Infrastructure fund structuring: new rules for a (not so) old game

How the tax evolution influences the infrastructure fund organization and what asset managers need to keep in mind to be up-to-date with new developments.

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Over the last decade, we have witnessed a stream of record-breaking events in terms of both fund raising and deal size within the infrastructure funds sector. While this trend demonstrates the strengthening of infrastructure as an asset class, the increased capital and therefore competition represents significant challenges—as well as opportunities—for asset managers and investors.

Throughout 2018 we saw an increased concentration of capital distributed among fewer funds with 67 funds closing in 2018 (compared to 94 in 2017), raising a combined US$85 billion (compared to US$75 billion in 2017). At the same time, while we have seen a decrease of 22 percent in the number of completed deals compared to 2017, the average deal size increased (from US$492 million in 2017 to US$542 million), emphasizing the universal consensus that valuations are high.

Fund managers are facing increased pressure to successfully deploy the record-breaking amounts of capital raised in recent years, while also maintaining the strong risk-adjusted returns that have previously attracted investors to this asset class.

While these internally generated pressures are high on the agendas of both GPs and LPs, there are a number of external factors and challenges that, despite existing for some time, have increased in prominence in recent years. These external factors and challenges are intrinsically linked to the considerable fund raising within the infrastructure fund sector.

We have focused on a selection of the external factors, which should be at the forefront of any GP or LP's mind, both when launching a new fund or when revisiting existing funds before asset disposals.

**Alternative Investment Fund Managers Directive (AIFMD)**

The European Directive on Alternative Investment Fund Managers (AIFMD) came into force in July 2013 and, through regulating fund managers (AIFMs), it has had a significant impact on the activities of the Alternative Investment Funds (AIFs). In this regard, the traditional qualification whereby AIFs were funds investing in alternative strategies reserved to qualified investors, changed into all funds which fall outside the Undertaking for Collective Investment in Transferable Securities (UCITS) regime.

One of the most important features of the AIFMD is the possibility for AIFs to be marketed to professional investors under an EU passport. This depends on whether they are managed by fund managers authorized under the AIFMD and located within any EU Member State, without the need to negotiate each local regime.

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1. Preqin Alternatives 2019 Report
2. Preqin Alternatives 2019 Report
This has led to the request from investors and fund managers for further regulation, which has affected how pooling vehicles and holding platforms are organized. There is also the key question of where to establish their operational footprint in a post—Brexit world with several jurisdictions introducing internal reforms to attract these nomadic fund managers.

Even though the AIFMD was issued as part of an increased push for investor protection by the EU and set standards for marketing when fundraising, remuneration policies set up, risk monitoring, reporting and accountability, there is also a convergence between the AIFMD and global tax trends in setting adequate substance standards and minimum level of operational activity.

Traditionally the decision on where to establish an AIFM was primarily driven by regulatory considerations (in order to benefit from the AIFMD Passport), with portfolio and risk management being performed or supervised in the jurisdiction of the investor pooling vehicle. However, having the AIF and the master holding platform (pooling all the investments) in the same jurisdiction provides an opportunity to align regulatory and tax substance demonstrating genuine business purpose for setting up an active investment platform. Going forwards, we would expect to see an increase in the number of single jurisdiction funds structures.

**Evolving tax landscape**

In response to the base erosion and profit-shifting report (BEPS) promoted by the OECD, the European Commission presented an anti-tax avoidance package on 28 January 2016. Following numerous discussions and revisions, the final version of the Anti-Tax Avoidance Directive (ATAD) has now been published in the Official Journal of the European Union. The general deadline for EU Member States to transpose the text into national law was 31 December 2018, with provisions applying as of 1 January 2019 (with some exceptions).

While three of the five provisions introduced seek to implement the BEPS measures, the remaining two—the general anti-abuse rule and exit taxations rules—represent the EU’s aim of addressing tax avoidance practices.
For some of the measures introduced by the ATAD, EU Member States have options on how to transpose them into their national law. Ergo, there are some differences from EU Member State to EU Member State.

Nevertheless, the provisions of the ATAD will apply to all taxpayers that are subject to corporate tax in one or more EU Member States and will affect new investments, as well as existing structures which have been previously set-up.

**CFC rule**
The purpose of the controlled foreign company rule (CFC) is to reallocate undistributed income (which would not have been taxed or exempt in parent jurisdiction) of a 50 percent owned direct/indirect subsidiary or permanent establishment, to the jurisdiction of the controlling entity under certain conditions.

**Interest limitation**
The purpose here is to introduce limitation to the tax deductibility of any “exceeding borrowing costs” to a percentage of the taxpayer’s tax-based EBITDA. Carve-outs are available, namely for AIF vehicles and long-term infrastructure projects which provide, upgrade, operate and/or maintain a large-scale asset (that is considered to be in the general public interest by a Member State) where the operator, borrowing costs, assets and income are all within the European Union. However, these carve-outs are expected to be difficult to apply on a practical basis.

