29 August, 2013

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Master Thesis

LL.M International and European Tax Law

Number of words: 31 722

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TAX OBSTACLES TO CROSS-BORDER INVESTMENTS THROUGH PRIVATE EQUITY INVESTMENT FUNDS

Table of Contents

I. Introduction

In recent decades, investment funds have grown in importance, especially, private equity funds. Today many European small and medium enterprises (SMEs) struggle in raising money for their activities and growth. As highlighted by the European Commission, the tightening of credit conditions during the crisis has made access to finance difficult, especially for SMEs[1]. Under current conditions private equity and venture capital are the main sources which can help to address needs of SMEs and contribute to their development. SMEs in turn can generate economic growth, create new jobs and contribute to the design and use of new knowledge and technology. For these reasons, private equity and venture capital investment plays a significant role in strengthening the economy in Europe and should be nurtured and paid the necessary level of attention.

Unfortunately, to this day, the European private equity and venture capital market still operates below its potential. The economic crisis has clearly produced an adverse effect on the private equity market in Europe. Overall fundraising of private equity vehicles in the EU decreased in 2012 by 43% to EUR 23.6 bn compared to 2011. Overall investment in European companies also decreased: EUR 6.5 bn was invested in European companies in 2012 with a decrease of 19% compared to the previous year.[2]

The fiscal environment is a very important factor which can reduce or reinforce the growth of the private equity and venture capital industry. As investment funds typically invest in a basket of worldwide companies, different tax issues may arise because of the interaction between the taxing jurisdictions of the states involved, i.e. the country of the establishment of the fund, the country of the target companies and the country of the investors. In order to ensure the development of the private equity investment sector, the main tax obstacles should be identified and appropriate solutions should be found.

Starting with the general introductory analysis concerning the nature of the activities of the private equity funds and the types of private equity funds in chapter I of this thesis, the author will further compare the tax treatment of private equity funds taking one of the most popular investment fund jurisdictions, i.e. Luxembourg and Ireland, as examples. In the next step in chapter III the author will focus on the problems of tax treaty entitlement of private equity investment funds which is necessary for the identification of the main tax obstacles to cross-border private equity investments. In chapter IV the author will analyze the major research questions by pointing out the most important tax obstacles to cross-border private equity

[1]COM(2011) 642 final, Communication from the Commission to the European Parliament, the Council, the European economic and social Committee and the Committee of the regions, p.11;
[2]Source: EVCA/PEREP_Analytics (http://www.evca.eu/knowledgecenter/statisticsdetail.aspx?id=416). Last visited on 28 August 2013;

investments. In particular, the author will stress the issue of unrelieved double taxation caused by different classification of the private equity investment fund vehicle by different states and by the risk of creation of a permanent establishment of the investors in the country of the fund and of the fund or the investors in the country of the target company. In addition, the author will analyze the obstacles faced by the investors of a tax transparent fund when trying to get a tax credit for the tax withheld in the country of the target company. Finally, in the last chapter the author will elaborate the current hottest topic of the alternative fund industry – the recent implementation of the Alternative Investment Fund Managers Directive which is aimed to achieve a harmonization for managers of alternative investment funds and clearly has a crucial impact on private equity industry. Although the Directive does not directly regulate tax issues of alternative investment funds, the author will show what tax implications the Directive has and how certain countries address them in their domestic laws.

Based on the performed analysis, the author will draw conclusions and provide for possible solutions to the identified obstacles.

II. Private equity investment funds and their tax treatment

2.1 Background

2.1.1 Definition and advantages of private equity investment funds

Investment funds are financial intermediaries which collect money from investors who may be individuals or corporations, pool them together and invest money in a spread of investments with the purpose of achieving capital growth and gaining income for investors.

Investors, especially in developed economies, find it more advantageous to invest their money indirectly, i.e. structuring their investment through collective investment vehicles, rather than directly purchase shares in the target companies. Many factors make funds an attractive vehicle from the investor's point of view as compared to a direct investment, in particular:

- Facilitation of investments. It may be difficult for the investor to choose the right target for investment because of the lack of the necessary expertise, time and resources. That is why it is easier to delegate the task of selecting and managing investments to professional investment fund managers.
- Risk spreading which is reached by the diversification of investments made by the fund. An average investor can usually afford to invest only a modest amount of money. So, it would be difficult for him to buy a holding in several companies directly. Investing money via fund allows the investor to become a shareholder in different companies. Holding shares of many companies eliminates the risk of losing all investor's money in comparison to direct investments in case of bankruptcy of one of the target companies and lowers risk in relation to return.
- Reduction of costs for the investors ("economies of scale"). The investor's transaction costs on small purchases or sales of shares are typically much higher as a percentage of the value of each transaction than those for the fund dealing in large quantities.

All above mentioned is of course applicable to private equity investment funds.

2.1.2 Regulation of private equity investment funds

However, in order to understand particularities of this type of funds, it is important to distinguish undertakings for collective investments in transferrable securities (UCITS) from other undertakings for collective investments (UCI) which are known as alternative investment funds (AIFs).

A UCITS fund is a European product regulated by the Directive 2009/65/EC[3] (known as the UCITS IV Directive). The objective of the UCITS IV Directive is to allow for open-ended funds investing in transferable securities to be subject to the same regulation in every Member State facilitating the cross-border offer of the funds and contributing to the establishment of the single investment fund market as part of the single financial market in Europe. For these purposes, the UCITS IV Directive requires UCITS to have a European "passport" in order to be marketable throughout the EU. The regulation of UCITS is based on "one-license principle" meaning that UCITS that are authorized in one Member State may market their units in another Member State without having to apply for the authorization in the latter.

AIFs, being alternatives to UCITS, in particular, include real estate, hedge and private equity investment funds, the latter of which represents the subject of this thesis. Alternative investment fund can be defined as a vehicle for joint investment that (i) collects capital from a number of investors in order to invest such capital according to a certain strategy for the investors' benefit; (ii) does not operate a business outside the finance sector; and (iii) does not qualify as UCITS. Such structures as holding companies and securitization vehicles can be explicitly excluded from the AIF definition.

In comparison to UCITS, AIFs are not regulated by the UCITS IV Directive, they do not need to have a European passport and hence cannot be freely marketed throughout the EU. In contrast to UCITS, there is no harmonization for AIFs within the EU: at one extreme, there are countries that adopt a specific legislation for AIFs that regulates, in particular, legal forms of the funds, rights of the investors and introduces special tax regimes. At the other extreme, some countries leave to the funds the opportunity of choosing their legal form and the terms under which the relation with their investors is established.

The fact that AIFs are less regulated than UCITS or even excluded by the legislator from regulation can be explained by the reason that they actually do not need a high level of regulation. Unlike UCITS, AIFs do not deal with the general investing public, attracting only certain qualifying investors such as wealthy individuals and/or investment institutions. The nature of their activities requires maximum structuring flexibility and a limited disclosure. Nowadays regulation of AIFs at the EU level is achieved only at the level of the fund managers through the Directive on the regulation of alternative investment fund managers (AIFMD)[4]. This aspect will be developed further in chapter V of the present thesis.

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[3]Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS);

[4]Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No.1060/2009 and (EU) No.1095/2010;

A private equity fund can be defined as a form of equity investment into private companies that are not quoted on a stock exchange. Private equity is distinguished by its active investment model, in which it seeks to deliver operational improvements in its companies, over several years[5].

Private equity funds differ from UCITS with regard to the types of investors, the types of investments and their business strategy. Usually private equity funds are reserved to well-informed investors (i.e. institutional investors, professional investors and any other qualified investors) whereas investors of UCITS can include the full spectrum of investor types. As far as types of investments are concerned, private equity funds may invest in any type of assets whereas investments of UCITS funds shall only comprise of transferable securities and money market instruments admitted to or dealt on a regulated market, of units of authorized UCITS or other collective investment undertakings and of deposits with credit institutions and financial derivative instruments.[6.] Business strategy of UCITS is aimed at investment to highly profitable particular types of assets mentioned above in order to distribute the income to investors afterwards or re-purchase or redeem the units at the investors' request. Private equity investment fund strategy, however, in most cases is aimed to foster growth and create additional value in the target company, for instance, through development of new products and technologies, expansion of working capital, taking an existing product into new market, resolution of ownership and management issues with the final objective to sell the target company after a few years for a higher price, and to generate profit for the fund's investors.

In addition, it is important to mention that UCITS funds are open-ended funds while private equity funds can be open-ended and closed-ended. An open-ended fund is where the amount of share capital is variable whereas the amount of share capital of the closed-ended fund is fixed. Open-ended fund in comparison with closed-ended is typically required to repurchase its shares or units at the request of the investor.[7]

2.1.3 Types of private equity investment funds

Private equity funds can be categorized into the following types:

- Leveraged buyout funds: traditionally they acquire control positions (through majority ownership and board representation) in mature underperforming or undervalued companies. Buyout funds have typically sought to leverage their equity investment with debt financing, and accordingly are more

[5]http://evca.eu/what-is-private-equity/. Last visited on 28 August 2013;
[6]Article 50 of the UCITS IV Directive;
[7]IBFD International Tax Glossary, 6th Edition, Julie Rogers-Glabush, August 2009;

concerned with the ability of a company to generate stable cash flows (which can be used to service the debt) than are venture capital funds;

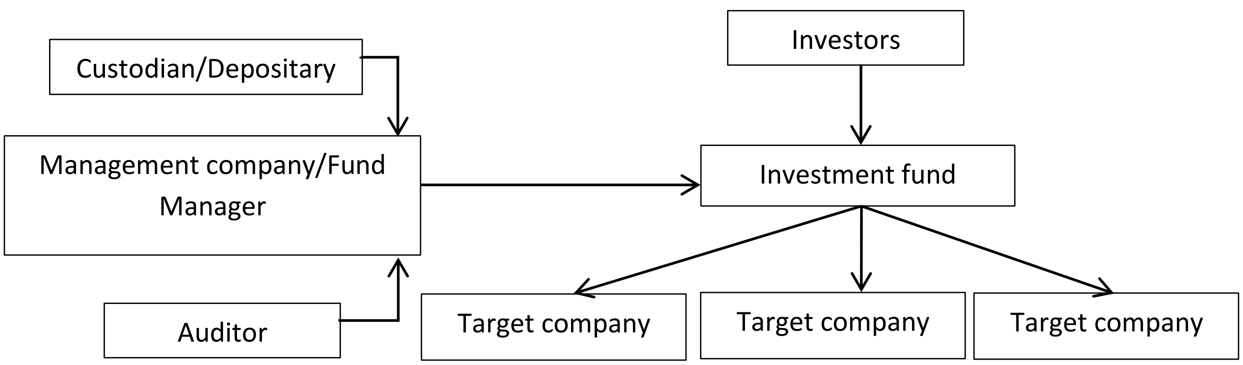
- Venture capital funds: traditionally they acquire minority stakes in relatively young or start-up private companies with a potential of growth that are typically driven by technological innovation and provide both equity capital and management skills. It is common for a venture capital fund to require as a condition to its investment that it receives seats on the board of directors of a target company, which are useful both for providing management expertise and for monitoring the investment;
- Growth equity funds: they invest in later-stage, pre-IPO companies or in PIPE transactions with public companies.

Private equity funds can invest in different companies irrespective of their size; however, most target companies for private equity investments are SMEs: nowadays around 83% of private equity investments are made into SMEs.[8]

2.1.4 Organizational model of a private equity investment fund

Private equity investment funds in most cases do not have employees as they delegate various functions to different service providers. Below is presented the classic simple structure of a private equity investment fund (see picture 1).

Picture 1.



Investors and Investment fund

Investors are individuals or corporations which commit their money to the investment fund. In exchange for their investments, investors receive units or shares of the fund representing the fraction of the total assets. Investors are entitled to income generated by the fund in the form of periodic distributions (dividends) or in the form of capital gains from the alienation of the fund's assets.

[8]Source: EVCA/PEREP_Analytics (2012) (http://evca.eu/wp-content/uploads/2012/07/EVCAs-Little-book-of-Private-Equity.pdf). Last visited on 28 August 2013;

The investment fund simply consists of the financial assets acquired by the fund with the funds received from the investors, together with possible cash reserves.

Management company/Fund manager

The management company/fund manager is the entity or a person that usually causes the fund to be created so it usually performs the functions of the promoter or initiator of the fund.

The managing of the fund can be performed either by an external manager, which is a management company or by the fund itself where its legal form permits an internal management and where the investors choose not to appoint an external management company. For example, Luxembourg SICAVs and SICAFs established in corporate form must either appoint a management company or designate itself as a self-managed investment company. However, private equity funds established in transparent forms, such as, for instance, Irish unit trusts and CCFs, are required to appoint an external management company.

A management company is the entity managing private equity fund as a regular business, which raise capital from a number of investors with a view to investing that capital for the benefit of those investors in accordance with a defined investment policy.[9] In practice management companies often administer several investment funds. The management company acts under the service contract signed with the investors. In case of internal management the fund usually employs the management team – individuals who have a respective expertise.

The nature of the management company's/fund manager's activities usually includes (i) servicing the fund's investors by defining investment objectives and strategies, carrying on research, investment analysis, identification and evaluation of potential investment opportunities, portfolio selection, executing investment transactions and (ii) administration activities including fund evaluation and pricing, operating accounts of the fund including income received and gains or losses realized, liaison with custodian and auditor. For these services, the management company is paid a management fee.

The employees of the management company/fund managers usually also receive an incentive fee based on the performance of the fund, known as the carried interest. Carried interest allows employees of the fund's management companies or the fund's internal managers to share in the profit generated by the fund's investments.[10]

[9]Par.6 of the Preamble to AIFMD;
[10]IBFD International Tax Glossary, 6th Edition, Julie Rogers-Glabush, August 2009;

Very often in addition to management services the management company acts as the fund's investment adviser providing the fund and target companies with consultancy services under an investment advisory agreement. For such services the management company receives additional fees.

Custodian (depositary)

Custodian is responsible for the supervision of the assets of the fund. This includes safekeeping of the fund's assets and the day-to-day administration of the assets based on instructions received from the management company/fund manager unless they conflict with the constitutional documents. In a dematerialized system (where the units ownership is recorded in electronic form) the fund's assets are registered in the nominal ownership of the depository and in a materialized system (where units ownership is recorded by a paper-based certificate and/or registers) the certificates are physically held by the custodian, so in both cases the management company is unable to buy or sell assets without the depositary's approval or cooperation. This is designed to prevent theft of fund assets by the management company or by the directors of the fund. For its services the depository charges a fee based on a percentage of the fund's average net assets.

It is important to mention that the recently introduced AIFMD requires managers to appoint independent depositaries for each AIF.[11] Among the key responsibilities of the depositary highlighted by the AIFMD are ownership verification and record keeping, cash flow monitoring and oversight duties. This requirement will influence the private equity fund industry because before the AIFMD custodians have not been used extensively. Only some jurisdictions, for example Luxembourg, were already familiar with the depository concept for its private equity funds, while this is a new constraint for fund managers in other member states such as the Netherlands, Cyprus and Ireland. Therefore, a selection process for a suitable depositary supported by appropriate due diligence procedures will be required for the private equity funds in the nearest future which may result in additional costs.

Auditor

Most jurisdictions including, for example, Luxembourg, Cyprus and Ireland, require an annual fund audit to be undertaken by independent and qualified auditors. Audit standards are set by domestic accounting standards. As the funds' operations are not comparable with ordinary companies, special accounting standards are usually set for the funds.

[11] Article 21 of the AIFMD;

2.1.5 Analysis of the functions performed by the investors, the fund and the management company/fund manager

Distinction of the functions performed by the investors, the fund itself and the management company deserves a special attention since it has a crucial impact on further analyzed issues such as treaty entitlement of the fund (see section III of this thesis) and creation of a permanent establishment of the investors or the fund in the country of the target company and of the investors in the country of the fund (see section IV of this thesis). Although these aspects will be considered further in the respective sections in more details, it is important to have an initial understanding of the nature and the extent of rights and obligations of the fund, the investors and the management company/fund manager.

As it was mentioned in section 2.1.4 of this chapter there are two possible management models for the private equity investment funds: external management performed by a management company or internal management performed by the internal manager employed by the fund.

In the situation of the internal management, it can be clearly said that the functions of the fund manager, described in section 2.1.4 of the present thesis, represent the functions of the fund itself. It can be concluded that in this case the fund carries on business activity by itself.

The situation of the external management is not so straightforward and raises uncertainty in practice.

From the one point of view it can be argued that the management company acts on behalf of the investors and the fund under the contract and, consequently, the management company's functions originally come from the investor's and the fund's functions. Such reasoning leads to the conclusion that the activities of the investors and the fund go beyond pure passive investment activities but represent active management which is delegated to the external management company. This approach brings potential risks of creation of a permanent establishment of the investors or the fund in the country of the target company (see section 4.2.1 of the present thesis for more details).

Another point of view which is supported by the author is that the role and the business of the management company are different from the roles and the businesses of the fund and its investors. The fund or the fund's investors themselves do not carry out management activity, they do not have day-to-day control over the operation of the management company. The investors simply invest their money into the fund and the fund is merely used for passive investments generating solely passive income (i.e. dividends, interest or capital gains), i.e. their activity is not commercially oriented. The fund itself also does not carry on any activity and is used just as a vehicle to facilitate the investments. Whereas the management company carries out its own independent business; the employees of the management company but not the investors or employees of the fund have sufficient expertise in investment field. An agreement between the management company and the investors or the fund typically confer broad powers on the management company, e.g. to enter into transactions in accordance with its investment objects. Consequently, the management company has rights, obligations and powers to make decisions on investment and distribution strategy of the fund.

