Private Equity Comment

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Speed Read

This edition of Private Equity Comment covers Brexit and the outlook for UK funds; the consultation on the UK as a jurisdiction for intermediate holding companies; the market's viewpoint on COVID-19; the Chancellor's cuts to Entrepreneurs relief; and Cayman's placement on the EU list of non-cooperative jurisdictions.

BREXIT AND THE OUTLOOK FOR THE UK FUNDS

In the last edition of Private Equity Comment, just prior to the UK general election, there were many questions still surrounding Brexit, and it was even technically possible at the time of publication that Brexit might not actually happen given the Labour Party's proposed approach. However, the decisive Conservative victory laid one question to rest, Brexit is happening. In fact it has already happened, as the UK left the European Union on 31 January 2020, and the questions are now all centred around what Britain's future relationship with the UK will look like.

As expected, financial services will not be at the top of the list of priorities for negotiation, and in fact the EU has said that there will be no negotiation at all. Their view is that the granting of "equivalence" will be decided by the EU alone, and the UK will also have to live with the fact that it could be unilaterally withdrawn at any point. While this may be a major point for UK based investment banks and others providing trading services, it is of little consequence to private fund managers. The only part of the AIFMD that looks even broadly similar to this idea of equivalence is the third country passport. This allows fund managers in certain non-EU jurisdictions that have been approved by the EU, and who comply with AIFMD, to market their funds to EU investors. The issue is that although legislated for in the Directive itself, this third country passport is yet to be introduced, and seems unlikely to be in the near future.

What options does the UK have? One would be to push in the negotiations for something resembling equivalence. After all, UK law is currently completely aligned with EU law on management of Alternative Investment Funds, and as long as that remains the case can UK managers not continue to market their funds in the EU? This would be an optimal result for UK based managers but for the EU, this would essentially mean granting the UK the same rights they had when they were members, and for the UK it would mean continuing to align with EU laws in order to maintain access. Both sides have repeatedly ruled this out. The UK could align itself with the likes of Jersey, Guernsey and the US, jurisdictions that have already been "pre-approved" by the EU for the third country passport, and try to inject fresh impetus into making the third country passport a reality. While perhaps a long term plan, it is unlikely that the UK would start this kind of lobbying until after the formal negotiations with the EU have been concluded. Even then, given the lack of progress so far, there is no guarantee that the passport would even be introduced. The last choice for UK funds would be to market into Europe under the national private placement regimes, which for some EU jurisdictions is entirely possible.

Looking outside of the EU – is there a chance for the UK to make a case that it is now the jurisdiction of choice for those managers who do not wish to be within AIFMD? Parallel structures are increasingly common among global funds wanting one fund vehicle within the AIFMD for EU investors and the other outside of it for global investors, so it could be that we start to see parallel UK and Luxembourg limited partnerships in fund structures going forward.

CONSULTATION ON UK AS A JURISDICTION FOR INTERMEDIATE HOLDING COMPANIES

The UK government has also started an interesting consultation on the UK as a location for intermediate entities through which funds hold their assets. This is a really positive move from the Treasury and will be of huge interest to the funds industry. The European tax system has always struggled with enabling tax exempt investors to invest through these types of funds into Europe on a tax neutral basis. In the last 12 months developments coming out of the implementation of the OECD’s BEPS initiative across Europe and the recent Danish cases on beneficial ownership for the purposes of EU Directives have threatened to create yet more obstacles to doing so. As such this consultation is likely to be welcomed by European fund managers and industry groups, as the emergence of the UK as a viable holding company location of fund investments is a goal well worth fighting for. Of course the key points being addressed in the consultation are, as expected, questions such as the application of the Substantial Shareholding Exemption and UK withholding tax on interest, but there is also reference made to the UK’s anti-hybrid rules. The importance of these rules, particularly as they apply facing a tax exempt investor base, should not be underestimated.

COVID-19: MARKET VIEWPOINT

The onset of the COVID-19 pandemic has had a significant effect on the private equity industry. On the fundraising side, funds that are near to closing are still closing, with many managers and investors keen to get them over the line as soon as possible. New fundraising has slowed to an extent, as marketing to investors has become difficult due to the inability to travel and have face to face meetings, and many investors pause to assess the situation. As assets become difficult to value, this has had an impact on transactions, both primary acquisitions/disposals and secondary transactions, and these transactions have slowed considerably with many being put on hold. The outlook is uncertain but parallels can be drawn to the 2008 financial crisis and the direction the industry took during that period. Fund managers had to look closely at their fund documents as some investors, particularly high net worth individuals, hinted at possible defaults, and restructurings were common at fund level as new money was brought in to give much needed liquidity to investors. Managers may also look at other opportunities such as widening recycling abilities to increase capital available, and possibly even changes of strategy, perhaps into distressed assets or debt as businesses look for greater access to funding.

CHANCELLOR CUTS ENTREPRENEURS RELIEF

In the recent Budget on 11 March, the newly appointed Chancellor cut Entrepreneurs Relief by reducing the lifetime gain allowance from £10m to £1m. It was anticipated that a change was going to occur, with some commentators even predicting it could be scrapped altogether. Prior to the Budget, business owners selling companies would (provided they met the qualifying conditions, discussed further below) pay capital gains tax at 10% on the first £10m of gains, and the full 20% CGT on all gains made above that amount (the £10m limit applying on a rolling basis to all qualifying gains realised in their lifetime). The tax break has effectively been reduced by 90% as that limit is now only £1m, meaning for some business owners will still benefit in full from the 10% rate, but those making larger gains will now pay the full 20% on a larger proportion of their gains. The qualifying requirements for Entrepreneurs Relief have not changed, which broadly require the shareholder (who would need to be an officer or employee) to hold at least 5% of each of the share capital and the voting rights and be entitled to at least 5% of either any profits available for distribution and assets on a winding up or any sale proceeds if the company were to be sold at market value. The conditions need to be met for the two year period prior to the disposal, save in limited cases involving asset sales followed by liquidations. As such, PE executives with stakes in the house commitment to their funds, often totalling 2-3% of the total fund size across the team, would have been unlikely to qualify. Holders of equity directly in PE portfolio companies often can meet these tests though, and are therefore likely to be affected by these recent changes. It should also be noted that the Budget changes included measures to counteract certain planning arrangements implemented prior to the Budget with the aim of “locking in” the higher £10m lifetime limit (e.g. entering into unconditional contracts for sale, with completion to follow at a date after 10 March). Any individuals who utilised any such planning should seek advice as to the potential operation of these counteraction measures.

CAYMAN IS PLACED ON THE EU LIST OF NON COOPERATIVE JURISDICTIONS

On 18 February 2020, the EU’s list of non-cooperative jurisdictions was updated to include the Cayman Islands, on the grounds that it does not have appropriate measures in place relating to economic substance in the area of collective investment vehicles.

Key impacts for fund managers could be: investors who are sensitive to investing in vehicles based in jurisdictions included on this list, side letter provisions agreeing not to invest in vehicles based in such jurisdictions, whether arrangements involving Cayman structures will be reportable under the new EU directive “DAC 6”, and whether EU based investments will be subject to withholding taxes.

The Cayman Islands is seeking to get itself taken off the list (on the basis that legislation relating to private funds, which had been designed to address the EU’s concerns, has now been passed and is now in force). The hope therefore is that this will be a short term situation. The list is updated twice a year with the next update being scheduled for October 2020.

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