KPMG

Fund structuring: beyond just theories

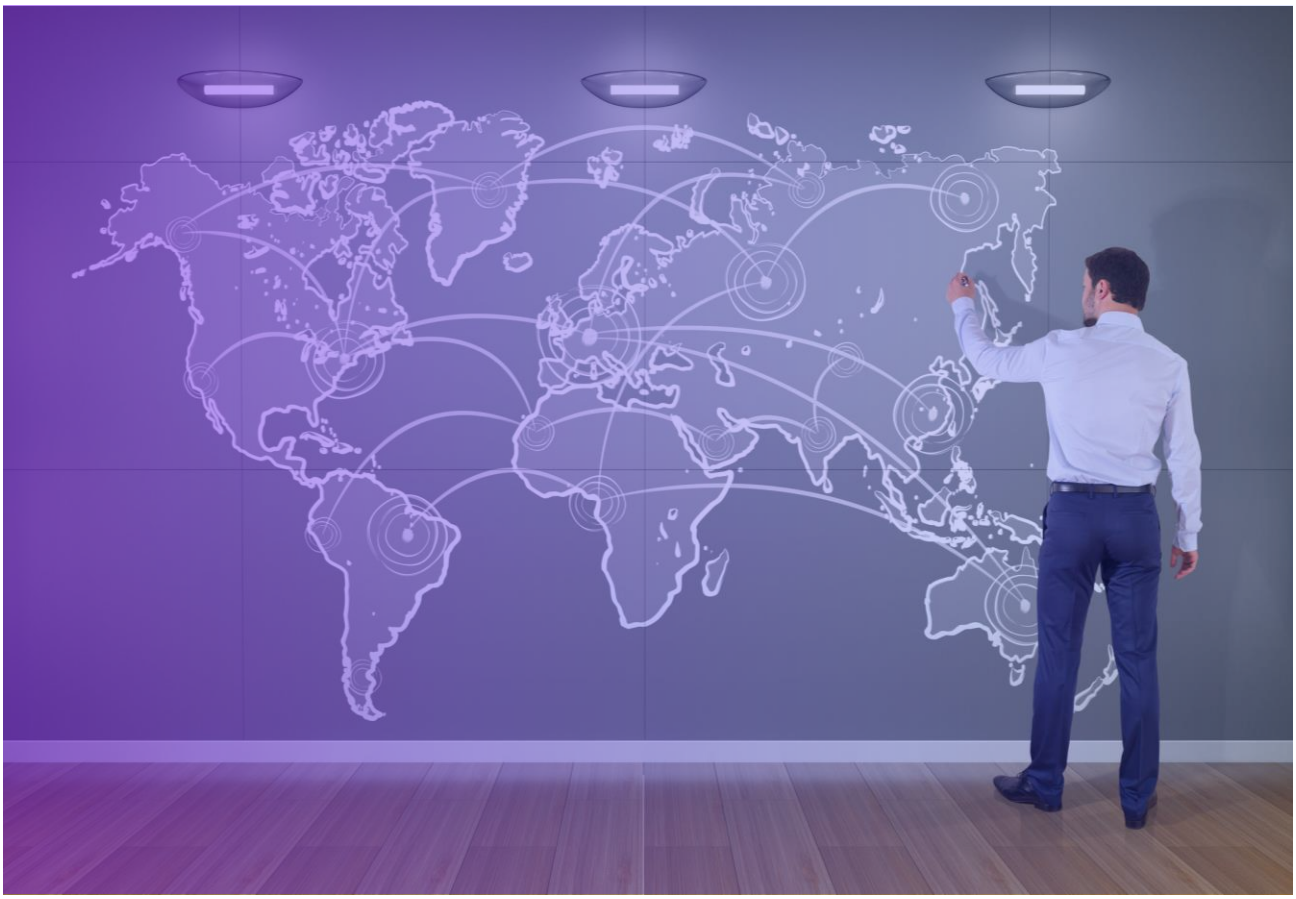
Content

1.0 Introduction

As many would agree, the current economic situation makes it extremely challenging for fund managers to raise capital in an environment that is already fiercely competitive. At the same time, complexity surrounding tax and legal regulations for funds is evolving so quickly it can be hard to keep track of what is going on. Further, investors and especially the ones with deep pockets have become more sophisticated and demanding over the years. For instance, some investors have started to scrutinise the tax structure of the fund and are making onerous requests on fund managers to make certain commitments in order to achieve the tax outcome that they desire. So if you think that fund structuring is as easy as just replicating an existing structure and only having to worry about dealing with tax and legal issues after you have raised the monies, then you may be in for a rude shock.

In essence, other than having the right investment strategy, it is pivotal that fund managers consider and are familiar with other aspects when structuring their funds in order to have a competitive edge against their peers. The above is especially true for aspiring and start-up fund managers, as well as family offices, who are looking to manage third-party monies for the first time.

This article discusses some of the key practical considerations from a tax and commercial perspective, with a light touch on the regulatory issues, when it comes to setting up a fund.



