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INDEPENDENT TAX CONSULTING

Nordic Tax Conference

- Carried interest in the Nordic Countries

Agenda

- Introduction to the topic
- Comparative overview
 - Norway
 - Finland
 - Sweden
 - Denmark
- Cross border issues
- Possible conclusions

Carried interest in general

Carried interest in general

- Definition
 - Business standard regarding remuneration of partners/managers in private equity funds and venture capital funds.
 - Most commonly via partnership structures either directly or through holding companies.
 - 2 (Management fee) and 20 (Carried interest)
 - Carried interest results in a distribution of the economic return on the investment which does not match the invested capital
 - Typically 20% yield if a hurdle rate of IRR 8% has been met at an initial investment of 1-2%.
- Global trend
 - Discussions on whether carried interest is salary income/fee's for managing money or capital gain?
 - Targeted legislation and challenged by authorities (UK, US, Germany, Holland, France, Norway, Sweden, Denmark)

Carried Interest in Norwegian Tax Law

Nordic Tax Conference - Oslo
October 2013

Anders Heieren



Tax in Norway - Carried Interest

- Formal starting point – agreed share of profits created in the fund = potential extra return on long term risky investment. Partners are employed by management company and receive salary from there, not from the fund.
- The General Partner has unlimited liability and 0 return until the Limited Partners have made a substantial profit (“hurdle rate”, f.ex. 10%) – freedom of agreement and fair to have extra return on capital in case of success.
- All Norwegian companies and fund:
 - GP AS should be taxed at 0.84% on distributions received from the fund (3% of the amount x 28% tax rate), or 0% if liquidation proceeds. (28% tax at fund level + 28% at personal level)
 - Principles applied in line with other countries that have not introduced special rules.
- Rumors – salary taxation alleged previously by taxing authorities but case settled in private agreement.
- The issue is now raised again and will, if not settled before, be dealt with by the Oslo City Court in November 2013. This will be the first Norwegian Court case.
- The facts in that case – next slide

Salary - arguments

- Assessment based on full salary taxation (approx 50%) + employers social contribution (arbeidsgiveravgift) for Advisory Co. 0 tax was paid and funds are largely reinvested.
- Legal argument – improper allocation; carried interest not related to the investment as such but rather to the successful management. Hence carried interest should be allocated to Advisory Co. Further, it should be allocated to the individual partners because these persons are those actually providing the services, and reclassified as salaries at the hand of the individual partners.

Salary counter arguments

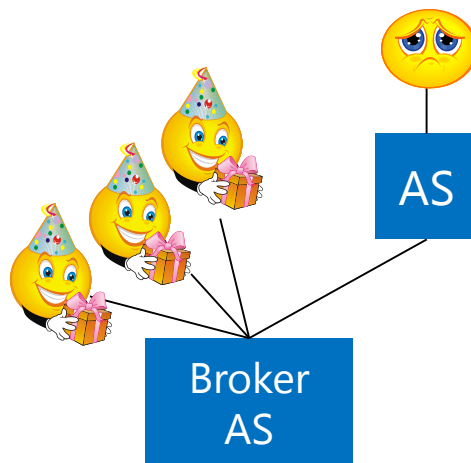
- «Forced salary» is traditionally reserved for cases where an employee nominates his private company as the recipient of his salary. And it should be; accepting the tax office position could leave question marks for many professionals who render their services through fully owned companies.
- The Norwegian tax system secures equal treatment any way and the timing difference/possibility to re-invest is accepted, and wanted.
- Employer's social security tax is a consequence of the tax office's view, even though no such salary was paid.
- In this particular case there is a third party passive investor receiving 40% of the carried interest, which further suggests that the carried interest is not salary.

Alternative view

- Carried interest is (I believe) not dependent on how large stake GP has in the fund. Therefore carried interest seems more like a success fee for services than a premium return on the capital contributed. This solution also secures equal return on all capital contributed.
- Ordinary business income for the GP to the extent it receives more for the capital provided than other investors.
- Allocation of such business income to Advisory Co conflicts with the agreements and no overriding reasons to do so.
- 28% tax at GP level. Levied at the hand of each partner's AS if GP established in low tax country.

