MACFARLANES

The GloBE rules

Private equity impact assessment

Start

Introduction

The OECD's proposals for a global minimum effective corporate tax rate are given effect in the Model GloBE Rules, which were published in December 2021.

While the rules are primarily aimed at large trading groups, in principle they can affect any kind of entity or structure that meets the scoping criteria – including private equity (PE) houses, their funds and asset holding companies (AHCs).

In this document we examine how the rules apply in a PE context and look at the issues that houses will need to think about when:

- assessing the rules' impact at house level;
- establishing new funds and determining the position of existing ones; and
- acquiring portfolio businesses.

The exposure dashboard on page 3 is designed as a risk assessment tool to help you identify where there might be exposure within your group and wider fund structures.

What is a "group "?

The GloBE rules draw heavily on accountancy including in their approach to identifying groups. A group is the collection of entities included in an Ultimate Parent Entity's (UPE's) consolidated accounts. An entity will not be a UPE if it is consolidated in another entity's accounts, so a group will be the largest collection of entities that are included in a single set of consolidated accounts.

The UPE's accounts must be prepared in accordance with an Acceptable Financial Accounting Standard (AFAS). Those standards include IFRS and the GAAPs of the UK, US, all EEA states and 13 other countries.

If the UPE does not prepare AFAS-compliant accounts – either because it uses a different accounting standard or does not prepare accounts at all – the GloBE rules require it to hypothesise what its position would have been had it prepared AFAS accounts. This ensures the rules can apply effectively to structures involving partnerships and other entities that might not be subject to a statutory requirement to prepare accounts. It appears that in such situations groups are free to choose which AFAS to apply.

Which groups are in scope?

A group is in scope of the GloBE rules if:

- it has at least one legal entity or permanent establishment outside the UPE's jurisdiction; and
- the revenues in the UPE's consolidated accounts are at least €750m per annum.

Countries that choose to implemant domestic minimum taxes modelled on GloBE may also apply them to wholly domestic groups that meet the revenue threshold.


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Pillar Two exposure dashboard

There are three main scenarios in which private equity houses will be impacted by the GloBE Rules. To determine whether the rules will apply, we have identified several critical issues that should be considered.

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Houses

1

Potential impact where the house has consolidated revenues of at least €750m and earns fee income, or holds house carry or co-investment, in a low tax jurisdiction.

Fee income

Does the house receive fee income in a low tax jurisdiction?

Learn more

House carry and co-investment

Does the house hold carried interest or co-investment in a low tax jurisdiction?

Learn more

Managers' remuneration

Does the house reward fund managers via transparent entities such as LLPs?

Learn more

Funds

2

Potential impact where a fund or AHC either:

- consolidates its portfolio businesses, which have aggregate revenues of at least €750m; or
- is consolidated by an in-scope investor.

Accounting consolidation

Does the fund or AHC consolidate its portfolio businesses in its accounts?

Learn more

The GloBE investment fund exclusions

Do the GloBE investment fund exclusions apply?

Learn more

Portfolio businesses

3

Potential impact where a portfolio business meets the €750m revenue threshold and is in scope in its own right.

Portfolio businesses

Does the fund own a portfolio business with standalone revenues of at least €750m?

Learn more

1 Houses

PE groups will be in scope of the GloBE Rules if their consolidated revenues exceed €750m.

For many PE houses the ways in which income is earned and executives are remunerated are more complex than for the typical listed trading groups that the rules are arguably designed to accommodate. It is worth examining how these aspects of PE businesses stand to be treated, and what structuring considerations that may provoke.

House income

PE houses might receive income for managing funds in the form of:

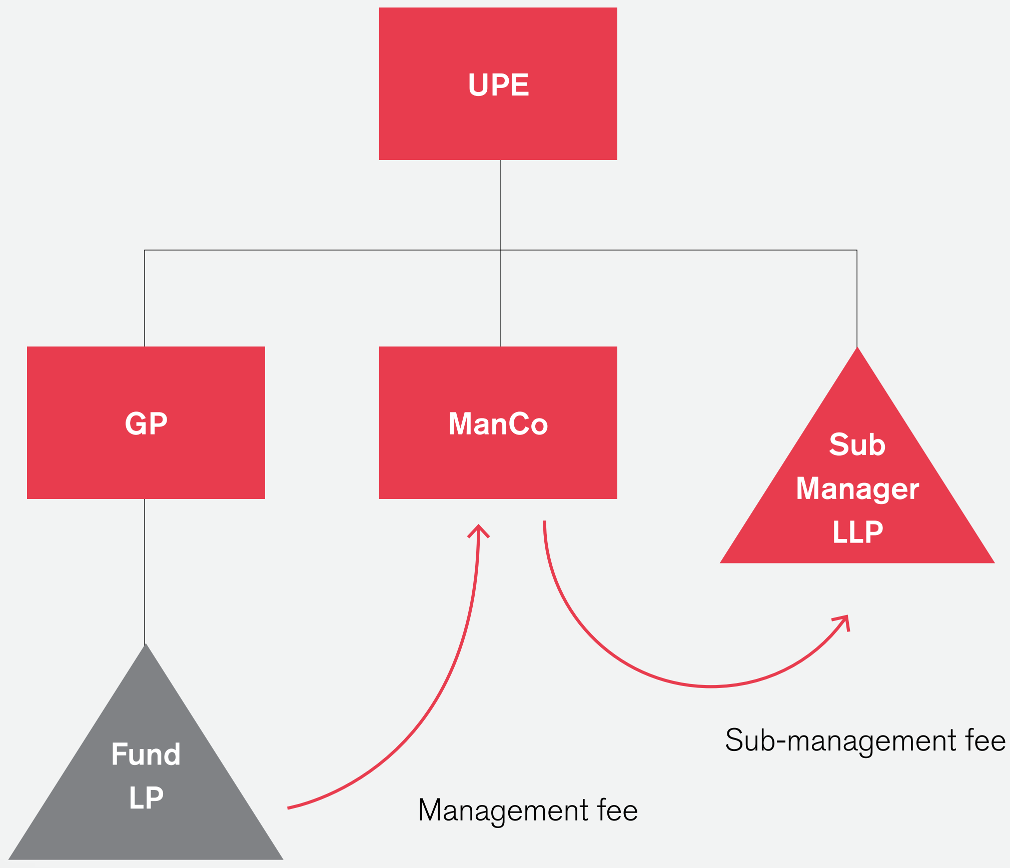
- fees paid by the fund to a management company;
- a priority profit share paid to a fund GP (e.g. to cover management fees based on assets under management);
- a share of the carried interest in a fund; or
- some combination of the above.

Fee income

In the simplified example opposite ManCo is paid a management fee by Fund LP for providing investment management services. Some or all of that fee is then paid on to Sub Manager LLP, which provides sub-investment advisory services to ManCo. We assume that Fund LP is not consolidated in the accounts of the UPE and is not therefore a Constituent Entity of the group.

The position is relatively straightforward.

- Any net income that is recorded in ManCo's accounts will be included in that company's GloBE income. If ManCo is resident in a low-tax jurisdiction that income will be subject to a top-up charge.
- The service fee income that arises in Sub Manager LLP will likewise be included in that entity's GloBE income. There are special rules that apply to transparent entities that are Constituent Entities of a group, which are discussed on page 7 (see Management LLPs).
- Because Fund LP is not a Constituent Entity, its payment of the fee should not impact on the group's GloBE income – effectively the fee in ManCo is regarded as income received from a third party.