Taking a position under which the nature of the management company's activity does not constitute the activity of the fund or the fund investors, it can be concluded that neither the fund nor its investors carry on any business activity. As a result there will be no risks of creation of a permanent establishment of the fund or the investors in the country of the target company as well as of the investors in the country of the fund (see section IV of the present thesis for more details).

The question of attribution of the management active functions to the investors and the fund or to the management company has impact on the concept of "enterprise" which is very important for the determination of the existence of a permanent establishment (see section IV of the present thesis for more details).

According to article 3 (1) (c) of the OECD Model Tax Convention with respect to taxes on income and capital (OECD MTC) the term "enterprise" applies to the carrying on of any business. The question that arises in this respect is whether the pure investment activity of the investors or the fund can be considered as "business". The OECD MTC does not include an exhaustive definition of the term "business" defining it as the performance of professional services and of other activities of an independent character.[12] Taking into account this broad definition, one can make a conclusion that based on article 3 (2) of the OECD MTC the definition can have the meaning that it has at that time under the domestic law of the country for tax purposes. This approach may lead to the result that the state applying the double tax treaty will consider the passive investment by the investors as a business with the consequence of the existence of an enterprise. Provided other conditions for a permanent establishment stipulated by article 5 (1) of the OECD MTC are met, the state may consider the creation of a permanent establishment of the investors in the fund's country (see section 4.2.2 of the present thesis for more details).

[12]Article 3(1)(h) of the OECD MTC;

However, the author does not share such a very broad approach and takes a position that the reference to the domestic law definition of a "business" is not allowed since the context of the double tax treaty requires otherwise.[13] In the author's opinion, a pure investment activity of the investor and passive role of the fund shall be distinguished from the business activity because the investor and the fund do not try to influence the income actively. This conclusion is in line with the IFA General Report on taxation of investment funds[14] which states that the purpose test shall be applied: as long as an investment activity does not become, for example, a trade or business, i.e. so long as the purpose or the intent remains to receive the income and the capital gains, the investor's activity cannot be considered as "business". Thus, in the author's opinion, there can be no enterprise neither at the level of the fund nor at the level of the investors. As a result there are no grounds for having a permanent establishment within the meaning of article 5(1) of the OECD MTC.

The approach which acknowledges pure investment passive nature of the investors' and the fund's activities, however, brings certain complications to the recognition of the fund as a "beneficial owner" (see section 3.1.3 of the present thesis for more details).

2.2 Tax treatment of private equity investment funds

2.2.1 Taxes payable by private equity investment funds

The main forms of taxes which can be payable by funds internationally are:

- Taxes on income – payable on any income of the fund, for example, on dividends received from target companies;

- Taxes on capital gains – levied on any profit made on the sale of assets held by the fund;

- Net worth taxes – levied on the capital owned by an enterprise or on business assets or equity. Funds are usually exempt from net worth taxes as the case in Luxembourg and in Ireland, for example;

- Registration duties – may be levied in respect of a variety of transactions, including, in particular, formation, an increase in capital by the contribution of assets and transfers of registered office or place of effective management. They are usually insignificant and do not put a heavy burden on funds;

- Subscription taxes – annual or quarterly taxes imposed on net assets of the fund.

[13]Article 3(2) of the OECD MTC;
[14]IFA Cahiers 1997 - Vol. 82b, *The taxation of investment funds - General Report*, L. J. Ed and Dr. Paul J. M. Bongaarts;

2.2.2 Ideal jurisdiction for establishing private equity investment fund

The taxation of funds is a key issue for the funds and their management companies because it affects the attractiveness of funds compared with direct investment or other forms of investment.

When developing an investment strategy, it is important to think about the proper investment structure from the very beginning so that when and if income from target companies is received or capital gain from the sale of target companies' shares is made in the future, investors will not be faced with a heavy tax burden.

Theoretically, a fund may be liable to pay tax on income or gains received from its target companies. Taking into account that this income is usually taxed at the level of the target companies, and then on distribution of income or gains by the target companies to the fund and by the fund to the fund's investors and then, in addition, the investors themselves may have taxation liabilities on their fund returns, in theory there may be several levels of taxation applied on returns received by fund investors. Whereas only two or maximum three would usually apply to a person holding shares directly in a company instead of through a fund (at the level of the company, in the hands of the shareholder and possibly on distribution of income to the shareholder). In such theoretical situation it is clear that an investor via the fund could be worse off.

To avoid this kind of problem many jurisdictions internationally accept and apply the concept of tax neutrality of the fund which means that the investor should be in a position of paying the same or not exceeding amount of tax as if he had purchased the underlying asset of the fund directly.

Such tax neutrality, depending on the legislation of a particular jurisdiction, can be achieved, for instance, either through treatment of the fund as tax transparent or by providing the fund with tax incentives such as exemption from taxation both at source (no withholding tax) and at residence (no corporate income tax). The idea behind both approaches is that fund itself suffers no tax, since this would interpose an additional level of taxation between the assets held by the fund and the returns of the investors, compared to a direct holder of those assets.

Since investors are interested in getting as much profits as possible, when developing their investment structures, they pursue the aim to find a jurisdiction which will generally, due to its basic tax characteristics, allow low or zero corporation tax on the capital gain or dividends realized by the fund and also for low or zero dividend withholding tax upon onward distribution of dividends to the investors. In case the domestic legislation of the country where the fund is established does not provide for such tax neutral treatment, the tax treaty network of the fund's jurisdiction can be of paramount importance in eliminating or at least lowering the tax burden.

It should be clear that it is not beneficial to establish the fund in a tax haven location (such as, for example, British Virgin Islands, Guernsey, Bahamas, Bermuda or Cayman Islands) since there are usually no tax treaties signed with such jurisdictions. It is true that offshore jurisdictions have always played an essential role in the world of investment funds. This is mainly because of such features as simple regulation, anonymity and no or very low taxation. However, during the past years, particular attention has been paid to offshore domiciles with the result of publication of such important reports aiming to regulate offshore centers as the OECD Harmful Tax Competition report and the EU Code of Conduct in 1998, the EU Savings Directive in 2003[15] and the recent OECD Base Erosion and Profit Shifting (BEPS) report in 2013. These initiatives as well as greater focus on money laundering have made the use of onshore, rather than offshore domiciles, more attractive than they used to be.

The conclusion on what is the best jurisdiction to establish the fund should not be made based only on tax implication analysis. Such aspects as legal certainty and practical experience should also be taken into account. It is not advisable to establish a fund in the jurisdiction where new tax laws were introduced. This may result in the risk that tax authorities will take a different approach on key issues than the tax advisers. It is always recommendable to analyze if tax authorities are comfortable with the funds in this jurisdiction, what is their position in respect of the application of the treaty benefits to the funds (i.e. if they test the fund's substance and its title to the income under the "beneficial ownership test", if they are willing to issue advance tax rulings on the major issues, so a taxpayer can rely, at least for an initial number of years, on a given tax treatment). It can be safely assumed that if a jurisdiction is often used as a fund jurisdiction and this location has been tested by hundreds of international tax advisers and found to be in order.

Luxembourg, Ireland, The Netherlands, Cyprus, Switzerland, Malta, the US and several other jurisdictions compete with each other and promote themselves as the locations of choice for the establishment of private equity and venture capital investment funds.

In the present thesis the author will focus on Luxembourg and Ireland. As an international alternative fund domiciles, these jurisdictions rank amongst the most flexible and advantageous onshore jurisdictions due to the wide variety of investment fund vehicles that may be established under their regulatory system and the beneficial tax regimes available for these vehicles. Moreover, a developed national infrastructure, a highly

[15]Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments;

competent and skilled workforce, political stability, and most importantly, a willingness on the side of the regulatory and tax authorities to adapt and develop regulations to keep pace with international developments, makes Luxembourg and Ireland competitive jurisdictions for establishment of funds. By the end of the first quarter of 2013 there were over 3500 private equity fund vehicles in Luxembourg, with net assets of approximately 720 billion Euros.[16] Whereas Irish private equity fund industry comprised more than 2000 private equity funds with approximately 280 billion Euros in net assets for the same period.[17]

2.2.3 Luxembourg as a private equity investment fund jurisdiction

Although over the last 20 years Luxembourg has built up its position as the most popular domicile for undertakings for UCITS[18], it has also developed a strong track record in alternative investment products and bespoke investment structures such as, in particular, private equity vehicles.

In Luxembourg non-UCITS investment funds, including private equity investment funds, can be set up either:

- under the part II of the law of 17 December 2010 on Undertakings for Collective Investment (the "Part II UCI Law"); or
- under the law of 13 February 2007 on specialized investment funds (the "SIF Law"); or
- under the law of 15 June 2004, which has been amended on 24 October 2008 (the "SICAR Law").

All private equity investment funds established under one of the above mentioned laws are authorized and supervised by the Commission for the Supervision of the Financial Sector (*Commission de Surveillance du Secteur Financier* - CSSF).

2.2.3.1 The Part II UCI Law and the CIF Law

The main differences between the funds established under the Part II UCI Law and the SIF Law relate to (i) the type of investors and (ii) the intention to raise capital from the public. Any types of investors are admitted to a Part II UCI whereas a SIF may only be invested by one or more well-informed investors, as

[16]Data of the Association of the Luxembourg Fund Industry (http://www.alfi.lu//sites/alfi.lu/files/files/Statistics/Luxembourg/L2%20Investment%20class%20distribution%20EN%20FIG%2002%20&%2003.pdf). Last visited on 28 August 2013;
[17]Data of the Irish Fund Industry Association (http://www.irishfunds.ie/fs/doc/statistics/2013-q1-5-fact-sheet.pdf). Last visited on 28 August 2013;
[18]Luxembourg was the first EU member state to implement the UCITS IV Directive by the law dated 17 December 2010;

defined under the SIF Law.[19] A Part II UCI must have the intention to raise capital from the public via public offering – independently of the type of investor it targets and independently of whether or not it will succeed in raising capital from the public. Conversely, it is not allowed for a SIF to raise capital from the public. Luxembourg law does not explicitly define the notion of "public offering", however, it is generally considered that units placed within the group of investors with fewer than 20 persons does not constitute a public offering.[20] That is why it is clear that private equity funds established under the SIF Law are more popular in Luxembourg in comparison to a Part II UCIs: at the end of March 2013 SIFs represented nearly 40% of the total market, there were registered 1505 funds under the SIF Law whereas only543 under the UCI Law.[21] The advantage of funds established under the SIF Law in comparison to other UCIs is that they benefit from a greater flexibility as far as their regulatory regime (for example, there are no limits on leverage or on the types of eligible investments) and especially their investment policy is concerned.

Private equity funds in Luxembourg under both regimes (the Part II UCI Law and the SIF Law) can be set up in a contractual form (FCP - *fonds commun de placement*) or in the form of investment companies (SICAV - an investment company with variable capital (*société d'investissement à capital variable)* or SICAF - an investment company with fixed capital (*société d'investissement à capital fixe*)).

FCP is a contractual co-ownership scheme without legal personality. The investors are unit holders who are liable up to the amount contributed by them to the FCP. The management company of the FCP has to draw up the management regulations of the FCP and the unit holders are deemed to accept the provisions of the management regulations by acquiring units of the FCP. Except as otherwise provided for in the management regulations, unit holders do not have any decision-making powers.

SICAV and SICAF are governed by the Act of 10th August 1915 on Commercial Companies in addition to the Part II UCI Law or the SIF Law insofar as no specific derogations from the provisions of the Companies Act are provided by the specific Part II UCI Law or SIF Law. The SICAF differs from the SICAV as it adopts the fixed capital structure instead of the variable capital structure. SICAV is a company whose capital is always equal to its net assets; no formalities are required to increases and decreases in

[19]"Informed investors" are institutional investors, professional investors and other types of investors who have declared in writing that they are informed investors, and either of the following: (i) invest a minimum of EUR 125,000; or (ii) have an appraisal from the bank, an investment firm or a management company (all of these with a European passport) certifying that they have the appropriate expertise, experience and knowledge to adequately understand the investment made in the fund (article 2 of the SIF Law);

[20]J. Fisch, P. Goebel and P. Berna, Luxembourg - Investment Funds & Private Equity, Topical Analyses IBFD, 2013;

[21]Data of the Association of the Luxembourg Fund Industry (ttp://www.alfi.lu/sites/alfi.lu/files/files/Statistics/Miscelleaneous/Annual%20Reports/Stats-ALFI-AR-2012-13.pdf). Last visited on 28 August 2013;

capital. SICAF's share capital corresponds to the funds it received upon incorporation and can only be increased or decreased by way of a formal decision of a general meeting of shareholders.

A Part II UCI adopting the variable capital structure (SICAV) may only be organized as a joint stock company (SA- *Societe Anonyme*). If a Part II UCI adopts the fixed capital structure (SICAF), it can adopt any legal form available under Luxembourg law.

A SIF adopting the SICAV structure may be organized as an SA, a corporate partnership limited by shares (SCA - *société en commandite par actions*), a private limited liability company (Sàrl - *société à responsabilité limitée*) or cooperative company in the form of a public limited company (SCoSA - *société coopérative organisée sous la forme d'une société anonyme*). If a SIF adopts the fixed capital structure (SICAF), it can adopt any legal form available under Luxembourg law, including the limited partnerships (common limited partnership SCS or special limited partnership SCSp - *société en commandite simple*).

The legal form of the fund is of a high importance for the purposes of their tax treatment and double tax treaty entitlement. This aspect will be developed further in this chapter and in chapter III of this thesis.

2.2.3.2 The SICAR Law

Another fund regime which represents an alternative to the classic vehicles described above is the SICAR regime. Under this regime which was introduced only in 2004 the SICAR entity can be established (investment company in risk capital - *société d'investissement en capital à risque*).

The SICAR regime deserves a special attention since by enacting the SICAR Law, the Luxembourg legislator aimed to create a specific legal framework promoting the development of private equity and venture capital in the EU which would allow flexible structuring possibilities and would ensure tax neutrality. The SICAR regime did not replace any of the existing regimes but merely closed the gap by delivering a tailored private equity and venture capital investment vehicle aimed at both the domestic and international qualified investor base. The Luxembourg SICAR regime distinguishes itself from other venture capital and private equity regimes in that the SICAR assets must be entrusted to a Luxembourg established depository bank. The legislator thereby clearly aimed at a higher investor protection standard.[22]

According to the SICAR Law, a SICAR may solely invest in risk-bearing values. The SICAR Law remains silent on the concept of "risk capital". It merely states that "risk capital investment" means the (direct or

[22]Article 8 of the SICAR Law;

indirect) investment in entities in view of their launch, development or initial public offering. The absence of a precise legal definition of the concept of "risk capital" was designed to allow for sufficient flexibility and to avoid over-restricting the type of assets or investments that could a priori be eligible for a SICAR.

SICARs may be formed as a joint stock company (SA), a corporate partnership limited by shares (SCA), a private limited liability company (Sàrl), cooperative company in the form of a public limited company (SCoSA) or a limited partnership (SCS or SCSp).

2.2.3.3 The new Luxembourg partnership SCSp

SCSp deserves a special attention as this new fund vehicle was introduced very recently – from 15th July 2013. Luxembourg decided to introduce it as one of the incentives adopted within the implementation process of the AIFMD with the aim of attracting migrating funds onshore. This special vehicle was designed based on the Anglo-Saxon limited partnerships model. To date, Anglo-Saxon limited partnerships are considered as the best vehicles for gathering investors and structuring the carried interest and management fees. Anglo-Saxon limited partnerships provide for flexibility, confidentiality, limited investor liability and tax transparency. They are also subject to few regulations and benefit from light reporting requirements and obligations, which explains their success in the fund management industry.

Luxembourg limited partnership (SCS) existing before has not offered the same advantages as those offered by Anglo-Saxon limited partnerships. From a legal perspective, an SCS is a company with legal personality, subject to the requirements for commercial companies, including requirements to keep, register and file financial statements with the company registry, publication of annual accounts, etc. The innovation of the newly introduced SCSp lies in the absence of legal personality distinct from that of its partners. Consequently, SCSp will not be subject to the legal obligations applicable to SCS and Luxembourg commercial companies as reporting obligations to its partners may be freely determined in the partnership agreement. There is also greater confidentiality in respect of a SCSp as it is not subject to any public disclosure requirement relating to investors identity or contributions to the partnership.

2.2.3.4 Taxation

Taxation of Luxembourg private equity funds depends on a legal form of their establishment and specific provisions in the law in respect of each regime applicable.

Fund established in the contractual form (FCP) are transparent for Luxembourg tax purposes, consequently all income and capital gains are treated as arising or accruing to each investor. In addition, the creation of a

UCI under the contractual form (FCP) does not trigger any capital or registration duties. However, the incorporation of the management company, as well as each amendment of the articles of association of that management company, triggers a fixed registration duty of EUR 75.[23]

Most of investment companies (SICAV and SICAF) forms and SICAR forms are non-transparent for tax purposes, for example SA, Sàrl or SCoSA. Although Luxembourg commercial companies are generally subject to corporation taxes on their worldwide income at a combined rate of 29,22%,[24] Luxembourg UCIs created under the Part II UCI Law and the SIF Law in the corporate form are tax exempt in Luxembourg from corporation tax and net wealth tax.[25] The SICAR Law also provides for the exemption from net wealth tax and from corporation tax of the SICAR entity in certain cases, i.e. in respect of income and gains derived from transferable securities[26] and income derived from risk capital investments, provided such investments are held for not less than a 12-month period[27].