Recent binding ruling – salary and not

- BFU 17.09.2013 – dividend distribution in reference to individual performance each year. Accepted for personal shareholders, but salary for the person owning indirectly. Relevant? Correct? Reasonable or unfortunate obstacle for reinvestment? Solution is for partners to own directly in GP and/or Advisory Co?





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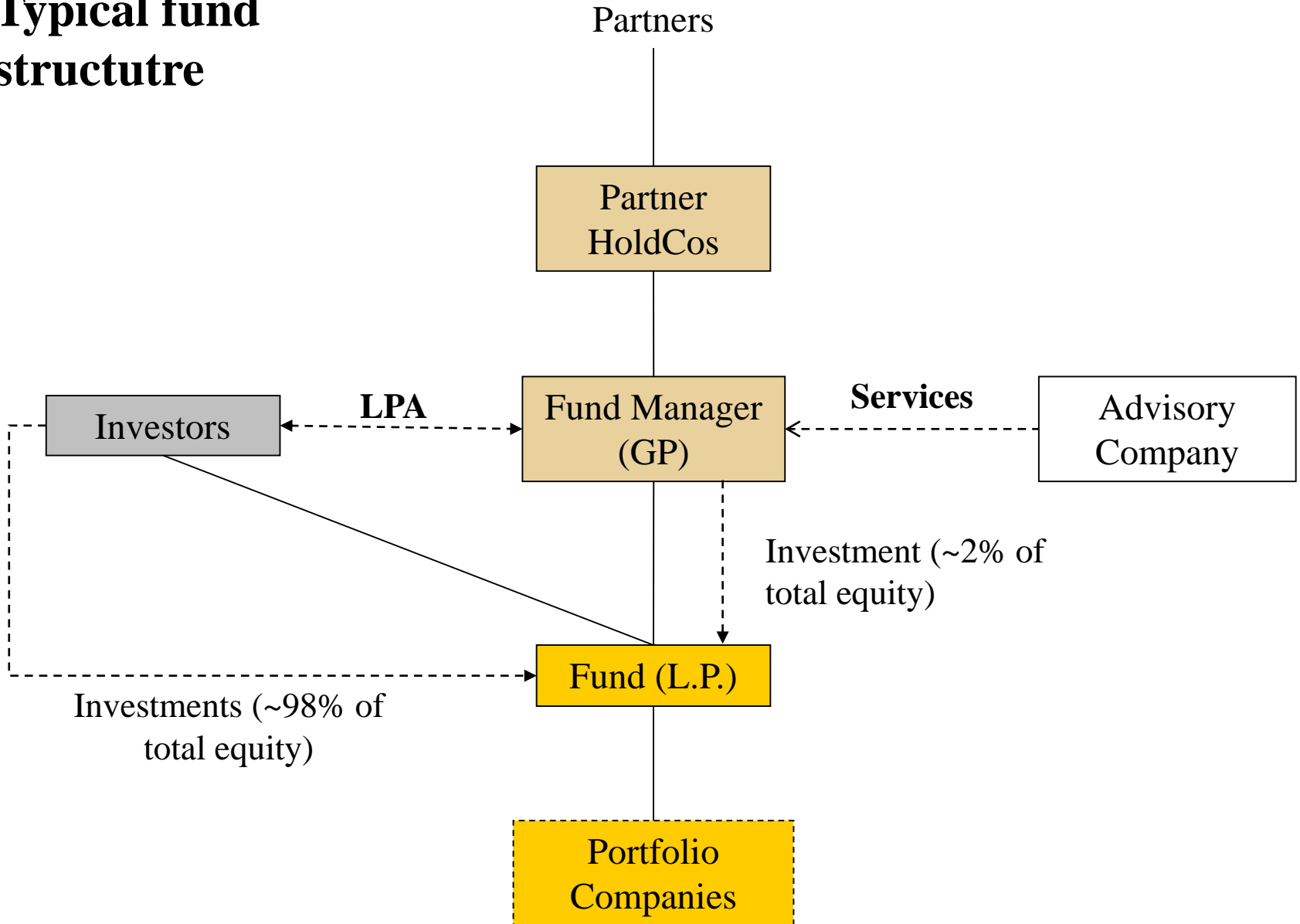
Carried interest in Swedish Tax Law