**Anti-hybrid rules**
The objective of anti-hybrid rules is to prohibit the deductibility of expenses incurred within the context of EU transactions/structures whereby the differences in the legal characterization of a financial instrument or entity result in a double deduction or a deduction without inclusion.

On 1 January 2020, ATAD II is expected to become effective, which extends the anti-hybrid rules to entities and to non-EU transactions/structures. This is possibly one of the most impactful changes in recent years from a fund structuring perspective.

**MLI**
In addition to the points surrounding ATAD, on 7 June 2017, 68 jurisdictions signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the MLI). One of the main purposes of the MLI (alongside others of an equally relevant nature that go beyond the reduced scope of this article) is to allow the minimum standard for the prevention of treaty abuse (the Principal Purpose Test or “PPT”). This is to be introduced in existing double tax treaties without the need for each jurisdiction to renegotiate each treaty individually.

To understand whether the MLI will impact any specific existing or future investment the asset managers will now need to consider whether the implemented structure relies on domestic legislation or on double tax treaties and in case of the latter, which options were followed by each jurisdiction. This analysis is of particular relevance on the payment of interest and dividends throughout the investment holding period and on non-resident capital gains upon an exit.

The evolving tax landscape also supports a move towards single jurisdiction fund structures established in a place where genuine operational activities exist.

**Carried interest**
Carried interest is a share of the profit for the manager of a fund on the gain realized on the exit of the investments.
It is a key incentive for the managers to realize the best and quickest exit possible, thus aligning the interest of the investors with those of the managers.

The calculation of carried interest is set out in the fund formation documents (prospectus or Limited Partnership Agreement) and is typically set as a fixed percentage of the fund’s net gains after the investors have been repaid of their drawn down commitments and preferred return (hurdle rate).

As such, depending on how the carry is designed and structured, it may be impacted by the changing tax landscape. This namely refers to the cases where the carry has a tax treatment at the level of the carry holders, which differs from the tax treatment at the level of the carry vehicle.

Indeed, with tax reforms it is becoming increasingly difficult to preserve the characteristics of returns on underlying assets in the hands of the carry holders with certain fund vehicles lending themselves to this better than others.

**The importance of fund structuring**
What we have outlined here may mean that the entire infrastructure fund industry will see their investments impacted. Therefore, they may need to change their pre-established holding platforms and pooling vehicles when considering new fund raising, regardless if they have EU investors, US investors, pension funds, sovereign funds, insurance companies or high net worth individuals.

The impact is certainly not solely at the level of the target jurisdictions. GPs need to map their investor base with a higher level of detail, analyze whether the vehicles used by each investor hamper the tax status of the investment platform as a whole, and work together with the investors and their advisors in order to determine the most suitable legal form for each pooling vehicle.

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We have summarized some of the questions that should be asked when setting-up the fund pooling vehicles:

**What is the cornerstone investors’ tax profile in their domestic jurisdiction (EU vs. US vs. other countries, pension fund vs. insurance company vs. sovereign fund, taxable vs. tax exempt, etc.)?**
Depending on how income is picked-up at the level of each investor, this may influence interest deductibility in the target jurisdictions and/or at the level of the investor pooling vehicle (under ATAD I and ATAD II).

**How do the cornerstone investors regard the investor pooling vehicle from a tax perspective (opaque vs. transparent) and the financing instruments issued by the pooling vehicle (equity vs. debt)?**
Depending on the tax treatment of the fund vehicle and of the issued financing instruments at the level of each investor and of each target, this may have an impact on interest deductibility in the target jurisdictions and/or at the level of the investor pooling vehicle (under ATAD I and ATAD II).

**Does the fund pooling vehicle and holding platform have an adequate level of substance?**
Depending on whether the holding platform has the adequate amount of substance from a target jurisdiction perspective, each jurisdiction may disallow the application of the double tax treaty and levy WHT at domestic rates. This is of particular relevance in cash models where the WHT reduction or exemption on dividends and interest, as well as the capital gains tax exemptions, rely on the application of double tax treaties.

**Is the carry structure sustainable or is it treated differently at the level of the fund pooling vehicle, the carry holders and of the carry vehicles?**
Depending on whether there is a mismatch on how these structures are regarded, this could limit the deductibility of interest at the level of the fund pooling vehicle and/or the carry vehicles. In addition, the specific waterfall of profit attribution in this instance may be affected by the latter considerations.
Hence, an upfront holistic view as to all these matters is something highly recommended for the purposes of fund structuring strategy.