

## The UK – Law Firms

### A Comparison Of Funds: The UK v. The U.S.

The Editor interviews **Mary B. Kuusisto**, a Partner in the Private Investment Funds Group and a member of the Tax Department in Proskauer Rose LLP's London office.

**Editor:** Please tell us about your practice in regard to private investment funds.

**Kuusisto:** Proskauer represents around 300 fund managers of all kinds – private equity, venture capital, fund-of-funds, secondaries, natural resources, distressed debt – and over 100 institutions that invest in those funds. Over the last 15 years, I've represented hundreds of most of those types of funds in connection with their economic and tax structuring. During the last five years, I've segued into overall representation of funds and investors, keeping an economic and tax focus. I joined the London office when it opened about two years ago, and since then my practice has become increasingly global. As samples of this representation, I work with a Russian credit opportunities fund, a California venture growth fund, a global fund looking to invest in the Middle East and North Africa ("MENA") region, a Danish pension fund engaging in secondary transactions, a Dutch pension fund engaging in primaries, and a UK university in connection with their U.S. fund investments. A representation of significance to me is that of the National Venture Capital Association ("NVCA") and its lobbying activities, including the carried interest tax legislation, the proposed registered investment adviser legislation and the SEC proposals regarding placement agents and campaign contributions. I serve on the European Private Equity and Venture Capital Association's ("EVCA") professional standards committee, and the British Private Equity and Venture Capital Association's ("BVCA") tax committee.

**Editor:** How does being a member of Proskauer's London office tax department broaden your perspective in structuring deals on behalf of these funds?

**Kuusisto:** I enjoy putting together the jigsaw puzzle that tax requires. Tax considerations are often one of the significant reasons we don't have a one-size-fits-all structure within the private equity industry. We look at a number of parameters – the jurisdiction and tax profile of the investors, the jurisdiction of the fund managers, where they perform services, the office location that they work out of, which might be multi-jurisdictional, and then the jurisdictions where the fund expects to invest. When you put all those parameters together, there are a significant number of fund structures that emerge for optimizing the tax results for everyone. Of course the more parameters there are, the more complicated the structuring.

**Editor:** How do you keep up with the tax changes in all those jurisdictions?

**Kuusisto:** It requires working with local counsel in the jurisdictions in which the investments are located – the reason that Proskauer needed to expand from being primarily in the U.S. to having significant funds practices in Paris, London, Hong Kong, and down the road, in Beijing.

**Editor:** The principle regulatory body in the UK is the FSA, and there's been some talk about its being replaced. Is this anything more than just a rumor?



**Mary B. Kuusisto**

**Kuusisto:** There have been proposals made by some political parties to have the FSA's regulatory function taken over in part by the Bank of England to find a better way to regulate post-Madoff abuses. The proposal would keep certain consumer aspects or retail functions with the FSA. While this is interesting, this proposal wasn't focused on the private equity industry. At the same time there is an additional proposal in the EU that would require all alternative investment fund managers whose investors include EU residents (the AIFM directive) to be regulated. If that is approved, it would need to be implemented by each of the EU member states. At this point it is unknown whether that would be handled by the FSA or by the Bank of England if the Bank of England proposal were enacted.

**Editor:** Do Britain and the Continent have the same notion of a "qualified investor" in terms of private equity participation as we have in the U.S.?

**Kuusisto:** It's similar. As you know in the U.S. we have different levels of protection afforded to investors – depending on whether they are qualified purchasers, accredited investors or qualified clients. In the UK there is a concept of a professional investor which generally covers institutional investors, which the FSA permits interests to be sold to. As in the U.S. certain retail investors may also qualify to invest in private equity funds as long as certain conditions are met in order to make sure that they are sophisticated investors. The AIFM directive would change the provisions applicable to retail investors. However, currently it is anticipated that new member states of the EU would continue to be permitted to allow participation on a regulated basis.

**Editor:** Are there certain tax advantages for U.S. investors who invest in UK registered funds and what tax disadvantages may ensue from foreign source income?

**Kuusisto:** The U.S. has a system of taxation that doesn't allow for a lot of movement by U.S. residents or citizens as in other jurisdictions. U.S. investors are taxed on their world-wide income. UK funds generally are tax transparent. For the most part U.S. investors are taxed on their shares of UK fund income in the same manner as they would be taxed on their shares of U.S. fund income.