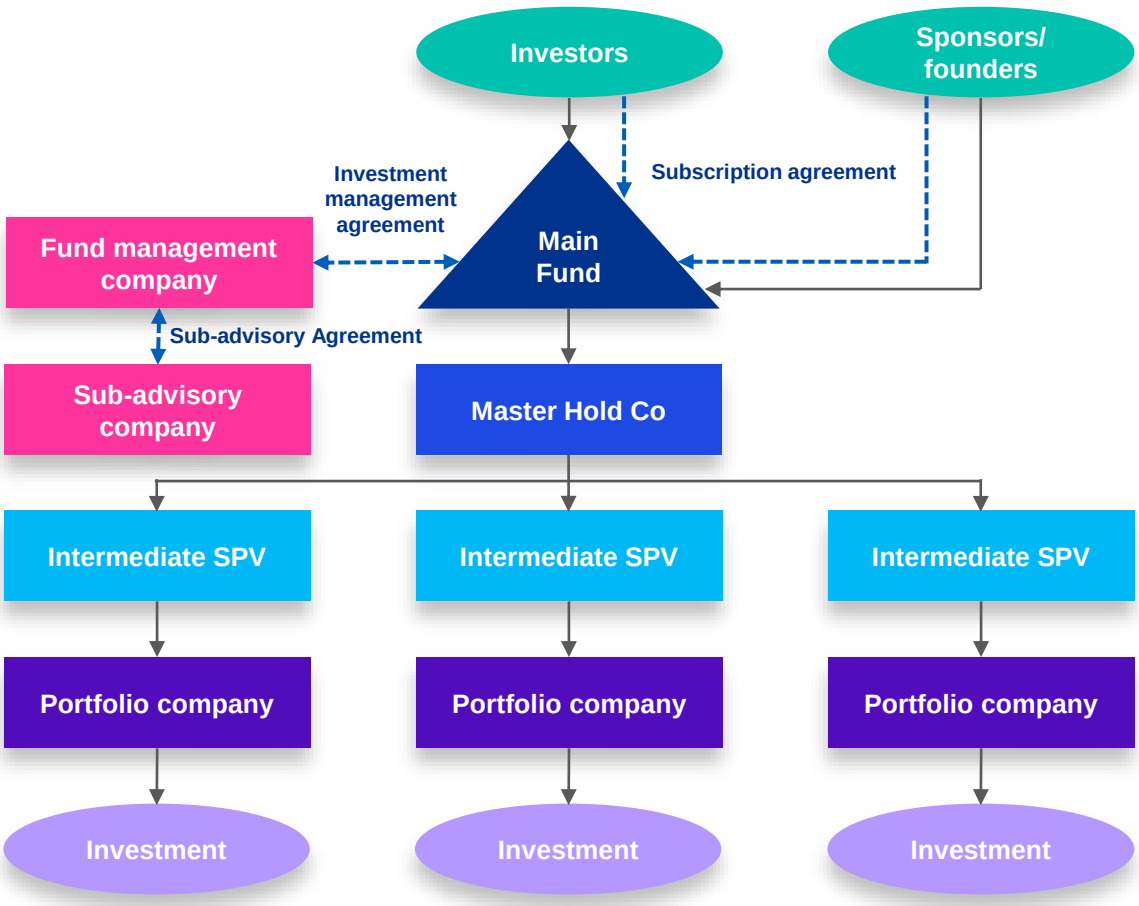
2.0 Key objectives of fund structuring

The overarching objective for any fund manager is naturally to maximise investors' return on investment. However, without any proper tax planning, the return on investment could be substantially reduced and may even have an impact on the entitlement to carry. An efficient fund structure should therefore seek to minimise tax leakages at all levels — from the main fund vehicle to the portfolio entity holding the investment.

The viability of a tax-efficient fund structure should include the following commercial and legal features which would greatly enhance the fund's marketability:

- Familiar to investors
- Complies with investors' regulatory requirements
- Optimal capital structure for ease of cash repatriation
- Allows exit flexibilities and caters to exit parameters
- Cost-efficient with minimal compliance
- Flexible enough to cater to future shocks

The failure of a fund manager to properly consider any of these factors could impair the fund's ability to attract investors or cause the fund to generate sub-optimal returns on investment. We will now discuss how tax considerations and the above factors would impact the fund structure.



2.1 Location and legal form of the main fund vehicle

There are quite a number of jurisdictions where one can set up a fund. The more common ones include the Cayman Islands, which by far is the most widely used and popular, followed by Luxembourg, Ireland and, more recently, Singapore.

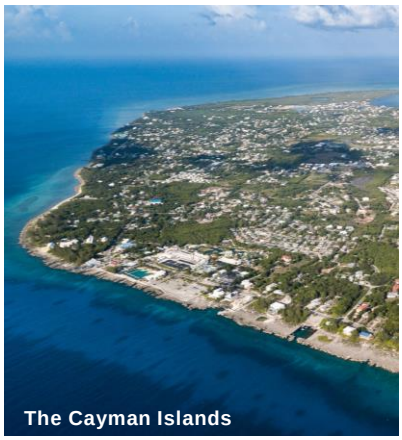
Less common jurisdictions include Bermuda, Jersey, Guernsey, the UK, Scotland, Mauritius, Australia, Delaware, Labuan, and the list goes on.

There are far fewer choices when it comes to legal forms and this would typically include limited partnerships, companies and trusts.

The following are key factors to consider when deciding on the legal form of the main fund vehicle and its location:

Tax neutrality

As the main fund vehicle is often perceived by investors as functioning predominantly as a pooling vehicle, it should be tax neutral. In other words, taxes should only be levied at the investment level and, where applicable, in the hands of the investors. Specifically, this means that the fund vehicle should not suffer taxes on investment income and gains. Further, taxes should not be levied on profit distributions and capital returns to investors.



The Cayman Islands

For these reasons, funds are traditionally set up in tax haven jurisdictions such as the Cayman Islands and Guernsey. This is not to say that funds cannot be set up in high-tax jurisdictions as tax neutrality can be achieved through other means such as tax transparency. Examples would include limited partnership vehicles that are set up in the UK and Delaware. Essentially, such vehicles are considered as “pass-through vehicles” for tax purposes and, accordingly, taxes would not be levied on the fund vehicles.

Fund vehicles can also obtain tax neutrality by availing themselves of specific tax regimes tailored to develop the onshoring of funds. The concept of “onshoring” refers to having the fund manager and the fund in the same location. For instance, funds that are domiciled in Singapore can apply for tax exemption from the Monetary Authority of Singapore. Funds set up in Hong Kong (SAR), China (hereafter “Hong Kong”) can also enjoy tax exemptions.

Some countries provide tax neutrality in more than one form. In principle, Luxembourg is a good example. It offers transparency treatment to funds that are set up as partnerships. At the same time, Luxembourg funds (including those that are set up as corporate vehicles) enjoy either subjective or objective income tax exemption if they qualify as regulated alternative investment funds. Examples include the Specialised Investment Fund (SIF), Investment Company in Risk Capital (SICAR) and Reserved Alternative Investment Fund (RAIF). In most cases, regulated Luxembourg funds should nevertheless be subject to subscription tax on their net asset value (possible exemption under conditions).

Investor familiarity and comfortability

Investor familiarity and comfortability are critical in ensuring the fund’s marketability. Marketing a fund structure that investors are not familiar with or are not comfortable with could significantly lengthen the time it takes for an investor to “tick the box” before subscribing to the fund. In a worst-case scenario, potential investors may even walk away.

Jurisdictions like the Cayman Islands have historically been popular fund locations due to the absence of taxes and a light-touch regulatory environment. Needless to say, investor familiarity with a Cayman Islands fund would tend to be high. In particular, investors from the US, the Middle East and Asia are used to investing into Cayman Islands funds. On the other hand, institutional investors from the European Union are more familiar with funds that are set up in Luxembourg and Ireland. German pension funds and insurance funds, for instance, are well known for their preference to invest into Luxembourg-domiciled funds (often due to regulatory reasons).

Whilst the more seasoned investors in Europe have moved on to funds set up in alternative jurisdictions, those who are just starting to venture beyond Europe, and especially the small and medium-sized investors, are still very fond of Luxembourg and Ireland.

