European Private Equity &
Venture Capital
Association

PRESS RELEASE

2006 EVCA Benchmarking Study:

Better tax and legal initiatives needed to support entrepreneurs in private equity and venture capital environment in Europe

Brussels, December 13, 2006

Today, at a press conference in Brussels, the European Private Equity and Venture Capital Association, EVCA, presented its third Benchmarking Study. The study enables comparisons to be drawn between tax and legal environments across 25 European countries, to the extent that they affect the development of private equity and venture capital and encourage entrepreneurial activity.

The aim of the survey is to highlight national practices, and engender more efficient tax and legal frameworks across Europe, since fragmentation inhibits economic growth.

It has focused on three main areas considered important for the private equity and venture capital industry:

- The tax and legal environment for limited partners (investors) and fund managers;
- The environment for investee companies;
- The environment for retaining talent in investee companies and management funds.

The collection of data was carried out by the KPMG M&A Tax Services, and the study evaluates seven criteria important to the development of private equity and venture capital, which are further split into 29 variables. Information gathered reflects the situation in each country surveyed up to July 1, 2006.

The results of the survey can be used to evaluate countries' evolution compared to previous years. Based on the scoring system used (where 1 is positive and 3 is negative), **the main findings** are as follows:

- A slight overall improvement in the tax and legal environment for private equity and venture capital and entrepreneurship across Europe, with an average composite score this year of 1.84, compared to 1.97 in 2004.

- There is still a wide divergence between top- and bottom-ranked countries: this year Ireland is at the top, with 1.27, and Romania (included for the first time) at the bottom, with 2.35. But the gap between the best-ranking and the European average has slightly narrowed.

- Most of the countries have adopted an appropriate domestic fund structure to attract capital from domestic as well as international investors. The tax and legal

environment has also improved with respect to pension funds and insurance companies investing in entrepreneurial projects. But very few countries provide incentives to invest in private equity and venture capital, scoring only an average 2.04.

- Likewise, tax and performance-related incentives to retain talent, within both investee companies and investment funds, are still not sufficient. Moreover, company incentivisation and fiscal R&D incentives achieve the lowest score of all, at 2.36 and 2.13, respectively.

- Ireland, France and the United Kingdom rank as the countries with the most favourable environment for the development of the private equity and venture capital industry, with composite scores of 1.27, 1.36 and 1.46, respectively. In all three surveys, the United Kingdom and Ireland have consistently been ranked within the top three countries, whereas France has moved into this band for the first time.

- Together with France, Belgium and Spain have moved to above-average composite scores since the first survey in 2003, indicating a relative willingness to reform.

- There is a wide divergence between the countries which have performed below the European average, with very different criteria for poor performance. Norway, Sweden and Germany have been ranked below average since the first survey in 2003.

- New EU countries and accession countries tend, unsurprisingly, to be below the European average, but they are making good progress.

Commenting on the research, EVCA Secretary-General, Javier Echarri said:

"It is encouraging that the European tax and legal environment has improved overall, but the differences between the countries at the higher and lower end of the ranking should be noted. It is worth highlighting those countries that have clearly focused on improving their competitive positions in this area, namely France, Belgium and Spain, where the most important progress of the last two years is to be found.

At the same time, there are still a number of tax and legal impediments across the global landscape and inadequate regulation creates high entry costs and low levels of cash flow. We would like to see a level playing field for domestic and international investors, but a domestic focus is all too evident across most countries.

EVCA's benchmarking survey is intended as a stimulus for change. Private equity and venture capital drives growth and, as many studies show, makes economies competitive, creating and developing businesses and jobs and encouraging entrepreneurial talent by rewarding the most successful venturers. We hope that the lower ranked countries can see the benefits of such change."

Indication of the tax and legal environment for the development of private equity and venture capital (1 = more favourable / 3 = less favourable)

