KPMG

Spotlight on:

Tax considerations for alternative investment funds

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Introduction

Over the past number of years, there has been an increased focus on Alternative Investments as an asset class, with a greater level of allocations from investors to alternative strategies, in addition to a continually evolving investment landscape.

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One factor has remained constant over the last number of years in the context of investor preferences: year-on-year increased investor allocations to alternative funds. As at 31 December 2023, the net asset value of Irish domiciled funds regulated as Alternative Investment Funds (AIFs) was €865b[1], with this figure expected to grow in the years ahead. AIFs would historically have attracted much of their capital from institutional investors however the so-called "democratization" of alternatives has become a clear theme with retail investors seeking to add diversification to their portfolio through increased allocations to alternatives.

The nature of assets held by alternative funds also continues to evolve beyond private credit, real estate and infrastructure into new asset classes such as royalties, aviation and digital assets. In addition, broader macroeconomic factors such as rising interest rates, changes in the international tax landscape and the continued focus from investors on Environmental, Social and Governance (ESG) are shaping future trends. Change has, and will continue to, increase complexity across the full spectrum of the fund life cycle as the sector evolves.

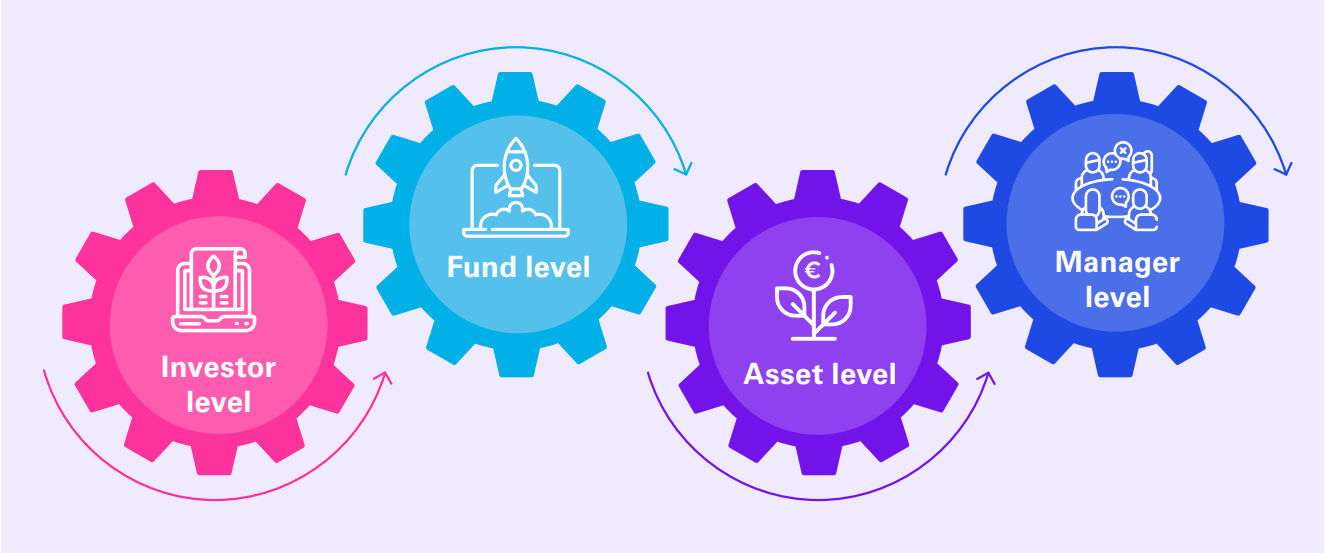
The expected focus by non-institutional investors on allocations to alternatives is complemented by the recent introduction of the EU's revised European Long Term Investment Fund (ELTIF 2.0) Regulation (which entered into force in Ireland on 10 January 2024). This regime is designed to provide both retail investors and professional investors access to longer term investments which cannot currently be accommodated by the existing AIF and UCITS regimes.

Given the diverse range of asset classes which are typically considered "alternative", there is usually increased tax complexity associated with establishing and operating an alternative fund structure. This document outlines some of the specific tax considerations, both generally and also in the context of certain specific asset classes.