Background

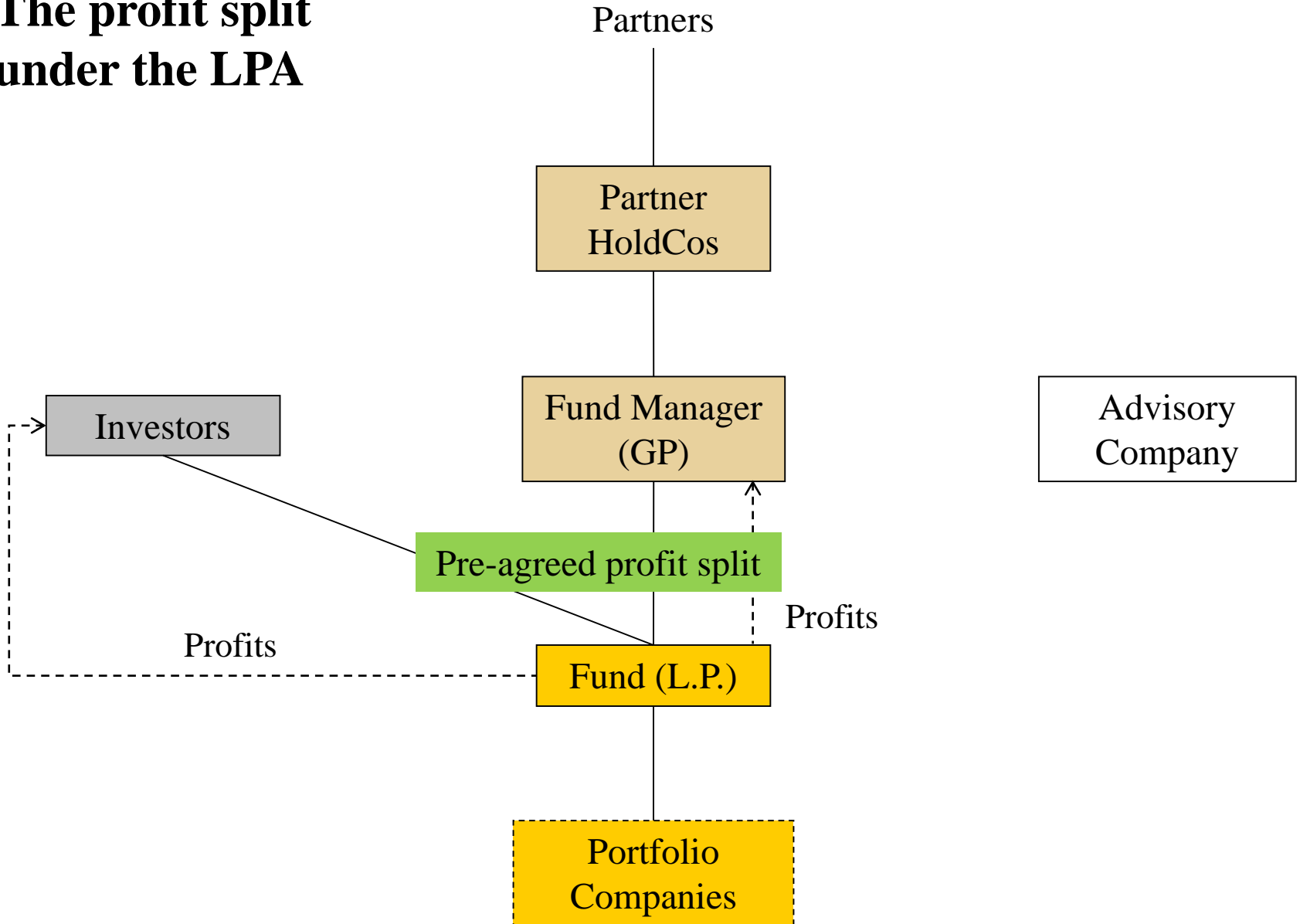


- All of the major private equity firms in Sweden are currently under review by the Swedish Tax Agency.
- The question is **by whom carried interest is to be recognized as an item of income;**
 - the GP which as the fund manager establishes the fund and has the right to carried interest under the LPA; or
 - the Advisory Company where the partners and others supply advisory services.
- The Court of Appeal will hear one of the cases in November this year.