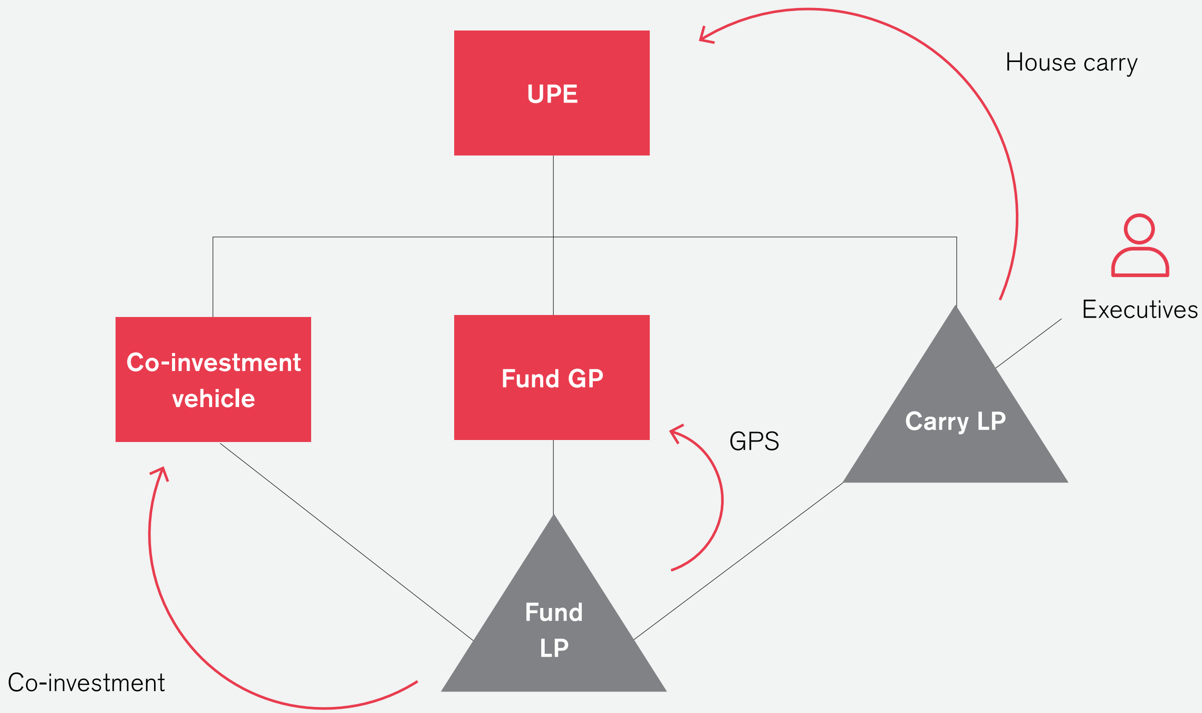
House carry and co-investment

In this example, the house receives three kinds of return from Fund LP:

- a management fee, based on a percentage of assets under management, that is paid to the Fund GP as a guaranteed priority profit share (GPS) from Fund LP;
- a share of the carried interest in Fund LP (house carry) – the entirety of the carried interest is paid as a profit share to Carry LP, which then splits it between the managers and the house; and
- returns on a co-investment made by the house in Fund LP.

If Fund LP is consolidated in the accounts of the UPE then it will be a Constituent Entity of the UPE's group. The group would include its proportionate share of Fund LP's underlying investment income and gains in its GloBE income. That income would be potentially subject to top-up tax, subject to the exclusions that apply to certain dividends and equity gains (see below).

We expect, however, that most typical PE funds will not be consolidated in the accounts of the house's UPE and will not therefore be Constituent Entities of the house group. In that case Fund LP is effectively treated as opaque for GloBE purposes from the perspective of the house. Instead of recognising a share of Fund LP's underlying investment income, the recipient entities will treat the GPS, house carry, and co-investment as a share of the profits of an entity outside the group (i.e. Fund LP). The starting point is that such profit shares are included in the group's GloBE income and potentially subject to top-up tax. However, it is possible that an exemption will apply.



Excluded Dividends

The Model Rules exclude from an entity's GloBE income any distributions received or accrued in respect of an equity interest in another entity provided:

- that interest is either at least 10%; or
- has been held for at least 12 months.

This exclusion most obviously applies to dividends from shareholdings in companies and the rules use the term "Excluded Dividends". However, "entity" is defined broadly, to include partnerships. We therefore consider that the most straightforward reading of the rules is that profit shares from a non-consolidated partnership in which an entity has held its interest for more than 12 months are excluded. That would exclude the GPS, house carry and co-investment described on the previous pages.

The OECD rules and Commentary and the UK's draft implementing legislation both support this approach. However, it remains to be seen whether the OECD will clarify this point further, and how other countries will approach the dividend exclusion in their implementing legislation. There is no provision in the Model Rules that would re-characterise a distribution on the grounds that it is in substance a return for services provided. It is possible, however, that some countries might seek to overlay general principles of substance over form where those exist in their domestic tax systems, which could lead to the exclusion being denied. We consider the risk of this would be greater in relation to GPS, which is effectively a fixed return, than house carry which is an investment return.

Managers' remuneration

Management LLPs

Many PE houses use transparent entities such as LLPs as their providers of sub-advisory services. Typically, senior fund managers will be members of the LLP, with other personnel employed by it.