1 Source: Irish Funds: Why Ireland? (2024-03-irish-funds-why-ireland-2024-euro-_web.pdf

General tax considerations - overview

The tax considerations relevant to alternative investment funds will typically span four different levels:



An overview of the key tax aspects that need to be considered at each of these levels when structuring an alternative fund are discussed below.

Investor level

- Ensuring that the investor does not have a tax filing obligation in any jurisdiction as a result of their investment in the fund (e.g., if there is any potential tax filing obligation, ensuring it is appropriately "blocked" by the fund structure.) This can be particularly relevant where the investor facing vehicle is established as a partnership or where the strategy includes loan origination or real assets.
- Minimising the incidence of any withholding tax on payments to the investor.
- Accommodating the specific requirements of alternate investor categories. This can be relevant where, for example, a fund promoter intends to distribute to different categories of US investors (e.g.,taxable and exempts), whilst also distributing to EU or other non-US investors. Each type of investor can have specific sensitivities from a tax perspective (e.g., US exempt investors are sensitive to any activity that can impact their exemption) so there can be a need to use feeders or other types of arrangement in the fund structure where flexibility is required in respect of investors.
- How an investment in the fund is treated in the investor's jurisdiction for tax purposes and nature of investment return (i.e., types of income and gains generated).
- Tax reporting requirements – investors in certain jurisdictions will require tax reporting information from the fund in order to complete their tax returns. Examples in this regard include the US (whereby investors will normally need either K-1 (partnership) or Passive Foreign Investment Company (PFIC) statements), the UK, Austria and Switzerland.

In addition to the tax implications noted above, general investor preferences / requirements also need to be considered as part of fund structuring. For example, where the fund is intended to be distributed to EU institutional investors, there has been a trend from this category of investors towards onshore and / or regulated vehicles, depending on the specific investor type and jurisdiction.

Fund level

- Management of fund level taxation, particularly ensuring the fund vehicle and structure does not create any incremental tax cost for investors. Many regulated fund vehicles (such as an Irish ICAV) are exempt from Irish corporation tax and capital gains tax and so fund level taxation on returns may not be an issue. Where the fund vehicle is transparent (e.g., a limited partnership structure) fund level taxation should not arise.
- VAT treatment of management fees and VAT recovery in respect of other costs (e.g., acquisition costs); as fund vehicles are typically not viewed as carrying on activity subject to VAT, any VAT charged on costs incurred by the fund vehicle may represent an absolute cost to the fund.
- Tax reporting and other compliance requirements (e.g., annual FATCA/CRS reporting in respect of the fund vehicle).
- Payroll tax implications for any directors of the fund vehicle (e.g., where it is a corporate entity).
- Managing risk that the fund manager could create a permanent establishment for the fund where it carries out activities on behalf of the fund in a foreign jurisdiction.
- Extent to which the fund could be within scope of the OECD's Base Erosion & Profit Shifting (BEPS) Pillar 2 rules in respect of global minimum taxation.