That said, fund managers should not rule out other jurisdictions for establishing their funds. Notably, investors are becoming increasingly sophisticated and are exposed to a myriad of investment platforms. For example, since the launch of the Singapore limited partnership framework in 2008, whilst Asian investors are generally familiar with Cayman Islands funds, many are also becoming more open to investing into funds set up as a Singapore Limited Partnership. Of late, investors from Canada, the Middle East, Korea, Malaysia, Germany and the Netherlands have also started to invest into Singapore domiciled funds.

Hong Kong, with the introduction of the Hong Kong open-ended company and with a limited partnership framework, is also seeking to increase its profile as a fund domiciliation location.

Further, incidents in tax havens such as the Paradise Papers and Panama Papers leaks and a renewed focus by governments on tax evasion and Base Erosion and Profit Shifting (BEPS) have caused some groups of investors to shy away from investing in funds established in "tax havens" because of reputational concerns. In particular, institutional investors such as pension funds and sovereign wealth funds have even implemented internal policies prohibiting or discouraging the use of investment in vehicles established in "tax haven" jurisdictions. Increasingly, we are also noticing that investors from Japan, Korea and Indonesia are becoming less comfortable about investing into Cayman Islands funds and are exploring Singapore funds as an alternative.

European investors also monitor the EU Blacklist of non-cooperative jurisdictions. With the recent inclusion of the British Virgin Islands, EU investors would find it difficult to invest into funds set up therein at least for now. Although Cayman Islands have been removed from the EU Blacklist, to some extent, some European investors may still be adverse towards investing into a Cayman Islands-domiciled fund. Admittedly, it is fair to say that fund managers may also think harder about setting up a Cayman Islands or British Virgin Islands-domiciled fund going forward. Hong Kong and Malaysia on the other hand have been added into the EU grey list at the moment. Would this pave the way for more funds in these countries to be redomiciled to jurisdictions like Singapore and the likes? Only time will tell.

Another growing trend that demonstrates the importance of investor familiarity involves US and Australian-based fund managers targeting Asian investor monies. In such cases, it is pertinent for the fund to be domiciled in an Asian jurisdiction such as Singapore which Asian investors are familiar with. Put simply, a US-based fund manager would find it most effective to market a US real estate-focused fund to Asian investors through a Singapore fund platform rather than a Delaware platform. Equally important is of course for these managers to also set up an office in Singapore.

Moving on, a related point of consideration is investors' familiarity with the legal form of the main fund vehicle. Most would agree that the limited partnership framework is by far the dominant legal form for alternative investment funds with the exception of hedge funds. Hedge funds, because of their open-ended nature and multiple strategies which require the setting up of sub-funds, on the other hand, tend to be set up as corporate vehicles with cell structures having a separate legal personality.

Examples include the tried-and-tested Luxembourg SICAV and Cayman Segregated Portfolio Company and, more recently, the Hong Kong open-ended fund company and Singapore variable capital company (VCC).

Trusts are commonly associated with estate planning and are perhaps the least familiar legal form to most investors. Having said that, there are exceptions. In particular, unit trusts seem to be the most common legal framework used for funds in Australia and Korea. Not surprisingly, these funds focus on domestic investors though obviously the lack of investor familiarity has unfortunately resulted in a lack of appeal of these vehicles to international investors.

Another example — a unit trust — is the default fund vehicle where the preferred or eventual exit strategy is listing a real estate investment trust (REIT) on the Singapore Exchange. Further, a lesser- known vehicle domiciled in the Luxembourg, the *fonds commun de placement* (FCP), the equivalent of a unit trust under French civil law, was at one point widely distributed in the EU but is now used in specific cases including Pan-Asian real estate funds to allow easy access to the Managed Investment Trust (MIT) regime in Australia.


Singapore

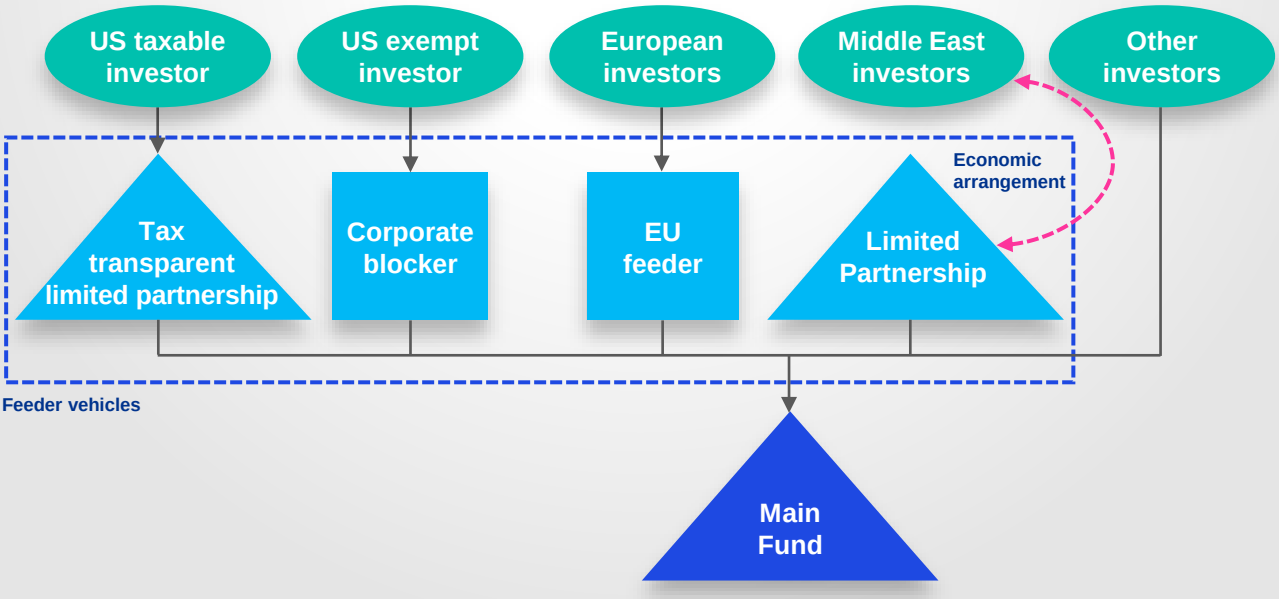
Feeder vehicles

A feeder fund acts as a pooling vehicle for certain groups of investors and then injects the capital into the main fund, sometimes known as the Master Fund. This is often required because of specific domestic tax or regulatory requirements of these investors, which render it impossible to invest directly into the Master Fund. A good example would be US investors and, specifically, taxable and tax exempt investors with conflicting tax objectives to achieve.