The incorporation of a corporate SICAV, SICAF or SICAR triggers a fixed registration duty of EUR 75. In addition, from 1 January 2013 similar to all Luxembourg companies, Luxembourg funds established in corporate form are subject to minimum tax in case aggregate financial assets, securities and bank deposits exceed 90% of their total balance sheet. For the SICAR vehicle, for example, this minimum tax amounts to EUR 3,210 (including the 7% solidarity surcharge) whereas for the other Luxembourg companies, it ranges between EUR 535 and EUR 21,400.[28] Moreover, the fund, whether under the corporate or the contractual form (except for SICAR) is subject to a subscription tax which is levied on a quarterly basis on its net asset value. The rate of this subscription tax varies between a Part II Law UCI (0,05%) and a SIF (0,01%) but may be reduced or even not levied at all under certain conditions.[29]

Although Luxembourg standard withholding tax rate is 15%, there are usually no withholding taxes on dividends paid by the Luxembourgish fund to its domestic and foreign investors, except if the EU Savings Directive applies (see section 2.2.3.5 of the present thesis below). This is due to the application of the EU Parent-Subsidiary Directive and due to the fact that Luxembourg has extended the benefits of the Directive to parent companies resident in non-EU tax treaty countries provided conditions similar to those under the

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[23]J. Schaffner and J.Wantz, *Luxembourg Investment Funds: a status report*, European Taxation, Vol. 51, no.1, 2011;
[24]The general effective corporation tax rate for resident companies is 22.47% (this consists of corporate tax of 21% and a 7% surcharge for the employment fund). In addition, a municipal business tax is payable at rates which vary in different areas. The rate is 6.75% in the city of Luxembourg, producing a combined corporate tax rate of 29.22%;
[25]Article 173 of the Part II UCI Law and article 66 of the SIF Law;
[26]Article 34(2) of the SICAR Law;
[27]Article 34(3) of the SICAR Law;
[28]J. Fisch, P. Goebel and P. Berna, *Luxembourg - Investment Funds & Private Equity*, Topical Analyses IBFD, 2013;
[29]U. Molitor March, *Luxembourg - Corporate Taxation*, sec. 9, Country Surveys IBFD;

Luxembourg participation exemption are satisfied and the parent company is subject to a tax similar to the Luxembourg corporate income tax.[30]

When the fund is incorporated in the form of a limited partnership (SCS or SCSp), it shall be treated as tax transparent entity, thus it will not be subject to corporate income tax (corporate income tax and municipal business tax) and net wealth tax. As a result, from the investors' perspective, a fund organized as an SCS or SCSp is neutral from a tax perspective, i.e. as if they had invested directly into the assets.

However, in Luxembourg exists the so-called "commercial imprint" concept (Geprägetheorie) which originates from German jurisprudence and was enshrined in Luxembourg tax law in 2001.[31] Under this theory if the general partner of a Luxembourg partnership is a Luxembourg joint-stock company (which is *per se* commercial by reason of its legal form), the whole activity of the Luxembourg partnership is deemed to be commercial. This infects the partnerships, making the SCS and SCSp subject to Luxembourg municipal business tax on its income and gains, and the foreign partners to corporate income tax and net wealth tax in Luxembourg due to the presence of a Luxembourg permanent establishment.

To avoid this undesired tax barrier Luxembourg has recently taken some measures aimed at relaxation of the conditions for the application of the Geprägetheorie. The respective provisions which became effective from 15 July 2013[32] established that the income realized by the partnerships will be considered as commercial income only to the extent the general partner is a joint-stock company, which holds at least a 5% interest in the Luxembourg partnership. As long as the general partner holds less than 5% interest in the partnership - which is generally the case in private equity funds - the Geprägetheorie will not apply, so no permanent establishment and no taxation will arise in Luxembourg. For the same reason, the SICAR Law ensures that SICARs set up in the form of a partnership are never considered as performing a commercial activity.

2.2.3.5 Application of the EU Savings Directive to private equity investment funds

It is interesting to note that the EU Savings Directive may apply in some cases of payments made by the Luxembourg fund to individual investors resident in a different Member State.

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[30]http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_Luxembourg_ICE_Desk_PE_Marketing_061413.pdf. Last visited on 28 August 2013. Last visited on 28 August 2013;

[31]R. Krawczykowski, R. Glohr and J. Lyaudet, *Luxembourg: Red carpet unrolled for alternative investment funds*, Tax Planning International Review, Vol.39, no.11, 2012;

[32]The Bill of law No.6471 of 24 August 2012 transposing the AIFMD;

In principle the objective of the EU Savings Directive is to ensure minimum effective taxation of savings income in the form of interest payments made in one EU Member State to individual beneficial owners who are resident in another EU Member State.[33] This objective in general should be achieved via exchange of information between Member States.[34] However, Luxembourg has opted alternatively for a withholding tax system for a transitional period in relation to such payments.[35]

The law implementing the Savings Directive into Luxembourg law has been adopted on 21 June 2005 (the Luxembourg SD Law).[36] Pursuant to the Luxembourg SD Law, the tax shall be withheld at the tax rate 35% since July 2011[37] and part of it (75%) shall be transferred to the country of the beneficial owner.[38]

Such withholding tax shall be withheld by the Luxembourg paying agent. The EU Savings Directive defines the paying agent as any "economic operator who pays interest to or secures the payment of interest for the immediate benefit of the beneficial owner.[39] It means that in a payment chain, the paying agent is the last intermediary that actively initiates the payment to the beneficial owner. Thus, in the case where the private equity investment fund is internally managed and does not depend on external service providers who would be in charge of effecting payments, the fund itself can be considered as a paying agent. However, in the case of an externally managed fund this is the management company who actually initiates payment to the investors and, consequently, the management company can be a paying agent in this situation.[40]

Of course, the fund or the management company shall be a paying agent for the purposes of the EU Savings Directive only in connection with a direct interest payment which is made to a beneficial owner who is an individual resident in another EU Member State.[41] This leads us to the discussion what income realized in connection with the fund can be considered as interest payment within the meaning of the EU Savings Directive.

[33]Article 1 of the EU Savings Directive;
[34]Chapter II of the EU Savings Directive;
[35]Article 10 of the EU Savings Directive;
[36]The European Savings Directive: ALFI's interpretations and recommendations, June 2005. Retrieved from: http://www.alfi.lu/sites/alfi.lu/files/file/Alfi%20guidelines%20and%20recommendations/ALFI%20Handbook%20Savings%20Directive%2005.pdf. Last visited on 28 August 2013;
[37]This corresponds to article 11 of the EU Savings Directive;
[38]Article 12 of the EU Savings Directive;
[39]Article 4(1) of the EU Savings Directive;
[40]The European Savings Directive: ALFI's interpretations and recommendations, June 2005. Retrieved from: http://www.alfi.lu/sites/alfi.lu/files/file/Alfi%20guidelines%20and%20recommendations/ALFI%20Handbook%20Savings%20Directive%2005.pdf. Last visited on 28 August 2013;
[41]Article 2 of the EU Savings Directive;

Under certain conditions, Articles 6(1)(c) and (d) of the EU Savings Directive qualify as an interest payment income distributed by or income realized upon the redemption, sale or refund of shares or units of:

- a UCITS authorized in accordance with the UCITS IV Directive;
- a UCI established outside the EU;
- an entity that has opted to be treated as a UCITS authorized in accordance with the UCITS IV Directive.

The Luxembourg law foresees that a Luxembourg entity that meets the criteria of a residual entity[42] will automatically be treated as a UCI authorized in accordance with the ICITS IV Directive.[43] This is for example the case of the Part II FCP. Part II SICAV/SICAF as well as SICARs are out of scope which means that payments from this types of entities will not trigger application of the Luxembourg SD Law.

For a UCI which distributions and redemptions are potentially in scope, they will be in scope or out of scope depending on the percentage of the assets of the UCI invested in debt-claims. According to article 6 (1) (d) of the EU Saving Directive only the sales or redemption proceeds for a Luxembourg UCI whose direct and indirect investment in debt claims exceed 25%[44], are within the scope.

Thus, proceeds realized by shareholders or unit-holders on the sale or redemption of shares or units in the Luxembourg fund which treated as a UCITS will be subject to the EU savings Directive and the Luxembourg SD Law if more than 25% of such fund's assets are invested in debt claims[45].

At the same time the EU Savings Directive allows a Member State not to treat as an interest payment a distribution from, or a proceeds from the sale, the redemption or the refund of shares or units of a UCI where the investment in debt-claims has not exceed 15% of the assets of the UCI.[46] Luxembourg has exercised that option.[47]

Thus, in case no more than 15% of the fund's assets are debt claims, the EU Savings Directive and the Luxembourg SD Law will not apply which means that dividends distributed by a fund and proceeds from

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[42]Based on articles 4(2) and 4(3) of the EU Savings Directive a residual entity is an entity established inside the EU or in a relevant dependent or associated territory, which is not a legal person; or is not taxed under the general arrangement for business taxation; or is not a UCITS;
[43]The European Savings Directive: ALFI's interpretations and recommendations, June 2005. Retrieved from: http://www.alfi.lu/sites/alfi.lu/files/file/Alfi%20guidelines%20and%20recommendations/ALFI%20Handbook%20Savings%20Directive%2005.pdf. Last visited on 28 August 2013;
[44]Please note that by article 6(7) of the EU Savings Directive the percentage established by article 6(1)(d) of 40% is reduced to 25%;
[45]Debt-claims are defined in article 6(1)(a) of the EU Savings Directive;
[46]Article 6(6) of the EU Savings Directive;
[47]The European Savings Directive: ALFI's interpretations and recommendations, June 2005. Retrieved from: http://www.alfi.lu/sites/alfi.lu/files/file/Alfi%20guidelines%20and%20recommendations/ALFI%20Handbook%20Savings%20Directive%2005.pdf. Last visited on 28 August 2013;

the sale and redemptions of the fund's shares or units will not be subject to withholding tax in this situation. If more than 15% of the fund's assets are invested in the debt-claim, dividends distributed by the Fund will be subject to the withholding tax 35%. However, proceeds from the sale, the refund or the redemption still can be out of scope if less than 25% of such fund's assets are invested in debt claims.

In addition, it should be mentioned that no withholding tax will be withheld by the Luxembourg paying agent if the relevant individual investor either (i) has expressly authorised the paying agent to report information to the tax authorities in accordance with the provisions of the EUSD Law or (ii) has provided the paying agent with a certificate drawn up in the format required by the EUSD Law by the competent authorities of his State or residence for tax purposes.[48]

2.2.3.6 SOPARFI

Besides semi-regulated fund vehicles described above, Luxembourg has built up its market share in private equity and venture capital funds thanks to its non-regulated special purpose companies (such as the SOPARFI - *Societe de Participations Financieres*, financial participation company). The most important distinction between the funds established under the SICAR/SIF/Part II UCI Law and the SOPARFI is the lack of regulatory oversight of the CSSF in case of the SOPARFI.

Strictly speaking, it is incorrect to label a SOPARFI as a fund as it is an ordinary fully taxable Luxembourg commercial company which can be incorporated under the legal forms of SA, SCA or Sàrl, and which primary activity is holding and financing private equity and venture capital investment. The success of the SOPARFI stems from the fact that, due to its non-regulation, SOPARFIs are faster to incorporate, cheaper to manage and less subject to reporting obligations.

Although a SOPARFI would in principle be subject to corporation taxes (29.22% in Luxembourg-City) and net wealth tax (annually at a rate of 0,5% of net asset value), it is subject to certain exemptions established by the Luxembourg domestic legislation and the applicable double tax treaties and EU Directives which makes this special purpose vehicle so attractive for investment funds. For example, the SOPARFI benefits from the Luxembourg participation exemption regime, according to which dividends and capital gains may be exempt from corporation taxes (subject to certain minimum holding conditions and eligibility of the subsidiary).[49] That is why in most cases foreign investors prefer to hold their participations via an

[48]Article 13 of the EU Savings Directive;
[49]Article 166 of the Income Tax Act of December 4, 1967;

intermediary SOPARFI in order to secure the benefits of the Luxembourg participation exemption or to secure treaty access in the source state.

2.2.4 Ireland as a private equity investment fund jurisdiction

Irish non-UCITS funds including private equity funds can be established as retail investor alternative investment funds, professional investor funds (PIFs) and qualifying investor alternative investment funds (QIAIFs). All non-UCITS Irish funds are authorized and regulated by the Central Bank of Ireland.[50]

Ireland, being interested in keeping the position of the one of leading jurisdiction for AIFs and alternative investment fund managers (AIFMs), recently enhanced its regulatory alternative investment funds regimes. Within the implementation process of the AIFMD, the Central Bank of Ireland issued the AIF Rulebook[51] which sets out the conditions applicable to fund managers and funds. The AIF Rulebook replaced the previous Central Bank's NU series of Notices and Guidance Notes with the exception that the old legislation will still apply to existing Irish AIFMs with existing AIFs until AIFMs are authorized or until the transitional period ends in July 2014.

Since retail fund regime represents the regime under which a fund is obliged to ensure that it maintains an adequate spread of investments and the diversification limits which quite similar to those of a UCITS fund (for example, not more than 10% of the net assets of a fund may be invested in securities which are not traded on an approved regulated market and no more than 10% of the net assets of a fund may be invested in securities issued by the same issuer),[52] this regime is not so interesting for private equity investment vehicles and the author is of the opinion that this regime can be left aside the scope of this thesis.

2.2.4.1 Professional investor fund (PIF)

PIF is a category of non-UCITS collective investment scheme authorized by the Central Bank of Ireland which requires a minimum subscription of more than EUR 100,000 per investor.[53] There are limited exceptions to this subscription requirement, in particular, where the investor is the management company. In addition, this regime imposes certain investment and borrowing restrictions for the fund which are lower

[50]The Central Bank became the regulator of authorized investment funds in Ireland pursuant to the Central Bank Reform Act 2010. Before this role was carried out by the Irish Financial Services Regulatory Authority, known as the "Financial Regulator";
[51]The first version of the AIF Rulebook was published on 15 May 2013. On 19 July 2013 the Central Bank published a revised version;
[52]Irish Funds Industry Association's response to the Committee of European Securities Regulator's / European Securities and Markets Authority's Call for Evidence on "Implementing measures on the Alternative Investment Fund Managers Directive", 2010. Retrieved from: http://www.esma.europa.eu/system/files/IFIA_Response_to_ESMA_Call_for_Evidence_on_AIFMD_Jan_2011.pdf. Last visited on 28 August 2013;
[53]*Excellence in Alternative Investments: Ireland knows Investment Funds*, Irish Fund Industry Association booklet. Retrieved from: http://www.irishfunds.ie/fs/doc/publications/alternative_investments_brochure_web.pdf. Last visited on 28 August 2013;

than in case of the retail fund regime but still can represent obstacles for private equity investors. Currently the Central Bank of Ireland allows investment in listed and unlisted securities subject to a general maximum of 20% of net asset value in any one issuer.[54] That is why structuring finds as PIFs is not as popular nowadays as the next regime.

2.2.4.2 Qualifying Investor Alternative Investment Fund (QIAIF)

Prior to the introduction of AIFMD, the qualifying investor fund (QIF) regime existed and was the key European regulated fund product for all types of alternative strategies. Staring from July 2013 Ireland has developed the Qualifying Investor Alternative Investment Fund ("QIAIF") which replaced the QIF.[55] Technically, the new regime is similar to the previous one: all of the key advantages, such as investment flexibility, speed to market and no borrowing restrictions remained in place. However, the Central Bank relaxed it even more, in particular, by removing the promoter regime, introducing more flexible rules in respect of share classes, extending the initial offer periods for private equity funds.[56] Importantly, like its predecessor, the authorization of the QIAIF can still be done on a fast track basis, i.e. the QIAIF can be authorized within one business day after submission of completed fund documentation and certification that certain regulatory requirements have been met.[57] The QIF/QIAIF is, by far, the most popular type of non-UCITS fund established in Ireland especially for private equity investment funds. As of the end of March 2013 the quantity of established QIAIFs was 1732 which is the majority out of all Irish alternative funds.[58]

QIAIF is a well-established, regulated investment fund vehicle designed for sophisticated, qualifying investors[59], who must meet minimum subscription and financial resources requirements. To qualify as a

[54] *Ireland as an international fund domicile*, brochure of Matheson, 2012. Retrieved from: http://www.matheson.com/images/uploads/publications/Ireland_as_an_International_Fund_Domicile_WEB_March_2013_-_Long.pdf. Last visited on 28 August 2013;

[55] *Establishing a qualifying investor fund in Ireland*, brochure of Matheson, brochure of Matheson, 2013. Retrieved from: http://www.matheson.com/images/uploads/publications/Establishing_a_Qualifying_Investor_Fund_in_Ireland_WEB_Feb_13.pdf. Last visited on 28 August 2013;

[56] W.Fry, *Asset management & investment funds news: Significant Enhancements to Ireland's AIF Regime in advance of AIFMD Implementation*, November 2012. Retrieved from: http://www.williamfry.ie/Libraries/test/Asset-Management-Investment-Funds-News---Nov-2012-1.sflb.ashx. Last visited on 28 August 2013;

[57] *AIFMD Implementation Guide*, GFM Special Report, July 2013. Retrieved from: http://www.hedgeweek.com/sites/default/files/GFM_AIFMD_13.pdf. Last visited on 28 August 2013;

[58] Data of the Irish Funds Industry Association (http://www.irishfunds.ie/fs/doc/statistics/2013-q1-5-fact-sheet.pdf). Last visited on 28 August 2013;

[59] Qualifying investors include (1) an investor who is a professional client within the meaning of Annex II of Directive 2004/39/EC (Markets in Financial Instruments Directive); or (ii) an investor who receives an appraisal from an EU credit institution, a MiFID firm or a UCITS management company that the investor has the appropriate expertise, experience and knowledge to adequately understand the investment in the scheme; or (iii) an investor who certifies that they are an informed investor by providing the following confirmation (in writing) that the investor has such knowledge of and experience in financial and business matters as would enable the investor to properly evaluate the merits and risks of the prospective investment; or that the investor's business involves, whether for its own account or the account of others, the management, acquisition or disposal of property of the same kind as the property of the scheme;

QIAIF, a fund must have a minimum initial subscription requirement of EUR 100,000 per investor, or equivalent in other currencies.[60]

The main advantage of the QIAIF is that it benefits from lighter regulation than other Irish funds: QIAIF is not subject to investment or borrowing restrictions and there are no diversification requirements. There are also no restrictions on the types of assets in which this fund can invest.