Investment / asset level

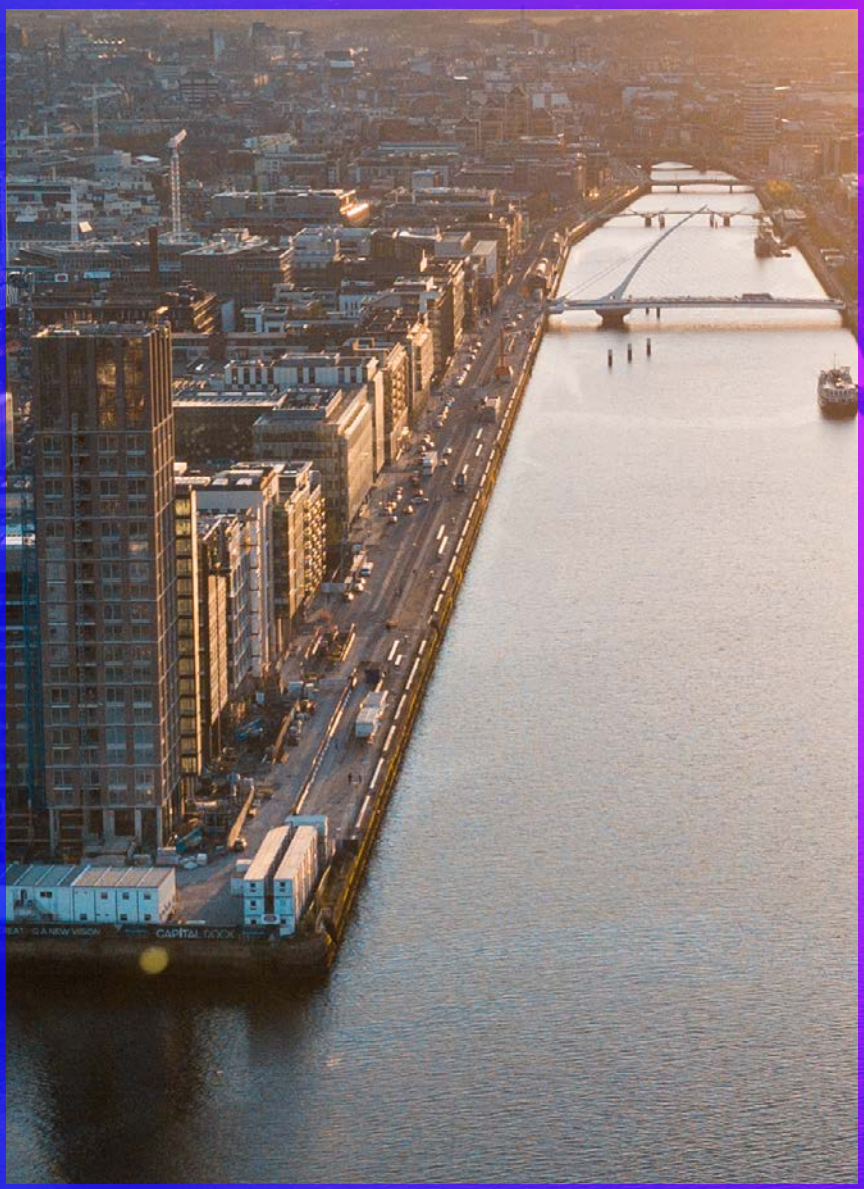
We have included some considerations specific to asset classes later in this document however some of the commonly recurring issues that need to be addressed when structuring investments to be made include:

- Management of taxes at the level of any vehicles formed under the fund to hold investments (e.g., it is not uncommon for a local SPV to be formed to acquire assets across each jurisdiction).
- In the event there are holding companies (or a master holding vehicle) used in relation to any underlying SPVs, taxation at the level of any holding company can typically be managed by utilising a holding company that is tax resident in a jurisdiction with exemptions from tax on dividends and capital gains or deductions for financing costs (albeit the optimal approach in this regard can vary on a case-by-case basis).
- Managing local taxes on future disposals of assets; certain jurisdictions will seek to impose capital gains taxes on the disposal of assets located in those jurisdictions (or shares in companies which derive their value from such assets).
- Tax due diligence on acquisitions (e.g., where there are significant equity positions being acquired)
- Dealing with conversions of debt assets to equity assets; where debt assets include convertible debt, often the fund will have separate sub-funds or holding structures for "pure" debt and "converted debt" instruments. This separation will typically be necessary from a commercial perspective where investors want exposure to only certain types of assets.
- Managing local asset level taxes that could arise on investors entering and exiting the fund (e.g., Foreign Investment in Real Property Tax Act (FIRPTA) rules in the US); where investors are viewed as holding direct or indirect interests in the local asset owning entities, an investor exiting the fund may be viewed as disposing of an interest in the asset owning entity.
- Claiming local tax on profits from alternative investments including exploring use of tax reliefs for capital expenditure (e.g., tax depreciation) and other structuring activities.
- Managing tax deductions for financing costs in general subject to local tax rules and transfer pricing considerations.
- Impact of OECD BEPS Pillar 2 and EU anti-tax avoidance directives (ATAD) measures on tax deductions including possible impact of anti-hybrid rules in the context of the broader fund structure.
- Ongoing tax compliance in respect of corporate taxes, payroll taxes etc. in relation to any entities formed by fund vehicle(s) in the structure.

