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Considerations For PE Funds Eyeing Foreign Portfolio Cos.

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With high private company valuations in the U.S. and competition for deals, managers of existing private equity funds, as well as those in formation, may be inclined to look to regions and markets outside of the U.S. for potential opportunities. The viability of pursuing such opportunities depends upon the composition of the fund's investor base, whether the fund's investment strategy allows the fund to make those types of investments, and whether the fund documents provide the requisite flexibility to make foreign investments on a tax-efficient basis. This article seeks to touch on the key considerations that fund managers of U.S. private equity funds, broadly speaking, should take into account when contemplating investments in foreign portfolio companies.

Structuring Considerations

For many U.S.-based private equity funds in formation, the threshold decision is whether to implement a parallel fund structure, whereby a non-U.S.-based partnership is formed to invest in certain portfolio companies alongside the main fund in order to address tax, regulatory or legal reasons important to the fund's investors or the structuring of fund investments. A parallel fund structure is certainly worth exploring where the strategy of the fund will involve making a considerable amount of portfolio investments abroad. However, the considerable costs and administrative burdens inherent in adopting a parallel fund structure approach must be balanced against the benefits to investors.

For existing U.S.-based private equity funds and those in formation with an investment strategy that permits the fund to make foreign investments but have not implemented a parallel fund structure at the outset, provisions are often included in the fund's limited partnership agreement that permit the fund to form one or more "alternative investment vehicles" (or AIVs) to make a particular foreign investment down the line in a more tax-efficient manner than if the main fund were to be used as the investment vehicle. Notwithstanding the benefit of such AIV language, the fund manager still would need to be willing to expend the resources necessary to implement an AIV structure if and when the time comes.

Putting aside the inherent benefits of using a parallel or AIV fund structure, there are other considerations that fund managers can keep in mind when targeting investments abroad that, if implemented properly, may avoid the need to use more complex fund structures. Such considerations include pursuing venture capital, "secondaries," or growth/minority stake investment strategies, targeting "active" or operating foreign portfolio company investments, as well as targeting investments in jurisdictions that will receive favorable treatment under U.S. tax treaties. Knowing which investments to target requires a working knowledge of a complicated set of U.S. tax rules, combined with careful structuring of each foreign investment with the help of competent legal and tax advisers.

CFC

The primary concern for most private equity funds with respect to making foreign investments is to avoid such foreign company being deemed a "controlled foreign corporation" (CFC). A U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax from those operations only when the income is repatriated to the U.S. as dividends. However, the CFC rules are an attempt to address the deferral of income that occurs under these general tax principles. A foreign corporation will generally be a CFC if more than 50 percent of the voting power or value of its stock is owned, or is deemed to be owned under relevant constructive ownership rules, by U.S. 10 percent shareholders. A U.S. 10 percent shareholder is generally a person or entity that owns, directly or constructively, 10 percent or more of the voting power of a foreign corporation. The CFC rules generally tax 10 percent U.S. shareholders on their pro rata shares of certain passive income from the CFC — referred to as "subpart F income" — regardless of whether that income was distributed to the shareholder.

The use of parallel fund structures or AIVs is primarily intended to address the CFC rules, because a foreign partnership, even if it is a pass-through for U.S. tax purposes, will not be considered a U.S. shareholder under the CFC rules, and the foreign partnership's investors (even if they include U.S. persons) will in most cases not be deemed to have a 10 percent or more indirect interest in the underlying foreign corporation. For private equity firms that adopt a more traditional control or leveraged-buyout strategy, it is generally not advisable to engage in foreign investment without strongly considering the use of one or both of these structural "tools." For other types of private equity funds, at minimum, the CFC rules should be considered for each foreign investment. In any event, foreign investments should be regularly monitored during the holding period as to the application of the CFC rules.

PFIC

U.S.-based private equity funds that pursue investment strategies like venture capital or a "secondaries" strategy or that take minority, noncontrol positions in foreign targets may be able to more easily avoid the CFC rules, assuming the fund owns less than 50 percent of the foreign corporation (and that there are no other 10 percent U.S. shareholders that, collectively with the fund, own more than 50 percent of the target). This may be ascertained at the time the investment is made and kept in control through information rights that allow for ongoing monitoring and restrictions to prevent the presence of other 10 percent U.S. shareholders in the future that are put in place when structuring the foreign investment. However, there is another anti-deferral tax rule that will come into play here called the passive foreign investment company or "PFIC" rules.