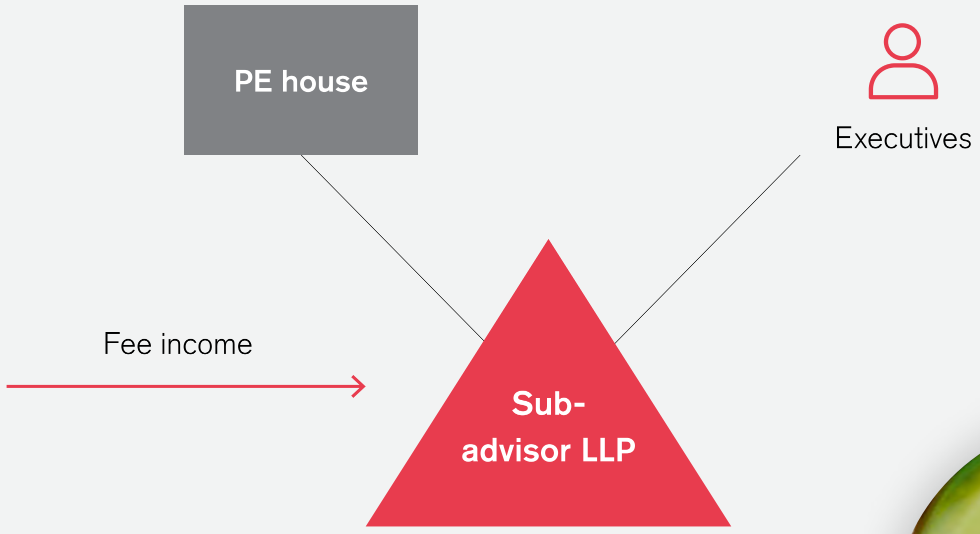
In the example below, Sub-advisor LLP earns fee income from one or more funds, and its net profits are divided between individual executives and a corporate member. The LLP is consolidated in the group accounts of the PE house by virtue of the corporate member's shareholding and is therefore a Constituent Entity of the group.

Under the GloBE Rules transparent entities that are Constituent Entities of a group are treated as follows.

- The GloBE income of the transparent entity is calculated on normal principles.
- That income is then reduced by any amounts that are allocable to any of the entity's members that are not also part of the group.
- The remaining income is allocated to the members that are part of the group or, where the transparent entity trades through a permanent establishment (PE), to that PE.

In this example, that means any LLP profit shares belonging to the individual executives are effectively disregarded. The group will include its entity's share of the LLP's investment management income in its GloBE income calculations or, where the LLP has a PE, in that PE's calculation.

Overall, this is a proportionate approach that ensures the group's top-up tax position will not be affected by the tax attributes of individual LLP members.



Personal carry and co-investment

In many instances individual executives will have a personal entitlement to carried interest, and have made co-investments, in the funds they manage.

Such personal carry and co-investments should not be impacted by the GloBE Rules if they are:

- held directly by the individuals, in which case they will sit outside the PE group entirely; or
- held via a transparent entity in the PE group, in which case they will be excluded from GloBE income in the same manner as the individuals' LLP profit shares described above.

2

Funds

Whether PE funds are directly impacted by the GloBE Rules will generally depend on whether they - or their asset holding companies (AHCs) - are required to consolidate their portfolio investments for accounting purposes.

In many cases fund entities and AHCs will fall within specific accounting rules for investment entities that remove the requirement to consolidate their subsidiaries. However, it is worth considering the situations in which this may not be the case, and the potential relevance of the exclusions in the GloBE Rules that apply to investment funds.

Accounting consolidation

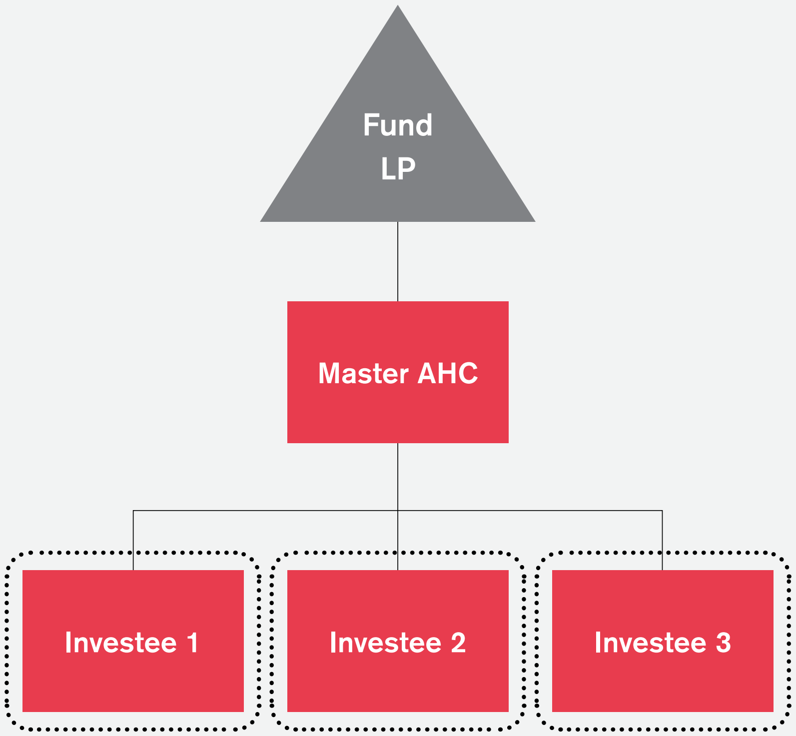
How do the rules apply to PE funds?