It can also be necessary to consider the interaction with any non-tax considerations. For example, where loan origination activities are anticipated, the fund may be subject to separate regulatory requirements in respect of its loan origination activities (such as stress testing). Therefore, loan origination assets would typically be organised into a separate sub-fund or compartment to minimise the regulatory requirements for the remaining sub-funds and to facilitate separate investment by investors in a loan origination mandate (if required).

Manager level

- Evaluating approaches for structuring performance fees and carried interest arrangements in light of the jurisdictions of tax residence of key fund principals.
- VAT treatment applicable to management fee arrangements.



Asset class specific considerations

In addition to the general tax considerations across the four levels which are noted above, there are some specific tax issues which can be applicable across certain strategies which are discussed below.

Property

- Stamp duty / transaction taxes on acquisition (usually a purchaser cost), in addition to on exit (in the context of the optimal exit approach).
- The jurisdiction where the immoveable property is located often retains taxing rights (income/corporate tax and capital gains tax) over income/gains derived from the property. In addition, there might be a tax filing obligation in addition to a tax liability where an asset transferred – in some cases the purchaser may be required to withhold a proportion of the gross purchase proceeds.
- Some jurisdictions have specific taxing regimes for property which can give rise to additional risks or obligations e.g., the FIRPTA regime in the US, the Irish Real Estate Investment Funds (IREF) regime in Ireland for regulated funds holding Irish property.
- Many jurisdictions have specific REIT rules which can vary in nature.
- VAT on property; different rates of VAT can apply depending on the type of property and whether it has been recently developed.
- Permanent establishment risk; if a fund acquires real estate in a foreign jurisdiction, this might create a permanent establishment for tax purposes meaning there will be a branch filing obligation and potential tax liability in that foreign jurisdiction. In many cases a local SPV might be used to manage this risk.

Infrastructure

- Infrastructure and real asset deals will normally require consideration of a local SPV or holding structure, which necessitates analysis in respect of withholding taxes, local country taxes, exit considerations, etc.
- Tax credits for innovation / technology – to incentivise development of infrastructure assets, some jurisdictions may offer tax credits / other incentives for qualified innovation and technology (e.g., in Ireland there is a 25% tax credit available for certain qualifying R&D expenditures).
- Accelerated tax depreciation may be available in relation to specific asset types, which can reduce the overall effective tax rate, subject to interaction with OECD's BEPS Pillar 2 rules in respect of global minimum taxation..
- VAT on infrastructure; different rates of VAT apply depending on the type of asset.
- Capital gains tax on disposal (likely the jurisdiction where infrastructure is located would have taxing rights).
- Permanent establishment risk; infrastructure located in a foreign jurisdiction may create a permanent establishment in that jurisdiction creating a foreign tax obligation in that jurisdiction.

Private equity

- Management of "dry" taxes for investors which could arise where, for example, an underlying position makes a payment to the fund which it does not distribute to the investors but they are nevertheless taxable on that amount (due to, for example, the fund being transparent for tax purposes).
- Tax due diligence of the target is a necessary part of any acquisitions to identify any risks and appropriately factor into commercial discussions where relevant (or seek contractual protections). The approach to due diligence can vary based on the investment method (e.g., direct, co-investing, etc.).
- Considering tax implications of repatriation of profits and gains to investors is a crucial part of any acquisition, particularly ensuring that the potential for a tax efficient future exit is contemplated.
- In the context of a private equity fund of fund strategy, it is crucial to understand the tax profile of the underlying private equity fund. In some cases, the private equity fund may have a complex structure and several different vehicles through which investors can hold their interest. Due diligence in this regard is strongly recommended to ensure the investment does not trigger any adverse tax impact for the fund or its investors. It is advisable to get an understanding of the approach which each underlying private equity fund adopts in respect of taxes as part of this process (i.e., to ensure an unforeseen tax does not arise in respect of their investment activity

Credit

- Management of withholding taxes in respect of interest payments, including consideration of potential future equitisation in the context of certain positions (e.g., where strategy is focused on special situations).
- Where debt positions will be held in tandem with equity, or there may be enforcement, there can sometimes be a need to separate the positions into a separate vehicle to manage tax considerations such as interest limitation considerations.
- Distressed debt and non-performing loans can give rise to additional complexities from a tax perspective; both on acquisition and on an ongoing basis.
- Management of foreign permanent establishment issues – loan origination typically requires a greater degree of activity from the investment manager (sometimes in the borrower jurisdiction) which can create taxable presence issues for the fund. This can require specific structure approaches in some instances e.g., for US direct lending, a "season and sell" type approach or treaty platform using an Irish regulated fund is often used to manage this issue.

