luxembourg for non resident carry holders
- For Luxembourg individuals -> exempt if non speculative gain + minority shareholding < 10% in the Fund
- Carried interest also does not constitute expenses (of the other investors)

B. Management Fees

Typical Fund Structure – Taxation of Management Fees

- **Deductibility at fund level**
 - Immediate deductibility as business expense or capitalization of management fees?
 - Deductibility by individual investors?
 - Charging of management fees to Finnish MRECs (mutual real estate companies)?
- **Management fee waivers**
 - Respected or not?
- **VAT implications**
 - Management fee as a consideration based on an exchange of services or a “contribution” by the investment managers which is compensated by a share in the profits of the fund?
 - (Finnish) problems with VAT-grouping and the potential VAT leakage in case of not getting the shelter from the grouping?



Are management fees deductible?



- Management fees generally fall under “miscellaneous itemized deductions” that are **not deductible** to individuals under current law
 - 2017 Trump tax reform suspended the deduction **through the end of 2025**
 - Unclear whether the suspension will be extended
 - Even if reinstated from 2026, the deduction generally may only be claimed to the extent the aggregate items **exceed 2 percent of individual’s “adjusted gross income”**

Management fees waivers



- **2015 proposed regulations** targeted management fee waivers
 - Describe when partnership allocations and distributions, such as fee waiver distributions, will be treated as **ordinary compensation income** rather than a capital gain distribution
 - Have **not been finalized** and no additional guidance available
- Adopt a facts and circumstances test
- Allocation and distribution of profits generally will be treated as compensation if it lacks “**significant entrepreneurial risk**”

Management fees: Deductibility / Waivers - Austria



- Management fees are tax deductible expenses
- Expenses are deducted at the fund level
- No guidance on management fee waivers, but following general principles they should be respected



- Deductibility issues:
 - Mutual Real Estate Companies (MREC) for holding Finnish real property
 - Based on bylaws, shareholder of MREC is entitled to use the property (including receive rental income)
 - MREC charges shareholder a fee to cover its maintenance and finance costs
 - Costs need to be allocated to the correct company
 - Any management fees relating to the technical management of the property charged to MREC shareholder level not deductible
 - Any management fees relating to the rental activity property charged to MREC level not deductible