To illustrate, US taxable investors generally invest in entities that are fiscally transparent for US federal income tax purposes, allowing the income, losses, credits and deductions of those entities to pass through to the investors, thereby allowing such investors to facilitate the use of those losses and deductions. Furthermore, such transparent entities would generally allow US taxable investors to facilitate the use of foreign tax credits and enjoy long-term capital gains tax rates depending on the nature of the underlying assets and the type of investor (e.g. individual investor) and, at the same time, avoid burdensome reporting and/or filing obligations related to certain anti-deferral tax regimes such as controlled foreign corporations (CFCs) and passive foreign investment corporations (PFICs).

On the other hand, US tax-exempt investors such as qualified pensions, charitable organisations and foundations generally invest through one or more entities that are not fiscally transparent (opaque) for US federal income tax purposes ("Blockers") to prevent receiving unrelated business taxable income (UBTI). Certain non-US government investors also generally invest through one or more Blockers to preserve their ability to claim certain exemption from US federal income tax with respect to US-sourced income.

It is also common for Middle East investors to invest via a feeder fund, particularly for investors who wish to be Shariah compliant. Generally, the feeder would be a Cayman Island LP or a Jersey LP. Interestingly, Middle East investors, instead of subscribing to equity interests in the feeder, would enter into some form of Islamic financing arrangement with the feeder, which grants them economic interests. The feeder would then subscribe to equity interests in the main fund.



Regulatory considerations

Regulatory regimes in the target investors' home jurisdictions could have a significant influence on the location of the main fund vehicle. Perhaps the most well-known regime is the Alternative Investment Fund Management Directive (AIFMD) regime which fund managers raising monies from European investors should be familiar with. The application of AIFMD is complex but put simply both the fund manager and fund domicile would have to be set up in the EU to comply with the AIFMD. Not surprisingly, Luxembourg is the most common jurisdiction for the "AIMFD compliant fund". For Asian and US fund managers that do not yet have a presence in Europe, they could consider "renting" a third-party AIFM for a fee if it is proving to be too time-consuming and costly to set up and maintain one. Having said that, it is also possible to raise money from EU investors through the private placement option under which, apart from investor familiarity, there is conceptually not a requirement for the fund to be set up in the EU. For instance, it is not uncommon for seasoned German and Dutch investors to invest into a Singapore domiciled fund. However, the private placement option may not be practical for funds that are open-ended in nature or for those that are intended to be marketed to numerous countries in Europe.

2.2 Master Hold Co and intermediate holding entities

Alternative investment funds are normally set up as limited partnerships. It is common for these funds to in turn set up a holding company, typically in a country with good access to an extensive network of tax treaties. The holding company would either hold the portfolio companies directly or indirectly through intermediary companies.

These entities are employed in a fund structure for a myriad of legal, commercial and tax reasons. Just like the main fund vehicle, we would also need to consider their locations. We outline some of these reasons in the succeeding section, as well as factors to consider when evaluating the appropriate location. For ease of our discussion, we shall refer to the holding company and intermediary companies as “holding platforms”.

Legal considerations

Fund managers may seek to ring-fence each of the fund’s investments to safeguard against potential claims on other fund assets in the event of a failed investment. This may be achieved by segregating the fund’s investments in Intermediate SPVs. Intermediate SPVs are often interposed where offshore debt financing is involved as creditors’ claims are limited to the assets of the Intermediate SPV instead of the fund.

For such legal ring-fencing to be effective, the holding structure should be set up in a jurisdiction with a well-established legal framework that is internationally recognised to provide the necessary protections. Investors should also be comfortable and familiar with the protection afforded under the relevant legal framework.

Treaty platforms

Tax treaties play an important role in mitigating withholding taxes on dividends, interest and capital gains, and in enhancing returns to investors. Generally, only companies or entities treated as corporates for tax purposes are eligible for treaty benefits. Partnership and trusts, on the other hand, are not. This issue may be addressed by interposing a vehicle or vehicles established as companies below the main fund entity. In the tax world, we sometimes refer to these vehicles collectively as “treaty platforms”.

It is not difficult to identify suitable tax neutral jurisdictions as candidates for the treaty platforms with an extensive treaty network. European holding structures were commonly adopted because of their participation exemption regimes that do not tax dividend and capital gains as long as certain minimum holding period and ownership requirements are met.

Traditionally, the Netherlands tops the list given that it has signed almost 100 Avoidance of Double Taxation Agreements (DTAs).

It was admittedly widely used not just for investments into Europe, but also for investments into Asia and Latin America. However, Luxembourg has recently surpassed the Netherlands, particularly for alternative investment funds investing into Europe, and to some extent for investments into Asia as well. For instance, prior to Singapore, Luxembourg was commonly used for investments into Japanese real estate.

Other examples in Europe include Cyprus, Malta, Ireland, Switzerland and even the UK and Belgium (interestingly for Korean investments). It is also worth mentioning that for funds investing into Europe the holding structure is commonly set up in the EU to allow access of the EU parent-subsidiary directives, under which withholding tax is exempted on interest, dividend and royalty payment between EU states.

Moving away from Europe, Singapore and Hong Kong are both popular treaty platforms for investments into Asia. Hong Kong, in particular, is commonly used for investments into Chinese mainland whilst Singapore, although less popular as a holding location for Chinese investments, is widely used for investments generally in Asia. Other notable mentions include Mauritius and Labuan, Malaysia's attempt at creating an offshore financial hub. Mauritius is widely used for investments into Africa and India, although in this part of the world it is probably most famous as an investment platform into India. That said, some clients are looking for alternatives such as Singapore to invest into India as well. Labuan, at one point, was widely used for investments into Korea. It has also been used for investments into Taiwan and, ironically, for investments into Malaysia until the loopholes were closed by the Malaysian tax authorities.

Gone are the days when all that was required was to "tick a box" in the relevant jurisdictions with minimum substance, which was sufficient for a company to obtain a tax residency certificate to facilitate access to treaty benefits. Tax authorities around the world have become smarter and with international tax policies evolving and becoming more complex in the last few years, the following considerations must be taken into account when setting up a treaty platform:

- A country's tax treaty network cannot be the sole determinant for incorporating an entity in the country. Such practices (also known as "treaty shopping") have been identified as being abusive and contributing to BEPS. One of the measures to combat BEPS was the introduction of the Principal Purpose Test (PPT), which is now a key feature in many tax treaties. Under treaty benefits where it is reasonable to conclude that one of the principal purposes of the arrangement or transaction is to obtain a treaty benefit.

- Tax authorities in the investee jurisdictions may also deny tax treaty benefits if the intermediate holding entity is not the beneficial owner of the income. Based on the OECD commentary, beneficial ownership means that the entity should have the right to use and enjoy the income unconstrained by a contractual or legal obligation to pass on the payment received to another person. The commentary goes on to clarify that agents, nominees and conduit companies are not the beneficial owners of the income due to their narrow powers over the income.