Irish tax developments relevant to AIFs

As illustrated above, the tax considerations applicable to an AIF are generally more complex and number of aspects need to be considered as part of structuring. In this context, legislative changes are normally of more relevance to an alternative investment fund, relative to a fund with a more traditional strategy. In this regard, we have set out some brief commentary below on developments which will be of relevance to certain alternative investment funds.

Forthcoming introduction of a participation exemption regime

Currently, Ireland is the only EU member state and one of only four OECD countries without a participation exemption for foreign dividends. Under current rules Irish resident companies are taxed in Ireland on a worldwide basis, with credit given for underlying foreign taxes. The requirement for companies with international subsidiaries or operations to navigate the complex foreign tax credit rules is burdensome and results in little by way of tax yield for Ireland.

Ireland is in the process of adopting and implementing a participation exemption which is expected to apply to certain foreign dividends received on or after 1 January 2025. This participation exemption for foreign dividends will reduce the compliance burden for Irish companies with foreign operations. This would also provide a greater incentive for fund structures to consider utilising an Irish holding company in their structure (either for Irish investments or as a master holding structure).

BEPS Pillar 2

Overview of scope

Finance Act 2023 included legislation to implement the 15% minimum tax rate under OECD's BEPS Pillar 2 rules in respect of global minimum taxation. The 15% minimum tax rate is also known as the Global Anti-Base Erosion (or GloBE) rules.

It should be noted at the outset that the GloBE rules will not affect the majority of Irish entities – generally only members of multinational groups with annual turnover exceeding €750 million in two of the last four years should fall in scope. However, Ireland's implementation of the rules has been extended to also apply to wholly domestic large-scale groups (subject to certain deferral rules), but again such groups with less than €750m consolidated turnover should fall outside the scope of the rules.

How it operates in practice

The Pillar Two GloBE rules are designed to implement a global minimum effective tax rate (ETR) of 15% on a jurisdictional basis. This means that the financial information of each of the group members in any given jurisdiction must be aggregated, adjusted as required under the rules, and an ETR calculated for that jurisdiction. If this jurisdictional ETR is less than 15%, then top-up tax is payable to bring the ETR up to 15%.

Ireland's implementation of the rules also includes mechanisms that would require Irish companies to pay top-up tax in Ireland with respect to foreign group members where the ETR for a particular jurisdiction is less than 15%. The Income Inclusion Rule ('IIR') could apply if an Irish entity is the direct or indirect parent of such foreign group members where that tax is not otherwise collected under that particular jurisdiction's QDTT regime.

The Under-Taxed Profits Rule ('UTPR') could also apply if any top-up tax remains payable after the application of the QDTT and IIR rules, meaning the Irish entities could be subject to additional tax in Ireland on behalf of any other low-taxed foreign entity within the same multinational group, be that a subsidiary, parent or sister company.

Key considerations for funds and fund structures

Exclusion from scope of rules

A key consideration for funds and fund structures is whether they fall within scope of the rules in the first instance. In this regard, there are a number of categories of entities which are specifically excluded from the rules, such as:

i. Any investment fund which is an ultimate parent entity (i.e., broadly speaking, which is not consolidated into any other entity, irrespective of whether consolidated financial statements are required to be prepared); or

ii. Any entity which is at least 95% owned by an entity referred to at (i) above, that operates exclusively (or almost exclusively) to hold assets or invest funds for the benefit of the entity referred to at (i) or exclusively carries out activities ancillary to those performed by it; or

iii. Any entity which is at least 85% owned by an entity referred to at (i) above provided that substantially all of its income is derived from dividends or gains that are excluded from the calculation of income for the purposes of the rules.