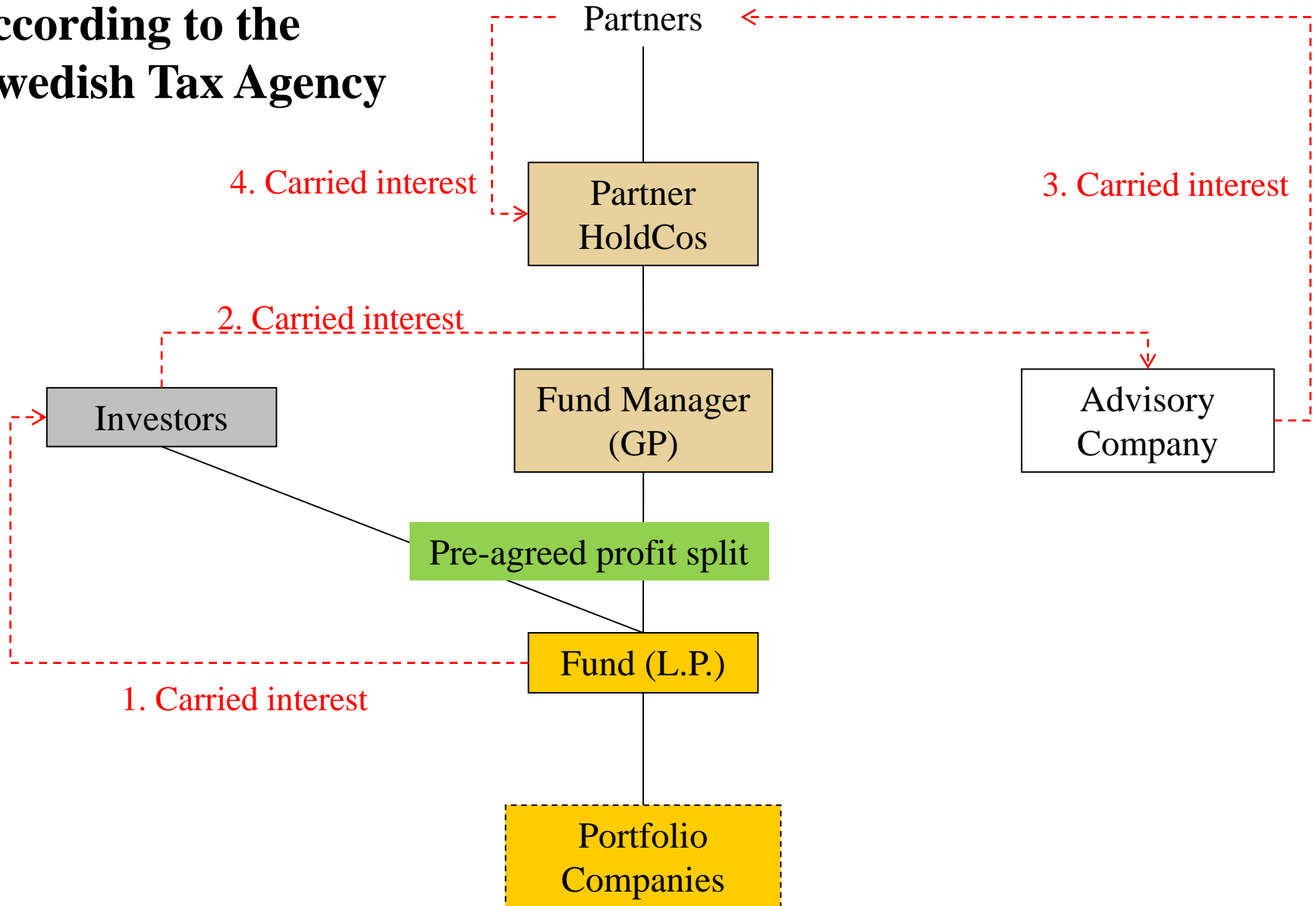
Typical fund structure



The profit split under the LPA



The profit split according to the Swedish Tax Agency





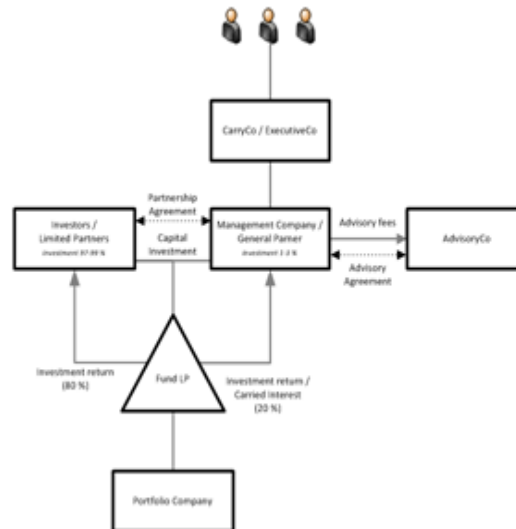
"SITUATION UNDER CONTROL" by Veikko Myller

WASELIUS & WIST

Members of the Finnish Bar

Carried Interest in Finnish Tax Law

Typical Finnish Carried Interest Structure



Taxation of partnerships

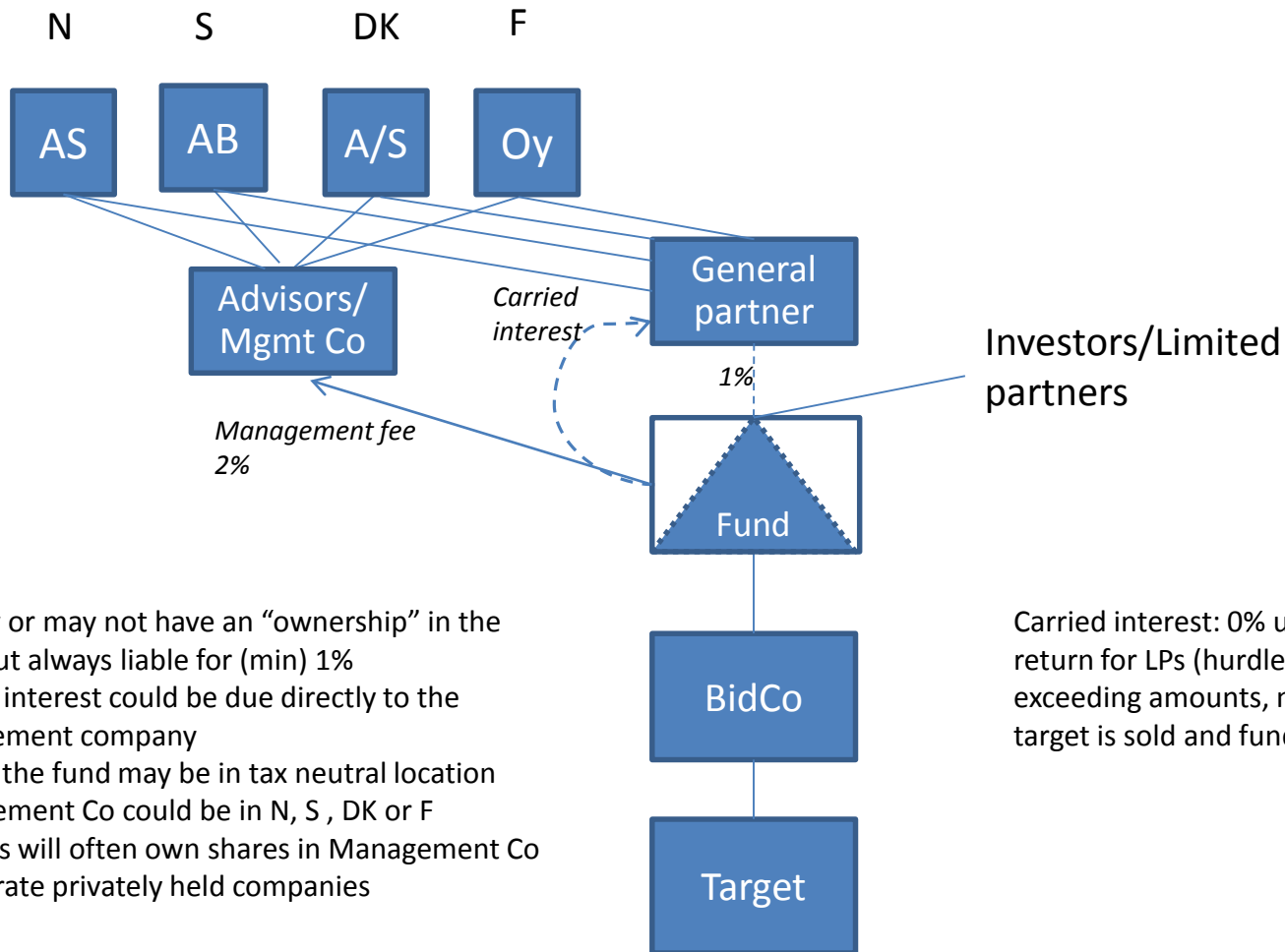
- A partnership is largely transparent and generally treated as a flow-through vehicle for Finnish income tax purposes.
- Does not subject the partnership to an entity-level tax.
- A partnership is only a vehicle for determining the net income (profits), which is then allocated to the partners and taxed at the level of the partners.
- The basis for the allocation of the income is the distribution of profits (profit share) agreed among the partners in the partnership agreement.
- Actual profit distributions made by the partnership to its partners are not taxable.
- Different taxation of the profit share for resident and non-resident partners.
- Resident partners may have income from different sources (for example, business income and/or other/personal income), each taxed separately and in a different manner.
- For non-resident partners, dividends, interest and capital gains from the partnership's investments are largely taxable at the level of the partners as if they had received them directly.