In order to satisfy the PPT and beneficial ownership requirements, fund managers should ensure that there are strong commercial and legal reasons for establishing the treaty platform which should have sufficient "substance" in the country of establishment. For instance, the board of directors should consist of majority, if not at least half, tax residents of the country of establishment, have the relevant experience and qualifications, and be genuinely empowered to make strategic decisions. This is the bare minimum and often would negate the use of nominee directors who are employees of third-party service providers. As the fund and its affiliated entities are mere investment holding entities, the substance provided by the fund manager would be of paramount importance. Obviously, the fund manager should also be based in the country of establishment of the treaty platform and, as a gold standard, the senior management such as the CEO, COO and CIO should also be based in the same location. Accordingly, if the treaty platforms are set up in Singapore one would expect the fund management company and their C-suites to be also based in Singapore.


Hong Kong

Exit reasons

The use of an intermediate holding entity in an offshore jurisdiction helps to facilitate an exit by selling the offshore entity. This is commonly known as an indirect disposal and is popular as it does not attract capital gain taxes in the country where the investments are made (though not in all instances). However, its usefulness extends way beyond tax efficiencies; the most obvious one being the creation of multiple exit options.

From a legal perspective, it is sometimes pertinent to use intermediate holding entities for ease of exit. For instance, in jurisdictions, such as Vietnam and China, disposal of the onshore SPV may require regulatory approval, which can be cumbersome and time-consuming. For this reason, foreign buyers would typically prefer to acquire the offshore vehicle which generally enables them to avoid the red tape associated with an onshore acquisition.

Not only does this help to avoid signing multiple SPAs, it could in some cases also achieve some tax savings. This is particularly true in the case of mitigating offshore disposals in respect of "land-rich" investments in countries like Australia, the UK, Japan, Malaysia, Vietnam and China, just to name a few. Specifically, these countries would impose capital gains tax where the market value of the assets of the offshore SPV at the point of disposal were to comprise at least 50% (in some cases 75%) in "land-rich" assets in the respective countries.

In the case of a portfolio exit involving investments in multiple countries, a sale of the master holding company is less likely to attract these taxes, particularly in the case of funds that invest in multiple countries and where normally this is a 30% to 40% cap on each country in order to manage concentration risk. A very simple idea indeed but easily overlooked.


Australia

From a foreign ownership perspective, using an offshore SPV to hold the onshore portfolio company can be critical during both the investment and divestment phase. For instance, having an offshore SPV allows a 100% divestment to a foreign buyer even if the investee locations were to amend the law to restrict or further restrict foreign ownership in the relevant sector in the future.

Without stating the obvious, having a master holding company to own the entire investments of a fund further facilitates a portfolio exit simply by selling this company.

Optimal capital structure

The internal rate of return (IRR) for a fund is also determined by how fast cash can be returned to investors. Obviously the sooner the cash is returned, the higher the IRR, making it one step closer to getting the carry. In the case of a core fund, the manager often has the obligations to meet certain cash yield requirements. Hence, having an optimal capital structure that allows cash to be freely repatriated is undeniably important.

The most common form of cash repatriation is dividend. However, the amount of dividend that one can declare is often subject to the availability of retained earnings.

Where there is a mismatch of cash available for distribution and retained earnings resulting from non-cash expenses, such as depreciation, unrealised foreign exchange loss and impairment loss, this results in what we call a "cash trap" issue. This issue is exacerbated in countries with laws that mandate companies to set aside a certain percentage of their profits to go into a legal reserve. To be honest, the cash trap issue originates in the country where the investments are made, but having said that we certainly do not want the capital structure of the holding platforms to worsen the issue.

Where the holding platforms are located in tax haven jurisdictions like the Cayman Islands and BVI, the cash trap issue is probably not serious, if at all, as entities incorporated in these countries normally don't need to adopt or follow complex accounting regulations, are able to make distributions out of capital or can pay dividends so long as the relevant entity is not insolvent thereafter. Admittedly, the company law is generally less stringent in these countries. However, the holding platforms are often incorporated elsewhere as these countries do not have an extensive tax treaty network.

The cash trap issue at the offshore level is generally mitigated by managing the debt-equity ratio of the holding company and its intermediaries.

Where intermediate holding entities are capitalised mainly by ordinary shares, one way of returning trapped cash could be by way of capital reduction. However, this can be time-consuming, cumbersome and costly, especially if court approval is required. On the other hand, where the majority of the share capital is instead issued as redeemable preference shares, a return of capital can shorten the process significantly. Still, this is not foolproof as the redemption process may typically entail all the directors of the company signing a solvency statement.

In some countries, it can be extremely onerous to sign the solvency statement, which can potentially be accompanied with a fine and, in a worst-case scenario, a jail term, if the relevant company turns out to be insolvent in the future.

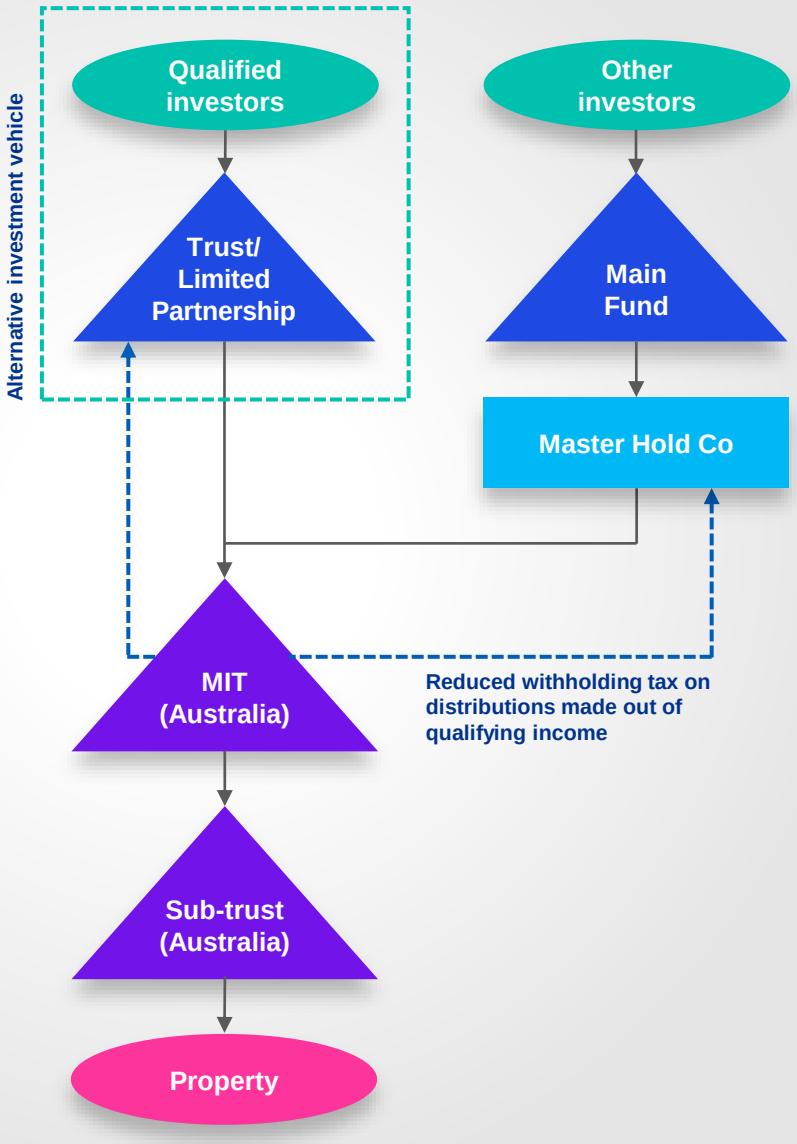
A much simpler and more straightforward way would be to inject capital as shareholder's loan, which could be either interest-free or interest-bearing. For one, the repayment of shareholder's loan is fast and easy and, at most, require directors to approve through a resolution via circulation. Ideally, the loan should be interest-free and this should be fine so long as it does not create too much complication from a transfer pricing perspective.