An investment fund for the purposes of the above is an entity which:

- Is designed to pool financial or non-financial assets from a number of investors, some of which are not connected;
- Invests in accordance with a defined investment policy;
- Allows investors to reduce transaction, research and analytical costs or to spread risk collectively;
- Has as its main purpose the generation of investment income or gains, or protection against a particular or general event or outcome;
- Its investors have a right to return from the assets of the fund or income earned on those assets, based on the contribution they made;
- Is, or its management is, subject to the regulatory regime, including appropriate anti-money laundering and investor protection regulation for investment funds in the jurisdiction in which it is established or managed; and
- Is managed by investment fund management professionals on behalf of the investors.

In light of the above, in practice it is expected that many investment funds and entities within investment fund complexes should fall outside the scope of the rules. That said, it is not clear that all collective investment vehicles will automatically satisfy the above conditions. Furthermore, there are some circumstances where a fund could require consolidation such that it will not automatically fall outside the scope of the rules. On a separate note, there is no exclusion applicable to investment management entities, which need to be assessed based on the relevant facts and circumstances.

Joint venture arrangements

There are specific provisions in the rules in relation to "joint venture" entities which are defined as any entity in respect of which at least 50% is held directly / indirectly by a parent entity where its results are reported under the equity method in the consolidated financial statements.

Whilst the entities described at (i) – (iii) above are excluded from this definition, it is worth noting that any vehicle within a fund complex which does not fall within (i) – (iii) and which is considered a joint venture entity could be within scope of the rules.

In assessing whether the €750m threshold is met, there is a requirement to include turnover from entities which are otherwise excluded from the rules.

As a result, the joint venture rules could result in a non-consolidated 50%+ entity in a fund complex coming within the scope of the rules, unless it is considered exempt (e.g., further to (i) – (iii) above), once the turnover of the broader fund complex is taken into account. This could be the case even where such an entity does not itself exceed the €750m threshold.

Key considerations to think about

Although there is a broad exemption from the scope of the rules which can apply to both fund and below the fund vehicles, it should not automatically be assumed that fund complexes are fully outside the scope of the rules.

In this context, the following considerations are important:

Q1: Is the fund vehicle itself consolidated into another entity or would it require consolidation should any investor(s) prepare consolidated financial statements?

Q2: Do below the fund vehicles meet the relevant criteria in every case, particularly where the consolidated turnover of the fund structure exceeds €750m?

Q3: Are there non-consolidated entities in the structure which are 50%+ held, particularly where the consolidated turnover of the fund structure exceeds €750m?

If the answer to any of the above is yes, it is important to consider the extent to which the rules might apply in more detail in the context of the fund structure (in addition to considering application in respect of any management entities).

Outbound payments

Overview of scope – who is affected?

Finance Act 2023 included a new provision which could result in the application of withholding tax to certain outbound payments made by Irish tax resident entities. This legislation operates by disapplying existing domestic withholding tax exemptions to certain payments made to non-resident entities, so is potentially relevant to any Irish entity which has been relying on domestic withholding tax exemptions to date in respect of such payments (including the Quoted Eurobond exemption in respect of interest).

That said, it will not apply to the long-standing withholding tax exemption which applies to distributions and redemption payments made by regulated funds to non-resident investors.

The legislation applies to payments of interest, dividends and royalties made by Irish tax resident companies, all of which are in principle subject to withholding tax but may qualify for a range of domestic exemptions where conditions are satisfied.

To be in scope of this legislation, which effectively switches off exemptions which would otherwise apply, the payment made by the Irish company must be made to an "associated entity" that is resident in a "specified territory". Both of these concepts are therefore important in assessing whether an arrangement falls within scope of the rules.

- Specified territory – a specified territory is defined as (i) a territory that is on Annex I of the EU list of non-cooperative jurisdictions or (ii) a zero-tax / no-tax territory. A specified territory cannot be another EU/EEA country, so these new provisions will not apply to any payments made to any recipient in an EU country. The legislation cross-references the version of Annex I of the EU list of non-cooperative jurisdictions that was most recently updated in February 2024. This list includes:

American Samoa, Anguilla, Antigua and Barbuda, Fiji, Guam, Palau, Panama, Russia, Samoa, Trinidad and Tobago, US Virgin Islands and Vanuatu.