Consider the simplified PE fund depicted on the right.

The GloBE treatment will depend on whether Fund LP or Master AHC are required to consolidate the Investee businesses in their accounts.

- If neither entity is required to consolidate the Investee businesses, the Investees will each be regarded as a separate group, to which the GloBE rules will apply independently (if that group meets the revenue threshold).
- If, however, one of Fund LP or Master AHC does consolidate the Investee businesses, they will then be regarded as part of a single GloBE group. In that case their revenues will be aggregated for the purposes of the revenue threshold, which might bring Investees that individually would have been below the threshold into scope of GloBE. The Investees' profits and taxes will also be aggregated for the purposes of the ETR calculations.

Aggregation would be undesirable in a PE context – even if it does not result in any additional top-up tax, blending the financial results of several independent businesses would be administratively challenging and not reflect commercial reality.



What will the position be for typical structures?

The reliance placed by the GloBE rules on the definitions set out in GAAP will pose additional challenges to management and those tasked with assessing accounting treatments at the house and fund level.

Tax authorities have been increasingly willing to challenge the underlying accounting judgements on which tax treatments depend. In such cases, businesses cannot necessarily rely on the audit process and its resulting external opinion, as the basis of materiality auditors use may not be one that tax authorities accept.

Added scrutiny may arise from the revisions accounting standard setters make to standards and principles to align with or challenge market practice and abuse. IFRS 10 Consolidated Financial Statements has been subject to three significant amendments, including two on the exemption from consolidation enjoyed by investment entities, in the ten years since its effective date in 2013. The Financial Reporting Council's (FRC) recent review of carried interest vehicles is a key example of regulatory bodies' interest in policing the market practice that firms may take for granted.

As a result, management could see a shift of emphasis from auditors over future audit cycles, and lately some asset managers have been required to consolidate investments held through funds they manage.

Private-equity houses are exposed to two key challenges:

Investment entity exemption under IFRS 10

Funds have relied on the exemption under IFRS 10 that excludes funds from the requirement to consolidate their underlying investments where they meet three mandatory requirements that establish the fund's overriding purpose, its business model and the basis up on which it effectively values its investments held in the investee. The standard also sets out four further characteristics. Failing to meet them does not preclude use of the exemption but prompts further analysis and better substantiation of the investment entity status.

Is consolidation required?

If it is concluded that a fund is an investment entity, then it will not need to consolidate its portfolio. However, even where the investment entity exemption applies at the fund level, the fund and its investees may still be consolidated in the accounts of the investment management firm (or its ultimate parent) if they are considered subsidiaries of the firm. That will be the case if the firm controls the fund, i.e. if it is exposed to variable returns from it and has power to affect those returns.

Where power over and an exposure to the returns of an investee is established, firms should clearly document whether a link exists allowing them to exert their powers to effectively direct an investee's decision-making. As private equity and credit strategies can involve extremely proactive management of a fund's underlying portfolio companies, establishing the absence of this link is not as straightforward as may be assumed.

Power arises from many sources. Holding a majority of voting rights in the investee may be indicative of power but is not conclusive. Funds expose themselves directly to investments through equity, debt and hybrid instruments that make deciding the effective voting control of their underlying investments more complex. The relationship of voting rights can be dynamic over time as instruments are restructured, refinanced or extinguished on settlement as investments reach investment targets and goals. Regulatory and tax structuring further complicate identifying the substantive rights that arise at various levels of the legal entity chain of ownership.