Results for 2006[1]		Results for 2004[2]		Results for 2003[3]	
Country	**Total Score**	**Country**	**Total Score**	**Country**	**Total Score**
Ireland	1.27	United Kingdom	1.26	United Kingdom	1.20
France	1.36	Luxembourg	1.49	Ireland	1.58
United Kingdom	1.46	Ireland	1.53	Luxembourg	1.67
Belgium	1.51	Greece	1.75	Netherlands	1.79
Spain	1.52	Netherlands	1.76	Italy	1.96
Greece	1.55	Portugal	1.81	Greece	1.96
Netherlands	1.60	Belgium	1.82	**Total Average**	**2.03**
Luxembourg	1.62	Hungary	1.86	Belgium	2.08
Portugal	1.71	Italy	1.86	France	2.09
Italy	1.72	France	1.89	Sweden	2.09
Austria	1.74	Switzerland	1.95	Spain	2.17
Denmark	1.75	Spain	1.96	Finland	2.25
Hungary	1.83	**Total Average**	**1.97**	Portugal	2.32
Switzerland	1.83	Norway	2.04	Denmark	2.36
Total Average	**1.84**	Sweden	2.05	Germany	2.41
Finland	1.91	Czech republic	2.12	Austria	2.53
Estonia	2.08	Poland	2.13		
Norway	2.08	Finland	2.30		
Sweden	2.12	Germany	2.37		
Latvia	2.12	Austria	2.42		
Germany	2.15	Denmark	2.46		
Poland	2.16	Slovak Republic	2.49		
Slovak Republic	2.17				
Czech Republic	2.21				
Slovenia	2.26				
Romania	2.35				

Methodology

For the research, a standardised procedure was followed based on detailed definitions of individual variables. The KPMG M&A Tax Services provided the detailed information on the 29 variables in 25 countries. The objective was to continue the discussion on the fragmented policy environments currently in place in European countries, as well as to

[1] For the 2006 EVCA Benchmark paper, the composite scores of Slovenia and Switzerland were calculated on only six of the seven criteria due to the lack of an appropriate or dedicated domestic fund structure in the country.
[2] In the 2004 EVCA Benchmark paper, some countries were evaluated on less than the thirteen variables due to a lack of applicability or the inability to use the given information for ranking.
[3] In the 2003 EVCA Benchmark paper, Denmark was evaluated on only nine of the ten variables due to the lack of a conventional private equity fund structure in the country.

highlight those areas where improvements to the tax and legal situation could positively affect the development in private equity and venture capital, as well as entrepreneurship.

The report does not claim to be an exhaustive comparison and there are of course more factors contributing to a favourable private equity and venture capital environment than have been selected for this analysis. An effort was made to select those aspects that are most relevant for a healthy private equity and venture capital industry. Neither the effectiveness of an initiative nor the ease of using it were reflected in the final analysis of this paper as it would have been difficult to come to a neutral evaluation.

To allow comparison to be made between different national environments, information on seven criteria (focused on the areas outlined above) was collected based on 29 variables and across 25 European countries. The cut-off date of the information collected was 1 July 2006.

As in previous years, for each country, a score was allocated per variable: '1' representing the best score, accorded to a favourable environment, through to '3', indicating less favourable conditions with room for improvement. Subsequently, an average was calculated per criterion, based on the scores for the underlying variables. Finally, a composite score per country was calculated by calculating the average score across all seven criteria. The country's composite score enables an assessment of the current conditions across all countries analysed. It is important to emphasize that equal weight was accorded to each of the seven criteria when calculating the country's composite score, meaning that no weighting was applied regarding the relative impact of the individual criteria on the overall environment.

The results from the previous assessments, 2004 and 2003, are also shown in the table. Please be aware that a strict comparison between the three sets of results is not possible, as some variables have been changed or further developed (for example, topics have been introduced such as young innovative company schemes, and the ability of pension funds and insurers to invest in this asset class has been assessed). In addition, while four new countries (Estonia, Latvia, Romania and Slovenia) have been included, Bulgaria, Cyprus Lithuania and Malta have not been included this year due to difficulties in gathering information.

Please note that the document does not attempt to outline specific situation in each country and is in no way designed to influence private equity or venture capital fundraising or investment decision making.

Notes to Editors:

1. Copies of the full report, 'Benchmarking European tax and Legal Environments: Indicators of Tax and Legal Environments Favouring the Development of Private Equity and Venture Capital and Entrepreneurship in Europe, December 2006', can be found at: http://www.evca.com

2. The methodology chapter at the end of the full report explains in detail how the different scores have been calculated.

3. EVCA: The European Private Equity and Venture Capital Association (EVCA), established in 1983 and based in Brussels, promotes, facilitates and represents the needs and interests of the private equity and venture capital industry in Europe. EVCA has over 925 members in 50 countries, including the leading fund managers in the European private equity and venture capital industry. In 2005, the private equity industry raised €72 billion from institutional investors and invested €47 billion in Europe's growth companies.

4. KPMG: KPMG is a global network of professional firms providing Audit, Tax and Advisory services. KPMG operates in 144 countries and has more than 104,000 professionals working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International, a Swiss cooperative. KPMG International provides no client services.

