# Sovereign wealth fund investments in private funds: selected tax planning considerations in the US, EU and UK

Daniel A. Nelson, Kate Habershon, Kathryn W. Hambrick, Meghan E. McCarthy, Alexios S. Hadji and Grace Tan

**Abstract**

**Purpose** – *To discuss US, EU and UK tax-related issues that sovereign wealth funds should consider when investing in private funds.*

**Design/methodology/approach** – *Discusses various tax-related structuring, operational, risk-allocation, and economic matters that private funds, sovereign wealth funds and other non-US institutional investors should consider a series when evaluating potential private fund investments.*

**Findings** – *Despite the market disruption caused by the COVID-19 pandemic, sovereign wealth funds continued to make significant capital commitments to private funds in 2020 and, as the world emerges from the pandemic, are expected to make similar or greater commitments in 2021 and beyond.*

**Originality/value** – *Practical guidance from lawyers with wide experience in international tax planning and investment fund structuring.*

**Keywords** *United States of America, European Union, United Kingdom, Sovereign wealth funds, Private funds, Tax planning*

**Paper type** *Technical paper*

Despite the market disruption caused by the COVID-19 pandemic, sovereign wealth funds continued to make significant capital commitments to private funds during 2020, on a global basis. As the world emerges from the pandemic, a similar or greater level of investment activity by sovereign wealth fund investors is expected for 2021 and beyond.

When committing to invest in a private fund, a non-US investor must consider a series of tax-related structuring, operational, risk-allocation, and economic matters in order to fully appreciate the potential risks and benefits inherent in that particular private fund investment. This can be a daunting task, especially as private funds increasingly pursue global investment strategies and, consequently, implement increasingly complicated structures intended to achieve optimized tax outcomes in relation to a variety of investor profiles and taxing jurisdictions.

In this article, we focus on a handful of US, EU, and UK tax-related topics that arise in the context of a private fund investment that we believe will be of particular relevance for a sovereign wealth fund investor in the near term. Although not an exhaustive list of all tax-related aspects of a private fund investment that must be evaluated when making a commitment, we believe that the topics discussed in this update will continue to be a key focus for sovereign wealth fund investors as the market transitions from the current pandemic phase to a post-pandemic phase. While we focus on sovereign wealth fund

Daniel A. Nelson (daniel.nelson@morganlewis.com) is a partner in the Boston, Massachusetts, USA office. Kate Habershon (kate.habershon@morganlewis.com) is a partner in the London, England office. Kathryn W. Hambrick (kathryn.hambrick@morganlewis.com) is a partner in the Washington, District of Columbia, USA office; Meghan E. McCarthy (megan.mccarthy@morganlewis.com) is an associate in the Boston, Massachusetts, USA office. Alexios S. Hadji (alexios.hadji@morganlewis.com) is an associate in the Abu Dhabi office; and Grace Tan (grace.tan@morganlewis.com) is an associate in the London, England office, all at Morgan, Lewis & Bockius LLP.

investors in this article, many of our observations will be relevant to global pension fund investors and other non-US institutional investors.

## United States

In addition to having direct relevance for private funds that pursue a US-focused investment strategy, US tax considerations are present in many private fund structures that are sponsored by non-US managers or have a non-US investment focus. This is due to the fact that many fund vehicles are organized and operated as tax transparent "partnerships" for US tax purposes. Thus, even when considering an investment in a private fund that ostensibly has no US connection, it remains important to consider the US tax aspects of the private fund's structure and governing documents in order to fully understand the operation and risk profile of the investment.

### *Potential changes in US tax law – uncertain economic impact on fund investments*

As a result of the 2020 presidential and congressional elections, it has become more likely that the US will enact significant federal tax law changes in the near term. Due to pandemic-related fiscal stimulus measures and other factors, the US is currently facing fiscal pressures that will need to be addressed as the US enters the post-pandemic period. While the details of any potential tax legislation remain unclear at this time, many observers believe that the Biden administration will seek to increase the US federal corporate income tax rate as part of any comprehensive tax package. Many observers also believe that there will be a push to increase US federal tax revenues in order to fund other legislative priorities of the Biden administration (such as, for example, legislation to spur infrastructure investment). Moreover, US states, facing their own fiscal pressures, may also pursue corporate income tax rate increases.