Firms are exposed to the underlying investments they manage held by funds. Co-investment arrangements expose the house directly to the return of the fund and the returns of its investments. Carry vehicles expose a firm and its key decision makers to returns of the funds and its investments. Power can aggregate between manager and its owners (and principals) where related parties have an incentive to act in tandem. Such individuals typically hold board positions in the investees where significant influence may tip the balance in favour of control.

Managers have traditionally relied on their perceived capacity as agents only in the investment process to 'prove' a lack of power. Such analyses have historically placed an overreliance on rights limited partners have to remove the firm as manager or advisor of the fund, which in practice may not be substantive or practically achieved. During a contentious removal process carry arrangements or co-investments may still remain, and in the absence of an effective mechanism to remove board members, residual power can still remain with the manager.

Material points overlooked in control assessments have included the coordination that can arise between parties, such as those involved in the financing of an acquisition. Shareholder agreements or other bilateral arrangements with mechanisms that dictate the size and membership of boards will be highly suggestive of control and are examples of documents that are commonly overlooked.

Finally, as managers seek to drive value through the combination of businesses or the development of synergies between them, control may arise where an investee is completely dependent on a sole supplier or sole customer or depends on any intellectual property or commercial know-how provided to the investee. An ability to withdraw support unilaterally may suggest power.

The GloBE investment fund exclusions

The GloBE rules contain several exclusions that are relevant to investment vehicles.

The exclusions apply after an MNE Group has been identified as in scope. Their effect is to remove the Excluded Entities' profits, losses and taxes from the GloBE ETR calculation.

Importantly, however, Excluded Entities' revenues still count towards the €750m threshold. Furthermore, the exclusions do not change which entities are considered to form a group. For example, as depicted below two sub-groups owned by a parent that is an Excluded Entity would still be aggregated for GloBE purposes (provided they are both included in the UPE's consolidated accounts).

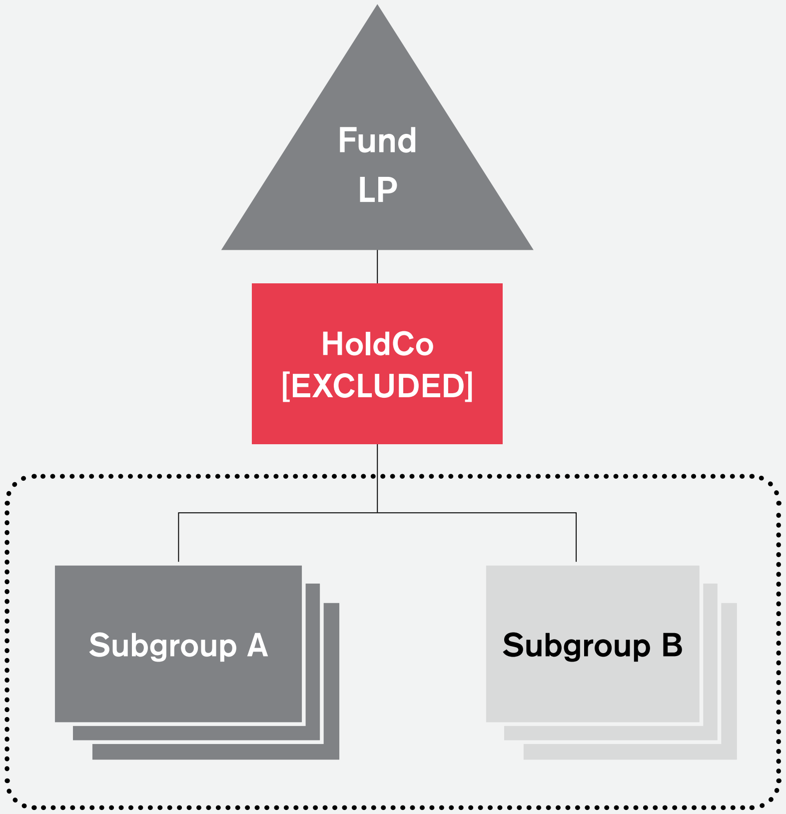
The main driver of how a PE fund structure will be treated for GloBE purposes remains its accountancy treatment, and not whether the fund or AHCs qualify for one of the GloBE investment fund exclusions. The exclusion may be more important for other types of funds, particularly those where the fund vehicles receive taxable income such as interest directly.

What are the exclusions?

Funds

The first exclusion applies to Investment Funds that are the UPE of a GloBE group.