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Private equity versus mezzanine: tax structuring cross-border investments

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Cross-border private equity investments contain a variety of tax elements that complicate the structuring of those transactions. They also offer several opportunities to optimise the investors' and target's tax position after acquisition. Mezzanine investments, which offer a mixture of debt and equity, can provide the returns of a traditional private equity fund, while presenting a lower risk profile. However, they also present particularly complex tax planning issues when attempting to maximise the after-tax return. In relation to tax planning issues, US tax aspects are frequently considered because of the importance of US investors for the private equity industry.

Against that background, this chapter examines a number of advantages and disadvantages of the private equity or mezzanine investments, concentrating on their basic features, specific tax issues and considering examples of particular tax structures that are employed.

CROSS-BORDER PRIVATE EQUITY INVESTMENTS

Basic features

Private equity fund structures can be of two main types: partnerships or corporate entities. The partnership structure is most commonly used, and for tax purposes is treated as fiscally transparent. This means that the fund is disregarded for tax purposes and the investors are considered to hold their investments directly in the target companies. As a result, income and capital gains arising from those investments are not taxed at fund level, but each investor is given its pro rata share of the profit or capital gain, which is then taxed according to the tax regime to which he is subject.

Investors in private equity funds mainly expect such funds to make equity investments that generate a return through capital gains on exit, by way of a sale to a strategic buyer of the target, or through an initial public offering (IPO). Sometimes, an exit (or partial exit) is not structured as an outright sale of the target's shares (for example, where the exit is structured as the target redeeming or repurchasing its shares). In particular, in relation to buyouts, private equity funds are sometimes able to derive an additional source of return from the investment before exit (this return could be dividends or payments resulting from a leveraged recapitalisation).

Tax issues

The key tax issues that must be addressed when structuring a cross-border private equity investment are:

- **Taxation on exit.** The fund will attempt to avoid capital gains being taxed in the target's jurisdiction and at fund level.
- **Taxation on early returns.** The fund will attempt to avoid or mitigate taxation on early returns from the target (such as withholding tax on dividends and repurchases or redemptions of shares, as well as on withholding tax on repayments of capital).
- **Preferential tax rates.** The fund will attempt to ensure that the investors are able to benefit from preferential tax rates on capital gains (and in some cases on dividends).

Depending on the tax rules of the target's jurisdiction, the private equity fund often structures its investments through special purpose vehicles (SPVs) which are resident in a jurisdiction that:

- Has a favourable tax treaty with the target's jurisdiction that avoids the need to pay local capital gains tax and avoids or significantly reduces the dividend withholding tax payable.
- Does not subject capital gains and dividends received by holding companies from overseas investments to taxation (for example, under a participation exemption regime, such as those that apply in The Netherlands, Luxembourg, Sweden and Cyprus).

Example structure of a leveraged buyout

When cross-border private equity deals are leveraged, the tax aspects of the investment structure assume even greater importance, because they must ensure that the interest expense can effectively be deducted from the target's taxable profits. Another additional complication arises when such deals are arranged with a consortium of private equity funds. With that in view a commonly used structure for a leveraged buyout (LBO) by a fund or by consortium of funds involves the following steps (*see box, Example private equity investment structure for an LBO*):

- The consortium sets up an SPV in an offshore jurisdiction (that is, a jurisdiction other than that of the target company). The most commonly used offshore jurisdictions are The Netherlands and Luxembourg. In certain situations, Cyprus, Jersey or a limited liability company in the US can be used.
- The offshore SPV is funded by equity (that is, the funds subscribe for shares in the SPV), and in turn establishes a local SPV in the target jurisdiction (also funded by equity or (subordinated) shareholders' loan).

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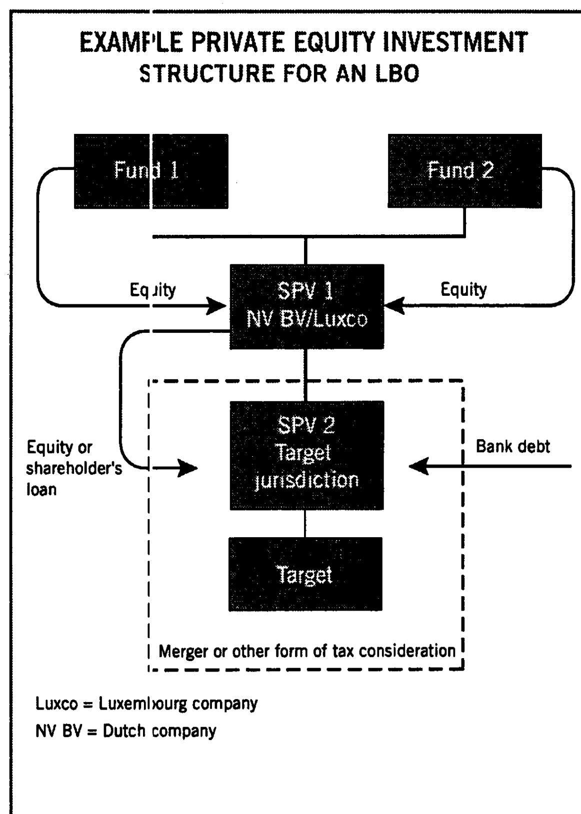