In evaluating the expected after-tax yield of any potential private fund investment, it will be important for investors to factor in the potential impact of U.S. tax law changes. For instance, a potential increase in the US federal corporate tax rate would impact the after-tax yield for an investor in a private fund that employs US corporate blockers as part of its structure. A US corporate blocker is a tax opaque entity that a private fund interposes in its investment structure to shield non-US investors from receiving allocations of so-called "effectively connected income" from the private fund, which can trigger a US tax filing obligation and a direct tax payment obligation for non-US investors. A US corporate blocker is currently subject to a 21% US federal corporate income tax rate. An increase in that rate would have a direct impact on the effective after-tax yield that an investor would achieve in relation to the profits from the underlying investment that are subject to the US federal corporate tax at the blocker level, even if typical mitigation strategies (e.g. partial capitalization of the US corporate blocker with shareholder loans) are employed as part of the overall structure.

As a practical matter, potential increases in the US federal and state corporate income tax rates make it even more important for an investor to evaluate the manner in which a private fund intends to structure its investments in order to increase the likelihood of tax-efficient ownership and exits. For example, if a US-focused private equity fund intends to invest in US tax-transparent portfolio companies, the fund's utilization of a structure that would permit non-US investors to invest in each underlying tax-transparent portfolio company through a separate US corporate blocker that is "dedicated" to the portfolio company should increase the likelihood that the fund could structure an exit to include a sale of the US corporate blocker. Such an approach may lead to a superior economic outcome for the non-US investor, as compared to an exit transaction in which a US corporate blocker would be forced to sell its interest in the underlying portfolio company and, as a result, be fully taxable at the corporate level on the gain from the sale. As part of their investment process, investors may wish to seek informal assurances from sponsors or negotiate more formalized obligations (including covenants in limited partnership agreements or side letters) that require a sponsor to use commercially reasonable efforts to implement an investment structure that contemplates the sale of a US corporate blocker upon exit.

*US partnership audits – guarding against indirect tax costs and expenses.* As noted above, many private fund vehicles (including many established in non-US jurisdictions) will be treated as tax-transparent "partnerships" for US tax purposes. The rules that govern US federal income tax audits of tax partnerships empower the Internal Revenue Service (IRS) to assess and collect tax underpayments directly from partnerships, at the entity level. These rules permit a partnership to make elections that would require the partners, and not the partnership, to take any adjustments to tax liability into account. The rules also permit the partnership to obtain reductions in the amount of tax to be paid at the partnership level, by taking into account the tax characteristics of the partners to whom the adjustment is attributable (e.g. sovereign wealth fund or non-US partners are generally classified as tax-exempt). In their governing documents, most private funds appoint the general partner or an affiliate as the "partnership representative" and give the partnership representative broad authority to make decisions on how a US tax audit of the partnership will be handled and what elections will be made in connection with the audit.

From the perspective of a sovereign wealth fund investor, it is important to understand how these rules operate and to ensure that they are not administered in a way that is prejudicial to the investor. For example, a sovereign wealth fund investor may invest in a private equity fund that utilizes a parallel fund structure, with the parallel fund for non-US investors operated so that it would only generate income and gains that would be exempt from US tax in the hands of the sovereign wealth fund investor under Internal Revenue Code Section 892 or otherwise. The IRS could audit that partnership, propose an upward adjustment to partnership-level income, and then assert that the partnership must directly pay a tax liability related to the upward adjustment as an "imputed underpayment" (in lieu of seeking to collect any increased tax liability associated with the upward adjustment from each partner that would take a share of the adjustment into account). In this example, if the increase in partnership-level income consists of income that would be exempt in the hands of the investor (e.g. an increase in the amount of a corporate dividend stemming from a dividend recapitalization of a portfolio company, which dividend would be exempt from tax under Section 892), the investor will want the partnership representative to take advantage of procedures available under the partnership audit rules to reduce the imputed underpayment so that the investor does not indirectly bear any tax expense stemming from the upward adjustment.

In practice, sponsors and investors have been negotiating covenants in fund documents and side letters that balance the need of the sponsor to have the flexibility to handle tax audits in a way that is both commercially practical and fair to all partners with the need of the investor to ensure that it is not indirectly bearing tax costs that it should not need to bear, in light of its profile for US tax purposes, or is otherwise exposed to unacceptable administrative risks, burdens, or expenses. As discussed above, the United States faces fiscal pressures that may, together with shifts in policy, induce the IRS to increase its enforcement efforts in the partnership area. We expect that these factors will heighten the focus of both sponsors and investors on the contractual features of fund documents that address how US tax audits will be administered. Because these rules are still relatively new (as they are effective for partnership tax years beginning on or after January 1, 2018, which years are not yet being audited for many partnerships), there may be further developments in market practice once market participants gain more experience with the practical application of these rules.