2.2.4.3 Legal forms of Irish private equity funds

AIFs in Ireland under any of the regimes described above may be established as:

- Unit trusts, under the Unit Trusts Act, 1990;
- Investment companies under the Companies Act, 1990 Part XIII;
- Investment limited partnerships under the Investment Limited Partnerships Act, 1994;
- Common contractual funds under the Investment Funds, Companies and Miscellaneous Provisions Act, 2005.

As a corporation, an investment company is a separate legal entity, managed and controlled by its board of directors, which can enter into contracts in its own name. Similar to Luxembourg investment companies SICAV and SICAF in Ireland there also two types of investment companies: variable capital company and fixed capital company.[61] Irish investment companies can have the form of private or public limited company.

On the contrary, a unit trust, investment limited partnership (ILP) and contractual funds are not separate legal entities. Unit trust is a vehicle created by a trust deed entered into by the trustee and the manager of the trust and, as mentioned above, the use of a management company in this structure is a necessity. Private equity fund established as ILPs represents a partnership between one or more general partners and one or more limited partners the principal business of which, as expressed in its partnership agreement, is the investment of its funds in assets. Common contractual fund is an arrangement for pooling and common management of assets created and governed by private contract.

[60] *AIFMD Implementation Guide*, GFM Special Report, July 2013. Retrieved from: http://www.hedgeweek.com/sites/default/files/GFM_AIFMD_13.pdf. Last visited on 28 August 2013;
[61] A guide to qualifying investor funds in Ireland, Dillon Eustace, 2010. Retrieved from: http://hb.betterregulation.com/external/A%20Guide%20to%20Qualifying%20Investor%20Funds%20in%20Ireland.pdf. Last visited on 28 August 2013;

2.2.4.4 Taxation

Tax treatment of regulated funds in Ireland is one of the key reasons for the success of the Irish funds industry.

Private equity investment funds established as investment companies are opaque for tax purposes. Unit trusts are not companies but for the purposes of Irish tax legislation they are treated as if they are companies. Investment companies and unit trusts fall within the definition of "Investment Undertakings" under Section 734 of the Taxes Consolidation Act, 1997 (TCA) and therefore they are subject to the same taxation regime. Based on this regime Investment Undertakings are not subject to Irish taxation on any income or gains they may realize from their investments.[62]

Under general rule the fund is responsible for a 20% withhold tax in respect of payments (for example, in case of dividend distribution or redemption of units) made to certain unit holders in a fund. However, there are certain exceptions from this rule, one of which is the case where the investors, which are non-resident or non-ordinarily resident[63] in Ireland, have provided the fund with the appropriate relevant declaration of non-Irish residence or the fund has satisfied and availed of certain equivalent measures. It is interesting to note that the Irish Revenue Commissioners (IRC), following lengthy negotiations with the Irish funds industry, introduced new measures into the 2010 Finance Act to amend the rules with regard to relevant declarations for non-residents.[64] The position prior to this was that no tax would be imposed on a fund with regard to payments in respect of an investor who was neither Irish resident nor ordinarily resident in Ireland at the time of the payment, provided that an appropriate declaration was in place. The 2010 Finance Act introduced measures that provide that the above exemption in respect of investors who are neither Irish resident nor ordinarily resident in Ireland apply where appropriate equivalent measures are put in place by the fund to ensure that such shareholders are not Irish residents nor ordinarily residents in Ireland and the fund has received approval from the IRC in this regard. [65]

Starting from 13 February 2013 the tax treatment of ILPs was changed by the Finance Bill 2013. Before ILPs were subject to the same regime that applies to investment funds structured as investment companies or unit trusts described above. ILPs authorized by the Central Bank after 13 February 2013 are no longer

[62]Article 734(4) of the Taxes Consolidation Act, 1997;
[63]A person is ordinarily resident in Ireland as distinct from resident for a year of assessment if he has been resident for each of the three years of assessment preceding that year. An individual who is ordinarily resident in Ireland will remain ordinarily resident until he has been non Irish tax resident for three consecutive years of assessment. In this situation, he will be non-ordinarily resident from the fourth year;
[64]D. Lawless and S. Murray, *Ireland: Taxation of collective investment funds and availability of treaty benefits*, European Taxation, Vol. 51, No. 2/3, 2011;
[65]Article 739D(7B) of the Appendix I(c), of the Investment Undertakings General Guidelines for calculating tax due and for completing declaration (updated October 2012);

considered as an investment undertaking under tax law.[66] They should be treated as tax transparent vehicles so that income and gains in an ILP are treated for Irish tax purposes as arising to the partners in the ILP in proportion to the value of their investment. This reform was made with the aim to bring the ILPs' treatment to consistency with the more common treatment of partnerships in Europe and to assist the international financial services sector in attracting new investment funds business to Ireland on foot of anticipated changes in the global market resulting from the Alternative Investment Fund Managers Directive.

Common Contractual Funds (CCFs) being an unincorporated body established by a management company, are transparent for tax purposes. As a result, investors in CCFs participate and share in the property of the fund as co-owners of the assets of the fund. The result of CCFs structure is that income and gains of such vehicles are treated as arising or accruing to the unit holders or investors and not to the vehicle itself.

2.2.5 Conclusion

Ireland and Luxembourg are one of the main European domiciles of choice for investment funds. Based on the above analysis of the existing regimes and tax treatment of private equity investment funds in both jurisdictions, it can be concluded that the tax rate established in the jurisdiction is not important for the purposes of developing of investment strategy. What makes these jurisdictions attractive locations for private equity investment funds is tax incentives adopted specifically for investment vehicles.

It is very difficult to conclude which one of the competitive jurisdictions, Luxembourg or Ireland, is more beneficial and the author is of the opinion that this question should be answered on a case-by-case basis taking into account many factors including non-tax factors such as, in particular, business objectives. Being different in their approaches to regulation of investment fund regimes, i.e. Luxembourg has enacted separate regulations applicable to different types of UCIs whereas Ireland addresses the UCI's activity in its general legislation depending on legal form, the results they offer are the same.

In both countries a regulatory body authorizes the conduct of collective investment schemes. Both locations regard investment vehicles as tax neutral. This means that there is no tax levied at the fund level achieved either through provision of tax transparent structures or by granting tax exemption to funds established in corporate form. Both jurisdictions provide for equivalent investment fund regimes – SIF in Luxembourg and QIAIF in Ireland. Both jurisdictions, being extremely interested in attraction of the

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[66] *Changes to the Investment Limited Partnership Regime in Ireland*, LK Shields, April 2013. Retrieved from http://www.lkshields.ie/publications/changes-to-the-investment-limited-partner-regime-in-ireland. Last visited on 28 August 2013;

investment, adapted their legislation in response to the recently implemented AIFMD: Luxembourg introduced a new fund vehicle – special limited partnership SPSp designed specifically to provide equity and venture capital investment whereas Ireland improved its QIAIF regime.

III. Tax treaty entitlement of private equity investment funds

Distributions or redemptions made by a private equity investment fund to foreign investors in most cases are not subject to withholding taxes neither in Luxembourg nor in Ireland on the basis of domestic law. Thus, one may say that access to double tax conventions of the fund is irrelevant in most cases. However, this is not true. Access to double tax conventions by a fund may be relevant if the vehicle carries out cross-border investments. In this regard, for investment funds, tax treaty access is of a high importance both from a perspective of source country benefits and double tax benefits. From the source country perspective, tax treaty access would generally have the important consequence of reducing the withholding tax rate in the source of income. While from double tax relief perspective it can be meaningful to claim the foreign tax credit for the withholding taxes levied in the source country.

Most of the double tax conventions are modeled after the OECD Model Tax Convention with respect to taxes on income and capital (OECD MTC). Therefore, the question of treaty entitlement will be analyzed in light of the OECD MTC and commentaries to it.

On 23 April 2010 the OECD Committee on Fiscal Affairs adopted the report entitled “The granting of treaty benefits with respect to the income of collective investment vehicles” (CIVs Report) which addresses the issue of treaty entitlement of Collective Investment Vehicles (CIVs). The conclusions of the CIVs Report gave rise to amendments in the Commentary to article 1 of the OECD MTC in order to deal with the granting of tax treaty benefits to income received by CIVs. The CIVs Report defined CIVs as widely held funds which hold a diversified portfolio of securities and are subject to investor protection in the country in which they are established.[67] Although the CIVs Report does not determine the term “widely held funds”, it makes reference to hundreds or even thousands of investors.[68] In this regard, it can be understood that application of the CIVs Report as well as the relative provisions of the Commentary is limited only to funds which have multiple investors, i.e. UCITS. It means that the CIVs Report and the Commentary do not apply to private equity funds since they do not fulfill the conditions to be considered as CIVs, namely, the fact of being “widely held”. This is also particularly mentioned in par.4 of the CIVs Report which states that issues of treaty entitlement with respect to investments through private equity funds, hedge funds or trusts or other entities that do not fall within the definition of CIV set out in this Report.

[67]Par.33 of the CIVs Report, par.6.8 of the Commentary to article 1 of the OECD MTC;
[68]Par.37 of the CIVs Report;

Thus, the tax treaty entitlement of private equity investment funds should be analyzed on the basis of general provisions of the OECD MTC.

The analysis of the applicability of the OECD MTC to private equity investment funds should have its starting point in article 1 of the OECD MTC where is stated that the OECD MTC shall apply to persons who are residents of one or both of the Contracting States. Such definition brings us to examine whether a private equity investment fund may be considered as:

1. a person under the definition of art 3(1)(a) of the OECD MTC;
2. a resident of the treaty country under the definition of article 4 of the OECD MTC; and
3. a "beneficial owner" of the income received.

3.1 Private equity fund as a "person"

The OECD MTC defines the term "person" as "an individual, a company and any other body of persons".[69]Whereas investment vehicles may not be considered as individuals, they may fit in definitions of a company or other body of persons depending on the legal structure they have adopted under their domestic law.

The term "company" means "any body corporate or any entity that is treated as a body corporate for tax purposes".[70] As a consequence, it may be easily inferred that if an investment fund is established under the corporate form (for example, Luxembourg SICAV/SICAF in the forms of SA or Sarl), it definitely fits under the definition of a "company" and consequently can be recognized as a person.

The Commentary defines "body corporate" as "any other taxable unit, although not incorporated, that is treated as a body corporate according to the tax law of the Contracting State in which it is organized." Thus, the concept of "any entity that is treated as a body corporate for tax purposes" means that entity, although not being a legal person, still should be considered as a person if it is considered to be a taxable entity in the Contracting State in which it is established.[71] An example of such entity can be a unit trust under the Irish law which is treated as a company for the purposes of Irish tax legislation.

For the cases of an investment fund not treated as corporations, it still may be considered to fall within the meaning of a "person" by inclusion in the definition of "other bodies of person". In this respect some

[69]Article 3(1)(a) of the OECD MTC;
[70]Article 3(1)(b) of the OECD MTC;
[71]B. da Silva, *Granting tax treaty benefits to collective investment vehicles: a review of the OECD Report and the 2010 Amendments to the Model tax Convention*, Intertax, Vol. 39, issue 4, 2011, pp.195-206;

difficulties can occur since this term is defined neither in the OECD MTC nor in the Commentary. That is why it is unclear how to treat this notion and it may depend on interpretation of a particular country. One position is that investment funds which are established in contractual form are not bodies of persons within the treaty definition, unless they are treated as taxable entities.[72] For example, Luxembourg considers that FCP does not fall into this definition and should not be treated as a person for treaty purposes.[73] Same approach is taken by Ireland in respect to CCFs.

Another, broader concept of the definition of "other bodies of person" can be argued on the basis of the Commentary to the OECD MTC which states that the term "person" is not exhaustive and should be used in a very wide sense.[74] Moreover, the Commentary makes it clear that partnerships are included in the definition of a "person" either because they can be considered as company or because they constitute "other bodies of persons". Following this concept, the term "other body of persons" may include any collaboration between two or more persons even if it is not formally organized. The result of such interpretation will be that non-corporate bodies are to be covered by this definition with the possibility to include funds irrespective of their legal forms and their taxable status. Not the legal form is relevant for considering the fund as a person but the fact that it is able to participate in legal traffic as a vehicle with its own identity. Since private equity fund, whether it is created in the corporate form, in the form of trust or as a partnership, operate as a separate vehicle in respect of their investors, they should always be considered as persons for treaty purposes.

Thus, it is the author's opinion that an unincorporated investment fund may be encompassed in the definition of person for double tax convention purposes.

3.2 Private equity fund as a "resident"

After having agreed that an investment fund may be considered as a "person" for treaty purposes, the second step toward the entitlement of investment funds to tax treaties is to check whether such fund may be considered a "resident" in the meaning of article 4(1) of the OECD MTC.

Article 4(1) of the OECD MTC defines a resident of a Contracting State as "any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature". Article 4(1) does not provide as such any rule of residence of its own

[72] T. Viitala, *Taxation of investment funds in the European Union*, Volume 8, Doctoral Series IBFD – Academic Council, 2005, pp.78-82;
[73] It is interesting to note that the only exception is the double tax convention concluded between Luxembourg and Ireland under which Luxembourgish FCP is entitled to the treaty benefits;
[74] Par. 2 of the Commentary to article 3 of the OECD MTC;

but leaves this to be determined under the domestic law of the contracting state where the fund is organized.

For the purposes of analyzing the question of residency of private equity investment funds it is important to distinguish between: (i) separately taxable entities which pay tax; (ii) separately taxable entities which are tax exempt and (iii) entities which are transparent for tax purposes.

Investment funds which are treated as separately taxable entities, i.e. which pay tax on their income, clearly satisfy the condition of being a resident of a contracting state and thus eligible for treaty benefits. However, taking into account that taxable investment funds are rare in practice, issues arise both in cases of tax-exempt and transparent investment vehicles.

Investment funds which are treated as separately taxable entities but are tax exempt cause certain interpretation difficulties stemming from the different positions on the definition of the term "liable to tax" in different states which influence the status of tax-exempt funds. Under domestic laws different states may choose to adopt an objective or subjective approach to this matter. According to subjective approach (applicable, in particular, by India and Middle Eastern countries[75]) the expression "liable to tax" is given a generous and broad interpretation. As a result, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax but the fund is tax-exempt if it meets all the requirements specified in the domestic tax laws. According to this wide interpretation, the term "liable to tax" would imply that a "potential taxation" would be sufficient in order to be eligible for treaty benefits. States applying such broader interpretation of the term "liable to tax" would view such entities as residents for purposes of the OECD MTC.[76]

In the states (for example, Germany, New Zealand[77] and the Netherlands[78]) applying objective approach, to the contrary, tax-exempt fund vehicles will not be considered "liable to tax" as they interpret the "liable to tax" requirement as an "effectively subject to tax" requirement. They take the position that in order to be considered residents an investment fund should be effectively taxed. These states, adhering to the narrower

[75]R. Galea, *The Meaning of "Liable to Tax" and the OECD Reports: Their Interaction and Ambiguous Interpretation*, Bulletin for International Taxation, Vol.66, no.6, 2012;
[76]Par.8.6 of the Commentary to article 4 of the OECD MTC;
[77]R. Galea, "*The Meaning of "Liable to Tax" and the OECD Reports: Their Interaction and Ambiguous Interpretation"*, Bulletin for International Taxation, Vol.66, no.6, 2012;
[78]*Netherlands Tax Alert*, 21 January 2009, Deloitte. Retrieved from http://www.deloitte.com/assets/Dcom-Belgium/Local%20Assets/Documents/Netherlands%20Alert%20(21%2001%2009).pdf. Last visited on 28 August 2013;

interpretation of the notion “liable to tax”, may not regard exempt fund vehicles as residents for purposes of the OECD MTC.[79]

The OECD MTC fails to address the issue of residency specifically in the context of private equity investment funds. Although there are some provisions relating to CIVs[80] in the Commentary, as it was mentioned above, they are not applicable to private equity funds. In this respect it can be concluded that the question whether an investment fund should be considered as a resident of a Contracting State for treaty purposes depends on the tax treatment to which such a fund is subject in its country of establishment.

The author keeps the opinion that the term should be interpreted in a wide sense bearing in mind the objective and purpose of the OECD MTC, i.e. to avoid double taxation.[81] The OECD MTC provides that a person is a resident of a contracting state if it is “liable” to taxation in that state. It is, however, not required that a person is “subject” to taxation. In other words, a mere virtual risk of double taxation should be sufficient for a taxpayer to get access to a double tax convention.[82]

An additional argument in support of the broad approach can be the fact that, for example, Luxembourg private equity UCIs are subject to a subscription tax (0.05% under the Part II UCI Law and 0.01% under the SIF Law) applied to its net asset value. As the subscription tax is a tax on capital, it could be argued that a UCI under the corporate form is effectively subject to taxation in Luxembourg. Thus, a tax exempt UCI under the corporate form should have access to double tax conventions.[83]

It is important, however, to distinguish funds that are tax-exempt due to the fulfillment of requirements set up by the law of the residence state and entities that are in any case assessed as tax-exempt entities. The general opinion, in this respect, is that entities that satisfy the requirements of the domestic law in order to be considered as tax exempt are considered as resident of the same state for treaty purpose; whereas entities that are by law assessed as always tax exempt are not residents for treaty purposes.