It is probably obvious that by now, a company should be capitalised with more debt than equity — the question is, what is the right ratio? Ideally, this would be the minimum that is allowed under the law and that can be as low as just a dollar. However, where treaty access is critical, this could affect the beneficial ownership requirements and eligibility to the preferential tax treatment under the relevant treaty as mentioned above.

In particular, a thinly capitalised company is often seen as a shell company and conduit. As a guidance, a 3:1 debt equity ratio is a good starting point, but there is obviously flexibility for a proportionately lower quantum of debt where substantial capital injection is involved, especially where there are other positive factors to substantiate beneficial ownership.

Sidecar/alternative investment vehicles

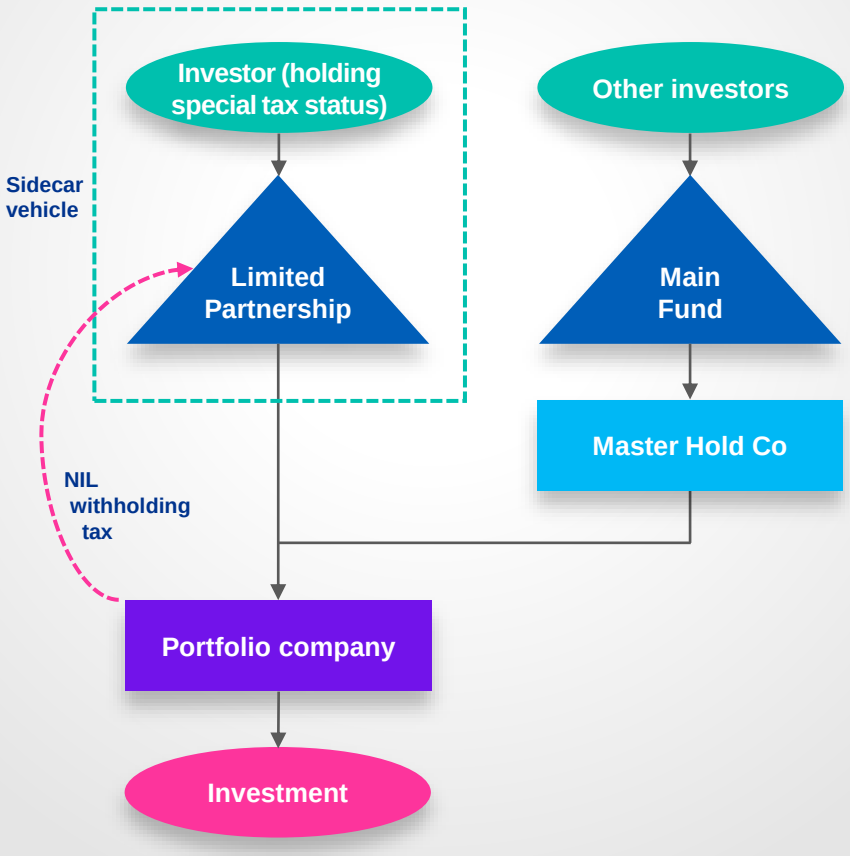
Under certain circumstances, it may not be the most tax-efficient for the main fund to make an investment directly. The fund, would instead, make such investments through a sidecar or an alternative investment vehicle (AIV) would have to be set up only for specific investors as there are occasions where they can be set up for specific investments or investee locations. One such example is Australia's Managed Investment Trust (MIT) regime, which halves the exit taxes from 30% to 15% if structured properly but would only work if the fund has most of its investors being qualifying investors such as pension funds and life insurance funds. Unfortunately, funds that are structured as limited partnerships would find it difficult most of the time to take advantage of the MIT concessions unless an AIV, such as a trust, is being set up to pool all the investors as illustrated in the diagram. The AIV is used only for investments into Australia which means that in the case of a Pan Asian Fund, all investments into other countries would still go through the main fund.



Sidecar/alternative investment vehicles (cont'd)

A sidecar or AIV may also be required for investors that are exempt from tax under local law and where the fund invests locally. For instance, in Singapore, charitable organisations and co-ops are exempt from income tax and therefore, where possible, their investments should not be co-mingled with other investors, particularly where the fund invests in Singapore real estate, which generates taxable rental income that is otherwise not taxable for charitable organisations and co-ops.

From a legal perspective, a sidecar is sometimes needed where a major investor may not necessarily want to invest in all the investments made by the main fund. In other words, it wants to be able to "pick and choose" and participate only in investments it considers "desirable".