*Private credit – an opportunity with tax complexity*

The market dislocations stemming from the COVID-19 pandemic have created an opportunity for private fund sponsors seeking to raise capital to pursue private credit strategies. The pace of private credit fund launches intensified in 2020, and we expect that this trend will continue in 2021 and beyond as the United States and other markets emerge from the pandemic period and business enterprises of all types revisit and revise their capital structures as part of adapting to the "new normal" of post-pandemic life.

From a US federal income tax perspective, private fund lending activities pose special challenges for non-US investors. If a private credit fund that is a tax partnership engages in lending activities that cause it to be treated as engaged in the conduct of a US trade or business, any non-US partner would generally also be treated as engaged in that US trade or business and, as a result, would incur a US federal (and potentially state or local) tax return filing obligation and would be subject to US federal (and potentially state or local) income taxation in relation to its share of the income from the lending business. Moreover, in the case of a sovereign wealth fund, such activities could cause the sovereign wealth fund to be treated as engaged in "commercial activities" for purposes of Section 892.

Because these consequences would often be unacceptable to a non-US investor, sponsors of private credit funds employ a variety of structures and approaches designed to permit non-US investors to indirectly participate in a private credit strategy on a tax efficient basis. These include so-called "season and sell" approaches, levered blocker structures, so-called "treaty fund" structures, REITs (in the case of real estate lending activities), insurance dedicated fund structures, and other approaches, sometimes in combination. Each of these structures and approaches comes with an inherent level of complexity from a US tax perspective, and sovereign wealth fund investors would typically want to examine them in detail in order to understand their practical commercial consequences and the tax risks involved with each. Despite their greater degree of structural and operational complexity as compared to a typical private equity strategy, we believe that private credit funds will remain an important part of the US private fund market in the near term, and that sponsors of these funds will continue to seek commitments from sovereign wealth fund and other non-US institutional investors.

*Secondary sales – planning ahead*

For many sovereign wealth fund investors, it is important to obtain as much flexibility as possible to dispose of interests in private funds (especially closed-end funds) through secondary sales of fund interests. In addition to commercially-driven restrictions on secondary sales typically imposed by fund sponsors, US federal income tax law may, as a process matter, create additional practical difficulties. For example, under Section 1446(f), a buyer of an interest in a tax partnership that generates "effectively connected income" is required to withhold and remit to the IRS a portion of the purchase price unless an exemption to the withholding requirement can be established. From a buyer's perspective, the preferred way to establish an exemption is to receive a certification, in a specified format, from the seller or from the partnership on which the buyer may rely. In the case of a sovereign wealth fund seller, it is not always possible for the seller itself to provide the required certification. Under some circumstances, the only available certification would need to be provided by the fund sponsor, on behalf of the fund. In order to avoid encountering a technical impediment to a future secondary sale, many sovereign wealth fund investors are requesting side letter covenants from fund sponsors that obligate the fund sponsor to provide reasonable assistance in delivering certificates that they are able to deliver, based on the facts that exist at the time of the proposed transfer.

It is also important to understand whether the governing documents of a private fund contain restrictions that could limit secondary sales, and what the practical impact of those restrictions are likely to be. For example, a fund that is treated as a tax partnership for US tax purposes will typically restrict transfers of interests in order to prevent the fund from being classified as a "publicly traded partnership". Similarly, a US real estate fund may impose transfer restrictions that are intended to protect REIT status for any REIT vehicles in the investment structure. While such restrictions are customary and serve an important protective role for all investors, a sovereign wealth fund investor that is otherwise negotiating for robust rights to make secondary transfers should not overlook the potential impact of such tax-related restrictions.

## European Union

The European Union (EU) has recently implemented considerable tax reform that member states have each been required to implement, sometimes with localized nuances. This includes implementation of many of the recommendations arising from the OECD base erosion and profit shifting project (BEPS), which have been adopted across the EU via anti-tax avoidance directives. In addition to having an impact on underlying tax expenses of portfolio investments, these rules have resulted in recent shifts in market practice for private investment funds that are established in the EU or the United Kingdom (UK), or that have their investment focus in the EU or the UK, and their relationships with their investors. Many of these changes pre-date Brexit, and consequently they tend to apply at least to some extent in the UK as well as the EU.