By analyzing how different jurisdictions approach this controversial issue of residency, it is interesting to mention that, for example, Luxembourg UCIs established in the corporate form (SICAV/SICAF). They are considered as such liable to Luxembourg corporation taxes and net wealth tax, however, by virtue of the UCI Law and the SIF Law, they benefit from an exemption from corporation taxes, provided they are

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[79]Par.8.7 of the Commentary to article 4 of the OECD MTC;
[80]Par.6.11-6.13 of the Commentary to article 1 of the OECD MTC;
[81]Par.1-3 of the Introduction to the OECD MTC;
[82]K. Vogel, *On Double Tax Conventions*, Kluwer Law International, 3rd ed., 1997;
[83]W. Oepen, K. Lievens, T. van den Bruel, *Belgium-Luxembourg Income and Capital Tax Treaty (1970) Resolves Double Taxation on Net Assets of Luxembourg Investment Funds with Belgian Investors*, Bulletin for International Taxation, Vol.67, no.8, 2013;

authorized by the CSSF. Hence, Luxembourg considers such fund vehicles as Luxembourg residents. However, being aware of uncertainty in respect of the issue how the other contracting states will treat the Luxembourg vehicle, Luxembourg usually address this issue directly in its tax treaties. In addition, Luxembourg keeps the list of countries which admits exempt funds as residents with a result of possible application of tax treaties, this list is available online[84]. As of the date of writing of the present thesis, corporate UCIs have access to a total of 37 double tax conventions (out of an overall total of 64). Pursuant to the same list, 20 double tax conventions are not accessible by Luxembourg corporate UCIs (based on a clear provision in the applicable double tax convention or a clear denial from the contracting state).

Unlike in Luxembourg, in Ireland the Irish IRC has not produced the list of treaty partners with which it has clarified whether Irish funds are entitled to treaty access or the list of countries in respect of which it believes Irish funds should be entitled to treaty benefits (based on the wording of the particular treaty). However, taking the position in assisting Irish funds to obtain treaty benefits, IRS issues certificates of Irish tax residence to Irish funds that clearly state that the relevant fund is tax resident in Ireland for Irish tax purposes.

Speaking about entities which are transparent for tax purposes it should be analyzed how partnerships are treated according to the OECD Partnership Report. Although the application of Partnership Report to investment funds is not clear, the author does not see any reasons why this Report cannot apply specially taking into consideration that the Report itself in its paragraph 1 states that “many of the principles of the Report may also apply with respect to trusts and other non-corporate entities”, and also that investment funds may be considered as transparent entities similar to partnerships.

Par. 40 of the OECD Partnership Report states that whether a partnership is to be considered “liable to tax” depends on how the income is determined. If the income is determined “in relation to the characteristics of the partners” then the partnership itself is not to be considered as “liable to tax” for treaty purpose, but instead the partners should qualify as residents as long as “they are liable to tax on their share of the partnership income.” The Report also takes into consideration the possibility that the income is computed at the level of the partnership before being allocated to the partners, or that the income is technically paid by the partnership, however specifying that none of these possibilities would change the result (i.e. the partnership itself is not liable to tax).

[84] http://www.impotsdirects.public.lu/conventions/opc/sicav/index.html. Last visited on 28 August 2013;

As a result of the Partnership Report, this issue is dealt now in the Commentary to the OECD MTC. According to the Commentary where a state disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State.[85] Instead, since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents.

The author considers this interpretation of the OECD MTC to be logical and correct since the purpose of the OECD MTC is to ensure treaty protection for the taxpayer if he is liable to tax on the same income in more than one state. In case an investment fund established in the form of the partnership is treated as transparent for tax purposes, the partners (and not the partnership) are the persons subject to double taxation. In this case the investors – partners meet the prerequisites of article 4 of the OECD MTC and should, consequently, be entitled to the double tax treaty benefits.

This approach generally is followed by the countries in practice. For example, Luxembourg FCP is considered to be tax transparent. Therefore, the Luxembourg tax authorities do not treat FCP as a tax resident with the consequence of no access to tax treaties.[86] Accordingly, from a Luxembourg tax point of view, the investors may themselves claim tax credits in accordance with their local tax laws and the applicable double tax treaties in respect of withholding taxes levied on the income generated by the assets of the FCP.

3.3 Private equity fund as a "beneficial owner"

Once it is established that the fund is a person and resident of one of the contracting states for the purposes of the tax treaty, the question of whether the fund is beneficial owner should be answered.

The concept of beneficial ownership is employed in articles 10 (dividends), 11 (interest) and 12 (royalties) of the OECD MTC. In accordance with these articles, the reduction or elimination of a withholding tax is available only if the recipient of the income can be regarded as the beneficial owner.

3.3.1 Definition of a "beneficial owner"

[85]Par.8.8 of the Commentary to article 4 of the OECD MTC;
[86]J. Fisch, P. Goebel and P. Berna, *Luxembourg - Investment Funds & Private Equity*, Topical Analyses IBFD, 2013;

The definition of this term is one of the most controversial issues in international tax law since there is no exact meaning of this term nowadays. Initially the concept of beneficial owner was found in some tax treaties concluded by the United Kingdom. The concept was introduced in the 1977 version of the OECD MTC with a view to combat tax treaty shopping, i.e. practice to obtain tax treaty benefits which are not available directly by the use of intermediaries.[87]

There are different views on the term “beneficial owner” in respect of the investment fund vehicles. On the one hand there is a view that the fund can never be the beneficial owner of the income it receives because – due to the relationship under local law of the investor and the fund or its managers – ownership of an interest in the fund is the equivalent of ownership of the underlying asset. On the other hand, there is a view that the fund that qualifies as a person and a resident in the state of residence should also be considered to be the beneficial owner of the income it receives. [88]

Until now the term “beneficial owner” is defined neither in the OECD MTC itself, nor in its Commentary. Under general rule any term not defined in the tax treaty has the meaning that it has at that time under the domestic law of the State for tax purposes unless the context otherwise requires.[89]

However, in the Commentary it is expressly mentioned that the term “beneficial owner is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance”[90]. The "beneficial ownership" test determines the availability of treaty benefits and the allocation of taxing rights amongst the contracting states. Accordingly, it is definitely not the intention of the OECD Member states to allow situations where double taxation arises due to diverging positions taken on who the beneficial owner is. Thus, in the author’s opinion the concept of beneficial owner should have an autonomous tax treaty meaning distinct from its meaning in the domestic law of the contracting state. The same opinion prevails in the literature where commentators have also argued that the first and foremost reason why the term cannot be construed by reference to the domestic law of the source state stems from the fact that none of the national systems of the OECD Member countries offer a precise definition of "beneficial owner".[91]

[87]Par.8-10 of the Commentary to article 1 of the OECD MTC;
[88]C. du Toit, *The evolution of the term “Beneficial ownership” in relation to international taxation over the past 45 years*, Bulletin for International Taxation, Vol.64, no. 10, 2010, p.500-509;
[89]Article 3(2) of the OECD MTC;
[90]Par.12 of the Commentary to article 10 of the OECD MTC, par.8-8.2 of the Commentary to article 11 of the OECD MTC;
[91]J. David B. Oliver, Jerome B. Libin, S. van Weeghel and Ch. du Toit, *Beneficial Ownership*, Bulletin for International Taxation, Vol.54, no.7, 2000;

The Commentary to the OECD MTC specifies that agent or nominee may not be considered as the beneficial owner of the income as well as "conduit companies for other persons who in fact receive the benefit of the income concerned. [92] The Commentary clarifies referring to the report of the Committee on Fiscal Affairs entitled "Double taxation conventions and the use of conduit companies" that conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

The OECD has attempted to propose a general definition of beneficial ownership in its discussion draft "Clarification of the meaning of "Beneficial owner" in the OECD Model Tax Convention" *(*2011) according to which "the recipient of a dividend is the "beneficial owner" of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full right to use and enjoy the dividend. [93]

This definition proposed by the OECD places emphasize on the use and enjoyment of income by the recipient, i.e. it focuses exclusively on ownership attributes of the recipient of the income. However, the author takes a position that this is not enough to consider the recipient of the income a beneficial ownership and this is the control exercised by the recipient over the income which should be crucial in determining whether the recipient is the beneficial owner. Indeed, the important element of treaty shopping structure is the legal, economic or factual ability of a person to interpose an entity for the only purpose to transfer the income from the source state with obtaining tax treaty benefits. Accordingly, it can be recognized that where the interposed entity genuinely holds the power to control the income it derives from the source state, it would be difficult to allege that it was interposed for treaty shopping purposes. In contrast, the fact that the recipient may own and economically benefit from the income received is not per se the element that conclusively prevents treaty shopping schemes from being implemented.[94]

The author takes the position that the beneficial owner shall be treated as the person, who not only has the full right to use and enjoy the received income but legally, economically or factually has the power to

[92]Par. 12(1) of the Commentary to article 10 of the OECD MTC;
[93] Par.12.4 of the OECD public discussion draft, *Clarification of the meaning of "Beneficial owner" in the OECD Model Tax Convention*, 2011. Retrieved from: http://www.oecd.org/ctp/treaties/47643872.pdf. Last visited on 28 August 2013;
[94]Prof. Dr. R. Danon, *Clarification of the Meaning of "Beneficial Owner" in the OECD Model Tax Convention - Comment on the April 2011 Discussion Draft*, Bulletin for International Taxation, Vol.65, no.8, 2011;

control the attribution of the income. Thus, the great importance should be placed on discretionary powers to manage the assets generating the income.

It is unfortunate that the above mentioned OECD discussion draft does not address the issue of a beneficial ownership in respect of the investment finds. However, this issue is touched in the CIVs Report and Commentary to article 1 of the OECD MTC. Although as it was mentioned above the CIV Report is not applicable to private equity funds, the position taken in this Report in this case can be fully applicable to private equity funds. The fund should be treated as the beneficial owner of the income it receives, so long as the managers have discretionary powers to manage the assets on behalf of the holders of interests in the fund and, of course, so long as it also meets the requirements that it be a "person" and a "resident" of the State in which it is established.[95] When the element of discretion disappears, there is no ground to treat the fund as the beneficial owner.

Based on the above, it may be inferred that, in order to determine whether the beneficial ownership can be attributed to the investment fund, an analysis of the nature and extent of rights and obligations of the fund receiving the income should be made.

It is important, however, to understand that although an investment fund may be misused in order to get treaty benefits otherwise not attainable, this possibility cannot become a default statement according to which an investment fund is always used to circumvent a higher tax burden otherwise applicable. As the reasons behind the setup of an investment fund are far beyond pure tax motivations, the mere interposition of a fund does not automatically imply an attempt to elude the law.

For the purposes of analysis of this question, it is important to distinguish internally managed investment funds from investment funds managed by the management company.

3.3.2 Internally managed private equity investment fund as a "beneficial owner"

As it was concluded in section 2.1.5 of the present thesis in the situation of the internal management, it can be clearly concluded that the functions of the fund manager represent the functions of the fund itself. Thus, the rights and obligations of the internally managed investment fund are definitely not narrow as powers of a nominee, agent or conduit. It is true that investment fund according to its legal and economic purpose acts as an intermediary between the investors and final investments but in case of internal management it clearly cannot be considered as an agent or a nominee in legal terms. Since the internally managed fund

[95]Par.35 of the CIV Report;

performs significant function through its employees – fund managers, it can be said that the fund has powers to control and manage its investments. If these powers of the fund are of a discretionary nature, i.e. it is free to decide whether or not the capital should be invested, how it should be invested and how the yields therefrom should be used, it can be considered as beneficial owner with the consequent access to tax treaty benefits.

It is, however, should be mentioned that in case the fund's activity is determined by the fund rules regulating the investment and dividend policy which were agreed with the investors beforehand, the question can arise whether the fund in this case has actually discretionary powers to make decisions in respect of management of the investments and distribution of income received from the target companies. The author's opinion is that in this situation the fund cannot be considered as beneficial owner since it acts in this situation on behalf of the investors as a simple intermediary administrator which performs compulsory redistributions of the fund's income.

3.3.3 Externally managed private equity investment fund as a "beneficial owner"

As it was concluded in section 2.1.5 of the present thesis in case of externally managed private equity investment fund the fund or the fund's investors themselves do not carry out any management activity. Investors just make passive investments into the fund vehicle with the aim to get returns in the future whereas this is the management company which acts independently and has a day-to-day control over the operation of the fund. The employees of the management company have decision-making power and discretion to take management decisions and influence the investment and distribution strategy of the fund. Moreover, the fund itself does not have any substance and is used just as a vehicle to facilitate the investments.

Thus, in the author's opinion, the fund managed by the management company cannot be regarded as the beneficial owner.

It should be stressed that in case of tax transparent private equity investment fund, the fund itself is not considered as the beneficial owner of the income, the underlying investors have to be considered as the beneficial owners of the income. It is, however, doubtful to apply the same approach to the opaque funds as in practice the treaty benefits for the fund will be simply rejected but not flow through to the investors. That is why in practice in order to avoid this problem and to get treaty benefits, certain legal entities such as holding companies, i.e. Luxembourg SOPARFI as described above in section 2.2.3.6 of this thesis, are often interposed in the fund structure to ensure the applicability of the relevant tax treaty benefits.

3.4 Conclusion

Based on the above it is clear that the tax treaty access of private equity investment funds is not a clear-cut question due to the various possible interpretations given to the term “person”, “resident” and “beneficial owner”. As in the majority of cases a substantial part of the income generated by an investment fund is derived from cross border transactions, this uncertainty of the treaty entitlement of the fund may result in certain tax obstacles analyzed in chapter IV of the thesis.

IV. Main tax issues related to cross-border private equity investments

Problems of cross-border investments of private equity and venture capital funds are acknowledged at the EU level. Being aware of the importance of clarity and certainty in the field of taxation for the development of a dynamic private equity and venture capital market and for the purposes of facilitating cross-border investment the European Commission established an Expert Group on cross-border tax obstacles to venture capital (VC) investment in 2007. The VC Tax Expert Group had a mandate to identify cases of double taxation and other direct tax related obstacles encountered by cross-border VC investments and to consider possible ways of overcoming such obstacles. The results of the Group's work were summarized in its Report published in 2010 (VC Report).[96] The report provided an overview of the tax issues which might arise for cross-border investments of VC in the EU.

For these purposes the EC organized public consultations in 2012 in order to collect factual evidence of the direct tax problems that arise when venture capital is invested across borders. For the present moment consultations are closed and now the Commission has to estimate the problems and decide whether there is a need for EU solutions to remedy the problems and what the benefits of any such solutions would be, for Member States and for the VC industry. There is no report issued by the Commission as a result of these consultations yet. However, the VC Report together with the responses received from different organizations, countries' tax authorities and fund associations provide a good picture of current practical problems of cross-border investments via private equity and venture capital fund vehicles.

Based on the VC Report and Public consultation paper[97], the following tax obstacles to cross-border investment via private equity and venture capital funds can be identified:

1. Unrelieved double taxation caused by mismatch in tax treatment of investment funds by different countries and subsequent difficulties in the application of double taxation treaties. This issue will be elaborated in section 4.1 of the present chapter.

2. The risk of a deemed permanent establishment for the fund or its investors in any other jurisdiction other than that in which they are based or resident together with the resulting double taxation. This problem will be developed in section 4.2 of the present chapter.

[96] Report of the EC Expert Group of the EC *On removing tax obstacles to cross-border Venture Capital Investments*, 2010;
[97] EC public consultation paper, *Problems that arise in the direct tax field when venture capital is invested across borders*, 3 August 2012;

3. The risk of non-relief from the withholding tax on dividends received from the target companies. This problem will be developed in section 4.3 of the present chapter.

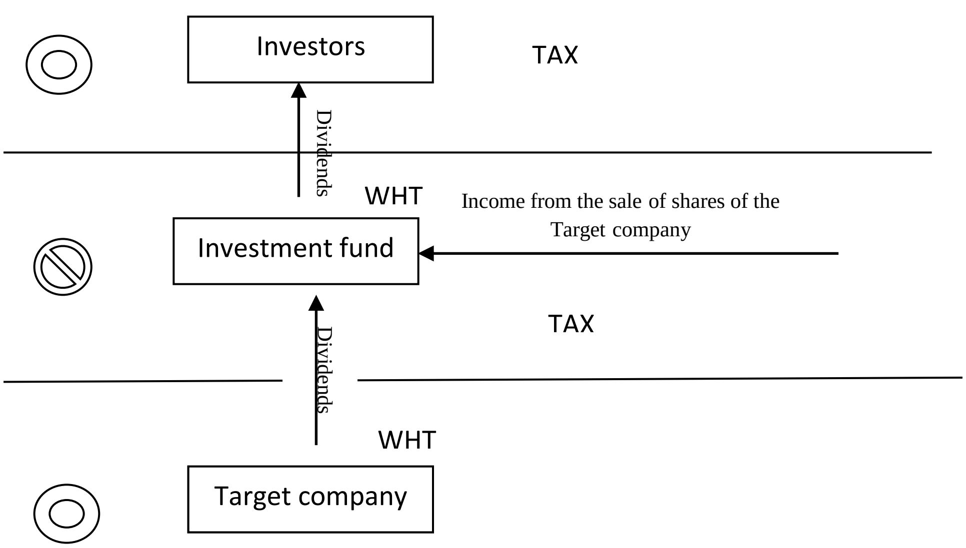
4.1 Double taxation caused by mismatch in tax treatment of investment funds by different countries

The concept of the fund is used by each country based on its own legal and tax system. Thus, problems may arise when the various states involved reach different conclusions as regard the characterization of the fund for tax purposes. This is especially relevant in case the fund is established in the form of a partnership: some countries follow entity approach and treat partnerships as separate legal entities and taxable persons, whereas other countries applying the aggregate approach do not recognize them as having any legal status separate from their owners and treat partnerships as transparent for tax purposes. The latter approach is the most common and applied, for example, in Australia, Germany and Sweden. The examples of the entity approach can be found in Belgium and Hungary where the partnerships are typically taxed according to the same pattern as companies.