Similar to the CFC rules, the PFIC rules generally require the economic equivalent of the current inclusion in gross income of a U.S. person's share of the profits of a foreign investment company. Any foreign corporation that meets certain income or asset tests set forth in the PFIC rules is treated as a PFIC with respect to each U.S. shareholder. The income test is met when 75 percent or more of the foreign corporation's income is passive income (e.g., dividends, interest, rent, royalties, etc.). The asset test is met when 50 percent or more of the foreign corporation's assets produce or could produce passive income, or produce no income. These rules tend to apply to a larger group of foreign corporations than just foreign investment companies, given the nature of the income and asset tests therein.

Most funds will seek to avoid investments in PFICs given the adverse consequences to investors and will go to great pains to make sure the foreign portfolio company is not a PFIC at any time during the holding period. As a precautionary measure, fund managers will often require the foreign portfolio company to provide an annual information statement, similar to a Form 1099, in the event it becomes a PFIC in the future so that the fund (if organized in the U.S.) or the U.S. investors (if the partnership holding the foreign portfolio company is organized outside the U.S.) can make an election to include in their income currently their share of the ordinary income and net capital gains of the PFIC (called a “qualified electing fund” election or “QEF” election). Under the QEF election, electing U.S. shareholders currently include in gross income their respective shares of the PFIC’s earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. However, unlike subpart F income (as is the case with a CFC), the QEF election permits the character of the underlying income to flow through to the U.S. investor (i.e., as ordinary income or capital gains), keeping in mind that net losses and foreign tax credits typically do not flow through.

Foreign Operating Companies

Although the PFIC rules affect many passive investments, it is important to keep in mind that “active” investments in startup or operating companies, like those often made by venture capital funds, secondaries funds and minority/noncontrol funds, can fall outside the purview of the PFIC rules by virtue of not meeting the passive income and asset tests therein. In that connection, there is a “startup exemption” under the PFIC rules that applies to startup companies with little revenue in the first few years of operations (other than passive income that would otherwise cause them to inadvertently be considered PFICs). Further, foreign portfolio companies the income of which is attributable primarily to operations, rather than passive income, may have the effect of minimizing the amount of “subpart F” income generated from such foreign investment in the event it ends up being categorized as a CFC at some point.

Check-the-Box Rules

Yet another way to help avoid the CFC and PFIC rules from applying to investors of a U.S.-based private equity fund is to make the foreign investment through an eligible offshore holding corporation in a jurisdiction that receives favorable treatment under local tax treaties, and having such holding corporation elect to be treated as a disregarded entity or partnership for U.S. tax purposes under the “check the box” rules. While this approach involves some structuring-related aspects, it may be less involved than putting in place a parallel or AIV structure but also depends on how attractive it is for the foreign investment to be treated on a pass-through basis. The check-the-box rules are helpful in avoiding the CFC or PFIC rules where the non-U.S. portfolio company and any other non-U.S. entities in the chain are not characterized as corporations for U.S. tax purposes. Otherwise, the attribution rules will apply to look through to the ultimate, indirect U.S. shareholders of the foreign corporation (e.g., the fund investors) to determine whether the CFC or PFIC rules apply.

Foreign Partnerships

It bears noting that the fund could also make investments directly into foreign partnerships (as opposed to foreign corporations) as a way to avoid the CFC and PFIC rules; however, such approach may require the U.S. person to file tax returns in the foreign jurisdiction. Foreign tax credits may ameliorate the impact as they generally allow U.S. taxpayers to take a credit against tax on foreign-source income based on the amount of foreign tax paid on such income, but tend to be complicated in their application.

Acquisition Vehicle

In addition to the fund-level structuring, care must be taken at the acquisition company level to properly structure the vehicle that will acquire the assets of or interests in the foreign portfolio company in a way that compliments the fund-level structuring. The acquisition vehicle is often formed in the jurisdiction of the foreign target (typically under the parallel fund, AIV or holding company structure mentioned above) and should be positioned to take advantage of local tax treaty benefits on reduced withholdings. In addition, consideration should be given to the level of debt and equity used to capitalize the acquisition vehicle in a tax-efficient manner that focuses on generating capital gains with respect to the equity piece and interest income (with corresponding deductions at the portfolio company level) with respect to the interest piece on the debt, as well as qualified dividends to the extent such treatment is possible under applicable tax treaties.

Conclusion

It is difficult to avoid some complexities when transacting business across borders, but with the right overview a fund manager will have the tools needed to target foreign investments and effectively plan for their execution, taking into account the nature and strategy of the fund and its investors. U.S. private equity funds that follow certain investment strategies, or that target minority stakes in foreign "startups" and operating companies, may be able to make such investments without the need to engage in the more complex structuring options that are available. Building the flexibility needed into the legal documentation and structuring aspects, while understanding the tax attributes particular to the targeted investments, are key to enabling the fund to execute, hold and exit foreign portfolio investments in a manner that compliments the fund's investment strategy and enhances returns.

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