- The local SPV attracts acquisition financing from a bank or a consortium of banks to fund the target's acquisition.
- After the target's acquisition, the local SPV and the target are often merged (or create a tax consolidation group) so that interest expenses on the acquisition debt can be "pushed down" to the level of the target, allowing the target to deduct them from its taxable income.

MEZZANINE INVESTMENT

Basic features

Investments by mezzanine funds have several similar characteristics to investments by private equity funds, but there are also a number of important differences. A typical mezzanine investment consists of:

- A loan (or loan-type) instrument, which provides the mezzanine fund with a level of downside protection (protection limiting the potential loss that would result from a decline in the investment).
- An equity kicker, which provides the upside potential (the amount by which it is expected the investment will increase).

The loan is subordinated to the regular debt component of the transaction (that is, debt from other providers) and can carry some recurrent interest payments during its term. Often, however, the entire or an important part of the interest is structured as a bullet (or lump sum) interest payment, or as an interest payment in kind by issue of a note (a PIK note), both of which are paid off on maturity of the loan.

The equity kicker that is provided to the lender is usually structured either as a conversion option on the loan, or (more often) as a separate issue of warrants or shares in the target's share capital. The shares are usually issued for nominal value, and the warrants are generally exercisable at a very low price per share (significantly below market value). The conversion of the loan or the exercise of the warrants will often occur at the time of exit.

Tax issues

Mezzanine investments generally require more complex tax planning than equity investments to mitigate the overall tax burden for the mezzanine fund and its investors. In particular, consideration needs to be given to:

- Withholding tax on interest payments.
- Tax planning at the level of the SPV.
- Reporting requirements of income for investors.

Withholding tax on interest

Unlike private equity funds, mezzanine funds need to deal with withholding tax on interest payments, which can be as high as 30%. Interest payments are often subject to different withholding tax rates than dividends and can apply not only on the interest actually paid but, in some jurisdictions, even on the interest that is capitalised or accrued, or represented by a PIK note.

Withholding tax can be significantly reduced or even avoided if the lender is resident in a jurisdiction that has a favourable tax treaty with the borrower's jurisdiction. Many funds, however, have been set up as fiscally transparent, and as a result cannot invoke the benefits of such a tax treaty. In addition, there is the administrative burden of claiming refunds for all investors in the partnership and, in some cases, investors cannot claim a refund at all.

For these reasons, funds generally set up a separate SPV (SPV 2), which functions as the lender. The SPV 2 should be resident in a jurisdiction that:

- Has a favourable tax treaty network.
- Does not levy a withholding tax on interest payments made to the fund (assuming that the SPV 2 is funded with debt (*see below, Tax planning at the level of the SPV*)).

While interest income is rarely subject to preferential income tax regimes there are certain jurisdictions that do not charge withholding tax on such income. The Netherlands, for example, does not impose a withholding tax on interest irrespective of whether the interest is paid to a domestic or non-domestic lender. In addition, it has concluded favourable tax treaties with nearly all European countries, almost all of which reduce the local withholding tax to zero. Other jurisdictions that may have favourable tax regimes include Luxembourg, Sweden, Austria and

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Germany.

Note that Directive 03/49/EC on interest and royalty payments (Interest and Royalty Directive) exempts interest payments from withholding tax f both the lender and the borrower are corporations resident in one of the European Union (EU) member states. However, EU mezzanine funds do not often qualify. This is because the Interest and Royalty Directive is only applicable if the lender holds at least a 25% shareholding in the borrower, and mezzanine funds generally hold only small (less than 25%) equity stakes.

In relation to the US, where interest is paid to a non-domestic lender, a 30% withholding tax is payable by non-US investors in the fund. However, this is generally avoidable under an exemption for portfolio interest, as long as:

- The debt is in registered form (as opposed to a bearer obligation).
- The amount of the interest is not linked to profits or distributions or property value fluctuations.
- The person receiving the interest does not own 10% of the borrower's equity.