Funds that are part of a group but not the UPE are not excluded but are subject to special ETR calculation rules.



An Investment Fund is an entity that meets the following seven conditions.

1. It is designed to pool assets (which may be financial or non-financial) from a number of investors (some of which are not connected).
2. It invests in accordance with a defined investment policy.
3. It allows investors to reduce transaction, research, and analytical costs, or to spread risk collectively.
4. It is primarily designed to generate investment income or gains, or protection against a particular or general event or outcome.
5. Investors have a right to return from the assets of the fund or the income earned on those assets, based on the contributions made by those investors.
6. The Entity or its management is subject to a regulatory regime in the jurisdiction where it is established or managed (including appropriate AML and investor protection regulation).
7. It is managed by investment fund professionals on behalf of the investors.

There is detailed guidance on the application of these conditions in the OECD Commentary on the Model GloBE rules. We expect that they should be straightforward for most widely held PE funds to meet.

AHCs

There are two investment fund exclusions that apply to AHCs.

First exclusion

1

The first exclusion applies to AHCs that are 95% owned (directly or through a chain of Excluded Entities) by one or more excluded Investment Funds and which:

- operate exclusively or almost exclusively to hold assets or invest funds for the benefit of the excluded Investment Fund(s); or
- only carry out activities that are ancillary to those carried out by the excluded Investment Fund(s).

Second exclusion

2

The second exclusion applies to AHCs that are 85% owned (directly or through a chain of Excluded Entities) by one or more excluded Investment Funds provided that substantially all of the AHC's net income is dividends or gains from 10%+ shareholdings.

Opt-out

Where an entity qualifies for an exclusion, it may nonetheless elect to disapply it. That election cannot be revoked for five years. Opting out may be desirable where an excluded entity incurs expenditure that is relievable for domestic tax purposes (see Portfolio businesses section).

While these exclusions will be helpful in some cases, it is not unusual to have minority interests – for example co-investments or management equity – of greater than 5% or 15% that would prevent them from applying.

The special ETR calculation rules that apply to investment funds that are not the UPE of a group also extend to their AHCs. The definitions of an AHC in this context are similar to those above, however there are some small differences relating to the ownership conditions.

3

Portfolio businesses

Even where a PE fund is not in scope of the GloBE Rules, its individual portfolio businesses will be if they have consolidated revenues of at least €750 million.

This section considers some issues that may arise specifically for PE-owned businesses that are in scope of the GloBE Rules.