- Associated entity – two entities are considered associated for the purposes of the rules if there is more than a 50% relationship in terms of share capital / ownership interests or in the case of an entity which does not have share capital, voting power or entitlement to profits.

Two entities will also be associated in cases where one entity has "definite influence" in the management of the other entity, or where the two entities are both associated entities of another entity. The concept of "definite influence" is new and is different to the existing "significant influence" concept which can have different meanings in the context of specific rules that are applicable to many alternative fund structures.

Broadly speaking, a company will be considered as having definite influence in the management of another entity where it has the ability to participate, via the board of directors or equivalent governing body of the entity, in its financial and operating decisions.

As a relationship of more than 50% is required, this could result in investments in joint ventures falling outside the scope of these new measures. Transactions with unrelated third parties should not be affected by the provisions.

Application – how does it impact?

As noted above, the rules operate by disapplying existing domestic exemptions however there are some nuances depending on the type of payment in scope:

Interest

Irish tax resident companies are generally required to deduct withholding tax on payments of yearly interest. However, a range of exemptions from interest withholding tax can apply, including interest paid in the course of a trade or business carried on in Ireland to a company which is tax resident in an EU member state (other than Ireland) or a country with which Ireland has a double tax treaty provided that that relevant territory imposes a tax that generally applies to interest receivable in that territory by companies from sources outside the territory, and interest payments made in respect of listed debt (the Quoted Eurobond exemption) or wholesale debt instruments where the relevant conditions are satisfied.

Where a company makes a tax-deductible interest payment to an associated entity that is tax resident in a specified territory (or a permanent establishment of an associated entity which is situated in a specified territory), the legislation will disapply the application of the existing Irish domestic interest withholding tax exemptions.

The legislation will also bring 'short' interest payments – interest payments on loans with a term of less than 12 months – made to an entity in a specified territory within the scope of Irish withholding tax. Each of the exclusions outlined above for royalties should equally apply for interest payments.

Notwithstanding the above, there is an exclusion from the legislation which will result in an interest payment continuing to qualify for exemption (assuming the relevant conditions are satisfied) where:

1. The recipient makes an onward payment of a corresponding amount (the meaning of which is undefined) to another entity within 12 months;
2. The corresponding amount would have been an excluded payment if it had been made directly to that entity (e.g.,, the payment would have been subject to tax); and
3. The payments were made for bona fide commercial purposes.

In the context of transparent entities, the intention of the legislation is effectively to allow a look through approach in respect of the ultimate recipient. Irish Revenue released detailed guidance in relation to a number of specific scenarios in this regard, which should be consulted where there are partnerships in a structure involving payments of interest by Irish tax resident companies.

Distributions / dividends

Where a company makes a distribution to an associated entity that is tax resident in a specified territory (or a permanent establishment of an associated entity which is situated in a specified territory), existing domestic reliefs from Irish dividend withholding tax will be disapplied. However, the new withholding tax provisions will not apply where the distribution is being made out of income, profits or gains that have been subject to (i) Irish domestic tax, (ii) foreign tax at a nominal rate greater than 0%, or (iii) a CFC charge or a top-up tax under Pillar Two. In addition, the provisions should not apply to distributions made out of foreign branch profits that are subject to foreign taxation.

Similar to the comments made above in respect of interest payments, a distribution should also be excluded from the scope of the new withholding tax provisions where it is reasonable to consider that, at the level of a direct or indirect recipient, the distribution is within the charge to a Pillar Two top-up tax, a CFC charge, a foreign tax at a rate greater than 0% or a domestic tax other than the new withholding tax.

Key considerations to think about

The measures will apply to in-scope payments made on or after 1 April 2024. However, there is a deferral of this date for existing structures, as the application date is 1 January 2025 in respect of any arrangements in place on or before 19 October 2023.

From a practical perspective, the following questions should be considered in the context of existing structures (particularly complex / alternative structures):

Q1: Is there any existing reliance by an Irish tax resident company on a domestic withholding tax exemption?

Q2: If yes, is the recipient of the payment non-EU and located in either an EU non-cooperative jurisdiction or zero / low tax jurisdiction (including the Cayman Islands)?

Q3: If yes, is the recipient of the payment associated with the Irish paying company?

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