Management fees: Netherlands

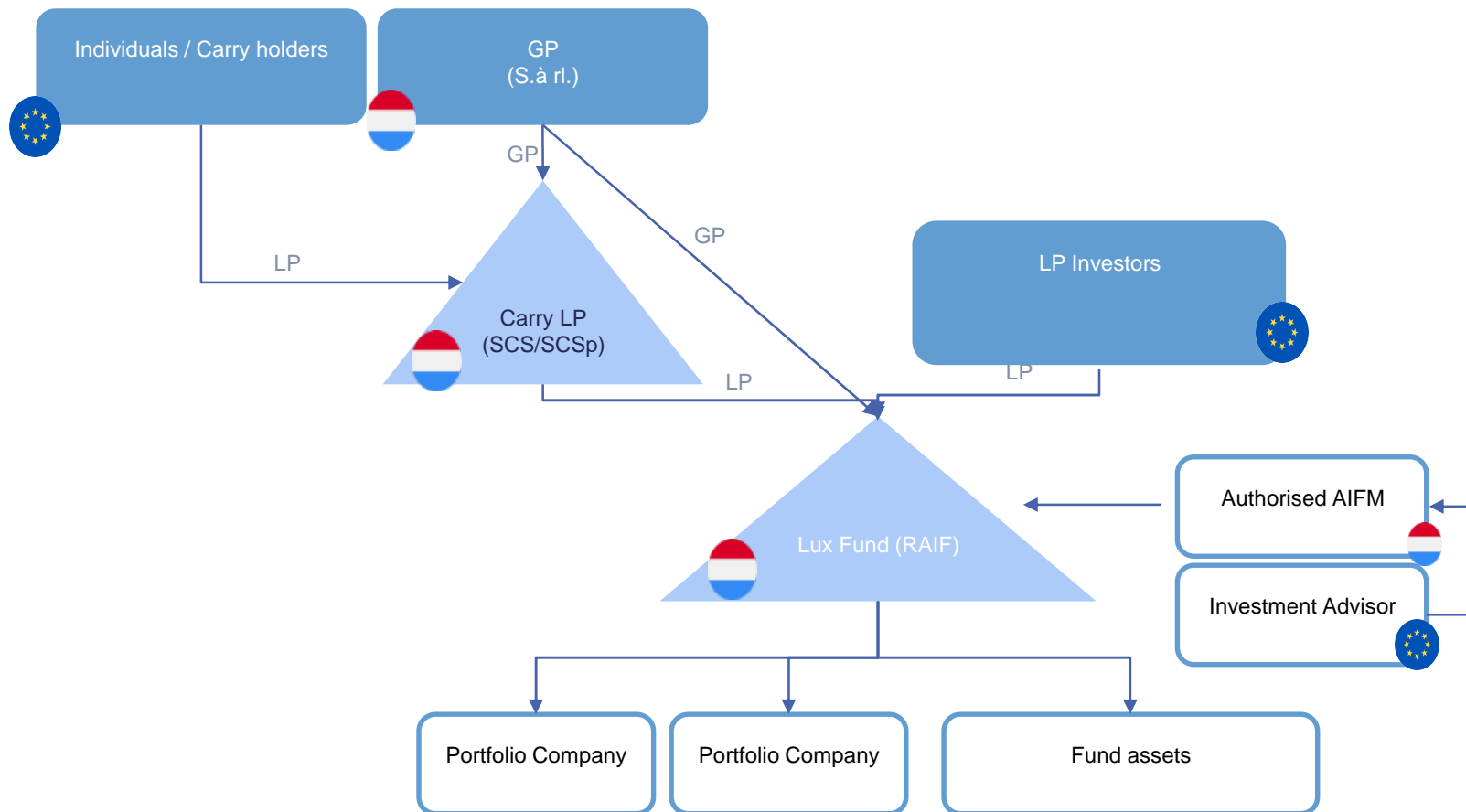


- Management fees → taxable income at ManCo level
- Management fees → in principle deductible at fund level
- Effectively no deduction:
 - PE/VC funds typically rely on participation exemption
 - Other funds typically eligible for tax regimes for investment institutions
- Alternative: preferred equity distribution?
- Waiver of management fee: generally respected, unless business reasons lack

Management fees – Luxembourg



Typical Luxembourg fund structures



- Luxembourg funds are not subject to income tax
- Not deductible at fund level (no taxable basis)
- Investment managers/advisors typically render management services to the AIFM or the Fund directly
- Management fees are taxable at AIFM / Investment advisor level



- VAT exemption for the management of special investment funds (Article 135(1)(g) of the VAT Directive)
- Also for outsourced advisory services, e.g., for recommendations to the manager on the purchase and sale of assets, which the manager implements after checking their compatibility with the investment limits (see CJEU 7 March 2013, *GfBk*, C-275/11)
- Services must form a distinct whole, fulfilling the specific, essential functions of the management of special investment funds (i.e., services solely used for management of fund's assets and connected administrative tasks) (CJEU 4 May 2006, *Abbey National*, C-169/04; 2 July 2020, *Blackrock Investment Management*, C-231/19)



- Austrian case CJEU 17 June 2021, C-58/20 and C-59/20 , *K and DBKAG*: exemption for the provision of particular software for risk management and performance measurement; tax services in connection with fund notifications
- No VAT exemption for (according to Austrian Ministry of Finance):
 - Due diligence;
 - Tax representation and advisory;
 - Audit;
 - Tax service to investors.



October 2020 VAT Decree by State Secretary of Finance

- Decree lists conditions to qualify as special investment fund:
 1. Fund must have >1 participant
 2. Capital must be invested based on principle of risk spreading
 3. Risks must be borne by all participants
 4. Investor have a proportionate interest in investments through participation in fund, though investors do not own the investments
 5. Fund must be subject to specific State supervision
- Decree confirms that fund is subject to specific State supervision where its manager is subject to AIFMD 'light-regime'



CJEU's ruling dated 9 December 2015 in case Fiscale Eenheid X NV

Specific State Supervision:

- UCITS → Yes
- AIFMD → Yes

AIFMD – Small Managers Regime (section 2:66 Financial Supervision Act)

- AIFM manages AUM → < 100 mio / < 500 mio
- Interests in AIF managed by AIFM subject to placement restrictions

Dutch Supreme Court, 4 December 2020 – Individual Asset Management:

- MiFID product may still qualify for VAT exemption for fund management
- Provided product is sufficiently comparable to UCITS



- VAT implications:
 - In Finland, management fees' VAT exemption generally guaranteed, in addition to applying exemption under the VAT Directive, by VAT grouping the AIFM, GP and the PE fund
 - Since the group is treated as a single taxpayer, intra-group management fees are not subject VAT
 - VAT grouping requires “close financial relations” between group members
 - Recent view from Finnish Tax Administration: “close financial relations” require generally at least 20% ownership
 - This is not always the case between AIFM and GP as in Finnish fund structures the fund team holds usually majority of the shares in GP
 - Risk for VAT leakage to the extent exemption under the Directive is not obtained (e.g., in case the management service has benefitted the portfolio company and not the fund)



- Luxembourg circulars 723 AED follow EU case law
- Luxembourg Funds are VATable persons, no right to recover input VAT
- Management services to Luxembourg funds are exempt (UCITS, AIFs, Securitisation companies)
- Typical exempt services:
 - Portfolio management
 - Legal and fund management accounting services
 - Customer inquiries
 - Valuation of portfolio
 - Regulatory compliance
 - Record keeping
- Are not exempt: control and supervisory services of a depositary, debt collection services

Questions?