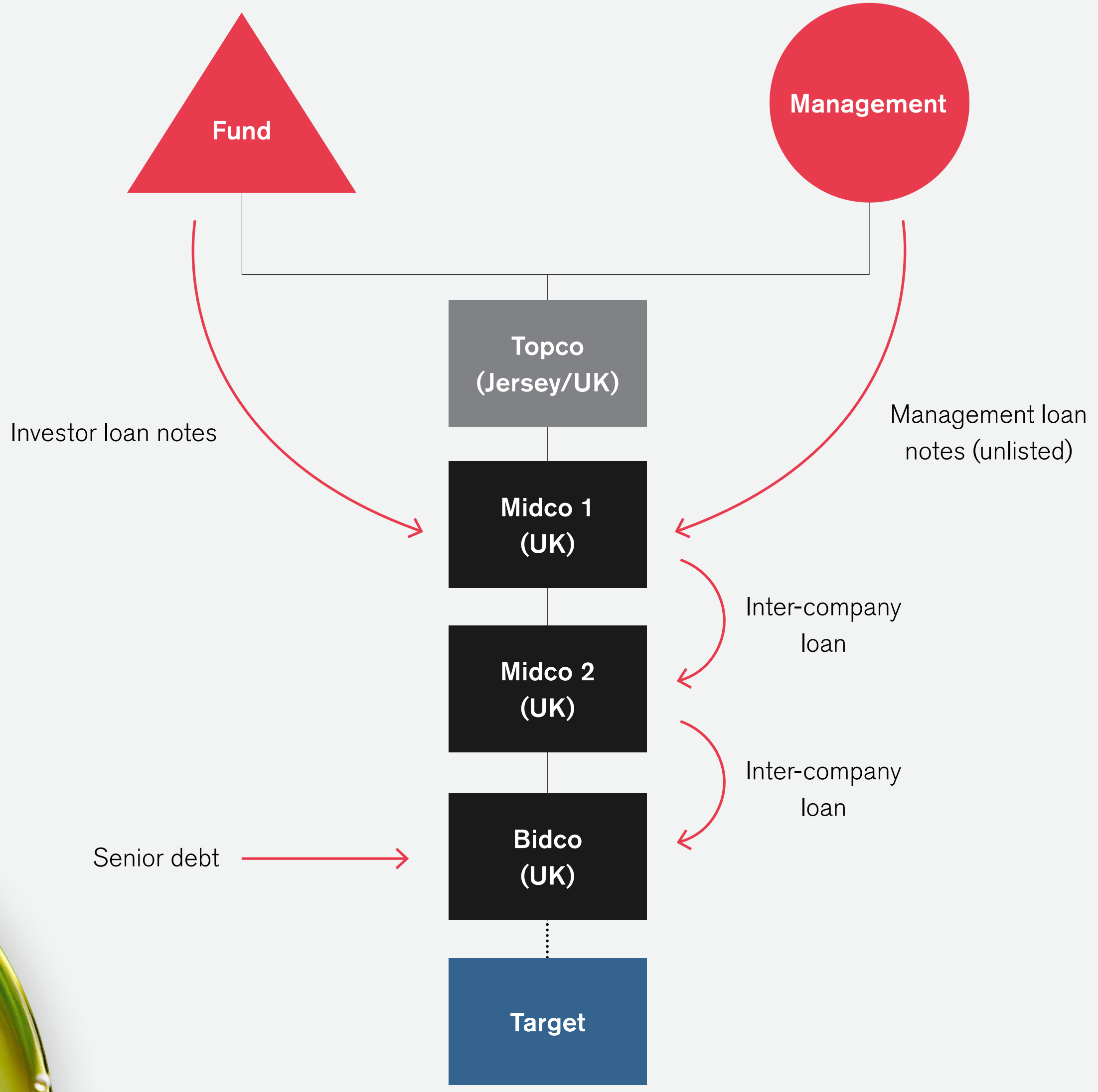
Portfolio businesses

Where PE funds' portfolio businesses exceed the €750m revenue threshold, they will be in scope of the GloBE Rules and potentially liable to pay top-up tax. That is as expected and will in most respects lead to the same tax outcome as for similar groups that are not PE-owned. However, there are some issues that may arise specifically in relation to typical PE ownership structures that houses may need to consider.

Typically, PE funds acquire target businesses via an "acquisition stack" of companies, as depicted on the right.

Potential issues

Expenditure in the stack



The Midco and Bidco companies may incur interest costs relating to a mixture of third party and shareholder debt. The structure may also incur some management costs, typically in Bidco. Often these expenses are not re-charged to the target, and tax deductions are effectively obtained via group relief.

If the companies incurring the expenses are either not consolidated with the target or subject to the GloBE investment entity exclusion, then the expenses will not be included in the target's GloBE ETR calculation. This will reduce the target's ETR and increase the likelihood of a top-up tax liability.

A target will only be able to take account of expenditure incurred in the acquisition stack if it is consolidated with the paying entities. In contrast to Master AHCs, therefore, it may be undesirable for stack companies to be treated as investment entities that are excepted from the accounting requirement to consolidate.

Again, this may affect the choice of accounting standard for stack companies. Whether the investment entity exemption applies to stack companies under a given standard will require careful examination. Any potential changes to structuring that might affect the consolidation position should be assessed early to avoid any unexpected outcomes.

If it is not possible to ensure the stack companies and the target are consolidated an alternative might be to re-charge the expenditure to the target although there may be commercial obstacles to this.

The GloBE investment fund exclusions are more straightforward: in situations where exclusion is undesirable funds may make the five-year election to opt out on an entity-by-entity basis. We expect that it will often be favourable to make this election in relation to stack entities that are consolidated with the target and that incur net expenditure.

Paying entities

A group's UPE is responsible for paying any top-up tax due under the IIR. If the UPE is an Excluded Entity, the obligation to pay passes to intermediate holding companies in the group that are not excluded.

Where companies in an acquisition stack are grouped with the target business and do not qualify for (or have opted out of) the GloBE investment fund exclusion, it will therefore be a stack company that is the IIR paying entity. This may present a problem if the stack company is unable to extract cash from the target to fund top-up tax payments, for example if the target is prevented from making distributions by its third-party debt covenants.

It is possible that countries will implement the IIR in a way that allows group entities in the UPE jurisdiction besides the UPE to settle the top-up tax liability, which would mitigate this problem.

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