**Editor:** Are they subject to double taxation?

**Kuusisto:** It all depends on where that fund makes investments. In either case (a U.S. fund or a UK fund) the fund itself does not pay a tax. Regardless of where a fund is organized, the goal is to make sure that investments are made in a way that

minimizes local tax. If a tax is imposed by the jurisdiction where the investment is made, that will require an additional level of structuring. It is especially important if you are making an investment in a foreign jurisdiction that imposes taxes on capital gains, because the U.S. does not impose a capital gains tax on non-U.S. citizens who invest in the U.S. As a result if another jurisdiction imposes a capital gains tax, the U.S. will not for the most part give the U.S. investor a foreign tax credit. When making investments outside the U.S., you also have to make sure that the investment, whether it is in a UK partnership or an underlying company, doesn't cause the investor to have what is called a "permanent establishment" in that other jurisdiction. If so, then all of the investor's income in that jurisdiction, regardless of whether it is from that particular investment, may be subject to tax there, and that would be a disaster.

**Editor:** What tax treaties are there between the U.S. and other foreign countries which provide the greatest tax advantage?

**Kuusisto:** The U.S. has a great tax treaty with the UK. In general interest is exempt from withholding and dividends are subject to a lower rate of five to fifteen percent. It has good permanent establishment (PE) protection so that the capital gains are not generally subject to tax in the private equity context. But if the fund invests throughout Europe, you are usually looking at more complicated structures that are needed to be used – the U.S. tax treaty is usually not applicable. You would usually set up a structure to allow for the reduction of withholding taxes within Europe or another off-shore jurisdiction. Very often Luxembourg holding companies are used to minimize withholding through the EU directive.

**Editor:** What are the major differences in the way that you would structure a private equity, leverage buyout or venture capital fund in the UK as compared to the U.S.?

**Kuusisto:** There are two sides to that answer. What we have seen over the last five to seven years is that the industry has become far more globalized. So there is much less variation of the general business arrangements among sponsors and investors in the private equity fund industry. But as mentioned earlier, there are differences that significantly affect the technical structures. In both the U.S. and the UK the first thing to think of when structuring a deal is whether to offer a public vehicle or a private vehicle. For various tax and regulatory reasons in the U.S. we see far fewer public (listed) vehicles than in the UK. If we assume that we use a private vehicle, the next decision is whether to use an on-shore partnership structure like a Delaware or English limited partnership structure or an off-shore partnership structure such as for a Cayman Islands fund for a U.S. fund or a Channel Islands partnership for an English fund. There are different considerations that go into the decision as to whether to go off-shore from a U.S. or a UK perspective. Once the decision is made to go off-shore, the off-shore jurisdiction is often determined by the proper time zone, investor familiarity and administrative costs. While the overall eco-

nomics are quite similar, there are certain other differences within the partnerships themselves that have developed as market terms. In the buyout fund industry the distribution timing is generally more favorable to general partners in the U.S. where those distributions typically include a preferred return and then a current pay of the GP's carry, which is often known as a deal by deal carry. In the UK, while a preferred return is typically included, the carry is usually delayed until capital is returned to the investors on a "fund as a whole" basis. Although always common, this term became entrenched in European fund documents when it became part of a tax "memorandum of understanding" with the UK government that allowed investment funds certain tax benefits. Today, however, its popularity in Europe is the result of market forces driven by institutional investors.

**Editor:** Does the U.K. have the same minimal regulations regarding registration of venture and private equity funds as in the U.S.? Is there a move afoot to bring these types of investment vehicles under the closer scrutiny of the regulatory authority?

**Kuusisto:** There is, and regulation is on everybody's mind right now. Currently investment fund managers operating in the UK generally need to be authorized by the FSA. This is quite different from the current rules in the U.S., where most investment fund managers are exempt from registration. Both the EU and the U.S., however, have proposed more regulation. Congress has proposed requiring that all investment advisors register and this would also apply to non-U.S. managers if their U.S. investors had invested at least 25 million dollars with them. In the EU the AIFM directive would require that all alternative investment fund managers be subject to increased regulation. Interestingly this would also apply to U.S. managers if they wanted to market their funds to EU investors.

**Editor:** What governing body at the EU oversees this activity?

**Kuusisto:** The European Commission makes this decision, but the implementation has to be affected in each of the member states.

**Editor:** What do you see as the future for private capital investment abroad in 2010?

**Kuusisto:** 2010 could well be a turning point for the industry, possibly extending into 2011. I think that we are going to see resolution on a number of regulatory and tax proposals that have really put the industry in the spotlight over the last year and a half. Certain proposals, if passed, such as carried interest taxation in the U.S. (which is very possible either at the end of this year or next year), investment advisor registration, the AIFM directive in Europe (which may take longer) could well affect almost every aspect of fund raising and fund manager operations and structures. This could lead to increased cost, more uncertainty and potentially decreased returns, at least for a time. My personal opinion is that the industry would be better off if self-regulated.