2.3 Other considerations

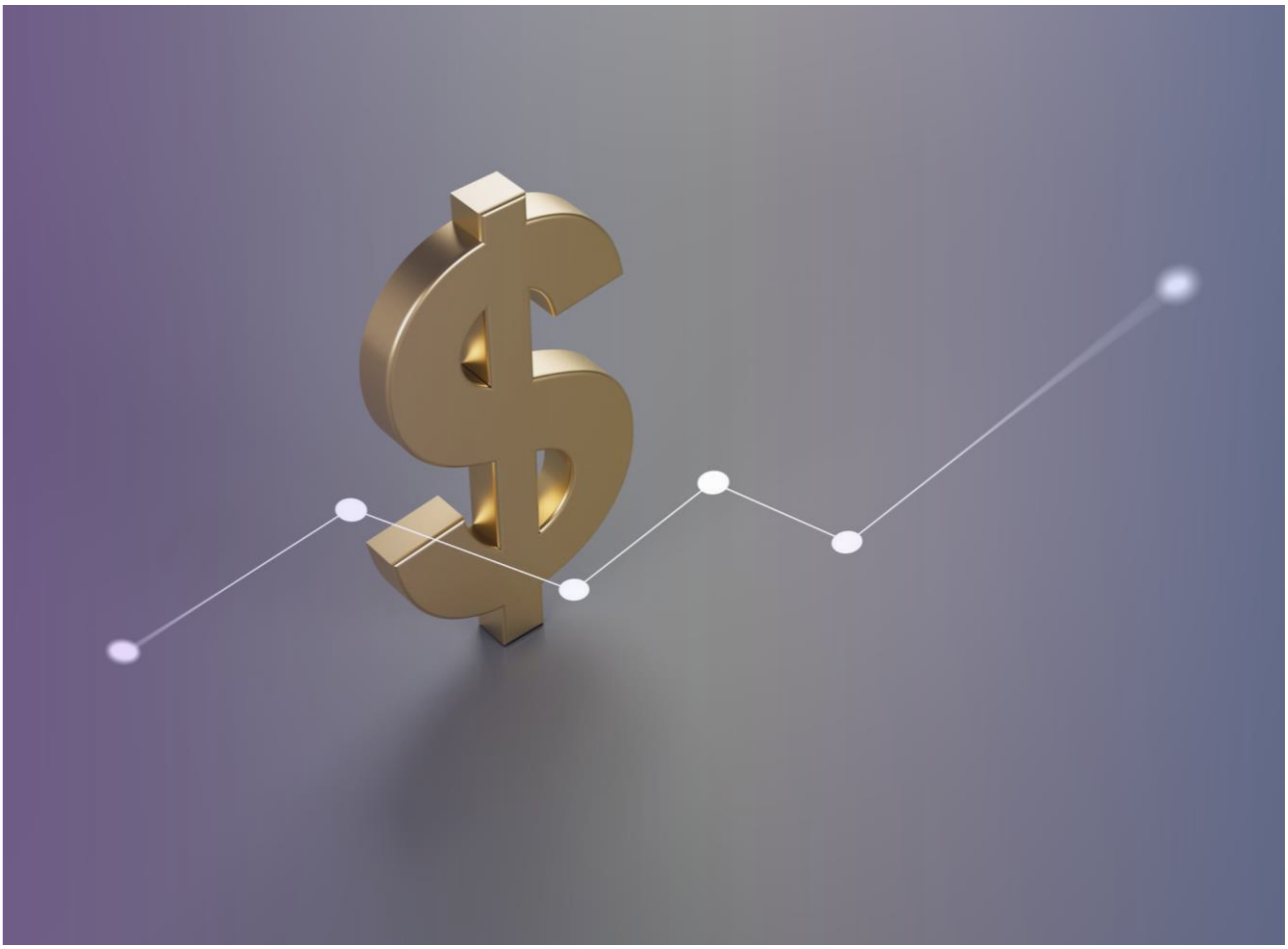
Cost of formation and maintenance

When structuring the fund, fund managers should also seek to minimise the set-up and ongoing maintenance costs of their fund structure. These include incorporation expenses, advisor fees, fund administrator fees, custodian fees and ongoing compliance costs, and so on. The formation and ongoing maintenance costs vary widely from country to country. A fund established in Luxembourg is considerably more expensive to set up and maintain, compared to a fund established in the Cayman Islands or Singapore.

Due to stricter regulatory oversight of the fund management industry in Luxembourg, ancillary costs such as advisor fees, administrator fees and depository fees are understandably higher. If the fund manager engages a third-party AIFM in Luxembourg, the AIFM's fees will add to the overheads. While the Cayman Islands used to be a cost-efficient platform to establish a fund, the recent introduction of the Mutual Funds (Amendment) Bill and the Private Fund Law, alongside the additional compliance requirements in relation to valuation and cash monitoring etc, would inevitably increase the costs of setting up and maintaining a Cayman Islands fund structure.

Though not absolute, this may potentially make setting up onshore vehicles in Singapore and Hong Kong relatively more attractive.

While there are benefits to using intermediate holding entities for reasons such as treaty access and legal ring-fencing, fund managers should be aware that an increased number of entities in the overall fund structure adds to the fund's overhead costs. Further, if the entities are located in multiple jurisdictions, there would be added monitoring costs to ensure that the fund structure is not adversely affected by new laws and regulations.