The mismatch in the treatment of the fund may cause difficulties in the application of double tax treaties and consequent unrelieved double taxation.

Based on the domestic laws of the countries involved, problems may arise if, for example, the fund is recognized as opaque in the country of its establishment but the country of the investors or the target company treats it as transparent (see picture 2 below).

Picture 2.



Assuming that the fund receives income from the sale of shares of the target company or dividends from the target company, double taxation may arise. As the fund is treated as opaque in its state of residence, income will be taxed in the state of the fund. However, as the investor's state treats the fund as transparent, the same income will be taxed in the hands of the investor. Thus, both states, i.e. the state of the investor and the state of the fund, will tax the same income from the source country twice.

In addition, when the fund distributes dividends to the investor later, the country of the fund theoretically can withhold tax as it treats the fund as non-transparent. At the same time the country of the target company classifying the fund as tax transparent can also withhold tax on the investor’s dividends. Thus, the different treatment of the fund may lead to withholding of the tax on the same income twice. The investor's state treating the fund as transparent based on its domestic law or double tax treaty will be able to give relief from double taxation only for the tax withheld by the country of the target company and will disregard distributions made by the fund later. It means that the investor's state will not grant a tax credit in respect of the tax withheld by the fund on the distributed dividend. It can be argued that in this case no double taxation arises *per se* because the investor’s state disregarding the dividend payment from the fund typically will not levy any tax upon distribution. However, in the author’s opinion there is a double taxation from a different perspective: dividends are taxed in the country of the investor when they are viewed as received directly from the target company but the same dividends are taxed again on distributions in the country of the fund. Consequently, the dividend taxation imposes a double taxation in the sense that it *de facto* constitutes a part of the tax already levied by the investor's country in the period when dividends are distributed by the target company. However, if under the domestic law of the fund’s country dividends distributed by the fund are exempt from withholding tax, double taxation described above will not be an issue.

However, double taxation may still arise if the investor’s state treats the fund as opaque and tax dividends received from the fund. In this case the investor will be able to get tax credit for the tax withheld by the fund. However, the country of the target company treating the fund as transparent will also withhold tax as if paid directly to the investor. The investor in this case will not be able to get a tax credit for the tax withheld by the target company.

When analyzing the question whether the respective double tax treaty helps to resolve the above issues, it should be stressed that there is a discussion in the literature regarding whether double tax treaties can be applicable in such situations. According to par.1 of the Introduction to the OECD MTC the rules of double tax relief are typically designed to relieve juridical double taxation, i.e. when the same taxpayer is taxed twice in different jurisdictions in the same period on same income. However, since in the present situation the income is taxed in the hands of different taxpayers (the fund and the investors) and the income is taxed in different periods (in case of dividend distributions the investor's country taxes income upon earning whereas the fund's state upon distribution of dividends), double taxation which arises as a result of different treatment of the funds does not fit in this concept. This double taxation constitutes economical double taxation, i.e. when the same income is taxed in the hands of different taxpayers. There is therefore a risk, at least from a theoretical perspective, that even in case the double tax convention between the countries is in place, economic double taxation cannot be adequately prevented by the application of the double tax treaties.[98]

The author does not find any convincing motive not to apply double tax conventions in case of such economical double taxation. It imposes the same obstacles on international investment as juridical double taxation. And par.1 of the introduction to the OECD MTC clearly states that harmful effects on the movement of capital are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries. This conclusion is also supported by the fact that the OECD Partnership Report was aimed to make the OECD MTC applicable in such situations.

Based on this conclusion, the next question which should be addressed is does the OECD MTC provide for double tax relief in the situation of double taxation caused by different treatment of the fund. It was concluded based on the analysis in relation to the treaty entitlement of tax transparent funds in chapter III of this thesis that tax transparent funds cannot be considered as tax residents for tax purposes and consequently they are not entitled to treaty benefits. Instead, investors in this case can claim tax relief. Applying this conclusion to our example, if the state of the investor treats the fund as transparent, it will consider it as not entitled to the benefits of the double tax treaty between the investor's state and the fund's State, however, it will allow the application of the treaty between the state of the investor and the state of the target company. Whereas the fund's state treats the fund as non-transparent and therefore subject to provisions of tax treaties concluded by this state. Hence, there is a problem in that the countries have different views on who is entitled to treaty benefits.

Assuming the tax treaties correspond to the OECD MTC, according to article 13(5) of the tax treaty between the investor's state and the state of the target company capital gains should be taxed only in the investor's state (the state where the alienator is a resident, the investor is considered as alienator).

[98] M. Lang, *The Application of the OECD Model Tax Convention to Partnerships*, Vienna: Linde, 2000, p. 29;

However, according to the same provision of the tax treaty between the fund's state and the state of the target company capital gains should be taxed only in the state of the fund.

Moreover, when the fund distributes the proceeds received from the sale of the target company to the investor, the state of the fund would recognize this distribution as a dividend from which it could withhold tax. But because the investor's state treats the fund as not entitled to the respective tax treaty, it might not grant any tax credit in respect of the tax withheld on the dividend by the fund's state.

Thus, the double taxation is not relieved by the application of the respective double tax treaties in the analyzed example.

Theoretically, double taxation resulting from the denial of double tax treaty access caused by the different classification of funds by different states could be avoided by way of a mutual agreement procedure between the tax authorities of the states concerned under article 25 of the OECD MTC. In practice, however, it is very hard for the countries to come to an agreement since it means that one of the countries would have to abandon its own tax treatment of the fund. Even in the case where mutual agreement is reached, it would generally only be binding on the two contracting states concerned and only in relation to a specific case. In addition, mutual agreement procedures are considered very burdensome and time-consuming. Thus, this solution does not appear to be effective.

In practice in order to avoid double taxation and to obtain legal certainty, investors have to interpose in the fund structure legal entities (such as holding companies) the classification of which is certain for all jurisdictions involved. However, this structuring may not be considered as a viable solution as it represents a significant additional cost.

It is important to note that the problem regarding the applicability of the OECD MTC in the situations of different classification was addressed by the OECD in the Partnership Report. As a result of the report, the application of the OECD MTC in asymmetrical situations is addressed specifically in the Commentaries on the OECD MTC.[99]

Based on the approach of the Partnership Report and the Commentary to the OECD MTC "the state of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person

[99]Par. 6.1-6.4 of the Commentary to article 1, par. 8.4 of the Commentary to article 4, par. 32.1-32.7 and par.56.1-56.3 of the Commentary to article 23A and par. 69.1-69.2 of the Commentary to article 23B of the OECD MTC;

claiming the benefits of the Convention as a resident".[100] It means that the source state shall recognize and follow the tax treatment of the fund in the country where the persons claiming treaty benefits are resident, regardless of its own classification. Applying this principle to the example under analysis the state of the target company (the source state) must recognize the opaque status of the fund and apply double tax treaty with the country of the fund and not the investor. As a result, the fund will be entitled to get tax credit for the tax withheld by the target company at a respective reduced rate. However, following this principle, in the situation of further distribution of profits by the fund to the investor, the fund should recognize the tax transparent treatment of the fund, so this principle obliges the fund state to follow the tax treatment of the fund of the investor's state. This means that the fund's country will have to reclassify its own vehicle. The OECD in the Partnership Report recognized unreasonableness of this approach in this situation mentioning that every jurisdiction has the power to create its own domestic entity types (such as investment funds in the form of partnerships in our case) and to tax them according to the principles it finds appropriate. No rule may deprive them of that right.[101] It is therefore not feasible to oblige the fund's country to disregard the actual characteristics of its domestic entity for the benefit of the classification made in another state.

In addition, such a solution will result in situations where the same type of business vehicle is treated differently for domestic tax purposes depending on whether its investors are foreign or domestic. Moreover, the tax treatment will depend on where the foreign investor resides as the rules of his country will determine how the entity should be classified. This could give rise to difficulties when the fund has investors in more than one foreign state and where these states classify the fund differently.

Thus, it is hard to expect that any country would approve the solution offered by the Partnership Report and the Commentaries to the OECD MTC.

However, from this approach it can be concluded that the main idea of a solution for the double taxation issue should be to ensure a symmetrical tax classification of the fund. Moreover, it is clear that any approach that does not respect the tax treatment of the fund in the state of its establishment will lead to the unacceptable consequence of the entity state to disregard the actual tax law characteristics of the entity for the benefit of the tax treatment adopted by a foreign state. This means that the most reasonable alternative would be to adopt an approach which obliges any country other than the fund's state, i.e. the country of the investor and of the target company, to respect the tax treatment of the fund in its home state.

[100]Par. 6.3 of the Commentary to article 1 of the OECD MTC; par.53 of the OECD Partnership Report;
[101]Par.131 of the OECD Partnership Report;

This approach actually was proposed by the European Commission in its VC Report which also suggested that the concept of mutual recognition should be introduced by an EU Directive, in order to ensure a common implementation into the domestic law of all Member States. Indeed, this approach would solve the issue of double taxation raised because of different classification of the fund vehicles by different states within the EU. However, the problem will still remain in case of cross-border investments involving non-EU participants. Moreover, the practical implementation of such approach will be difficult and time-consuming.

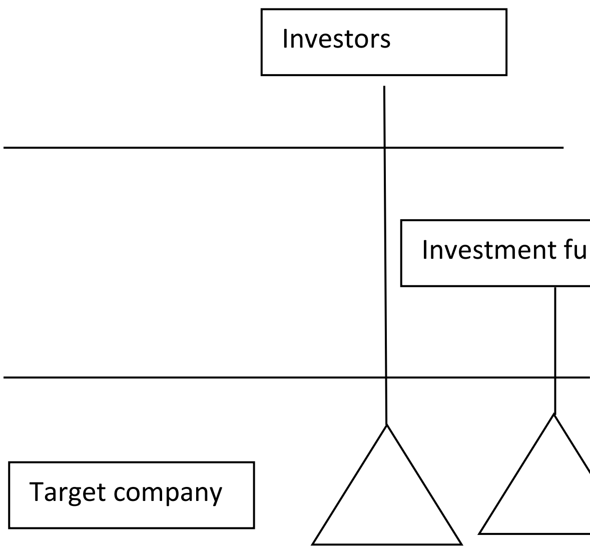
Another solution proposed by the VC Report is that EU Member States could agree on a common classification of certain specific legal forms often used for private equity funds as either non-transparent or fully transparent. The Member States could issue a list detailing these different legal forms of taxable or fully transparent funds. The list should be implemented through an EU-wide legal arrangement or by general agreement or on a bilateral basis between Member States. In the author's opinion this approach can be realized in practice, however, in order to be able to cover all types of the funds it is recommendable either to include an "open clause" which would stipulate that the classification of newly established forms of investment funds should be determined based on the agreed classification of the vehicles which share similar characteristics with the newly established vehicles or, and this second approach would provide more legal certainty, to update the list of the investment funds on a regular basis (e.g. annually). The latter approach is actually effectively applied in respect to the annexes of the Parent-Subsidiary Directive.[102]

[102] Annex I. Part A. List of companies referred to in Article 2(a)(i) has been updated several times. The last update was made by the Council Directive 2011/96/EU of 30 November 2011 "On the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States;

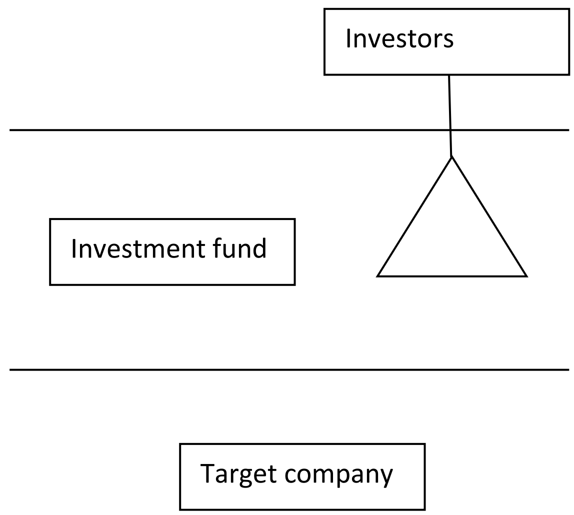
4.2 Permanent establishment issues related to cross-border private equity investments

Permanent establishment issues may arise in practice in two different cases: permanent establishment for investors and/or the fund in the home country of the target companies (see picture 3) and permanent establishment for foreign investors in the home country of the fund (see picture 4).

Picture 3.



Picture 4.



4.2.1 The permanent establishment for investors and/or the fund in the home country of the target company

The role of the management company/the fund manager in the investment fund structure is extremely important. The fund manager, acting under the service contract with the fund, may carry out activity of research and selection of potential investments, evaluation of such investments, preparation of the business and financial model, drafting of a proposal of investment, supervision and coordination of the due diligence activity, negotiation of the contracts and conduct of the acquisition process until completion, monitoring of the investments, identification of potential buyers and alternative exit strategies and reporting to the investors or the fund.[103] These activities ideally require a presence of the fund manager in the state of the target company which in practice in some cases leads to the risk of creating a permanent establishment for tax purposes for the fund or for its investors in that state. The result of this could be undesired double taxation (taxation of the investment in the country where the investment takes place and also in the country where the investors are located) which can make investing in private equity uneconomic for investors.

[103]EC public consultation paper, *Problems that arise in the direct tax field when venture capital is invested across borders*, 3 August 2012, p.3;

In order to understand why the tax authorities of many countries view the activities of the fund manager as creating a permanent establishment, it is necessary to analyze the concept of permanent establishment. The concept of a permanent establishment is necessary to ensure that jurisdictions can protect their tax bases. Without this concept, a business could be carried on in a country and not be taxable there if it was not carried on as a separate business through a local entity such as a subsidiary. If a permanent establishment exists then it normally follows that the profits attributed to that establishment are subject to tax in the state where it is situated.

Although each state generally has its own domestic definition of what constitutes a permanent establishment, this is usually overridden where there is a double tax treaty between the state of the enterprise and the state where the permanent establishment of the enterprise is situated. In such a case the definition contained in the tax treaty shall apply which is usually based on the definition contained in Article 5 of the OECD MTC.

Article 5 of the OECD MTC in principle provides two grounds when permanent establishment may occur. First, on a general basis an enterprise will be considered to create a permanent establishment in another state if it has a fixed place of business there through which the business of an enterprise is wholly or partly carried on.[104] Second, a permanent establishment will be created in case there is a person present in another state who is acting on behalf of an enterprise and has, and habitually exercises, in that State an authority to conclude contracts in the name of the enterprise.[105]

4.2.1.1 The permanent establishment according to article 5 (1) of the OECD MTC

Analyzing the former permanent establishment ground, it should be noted that the term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal.[106] The term "fixed" means that the place of business shall have a certain degree of permanency, which is generally a period longer than six months.[107] The author's view is that the fund manager cannot be considered as a place which is at the fund's or investor's disposal even in case, for example, when the fund manager has a local office in the country of the target company for facilitating of providing of its services. However, in case the fund maintains a local office in the country of a target

[104]Article 5(1) of the OECD MTC;
[105]Article 5(5) of the OECD MTC;
[106]Par.4 of the Commentary to article 5 of the OECD MTC;
[107]Par.6 of the Commentary to article 5 of the OECD MTC;

company through which the fund manager carries out its daily activities, such local office can be seen as a "fixed place of business" of the fund.

However, for the purposes of creating a permanent establishment it is not enough to have a fixed place of business, but the business of an enterprise (the fund or the fund's investors) should be wholly or partly carried on through this place.

In this respect it makes sense again to consider two possible management models of the investment fund: internal and external management.

4.2.1.1.1 Internally managed private equity fund

As it was concluded in section 2.1.5 of the present thesis in case of internally managed fund the nature of the activity of the fund management team employed by the fund does constitute the activity of the fund. It means that the find itself carries on business activity. Consequently, if the fund's managers present in the country of the target company and have their fixed place of business through which they perform their functions, the fund will create a permanent establishment in the country of the target company on the basis of article 5(1) of the OECD MTC.

4.2.1.1.2 Externally managed private equity fund

However, in case of the external management, as it was mentioned in section 2.1.5 of the present thesis, it is important to distinguish the role and the business of the management company and the roles and the business of the fund and its investors. As it was concluded, the fund or the fund's investors themselves do not carry out any business activity whereas the management company carries out its own independent business. Thus, as there is no business activity of the fund (but only passive investment activity), there can be no permanent establishment of the fund or the investors in the country where the investment takes place.

However, since there is no certainty in respect of such understanding in practice, it would be advisable if the European Commission proposes a legislative framework establishing that the fund does not create a trade or business and therefore cannot create a permanent establishment.

Although it was concluded above that the fund manager cannot be regarded as creating a permanent establishment within the first ground of article 5 of the OECD MTC, the second ground – the risk of the agency permanent establishment - should be analyzed as this provision in most cases gives the tax authorities basis to try to declare the existence of permanent establishment in practice.

4.2.1.2 The permanent establishment according to article 5 (5) of the OECD MTC

According to article 5(5) of the OECD MTC notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

Under provisions of par.32 of the Commentary to article 5 of the OECD MTC persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether or not employees of the enterprise, who are not independent agents falling under par.6 of article 5 of the OECD MTC. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the state concerned.