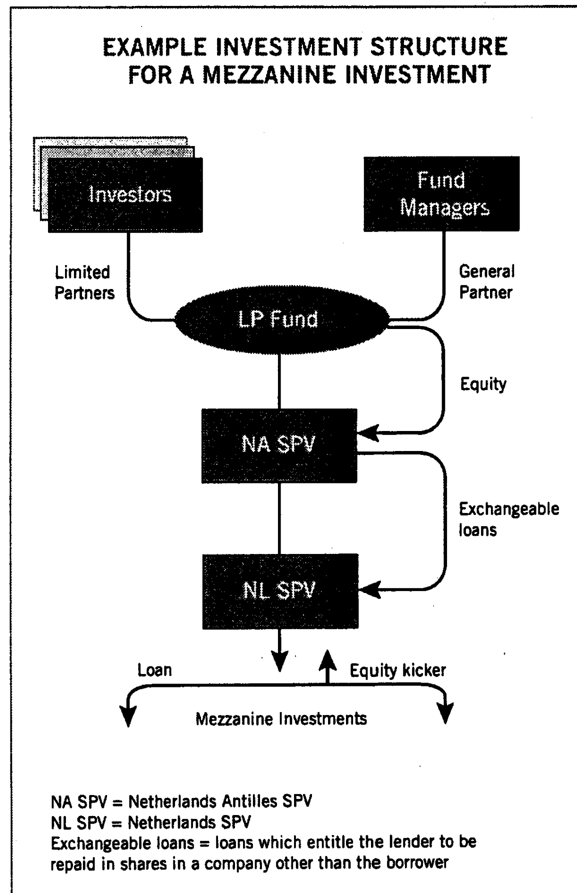
Tax planning at the level of the SPV

If a mezzanine fund requires the use of an SPV to avoid or reduce local withholding tax on interest payments, the overall tax planning for the fund structure must take into account tax minimisation at the level of that SPV. This includes reducing taxation on interest income and capital gains realised on the equity elements of the mezzanine instrument.

SPV taxation of interest income. Generally, jurisdictions with extensive treaty networks have income tax systems with relatively high tax rates. Funding an SPV 2 that is resident in such a jurisdiction with only equity, to enable it to provide mezzanine financing, will fully expose its income to those high rates. By funding an SPV with debt and creating a back-to-back debt structure (a corresponding loan to the SPV on the same terms as the loan provided by the SPV) the income at the level of SPV2 is balanced by the corresponding interest expense. Depending on local transfer pricing regulations, SPV2 usually only needs to report a small interest spread as taxable profit. In addition, the substance of the SPV2 in its tax jurisdiction (that is, sufficient economical nexus with a jurisdiction to justify its presence in that jurisdiction for tax purposes) and its beneficial interest in the loans require attention.

The interest income, paid by SPV 2, should ultimately be received in a no-tax or low-tax jurisdiction. A frequently used combination is a Netherlands Antilles SPV with the offshore regime (NA SPV) as the holding company of a Netherlands SPV (NL SPV). The mezzanine fund sets up NA SPV and funds it with equity, which it uses to provide a loan to NL SPV in a back-to-back debt structure, which then makes the mezzanine investment (*see box, Example investment structure for a mezzanine investment*). Interest income can then be distributed tax free by the NL SPV to the NA SPV. Another structure that is frequently used involves setting up a Cayman Islands company, which is

EXAMPLE INVESTMENT STRUCTURE FOR A MEZZANINE INVESTMENT



NA SPV = Netherlands Antilles SPV
NL SPV = Netherlands SPV
Exchangeable loans = loans which entitle the lender to be repaid in shares in a company other than the borrower

then used to provide a loan to a Luxembourg company, which then makes the investment.

SPV taxation of equity elements. Mezzanine instruments often include an equity kicker (*see above, Basic features*).

In some jurisdictions, the value of the equity kicker at the time that the mezzanine instrument is issued is considered to be an interest element and taxed on an accruals basis during the term of the loan. For example, a mezzanine fund might lend EUR100 (about US$121) to the target and receive a bond with a face amount of that value together with a warrant to acquire shares at a nominal price (those shares already having a value of EUR20 (about US$24)). Many jurisdictions allocate, for tax purposes, the EUR100 partly to the loan (for example, EUR80 (about US$97)) and partly to the "purchase" of the warrant (for example, EUR20). The difference of EUR20 is considered a discount on the loan and each year, during the loan's term, the investors must report part of this discount, irrespective of when the value of the warrant is actually realised. This must be taken into account when structuring the mezzanine investment through an SPV to avoid taxation in the SPV's jurisdiction.