Tax treatment of carried interest

- Finland does not have any specific rules on the taxation of carried interest.
- Carried interest is therefore a part of the partner's overall profit share.
- For Finnish resident partners, normal principles on the allocation of income between income from business, income from capital and income from employment should apply to a partner's profit share.
- For non resident partners, the profit share is subject to different taxation depending on the underlying source of income.
- Normally, carried interest is ultimately declared by the management partners as income from capital (dividends from their respective holding companies).
- Management partners typically hold shares in the general partner entity through holding companies in order to be able to receive the carried interest as a tax exempt dividend from the general partner entity.

Case study - Taxation of carried interest

Partners:



- GP may or may not have an “ownership” in the fund, but always liable for (min) 1%
- Carried interest could be due directly to the management company
- GP and the fund may be in tax neutral location
- Management Co could be in N, S, DK or F
- Partners will often own shares in Management Co in separate privately held companies



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Carried interest in Danish Tax Law

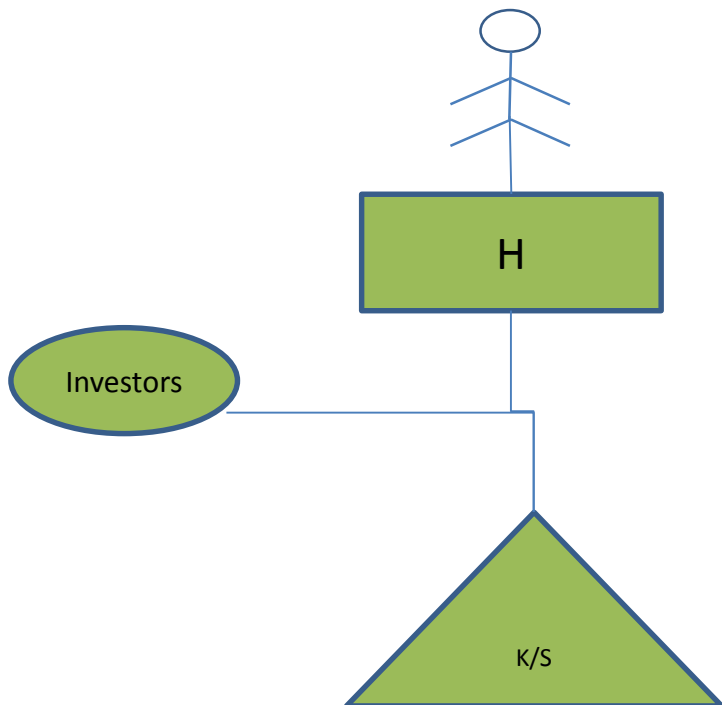
Carried interest in Danish tax law

- Background
 - Targeted provisions introduced in Denmark in 2009
 - Historical structures have not been challenged
 - i.e. Carried interest yield treated as capital gains.
 - Different rules depending on whether investment is carried out directly or through personal holding company
- Personal investment in PE/VC funds (ABL § 17 A)
 - Normal yield taxed as share income
 - Extraordinary yield taxed as personal income
 - Requirements:
 - Tax payer is an individual
 - The individual has a preference with respect to economic yield.
 - » I.e. more than other investors
 - In a private equity or venture capital fund
 - » Investing in shares with the objective of participating in the management and operations of the companies.

Carried interest in Danish tax law

- Investment through personal holding company (LL § 16 I)
- Effect
 - Include the share income of the holding company at the level of the individual level to be taxed at 25% as CFC-income
- Requirements:
 - A taxable individual
 - Which directly or indirectly controls
 - A Danish or foreign legal entity
 - The company should acquire shares directly through a private equity or venture capital fund.
 - The company has a preference with respect to economic yield.

Example



| Total taxation of yield | |
|---|--|
| Income in H via LP from sale of portfolio | 120 |
| CIT 0% (If H is Danish and underlying income is capital gains from tax exempt portfolio shares) | (0) |
| Share income in H (standard yield is 20) is considered CFC income for partner | $120 - 20 = 100$ which is taxed at 25 % = 25 |
| Relief for H tax from capital gain | (0) |
| Tax at partner level after relief | 25 |
| Tax upon distribution of dividends from H (42 %) | $120 * 42 \% = 50,4$ |
| Total taxation of yield | $25 + 50,4 = 75,4$ |
| Effective tax rate | 62,8 |
| Reimbursement if investors should receive a pay back of carried interest | 25 |

Carried interest in Danish tax law

Timing issues in the context of carried interest.

- Computation on the basis of "deal by deal" or "fund as a whole"
- Deal by deal structure is often followed by an obligation to place payments in escrow and an obligation to repayment upon adjustment (claw back)
 - Income in LP's is taxed at accrual irrespective of escrow
 - Introduction of LL § 16 J
 - Taxes paid regarding carried interest can be repaid if payments are adjusted
 - Timing issue

Foreign partners in Danish based PE/VC funds

- No specific provisions
- Withholding tax on dividend payments
- No withholding tax on capital gains on shares
- Danish law does not reclassify carried interest to e.g. salary