Par.32.1 of the Commentary to article 5 of the OECD MTC clarifies that “authority to conclude contracts in the name of the enterprise” means that an agent does not necessarily enter into contracts literally in the name of the enterprise but also if he just concludes contracts binding on the non-resident even if the contracts are not actually in the name of the enterprise. The Commentary stresses that a lack of active involvement by the enterprise may be indicative of a grant of authority to the agent to conclude contracts in the enterprise's name, such as, for example, where the enterprise routinely approves transactions which are in reality dealt with by the agent.

In addition, the Commentary states that a person who is authorized to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise the authority to conclude contracts, even if the contract is signed by another person in the state in which the enterprise is situated.[108]

Currently within the EU the different approaches by the tax authorities of Member States create uncertainty as to whether the fund manager can be considered as dependent agent constituting a permanent establishment of the fund or its investors in that state. Some Member States take a position that the activity carried out by the fund manager in the country of the target company could be considered as that of a

[108] Par.33 of the Commentary to article 5 of the OECD MTC;

dependent agent on the basis that the fund manager is heavily involved in the negotiations and investment decisions and he negotiates all elements and details of an investment contract to be concluded between the investors and the target company in a way binding on the fund or the fund's investors. Typically, tax authorities take the view that it is even not necessary in this regard for the fund manager to act under the written authority or power of attorney but it is sufficient if the agent exercises the power to conclude contracts or negotiate their significant terms. In particular, this is the approach that the Italian tax authorities take in their tax audits.

However, it is crucial to remember that the concept of an agency permanent establishment explicitly excludes agents who have independent status. Based on article 5(6) of the OECD MTC an enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an agent of an independent status, provided that such persons are acting in the ordinary course of their business.

Paragraph 37 of the OECD commentary to Article 5 of the OECD MTC provides that agents would be regarded as not constituting permanent establishments of the enterprises for which they carry out their activity if they: (a) are independent of the customer, legally and economically; and (b) act in the ordinary course of their own business when acting on behalf of the customer.

The test of legal and economic independency can be assessed on the basis of the fact whether the fund manager has general freedom to act (albeit within an agreed scope of authority), rather than being subject to detailed instructions or comprehensive control of the enterprise.[109] Paragraph 38.6 of the Commentary to article 5 of the OECD MTC also states that a factor indicating an independent status is the number of principals that the agent represents. While this factor is not in itself determinative, the Commentary specifies that independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time.

4.2.1.2.1 Internally managed private equity fund

In case of internally managed fund it can be said that the fund manager employed by the fund acts on behalf of the fund in the country of the target company. It is clear that in this case the fund manager cannot be considered as independent agent as he has only one fund which he represents and he is dependent of the fund legally and economically. Thus, in case the internal fund manager habitually exercises in the state of the target company an authority to conclude contracts, i.e. involved in the negotiations and investment

[109]Par.38 of the Commentary to article 5 of the OECD MTC;

decisions in a way binding on the fund or the fund's investors, he can create a permanent establishment for the fund or the investors in the country of the target company on the basis of article 5(5) of the OECD MTC.

4.2.1.2.1 Externally managed private equity fund

The external fund manager/the management company acts under the service contract with the fund, it is paid an arm's length fee for its services, it is not normally subject to detailed instructions or day-to-day control by the investors of the fund, decides autonomously how to invest the funds received from the investors and bears the risk of its business activities. Thus, the fund manager conducts its activities under a general freedom to act.

Moreover, normally fund management agreements include provisions which make clear that the fund manager shall have absolute and unfettered discretion and authority to manage, invest and reinvest the fund. The management company is fully empowered by such management agreements to identify investment opportunities and to decide what investments shall be purchased, held, sold or exchanged by the fund and what portion, if any, of the assets of the fund shall be held uninvested. Thus, it has autonomy on the definition of investment strategies. Typically, investors rely on the special skills and knowledge of an external fund manager/management company's experts to research the local market and identify and assist possible investments which the fund and the investors do not have. This is an indication of independence.[110]

Although the external fund manager/the management company is very often obliged to report to the investors, this cannot be considered as sign of dependence. Based on par.38.5 of the Commentary to article 5 of the OECD MTC the provision of information to the investors is not a sufficient criterion of dependency unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. As the provision of information to investors is intended to ensure the smooth running of the agreement between the fund manager and the investors and good relations with the investors, this does not make the fund manager a dependent agent.

In addition, the external fund manager/management company usually provides services to a plurality of funds and funds' investors.

[110] Par.38.3 of the Commentary to article 5 of the OECD MTC;

The activities of the external fund manager/management company would continue even if one or more of a number of investors withdraw from a particular fund; the management company's activities will remain the same in relation to those investors who are in fact present in the fund, which is indicative of the activities' independence of any particular investor's participation.

Moreover, the activities of the external fund manager/management company can be considered as activities carried on in the ordinary course of business since they do not belong to the sphere of the investors and, consequently, they are customarily carried out by the fund manager.[111]

Based on the above, the author's opinion is that the external fund manager/management company shall be considered as an independent agent with the consequence of not creating permanent establishment for the fund or the investors in the country of the target company.

4.2.1.3 Possible solutions to the permanent establishment issue

Since there is inconsistency and uncertainty among countries regarding the question of creation of a permanent establishment of the investors or the fund in the country of the target company caused by activities of the external manager/management company, the fund industry of many countries interested in attraction of investment tries to adopt remedies to ensure that no permanent establishment of the fund or of the investors is deemed to exist in the state of the target company in this situation. Because of this uncertainty, fund managers in practice have to limit their activities they carry out in the jurisdiction of the target company to the mere provision of advice. In such a case the fund managers usually establish an advisory company in the state of the target company which analyses the local market, identifies and evaluates potential investment opportunities and prepares investment proposals, including proposed terms and price. Once the investment is made by the fund, the advisory company provides some further services related to activities of the target company aimed at increasing its value and monitoring its performance. The advisory company functions under the service agreement signed with the fund manager are limited to those indicated above; it does not perform managerial functions, it is not granted authority to conclude contracts and its participation in negotiations is subject to detailed and frequent reporting to the fund manager which would be responsible for approval and decision on whether to proceed with an investment.

This helps to ensure that it could not be said that the advisory company negotiates elements and details of a contract in a way binding on the fund or the fund's investors and as a result constitutes a permanent establishment in the country of the target company. However, such practices are very disadvantageous for

[111]Par.38.8 of the Commentary to article 5 of the OECD MTC;

funds from a commercial and management point of view: they are highly inefficient, costly to implement, complex and create lower returns.

Ideally the fund's cross-border investments require management functions in the country of the target company in order to actively contribute to investment decisions and facilitate investment and after-investment process and it seems artificial and restrictive to limit the local expert's activities only to giving advice on the investments of the fund. Thus, removing this obstacle would facilitate cross-border investments significantly.

The optimum solution to the above taxation problem which was suggested by the VC Report and which is supported by the author would be for the tax authorities of the state of the target company to confirm that the activities of the fund manager in regard with the fund and its investors could be classified as activities of an independent agent as defined in the OECD MTC, and therefore as not constituting a permanent establishment of the fund or its investors in the country where it carries out its management functions. This could be achieved through clear statements from tax authorities that they agree with such treatment of fund managers.

It is interesting to note that the question of permanent establishment issue related to activities of fund managers was addressed in the OECD discussion draft on the "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention" released on 12 October, 2011. However, dealing with the question whether a local fund manager could be considered to be an independent agent if it concluded contracts in the name of the enterprise, the working group did not provide any answer, referring to the fact that it would be difficult to provide specific guidelines as the situation is highly factual.[112]

However, in the author's opinion, it would be recommendable to include the provisions into the Commentary to article 5 of the OECD MTC clarifying that fund managers carrying out management functions are independent of the investors and of the fund both legally and economically and act in the ordinary course of their business and, therefore, qualify as independent agents. It is also possible to list the typical fund manager's activities.

In the VC Report it was mentioned that some experts believe that the independent agent treatment should apply only among EU Member States with regard to investors and fund vehicles which are resident or established within the EU and that in other cases the provisions of double tax conventions, if any, should

[112]Par.129 and 131 of the OECD discussion draft on the "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention" of 12 October, 2011;

apply. The reason behind this was to minimize the risk of abuse. However, the author cannot agree with such limitation of the suggested solution to the EU Member States. Without extension of the this solution to fund vehicles outside the EU or tax convention network, the benefits to the fund industry would be lost as there are many funds investing across the EU with fund managers located outside the EU. At the same time, EU Member States should be able to continue to apply their existing anti-avoidance or evasion rules where these comply with the EU Treaty freedoms and non-discrimination rules.

4.2.2 The permanent establishment for investors in the home country of the fund

In case when the fund takes a fiscally transparent form, some countries have a position that a mere investment into such fund causes the foreign investor to create a permanent establishment in the country of the fund. The result of such approach is that the foreign investor will be taxed on its investment income in the country of the fund.

According to article 5(1) of the OECD MTC the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

The notion of an “enterprise” was analyzed in section 2.1.5 of the present thesis and the author concluded that there can be no enterprise both at the level of the fund and at the level of the investors.

However, countries which try to treat transparent funds as permanent establishments of the investors usually use the following reasoning. They consider that the fund forms a distinct enterprise carried on jointly by the investors. This enterprise, being carried on by each investor, constitutes an enterprise of each contracting state of which an investor is a resident as regards the share of that particular investor. This approach of seeing the transparent fund as a distinct enterprise carried on by the investors is based on the par.19.1 of the Commentary to article 5 of the OECD MTC dealing with partnerships and originates from the Commentary to the OECD MTC 1963 which stated that “each participation in a transparent partnership is looked upon as a separate enterprise”[113]. At the same time these countries qualify the acquisition, management and disposal of target companies as “own business activities” of the fund for tax purposes. Such approach, for example, is applied by Finland.

Under this approach if a non-resident investor invests in a tax transparent fund that is actively managed by a management team operating from the fund’s country, the foreign investor can be considered as engaged in business activities through a permanent establishment in the country of the fund.

[113]Section 6 of par.1 of the Commentary on article 3 concerning definitions of the OECD MTC 1963;

As a result, the investor's country may not provide for double taxation relief in respect of income taxed in the fund's country as from the perspective of the investor's state the activities of the fund do not constitute a business enterprise with the result that there is no permanent establishment of the investors in the fund's country. Tax treaties concluded between the country of the foreign investor and the fund's country will generally not force the investors' country to grant double taxation relief in case of a mismatch between two treaty countries in determining whether or not certain activities are deemed to constitute a permanent establishment.[114]

In the author's opinion, it can be argued whether the acquisition, management and disposal activities can be attributed directly to the transparent fund's activities as in majority of cases the transparent fund has a management company acting under the agreement with the investors which performs these activities. As it was analyzed above in section 2.1.5 of this thesis, the nature of the fund's activities is totally different from the fund manager's activities. Investment funds themselves do not carry out any business activity but are merely used for passive investments generating solely passive income (dividends, interest, capital gains). It is not appropriate to apply the conclusions of par.19.1 of the Commentary on article 5 of the OECD MTC to the specific case of investment funds in the form of a tax transparent partnership.[115] As there is no business activity of the fund, unless the investors directly participate in the management activity of the fund, there can be no permanent establishment of the investors in the fund's country.

However, since there is an uncertainty in respect of this question nowadays, an effective solution must be found. Being aware of this issue some countries try to solve it domestically. For example, Luxembourg law clearly mentions that SICARs set up in the form of a partnership will never be considered as performing a commercial activity.[116] There is therefore no risk of a Luxembourg permanent establishment when SICARs are set up in Luxembourg to invest in the venture capital sector. Denmark, for instance, has different approach in solving this problem. Danish tax authorities provide the fund's investors with advance tax rulings confirming that foreign investors investing in Danish private equity and venture capital funds does

[114]This is based on par.32.5 of the Commentary to article 23A and B of the OECD MTC according to which conflicts resulting from different interpretation of facts or different interpretation of the provisions of the Convention must be distinguished from the conflicts of qualification. In the former case the state can argue that double taxation arose from the wrong interpretation of the facts and the Convention and, consequently, refuse to give a relief;

[115]EVCA comments on the discussion draft on "*Interpretation and application of article 5 (permanent establishment) of the OECD Model Tax Convention*", 8 February 2012;

[116]Response of the Taxand to the EC public consultation on "Problems that arise in the direct tax field when venture capital is invested across borders". Retrieved from: http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/double_non_tax/tax_problems_venture_capital_investment_en.pdf. Last visited on 28 August 2013;

not create a permanent establishment in Denmark.[117] The UK adopted a special legislative provision known as the "investment management exemption" under which a passive investment activity in a fund is never to be regarded as a trading or business activity except for the case when an investor acts as a dealer in securities or a financial trader.[118] However, in the author's opinion a common solution of this issue shall be found which should be implemented into the domestic legislation of EU Member States or/and tax treaties. Such provision should clearly state that the fund management activities should not constitute a trade or business enterprise for tax purposes. As a consequence, an investor in a tax transparent private equity fund cannot, solely because of its investment in the fund, be considered to be engaged in business activities. If the fund (and therefore the investors too) is not deemed to be engaged in business activities, the permanent establishment issue cannot arise.

4.2.3 Possible solution at the European level

It is interesting to mention that in its response to the European Commission Public Consultation paper on "Problems that arise in the direct tax field when venture capital is invested across borders" European Private Equity and Venture Capital Association (EVCA) proposed the creation of a pan-European tax-neutral vehicle, which aim is to eliminate the discriminatory and prejudicial treatment of investors as soon as they are "pooled" in a fund and to ensure that investors are treated the same as if they had invested directly into the underlying portfolio companies.

Based on the EVCA idea this new vehicle would be the best and most effective solution to resolve the problems and obstacles referred to above in sections 4.2.1 and 4.2.2, at least within the EU. This vehicle is supposed (i) to be treated as fiscally transparent in all Member States irrespective of whether the Member State is the home country of the investor, the fund entity, or the investee company (the "Transparency Rule"), and (ii) not to be considered to be engaged in business for tax purposes (the "Non-Business Rule").

According to the EVCA opinion, this may be achieved either by way of introducing a European fund entity or by way of introducing a regulation that requires Member States to observe the Transparency Rule and the Non-Business Rule if the fund and its investors elect the application of this regulation.

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[117] Response of the Association of Danish Tax Lawyers to the EC public consultation on "Problems that arise in the direct tax field when venture capital is invested across borders". Retrieved from: http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/double_non_tax/tax_problems_venture_capital_investment_en.pdf. Last visited on 28 August 2013;

[118] D. Gubbay, *The investment management exemption – New statement of practice published*, a legal update from Dechert's Tax Group, August 2007. Retrieved from http://www.dechert.com/files/Publication/76152815-6a45-4e1f-a017-fdc3c54a008a/Presentation/PublicationAttachment/8e59a486-9488-4da4-a8d7-018e2c4ef0d5/Tax%20_Update_%2008-07.pdf. Last visited on 28 August 2013;

In the author's opinion, a pan-European tax neutral fund structure can play a positive and supporting role in solving the most important tax problems of the funds. However, the author is completely sure that it should be done in parallel with existing investment funds regimes implemented in countries domestically leaving the possibility for investors to structure their strategies using opaque vehicles. This can be important in case the investors and/or management company of the fund are interested in getting a treaty access for the fund vehicle. Taking into account the issues of treaty entitlement for tax transparent funds described above, application of a pan-European fund structure can be unfavourable.

In addition, by suggesting to introduce such vehicle, the European Commission first must solve the administrative problems related to withholding tax relief analyzed in section 4.3 below.

4.3 Withholding tax relief obstacles

In principle, in a standard situation when dividends are paid, they are subject first to withholding tax in the country of the payee and then again in the hand of the recipient with the result that juridical double taxation arises. Such double taxation usually avoided by double tax treaties by provision of a credit allowing to offset the withheld tax against tax liability to be paid in the recipient's country. However, when applied to the funds, certain issues may arise in respect of the withholding tax offset influenced, in particular, by the problem of treaty entitlement of investment funds.

In case the fund is opaque for tax purposes and entitled to benefit from the applicable tax treaty protection, theoretically it is entitled to get a credit for the withheld tax. However, as it was described above in most cases countries, trying to achieve tax neutrality between direct and indirect investment, implemented special tax regimes for funds which provide for exemption. These are likely the situations when an investment fund that is liable to comprehensive taxation in the state where it was established, is not actually subject to tax. Thus, there is no tax liability that can be offset against the withholding tax levied in the state of the distributing company. It means that in practice the non-transparent exempt funds will not be able to claim any tax credits in the fund's state.

Furthermore, dividends are usually subsequently distributed by the fund to the investors and in most cases there is no withholding tax on dividends paid to resident and non-resident investors by the fund. When dividends are received by the investors, the investors are not able to get credit for the tax withheld at the level of the target company against their tax liability since the tax treaty between the country of the fund and the investor's home country is applicable in this case, but there is no withholding tax in the fund's state.

Consequently, tax neutrality is not achieved in this situation cause in case of direct investment the investors would be able to offset the respective withheld amount of tax and would be better off in comparison with the investment through the opaque fund vehicle.

This obstacle for foreign investors could be neutralized if a tax treaty between the country of the distributing company and the country where the fund is resident would allow for the foreign tax credit to flow through to the fund's investors. In this case the investor would be able to offset the withholding tax and tax neutrality would be achieved. However, in practice it can be possible only if the investors are resident in the same country as the fund. Otherwise, double tax treaty between the fund's state and the state of the distributing company on the one hand and tax treaty between the fund's state and the investor's state would be in conflict.