If the value of the warrant or the shares increases beyond its initial valuation, that increase is generally treated as a capital gain. If the instrument is a warrant, most of the preferential tax regimes for capital gains on shares do not apply. As a result, the capital gain realised on an equity kicker is ordinarily fully taxable

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at the level of the SPV.

Another aspect of the equity kicker that needs to be considered is the tax treatment of the shares that are received either directly or through exercise of the warrant. Generally, the shares received comprise only a small percentage shareholding and may therefore not qualify for preferential participation exemption regimes. In order to benefit from a capital gains exemption, such regimes usually require that the investor hold:

- A minimum percentage of the shareholding or a certain minimum value of the shareholding.
- The shares for a minimum period.

Warrants are usually exercised immediately before the sale of the company to a third party. This means that any subsequent capital gains realised on those shares (and any dividends received) are fully taxed.

Examples of jurisdictions where capital gains on warrants may qualify for a tax exemption include:

- **The Netherlands.** Recent case law provides that capital gains on warrants and similar derivative instruments can qualify for a full exemption under the participation exemption regime, but the rules are still not very well defined. It appears that the participation exemption regime can apply to certain types of derivatives, but only if the shares received by the holder of the derivative instrument on exercise comprise a shareholding that can separately qualify for the participation exemption regime. This suggests that the shareholding should be at least 5% (although under certain circumstances a lower percentage shareholding may also qualify for the participation exemption regime) and cannot be held as a passive portfolio investment. The Netherlands does not apply a minimum holding period or a minimum value for the shareholding.
- **Luxembourg.** Although Luxembourg makes a distinction between the tax exemption regime for dividends and that for capital gains, both are generally exempt under the Luxembourg participation exemption regime if the shareholding:
  - represents at least 10% of the share capital or a minimum of EUR6 million (about US$7.3 million); and
  - has been held for at least one year (for shareholdings in EU companies the rules of Directive 90/435/EEC on the taxation of parent companies and subsidiaries (Parent-Subsidiary Directive) apply). This second requirement suggests that capital gains are taxable on shares acquired after exercising the warrant unless that exercise took place more than one year before sale.

  A recent development in this respect is the use of a Luxembourg venture capital vehicle, the SICAR (*Société d'Investissement en Capital á Risque*). This vehicle benefits from an exemption that is much wider than the standard participation exemption on shares and also applies to gains from convertibles, warrants, interest and so on.
- **Sweden.** The Swedish participation exemption regime (as applicable to non-listed shares) does not require minimum shareholdings by percentage or value, or a minimum holding period. In addition, Sweden does not impose any withholding tax on:
  - interest payments or other financial expenditures; or
  - dividends, if:
    - the receiving company holds at least 25% of the share capital of a Swedish company; and
    - the shareholder is not resident in a no-tax or low-tax jurisdiction, that is, it has a rate comparable to the tax rate of Sweden (but irrespective of whether the shareholder is resident in a country which has concluded a tax treaty with Sweden).

In some cases, it is possible for a mezzanine fund to hold the warrants directly and only structure the loan portion through an SPV where the gain on the sale of the shares or receipt of countervalue of the warrants is not taxed locally, such as is the case in the UK and the US, and usually The Netherlands and Germany. This does not work for France, Spain, Italy, Greece, and most of the Central and Eastern European countries.

If a preferential tax regime cannot be relied on, another way to reduce the taxable capital gain is to structure a compensating payment on the loan with which the SPV was funded. This could include a back-to-back structuring of the equity kicker, for example, by structuring the corresponding loan as exchangeable, through which the low-tax lender can elect to be paid in shares held or acquired by the SPV as a result of conversion or exercise of the warrant. In such cases, the ultimate benefit of the value of the equity kicker should be received by an SPV resident in a no-tax or low-tax jurisdiction. In this context, the use of an SPV from the Cayman Islands combined with one from Luxembourg, or an NA SPV with an NL SPV can achieve significant tax benefits (*see box, Example investment structure for a mezzanine investment*).