The Panel Co-Chairs



Torsten Engers

Torsten.engers@fgs.de

+49 69 71703-0

Dr. Torsten Engers is a lawyer since 2003, certified tax advisor since 2006, and expert advisor on international tax law. He also is a lecturer at the University of Frankfurt/Main and the Institute for Law and Finance.

Torsten has deep expertise with the structuring of cross-border investments (inbound and outbound), Mergers & Acquisitions corporate reorganizations, business taxation and taxation of real-estate transactions.



Morgan Klinzing

Morgan.Klinzing@troutman.com

+1 215 981 4560

Morgan Klinzing advises clients on U.S. federal and international income tax and private equity matters. Her practice includes advising on mergers, acquisitions, reorganizations, dispositions, capital markets, and restructurings. She is also involved in the formation of private equity and venture funds.

Morgan is ranked in Chambers and is an adjunct tax professor at Temple University Beasley School of Law, Vice-Chair of the Partnership Committee of the Tax Section of the American Bar Association, and treasurer of the Philadelphia Tax Conference.

The Panelists



Antti Lehtimaja

antti.lehtimaja@krogerus.com

+358 440 100 440

Antti Lehtimaja is a tax partner at Krogerus, based in Helsinki, Finland. He advises clients with over 25 years' experience on corporate and international tax matters, such as transactions, disputes and general advice. He is particularly well known for his expertise in tax matters relating to the field of private equity / real estate fund formation and transactions.

"Antti Lehtimaja is able to simplify and streamline complex taxation related questions in a manner where focus remains on the deal itself instead of escalating taxation as a main point of discussion."

Legal 500 2023 / Tax



Paul Kraan

Attorney at law / Tax advisor

Paul is specialized in international taxation, predominantly advising funds, family offices and corporations on Dutch and international tax aspects of their structures. He has ample experience with fund formation, corporate tax planning and structuring management participation, as well as transaction work. Paul is a board member of the Netherlands Association of Tax Attorneys (NVAB) and STEP Benelux. He has litigated a substantial number of tax cases before the Dutch courts.

* Admitted to the bar in the Netherlands

T +31 20 760 1626

M +31 63 167 3292

E paul.kraan@vancampenliem.com

The Panelists



Veronika Polakova

vpolakova@debevoise.com

+44 20 7786 9121

Veronika Polakova is a U.S. tax associate at Debevoise & Plimpton LLP based in London. Her practice focuses on U.S. tax aspects of the establishment and operation of investment funds across a range of strategies, including private equity, debt, secondaries and venture capital. She also advises clients on U.S. tax aspects of a variety of private equity transactions, carry planning and co-investment arrangements.



Mathilde Ostertag

mathilde.ostertag@gsk-lux.com

+352 271802-60

Mathilde Ostertag heads the tax practice at GSK Stockmann in Luxembourg. Her areas of expertise include domestic and international tax law, in particular tax planning, funds structuring in private equity and real estate. She also has in-depth knowledge on capital market transactions, structured finance, cross-border restructurings, and debt restructuring.

Mathilde is further the President of the Ladies in Law Luxembourg Association (“LILLA”), which aims at actively promoting gender diversity and women in senior positions in the legal sector.

The Panelists



Karin Spindler-Simader

karin.spindler-simader@wolftheiss.com

+43 1 51510 1419

Karin Spindler-Simader specializes in corporate tax law and tax aspects of reorganizations, international tax planning as well as international and European tax law. She is admitted as a tax adviser with years of experience as an authorized signatory in leading tax consulting firms and is experienced in providing tax advice on complex international M&A transactions and private equity structures. Prior to working in tax consulting, she was a research and teaching assistant at the Institute for Austrian and International Tax Law at the Vienna University of Economics and Business where she continues to teach. Karin has authored numerous professional publications and regularly lectures on tax related topics.

“Karin Spindler-Simader provided us with very helpful Austrian tax advice on cross-border M&A investment structures. She is very responsive and provided advice which was perfectly tailored to our needs.”

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