In case the investors are resident in a country other than the fund's country of residence, neutralization could be achieved if, under a tax treaty between the state of residence of the fund and the state of residence of the investors, the latter state specifically allows, as a deduction from the tax liability of its residents, an amount equal to the withholding tax levied in the state of the distributing company. This provision named "equivalent beneficiary approach" is suggested by the CIVs Report.[119] Although this report is not applicable to private equity funds, the author cannot find any impediments not to apply this solution in the present situation. At the same time the author agrees with the Report in that in practice some countries may be reluctant to include such a provision in a bilateral treaty because it would constitute a two-party, and therefore incomplete, solution to a multilateral problem.[120] As a result, a Contracting State potentially would be providing relief for taxes paid to a third State without regard to whether that third State would provide reciprocal benefits.

In the situation when the fund is treated as tax transparent for tax purposes the tax neutrality is achieved as the investor will be entitled to offset the withholding tax levied in state of the target company.

However, it seems that in practice this is more theoretical rather than feasible solution: difficulties may arise for investors in filing applications for withholding tax relief. The situation of a transparent fund requires each single investor to apply for relief of withholding taxes on dividends in the country of the target companies. In practice, such applications are often not filed, due to the administrative workload which their preparation and filing involves. First, it is very difficult for an investor to track the source of the income distributed by the transparent fund and apply the correct tax treatment to each item of income.

[119]Par.45 of the CIVs Report;
[120]Par.46 of the CIVs Report;

Administrative difficulties such as too many changes in ownership, too small amount to file can prevent investors to claim relief. Furthermore, the fund may capitalize its income rather than systematically distribute all of the income it generates. As a matter of simplification, the Luxembourg tax administration, for example, considers, as far as Luxembourg resident taxpayers are concerned, that income arising in an FCP becomes only taxable in the hands of the investors when it has been distributed to them, whereas in theory such income should be taxable in the hands of the Luxembourg resident investors whether distributed or not. As a result the investors do not have the information when the tax was factually withheld by the target company. All this may discourage investors to make investments via fund vehicles.

The solution which seems to be feasible is proposed by the VC Report and it is to allow funds to apply for exemptions from, reductions of, or refunds of, withholding taxes on behalf of their investors. The applications would be made in accordance with the tax treaty which the state of the target company has concluded with the state of residence of the respective investor, or, if more beneficial, in accordance with the domestic law of the state of the target company. The fund's entitlements under the respective tax treaty or, as the case may be, domestic tax legislation, should be determined on the basis of the investors' commitments to the VC fund. The entitlement of the fund to apply for tax relief under tax treaty or under domestic tax laws on behalf of the investors should be considered as a separate matter from the entitlement of the fund to tax treaties in its own right.

V. Tax implications of the Alternative Investment Fund Managers Directive

5.1 Aim, scope and impact of the Alternative Investment Fund Managers Directive

Historically AIFMs were regulated by a combination of national regulations and general provisions of EU law, supplemented in some areas by industry standards.[121] AIFMs in principle impose many risks on the markets which was especially evident in situation of the economic crisis that began in 2007 and 2008. They contributed to asset price inflation in many markets. Indeed, in adverse market conditions of the financial crisis, many AIFMs were faced with increased redemption demands from investors and with tighter lending conditions from banks. Faced with such pressures, funds were often forced to sell assets into declining markets – thereby realizing losses and adding further momentum to declining asset prices. This behaviour without any doubts contributed to a deepening of the crisis.[122]

At the same time the impact of AIFMs on the markets in which they operate can be largely beneficial since they may serve to spread or amplify risks through the financial system.[123] However, due to lack of coordination within the European Union, the efficient management of those risks appeared to be difficult to effectuate.

For that reason, in order to establish a common European regulatory framework for managers managing AIFs the AIFMD was introduced.[124] AIFMD came into force on 21 July 2011 and Member States were granted a two-year period to interpose it into national legislation. Implementation process was finished by 22 July 2013. On 19 December 2012 the European Commission published the Commission Delegated Regulation implementing the Level 2 provisions of the AIFM Directive. These measures also became effective as of 22 July 2013 and they contain detailed rules on a significant number of issues, including on depositaries, leveraging and transparency.

AIFMD regulates both external AIFMs acting under service agreement with the investors of the fund and in case of internally-managed AIF – the AIF itself. Although the preamble of the AIFMD explicitly mentions that it does not aim to regulate AIFs, by means of regulating the management companies it effectively regulates the funds themselves. As the scope of the AIFMD is wide, capturing nearly all non-UCITS collective investment vehicles, undoubtedly, it will have a considerable impact on the business of private equity investment funds in Europe.

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[121] L. Woltring and T. Daniels, *EU Directives - Investment Funds & Private Equity*, Topical Analyses IBFD, 2013;

[122] Commission staff working document of 30 April 2009 "Impact assessment" accompanying the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/…/EC;

[123] Par.2 of the Preamble to the AIFMD;

[124] Preamble to the AIFMD;

When it comes to assessing the impact of the AIFMD on AIMs and its AIFs, AIFMs should review their structures to map where their AIFMs, AIFs and investors are located, as this will drive how the AIFMD rules apply to them and, as a result, what their choices could be when it comes to reacting to the Directive's requirements.

AIFMD provides two different regimes for the marketing of the funds: (i) one is for EU managers managing EU funds and (ii) another one is for non-EU managers managing EU funds or non-EU funds to investors in the EU and EU managers managing non-EU funds.

The first category of AIFMs will benefit from an EU passport and shall be fully compliant with and authorized under the AIFMD until 22 July 2014. An EU passport will permit EU-based AIFMs to market units or shares of its EU-based AIFs to investors in the whole EU similar to the UCITS.

For the second category of AIFMs regulation under the AIFMD is lower. An EU AIFM managing non-EU AIF should be fully compliant with and authorized under the AIFMD, except that it can benefit from softer depositary requirements.[125] However, it will not have access to the EU passport until 2015. Access to EU professional investors will continue under the national private placement regimes.

Non-EU managers mentioned in the second category are also able to market their EU and non-EU AIFs to EU investors by using the existing private placement regimes. Although the AIFMD does not modify existing private placement regimes, there still some requirement to be met under the AIFMD if AIFs are to be marketed in the EU by non-EU AIFMs through private placement regimes. Such requirements are the following: (i) appropriate cooperation agreements should exist between the regulator in the EU Member State into which marketing takes place, and the supervisory authorities/regulators of the countries in which the AIFs and non-EU AIFMs are established; and (ii) the third country where the non-EU AIFM is domiciled should not be listed as a non-cooperative country and territory by the FATF[126]; and (iii) the non-EU AIFM should comply with the transparency requirements of the AIFMD. As from 2015 a non-EU AIFM may be provided access to the EU marketing passport with the obligation to be fully complied with the AIFMD. However, it will be on voluntary basis and AIFMs may decide to continue marketing its AIFs in the EU through national private placement regimes until 2018. In 2018 the European Security and

[125]The AIFMD exhaustively prescribes which parties may act as a depositary. The biggest group of depositaries is those for which depositary services are part of their professional business, such as authorized credit institutions and investment firms. For non-EU AIFs, an entity of a similar nature may be appointed as long as it is subject to effective prudential regulations and supervision of the same effect as EU requirements. In addition, a prime broker may act as depositary provided its depositary functions is functionally and hierarchically separated from its prime brokerage functions;

[126]http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/documents/public-statement-june-2013.html;

Markets Authority (ESMA) is expected to report on whether this regime should remain a route available to access investors in the EU.

As we can see, EU AIFs with EU AIFMs get access to passport under AIFMD, allowing them more certainty of being able to market across the EU. However, in the first phase of AIFMD implementation, non-EU AIFMs cannot become authorized under the AIFMD and must access the EU market through individual country private placement regimes. The AIFMs of these AIFs will still need to meet some of the AIFMD requirements and at the same time access only through private placement regimes may bring certain difficulties as these regimes are different from country to country. Managers need to check the requirements in each country before marketing there to ensure they are able to raise new capital in that country or whether they need to meet additional requirements first. That is why non-EU AIFMs which are focused on marketing their AIFs to investors within the EU in order to avoid such complications may decide that it will be more beneficial for them to be based in the EU. This can be also a policy issue, since European investors being aware of the protection they can get from the AIFMD may prefer to invest into EU-funds managed by EU managers. In order to be competitive on the European market non-EU managers may consider re-domiciling to Europe.

In addition, although AIFMD makes no changes to private placement regimes, some countries, for example, Germany and France, take steps to change or even abolish their private placement regimes now, so all AIFs that access their market in future will have to do so under the AIFMD passport. This can be additional drive for relocation.

Even if the manager considers it appropriate to manage its non-EU fund from non-EU jurisdiction, in some cases the issue of re-domiciling to the EU or another non-EU country may arise, in particular, in case the necessary cooperation agreements are not entered into by the relevant authorities or the non-EU country, in which the non-EU AIF or the non-EU AIFM is domiciled, is listed by FATF as a “Non-cooperative country and territory”.

5.2 Tax implications of the Alternative Investment Fund Managers Directive

Although the AIFMD does not directly regulate taxes, as we could see above in order to comply with its rules fund managers will have to adapt and change their operating model to ensure compliance with the Directive. Strategic and operational issues which fund managers need to consider in this respect may have significant tax implications.

5.2.1 Issue of residency

One of the most important issues which can arise from the AIFM relocation is the issue of residency as it may lead to double taxation or generate a complex and unpredictable tax regime for the fund and its investors. Under the generally accepted doctrine, many EU Member States determine the residency of an entity for tax purposes on the basis of its place of effective management and, consequently, transfer of the management company may result in a change of tax residency of the AIF. It may lead to different adverse consequences. For example, if the fund in the jurisdiction of its location benefited from tax-exempt status the transfer of the management company to another state which does not provide specific tax-neutral regime or such regime is subject to specific conditions the fund does not fulfill will lead to taxation of the fund.

In case one country determines residency of the fund according to where the fund is registered and another applies the approach according to which the residency is defined as a place where effective management is exercised, dual residency may arise. In case there is no double tax treaty between the countries solving this issue, it can lead to unrelieved double taxation. According to article 4(3) of the OECD MTC where a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the state in which its place of effective management is situated. However, even in case double tax treaty exists, it may not include the respective provision similar to article 4(3) of the OECD MTC. Moreover, even if it contains it, this cannot protect the fund and its investors from adverse tax consequences in case the country of the effective management generates worse tax regime for the fund.

One more issue which is relevant is availability of relevant tax treaty benefits under an applicable tax treaty. Based on article 1 of the OECD MTC the application of tax treaty requires a person to be a resident in one or both of the contracting states. The result of change of residency and consequently the change of applicable tax treaty can be that the new treaty signed between the country of the target company and the country where the place of effective management of the fund is located does not provide for the same relief or mitigation of withholding taxes on payments received from the target company.

The issue may become even more complicated in case the country where the place of effective management is situated classifies the fund differently for tax purposes treating it, for example, as non-transparent instead of transparent (see picture 5). In this case the distributions by the fund to its investors might become subject to withholding taxes under the legislation of the country where place of effective management of the fund is located. Also a future sale of the units or shares may trigger additional taxation at the level of the investors.

Thus, based on the above it is clear that tax issues should be the part of the general structure analysis of a relocation of the management company caused by the AIFMD.

5.2.2 Domestic tax developments introduced as a part of the implementation of the AIFMD

AIFMD focuses only on regulatory issues and does not coordinate tax matters which means that each Member State decides what changes if necessary it will make in its domestic legislation in connection with the interposition of the AIFMD. That is why countries which are interested in attraction of AIFMs, being aware of such undesired tax barriers resulting from relocation of AIFMs, directly addressed this issue in their domestic legislation introduced as a part of the implementation of the AIFMD. For example, the Netherlands amended general Dutch tax residency rule which determined that an entity is considered to be a tax resident of the Netherlands if its effective place of management is situated in the Netherlands. The new amendment provides an exception to the tax residency rule under which the AIF should not be considered a Dutch tax resident if it is registered in another state but managed in the Netherlands by a Dutch AIFM.[127] Luxembourg also found a solution to this issue by introducing a tax exemption for foreign AIFs when their central administration or place of effective management is located in Luxembourg.[128]

In addition to the solution to the above mentioned problem, countries interested in providing a flexible but secure and safe environment for AIFs and AIFMs, adopted other different tax benefits. The best example of the country trying to turn the implementation of the AIFMD for the benefit of managers and funds is Luxembourg. In addition to introduction of a new limited partnership (please see chapter II of this thesis) with similar features and advantages as an offshore partnership and solution to the issue of residency, it introduced many tax incentives important for AIFMs. In particular, it adopted a VAT-exempt status for AIFs and VAT exemption for management services performed by AIFMs.[129] Moreover, by the Bill of law No.6471 of 24 August 2012 Luxembourg introduced a specific tax regime dedicated to employees of AIFMs newly established in Luxembourg. The Bill distinguished between remuneration *stricto sensu*, i.e. the counterpart of the management mission, and carried interest. Remuneration *stricto sensu* falls within the scope of employment income (salaries), while carried interest falls within the scope of short-term

[127]P.Borsje and W.Specken, *Tax implications of the amended UCITS and the AIFM Directives: a general overview from a Dutch perspective*, Derivatives&Financial Instruments, Vol.14, no.4, 2012;
[128]R. Krawczykowski, R. Glohr and J. Lyaudet, *Luxembourg: Red carpet unrolled for alternative investment funds,* Tax Planning International Review, Vol.39, no.11, 2012;
[129]J. Afakir and P.Dukmedjian, *Implementation of the Alternative Investment Fund Managers Directive (2011/61) into Luxembourg Law: a full legal and tax beneficial package*, Bulletin for International Taxation, Vol.67, no.6, 2013;

capital gains. For new Luxembourg tax residents, carried interest remuneration will be considered to be extraordinary income and as such will benefit from a reduced taxation. Tax will only apply at 25% of the income tax rate including the solidarity surcharge, i.e. 10.9%. This beneficial regime is subject to certain conditions and will be available for up to 10 years after the year during which the relevant professional activity started in Luxembourg.[130]

[130] *Implementation of the AIFMD – Taxation of carried interest and main remuneration requirements*, flash news of PWC Luxembourg, 2013. Retrieved from: http://www.pwc.lu/en/aifm/docs/pwc-aifmd-110713-2.pdf. Last visited on 28 August 2013.

VI. Conclusion

Taxation of investment funds is very important aspect that directly impact the development of SMEs and growth of the European economy. The importance of this is especially crucial in the current economic turbulence and downturn. In the present thesis the author showed on examples of Luxembourg and Ireland that favourable tax treatment of private equity and venture capital investment funds is a key to successful development of the fund industry. Indeed, long history of existing tax incentives combined with permanent endeavours to make their funds more competitive by creating new niche vehicles and adapting legislation in response to the recent creation of a single market for alternative investment fund managers ensured for Luxembourg and Ireland the world's leading positions in the fund industry.

Analysis of the available tax regimes for private equity investment funds of both jurisdictions proved that it is necessary to ensure the tax neutrality of the fund vehicle irrespective of the form of its organization. Whether it is established as a tax-exempt company or as a tax-transparent partnership, an investor should not receive a tax advantage or suffer a tax disadvantage by using an investment fund rather than making a direct investment.

In the present thesis the author made an insight to the main tax problems of the private equity funds. First, the author analyzed the treaty entitlement of the funds and showed that nowadays there is no certainty in that regard: there are different views among states on whether the fund should be treated as a person, resident and beneficial owner of the income and, therefore, entitled to claim tax treaty benefits. Indeed, this problem makes states to seek solutions applying domestic approach or bilateral negotiations, however, the common solution to this problem should be found at the European level.

Further the author focused on the main obstacles to cross-border private equity investments.

The first obstacle arises from the fact that investment funds may be treated by different states in very different ways for tax purposes, i.e. transparent vs. non-transparent. This mismatch may cause difficulties in the application of double taxation treaties and consequent unrelieved double taxation. In the author's opinion, the solution suggested by the European Commission in the VC Report, i.e. mutual recognition of the classification applied by the home country of the fund for tax purposes, is difficult to implement in practice. That is why until the EU reaches the common approach, the issue should be addressed in double tax treaties.

The second obstacle arises because it is generally necessary for the fund manager to be personally present in the state of the target company. The state of the target company may treat such local presence of the fund manager as creating a permanent establishment of the fund or its investors and apply taxation accordingly. If the country of the fund and/or investors also applies taxation to the return on the investment, the relevant double taxation treaties may not provide for a credit. The author supports the solution to this problem suggested by the European Commission to adopt in the legislation that the fund manager should be considered as an independent agent.

In addition, the issue of the risk of creation of a permanent establishment of investors in the country of the fund was brought up by the author. The author came to the conclusion that the passive nature of the fund's activities as well as the mere fact of investments made by the investors cannot lead to creation of the permanent establishment.

The last tax obstacle analyzed in the thesis is that investors in most cases are not able to claim double tax treaty relief for tax withheld in the country of the target company both in cases of opaque and transparent funds. The author's position is that the allowing the fund to claim treaty relief on behalf of the investors can significantly facilitate cross-border private equity investments.

In the last chapter the author analyzed the impact of the recently implemented AIFMD on taxation of private equity funds' industry in Europe. The fact that the AIMD causes fundamental reviews of business models may lead to the issue of the change of residency for the funds as a result of re-domiciliation of the fund's manager location. The author showed on examples of The Netherlands and Luxembourg what solutions may countries take in order to address adverse tax consequences which may arise because of this. Moreover, the author, by providing an overview of the most important tax amendments introduced by Luxembourg, showed how investment-friendly jurisdictions used the necessity to comply with the provisions of the AIFMD to efficiently improve their investment attractiveness.

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