Reporting requirements of income for investors. Investors investing in a tax transparent fund are usually required to report the interest income as ordinary income on an annual basis, in contrast to reporting capital gains at the end of an investment. This can be significantly less attractive for certain types of taxpayers:

- Dividend income and capital gains may benefit from a lower tax rate, which is not available for interest income.
- Current interest income includes not only the actual interest payments received but also, in many jurisdictions, interest accruals, either as reflected in the bullet interest payment at maturity or the interest embodied in the PIK notes, even if the receipt of cash only occurs on redemption of the loan. This is generally referred to as "phantom income".
- The "free shares" received or the value of the warrants or other forms of equity kickers will, in some jurisdictions, lead to interest accruals or phantom income, as these instru-

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ments are viewed as having an interest component value, which needs to be accrued as income to each of the years in which the mezzanine loan is outstanding.

Although mezzanine investments also often contain current interest payments, so that investors can use that cash to satisfy their tax liabilities, phantom income can become problematic for investors if either:

- Cash receipts never materialise because the borrower defaults.
- The fund is not required to distribute the cash interest to investors (for example, because it uses the cash interest to provide leverage or make additional investments).

In these cases, the investors themselves need to fund tax payments on this income.

TAX ISSUES FOR US INVESTORS

There are a number of issues of particular importance to US investors, including:

- Phantom income (which arises in relation to mezzanine funds).
- The taxation of US individuals on their returns as capital gains or income tax.
- Whether income is taxed outside an investor's tax exempt activities as unrelated business taxable income (UBTI).
- Certain specific measures that can have an adverse tax affect on investors, such as controlled foreign company (CFC), and passive foreign investment company (PFIC) rules.

Phantom income

The issue of tax on phantom income which arises in relation to mezzanine funds (*see above, Mezzanine investment*) is particularly important for US investors, because of US tax reporting requirements. Certain elements of a mezzanine loan result in annual income tax liabilities for US taxpayers, including bullet interest, PIK notes and also that part of the warrants' value that qualifies as original issue discount (OID) (that is, the amount of value by which the debt instruments are discounted from their face value).

This is not applicable to standard cross-border private equity investments.

Taxation of US individuals

Individual US investors in a private equity fund, who invest either directly in the fund or through a fund of funds or as part of the fund managers' team, will need the private equity fund to ensure that they receive their return as capital gains on the sale of shares in the target or as qualifying dividends (since 2004) from companies in "white-listed" countries. They are then subject to a more favourable tax rate of 15%, whereas receiving returns as ordinary income is subject to the usual progressive income tax rates. This can be achieved by using the US entity classification regulations (the "check-the-box election"), where SPVs in the fund structure can elect to be treated as fiscally transparent for US tax purposes.

For mezzanine funds, the interest component is treated as ordinary income and is taxable at ordinary rates. Further, the equity kicker linked to the loan may also not fall within the low tax rates if the warrants are exercised (or the loan converted), and the shares acquired as a result, are not held for at least 12 months. Structuring the equity kicker with shares increases the chances of applying preferred tax rates.

UBTI issues for US tax-exempt investors

US tax-exempt investors (for example, US pension funds), are a major source of funding for European private equity and mezzanine funds, and it is therefore important to take into account the specific tax requirements of such investors.

For tax-exempt investors in the US, any income generated by a business undertaken by an investor outside its exempt activities is taxed as UBTI. This includes income and capital generated by investments that are made by the fund and that are financed in whole or in part by debt. As a result, exempt investors should not attract, or be deemed to attract, loans to make investments. This may happen if the mezzanine fund and/or any SPV it has established attract debt but are fiscally transparent for US tax purposes (as the loan will then be attributed to the investors). This can happen even if the fund itself grants the loans to the SPV. This situation can usually be solved by offering exempt investors the opportunity to invest:

- In a separate partnership, which will elect for US tax purposes to be taxed as a corporation.
- Through an offshore feeder, which serves as a corporate "blocker" vehicle which will eliminate the attribution of lending activities to the US exempt investors.

CFC and PFIC rules

The following US tax measures can have an adverse affect on US investors:

- **CFC rules.** This regime applies if:
  - 50% of the SPV or target is directly or indirectly owned by US shareholders; and
  - each shareholder owns at least 10% of the respective company.

  If the CFC regime applies US investors can be subject to tax on items qualified as "bad income" that arise at any level in the fund structure, such as interest, dividends and capital gains.

  This only applies to US investors in a mezzanine fund if there are other US shareholders in the borrower entity and if the mezzanine fund owns more than 10% of the shares, or of the warrants to acquire shares, in the borrower. This is avoidable for funds that are not US limited partnerships as the 10% threshold then applies to the separate US investors in the

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partnership, and not to the aggregate holding of the partnership itself.