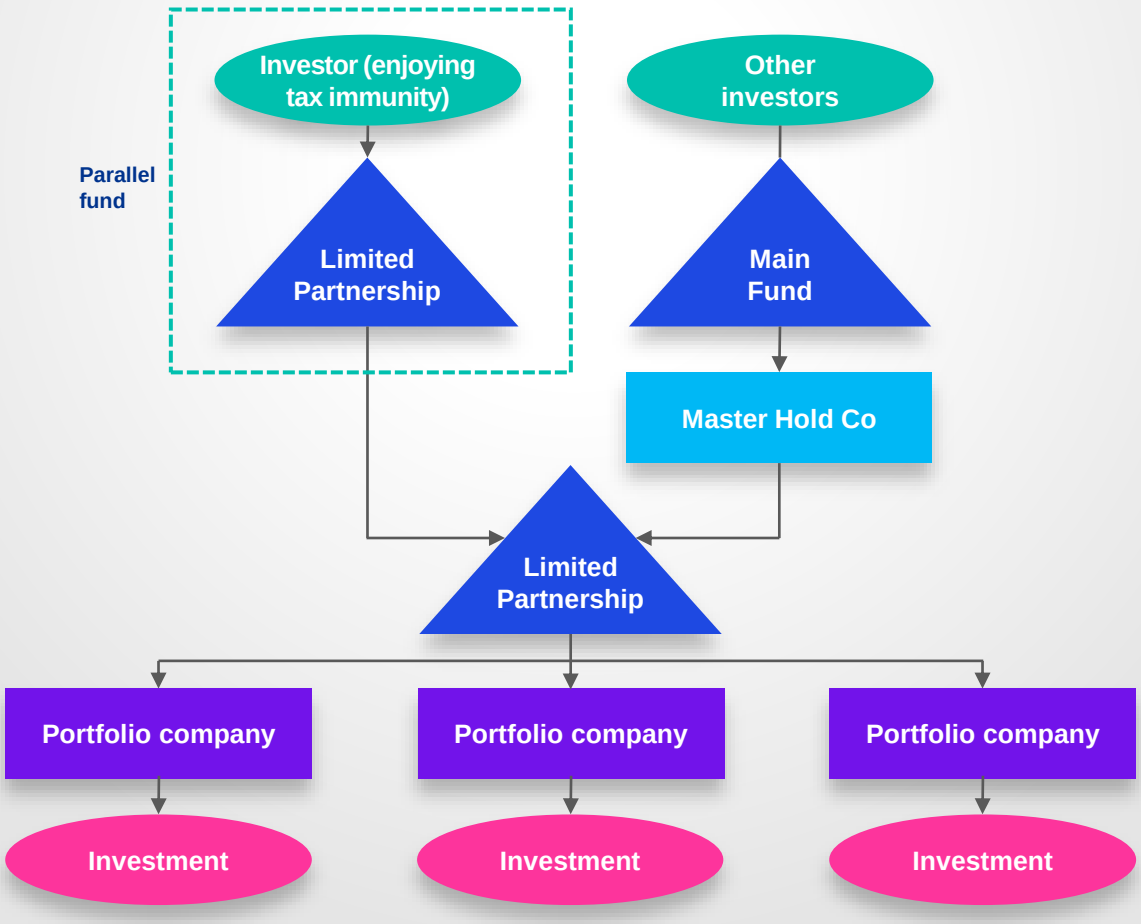


Parallel funds

Under certain circumstances, it may not be the most tax-efficient for an investor to invest directly into the main fund. For example, government entities, sovereign wealth funds and some inter-governmental organisations may, either by way of domestic/international law or tax treaties, enjoy tax immunity on income and gains derived from investee locations. For tax immunity to apply, these investors would be required to invest via a parallel fund vehicle which needs to be tax transparent from the perspective of the investee locations. Often, for legal and administrative purposes, where possible, there should also be a pooling vehicle for both the main and parallel funds. Again, the pooling vehicle needs to be tax transparent as well.

There could also be investors from a certain country that has concluded a tax treaty with the investee location that offers a more preferential treatment compared to the one that the treaty platform has entered into with. One example is the Japan-Korea treaty which offers tax-free return for a certain structure for Korean investors investing into Japan. As a result, Korean investors would often invest via a parallel fund structure in order for them to take advantage of the said benefit.

Parallel funds are sometimes required when raising capital from investors with specific and strict regulatory requirements. Perhaps the most common example would be managers who want to comply with AIFMD when raising money from EU investors. A lesser-known example involves raising money from Islamic investors such as those from the Middle East that have strict requirements to comply with Islamic laws. This group of investors can either come in via a feeder fund or a parallel fund where they would enter into some form of Islamic financing arrangement, which grants them economic interests.



The new global minimum effective tax rate (BEPS 2.0 Pillar 2)

The historic BEPS 2.0 agreement reached at the G20 Rome Summit in October 2021 has put forward one of the most significant reforms to the international tax system in over 100 years. Among others, BEPS Pillar 2, and particularly the global minimum tax rules, present significant complexity in its design, as well as excessive compliance burdens for MNE Groups and fund structures. Though doubts were once cast on whether and when this set of rules would garner global consensus and come into effect, the implementation and application of these rules are now a reality with the landmark approval of the EU Minimum Tax Directive on 15 December 2022 and a series of country tax legislation being reformed in Japan, Korea and Switzerland, with more jurisdictions to come.

BEPS Pillar 2 rules will subject thousands of MNE Groups around the world to a global minimum tax of 15%. Every jurisdiction in which the MNE Group has operations is looked at separately to see if their effective tax rate (ETR) falls under 15%. If so, then top-up tax will need to be calculated and paid. Pillar 2 rules will only apply to MNE Groups if they have revenues over EUR 750 million. In a separate set of rules, it is also intended that specified intra-group payments made to related parties and taxed below 9% may be subject to a top-up tax (STTR).

As a general rule, investment funds and REITs that are not controlled by an MNE Group and are the Ultimate Parent Entity (UPE) in their own right would likely qualify as “excluded entities” for BEPS Pillar 2 purposes. However, controlled fund entities (investments funds and REITs) in which an MNE Group owns controlling interest and consolidates the investment funds and REITs on a line-by-line basis (to the extent the EUR 750 million consolidated revenue threshold is met) could be caught under BEPS Pillar 2 rules.

Although non-portfolio dividends and equity gain income are generally exempt from BEPS Pillar 2 ETR calculations, the place of incorporation of the fund entities may be affected by BEPS Pillar 2. Fund set-ups relying on specific tax incentives are expected to be significantly impacted given the interactions between the specific tax regimes and the operations of the minimum tax rules. If this is the case, the recent process of onshoring of funds in Singapore and Hong Kong could help in raising the ETR of the group based on the potential application of the payroll-based substance-based income exclusion at the level of the Fund Management Company.

Even “excluded entities” which are active in M&A deals should consider BEPS Pillar 2 implications on a deal-by-deal basis. Although non-consolidated investment funds and REITs may be regarded as an “excluded entity” itself, their investments in Joint Ventures or Partially Owners Parent Entities (POPE), with other co-investors subject to BEPS Pillar 2, could trigger the application of the BEPS Pillar 2 rules at the level of said entities, affecting the expected returns. Hence, regular monitoring of each specific deal for BEPS Pillar 2 future implications is recommended (e.g., EUR 750 million revenue threshold, bolt-on acquisitions, anticipated M&A activity, etc.).

Setting up the Fund in a jurisdiction which does not apply BEPS Pillar 2 rules would probably not mitigate the impact of said rules. This is because the jurisdiction of the UPE of the MNE Group which owns the controlling interest and consolidates the Fund will probably collect the top-up tax through a mechanism known as the Income Inclusion Rule (IIR). In addition, whether or not the IIR applies, local governments which have implemented the Qualified Domestic Minimum Top-up Tax (QDMTT) rules in their own jurisdictions (which apply in priority to the IIR) could require the Fund’s entities established therein to pay a top-up tax where the ETR in these jurisdictions is less than 15%.

Fund structures that are caught under BEPS Pillar 2 rules are likely to give rise to tax, data and operating model challenges. Assessing BEPS Pillar 2 impacts and planning for the management of future compliance obligations is a significant undertaking.

3.0 Conclusion

Fund structuring is as much of an art as it is a science. There are numerous factors to be considered when choosing a fund structure and the domicile of its vehicles.

It is important for fund managers to bear in mind that there is no "one-size-fits-all" approach and that the tax, legal and commercial considerations would vary from fund to fund.

In addition, the location of the fund manager, the investment decision-making process and the activities carried on by the fund manager would also have an impact on the fund structure. The regulatory issues for the fund manager, and how its income and carry would be taxed, are also critical issues to be considered.

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