### *Anti-Hybrid rules*

One of the key tax reforms relates to the tax consequences of structures that include hybrid entities and/or hybrid instruments, such as partnerships that are treated as transparent in one jurisdiction but opaque in another, or a debt instrument that is regarded as deductible debt for the borrower, but as equity for the creditor. Historically European-focused funds used holding structures that regularly incorporated hybrid instruments or entities, and sponsors have had to rethink how to ensure investments are tax efficient. Investors often try to seek formal or informal comfort from sponsors that they have adapted to these changes.

In addition, the fund vehicles may themselves qualify as hybrids. This could be because there is a partnership that has "checked the box" for US tax purposes to be treated as opaque, or simply because some investors treat a fund vehicle in a different way from the treatment in the fund's (or a portfolio company's) jurisdiction. The use of such hybrids can cause portfolio companies to suffer additional taxes. As a result it has become common practice for sponsors in European or European-focused funds to require investors to provide information on how they would treat certain vehicles and/or instruments for tax purposes. This information enables fund vehicles and portfolio companies in Europe to assess the extent to which any such hybrids may have an adverse impact on their own tax position (such as denying a tax deduction for payments made to some hybrid vehicles). Failure to provide this information may result in various remedial measures, including associated costs being passed to the relevant investor. One of the reasons for this is that in some jurisdictions, including The Netherlands and Denmark, and to some extent the UK, a portfolio company may be required to assume that there is a hybrid in a structure if it is unable to determine with certainty that there is not, and thus suffer additional taxes. Investors, therefore, need to become more sophisticated about understanding how their jurisdictions treat various types of vehicles, which for investors that are tax exempt can be a novel and sometimes challenging experience.

Another aspect of these rules is that typically (although not always) if the ultimate investor is tax exempt, there is minimal risk under the hybrid rules. It is becoming increasingly common for sponsors to pass on hybrids costs to the investor the characteristics or jurisdiction of which triggers such costs (in addition to passing on costs for investors who fail accurately to provide information). For a tax-exempt investor, it is generally in the investor's interest to encourage such position, to cover costs that may be caused by other non-tax exempt investors.

### *Reliance on treaties*

Another aspect of the anti-tax avoidance directives is that it is becoming increasingly hard for structures to rely on double tax treaties – this tends to be an issue across a much wider range of jurisdictions than just Europe. Although historically reliance on treaties took place within the fund structure itself (for example, between a holding vehicle and a portfolio company), this is increasingly challenging, and there may be situations where the investor may need to rely on treaties itself to minimize withholding taxes. Investors may also seek information confirmation from sponsors that their structures will be tax efficient and will not result in tax leakage for the investor.

### *Dac 6*

The EU also recently implemented a rule requiring mandatory disclosure of certain "tax schemes" to their tax authority. Where disclosures are required, considerable detail may be provided and in some cases this may include the names of investors. The goal of these rules is to provide tax authorities with early information on aggressive tax planning being adopted, although in practice the rules can be much wider. Although the information disclosed should not in any case be made public, and for non-European entities there should be no immediate associated tax costs, many investors are sensitive to their details being provided to tax authorities as parties to tax aggressive planning. Investors may prefer to be notified if the sponsor is expecting that the name of the investor will be provided in any report made under DAC 6.

## The United Kingdom

The issues described above also apply to funds that are established in, or have an investment focus in, the UK

In addition, the UK recently introduced (in the Criminal Finances Act) a corporate criminal offence of failing to prevent the facilitation of tax evasion. The offence may be committed if an employee or associate of a business facilitates tax evasion by a third party. The sole defense is that the business has in place, and adheres to, an appropriate policy to prevent such facilitation. The rules are fairly broad, and where a non-UK entity has another business that is acting on its behalf in the UK, such as investment manager with authority to make fund investments on behalf of a fund and its investors, there is some risk that the UK person could bring the non-UK entity within the scope of the UK corporate criminal offence. As investment managers are regulated in the UK, and tend to take this offence seriously, the risk is low, but nevertheless investors may seek formal or informal comfort that the GP and/or investment manager have suitable policies in place to ensure that they do not fail to prevent facilitation of tax evasion.


## Corresponding author

Daniel A. Nelson can be contacted at: daniel.nelson@morganlewis.com