- **PFIC rules.** This regime also aims to tax US investors with an interest in non-US companies that have bad income (primarily dividends, interest and capital gains) or assets that can produce this income. It applies to US shareholders:

  - that own non-US companies (but only if that company does not already qualify as a CFC); or

  - that have a less than 10% shareholding in a CFC, and therefore do not fall under that regime.

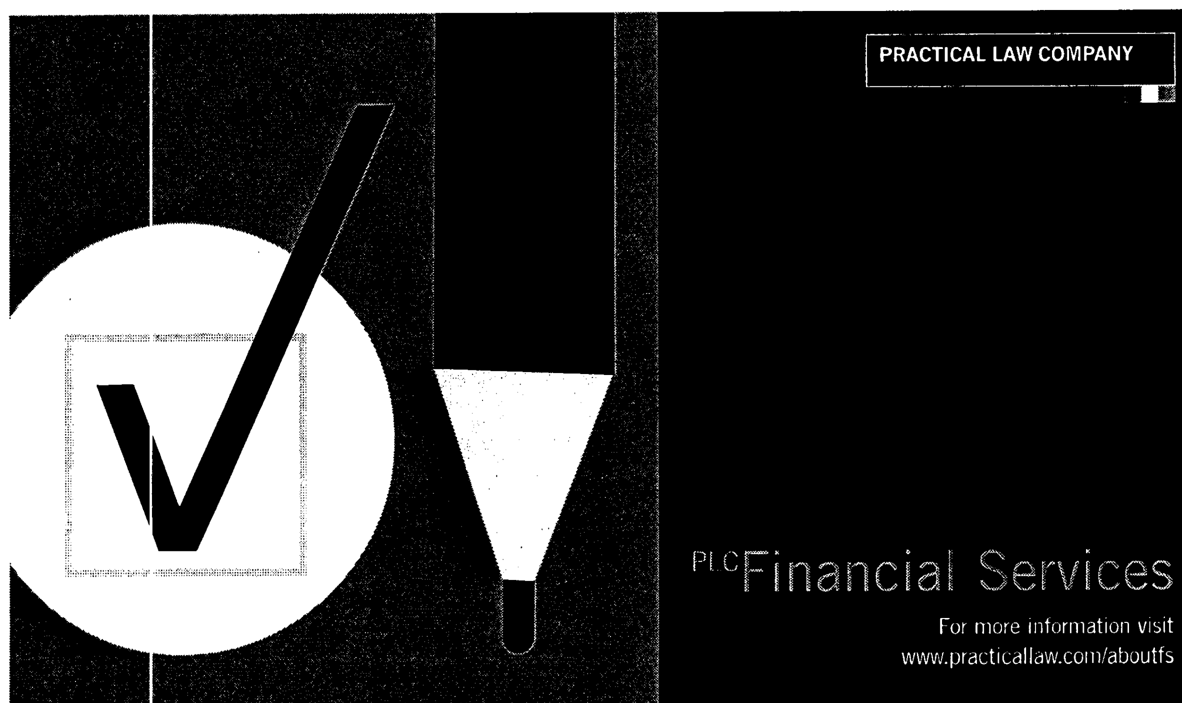
It is more likely that US investors in mezzanine funds will be affected by the PFIC regime than the CFC regime because the PFIC regime does not require a minimum shareholding for the US investors in order to apply.

The PFIC regime imposes additional tax charges on income or gains derived from the interest in the PFIC. This includes taxing capital gain on the sale of shares in a PFIC as ordinary income, and, more importantly, charging interest as if the gain was not realised on disposal but instead realised proportionally in each of the years in which the shares in the PFIC have been held.

Generally, US investors can avoid the onerous tax consequences of the PFIC regime by electing for a type of "look through" treatment, under which tax is charged on any net income and gains of the PFIC (a "qualified electing fund" election (QEF)). A QEF election requires the submission of certain information by the PFIC every year. In addition, it can only be made for shares in a PFIC (and not for options or warrants). At the same time, the gain realised on the shares on final disposal includes the value generated during the period in which any warrants were held and the period in which the warrant was held is also included for the interest charge.

For the above reasons, a mezzanine fund with US investors should consider structuring the equity kicker through shares rather than options or warrants so that a QEF election can be made. A QEF election also requires the company to provide certain information every year.

US investors can often avoid CFC and PFIC issues by making the check-the-box election, which ensures that the relevant companies are treated as fiscally transparent. However, it is worth noting that the check-the-box election applies to all US investors, which may not suit other US shareholders in the company. Like the QEF, it requires the relevant company to provide certain information every year.



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