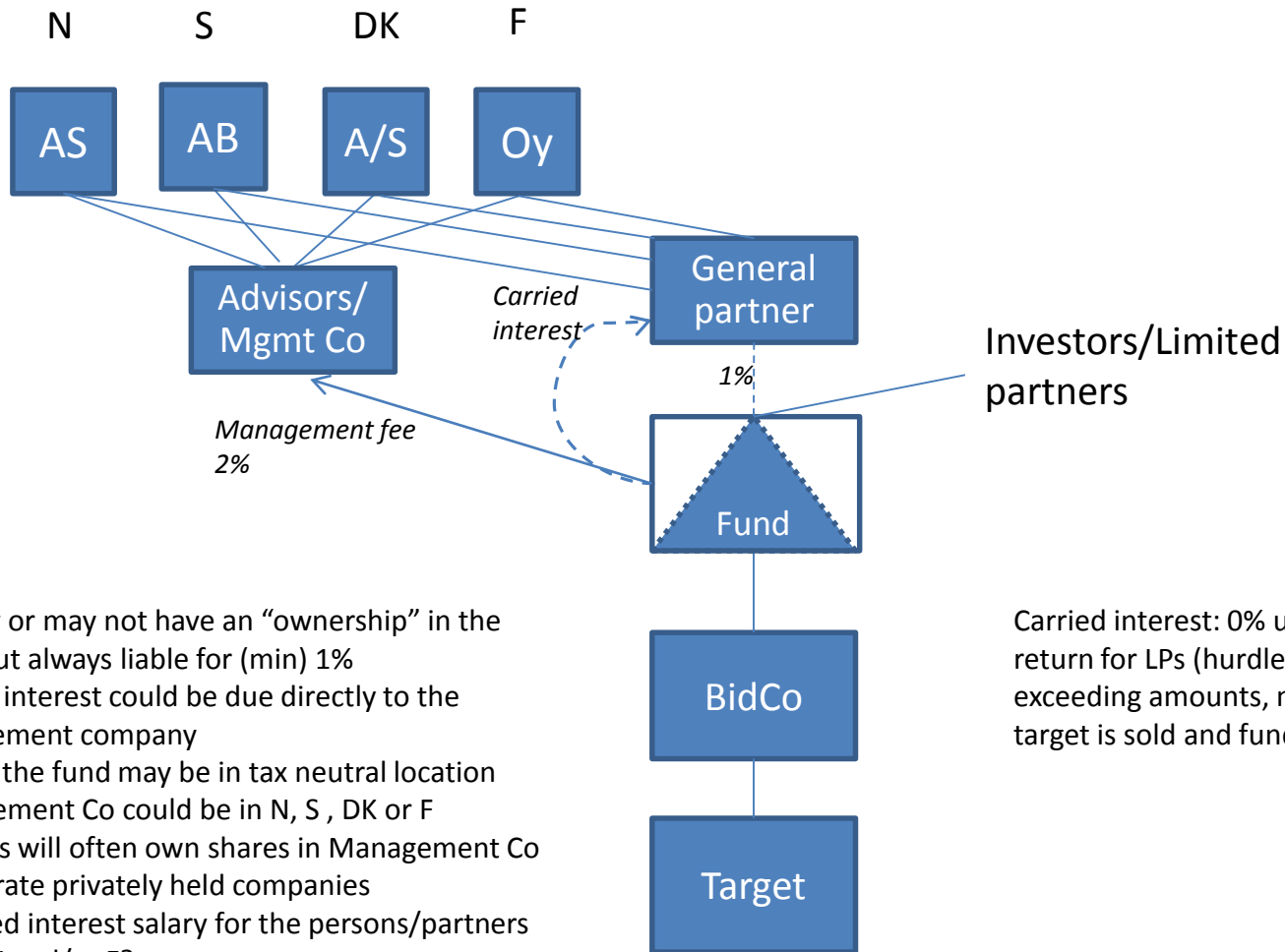
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Cross border issues

Case study - Taxation of carried interest

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- GP may or may not have an “ownership” in the fund, but always liable for (min) 1%
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- GP and the fund may be in tax neutral location
- Management Co could be in N, S, DK or F
- Partners will often own shares in Management Co in separate privately held companies
- Is carried interest salary for the persons/partners N, S, DK and/or F?

Carried interest: 0% up to say 10% return for LPs (hurdle rate), 20% of exceeding amounts, normally when target is sold and fund closes.

Cross border issues

- Basic cross border scenarios
 - Scenario 1
 - Partner is taxed in state of residence as salary/fee
 - Yield is considered capital gains in source state
 - Scenario 2
 - Partner is taxed as capital gains in state of residence
 - Yield is considered salary/fee in source state and subject to withholding tax.
 - Variations
- Tax treatment according to Nordic Tax Treaty
 - Business profits – Article 7?
 - Dividends – article 10?
 - Interest – article 11?
 - Capital gains – article 13?
 - Salary income (wages) – article 15?
 - Other income – article 22?
 - Domestic law and classification conflicts
 - Article 3(2)?
 - 2000 OECD Commentary to article 23 A and B (para. 32.1-32-7) should not affect the interpretation of the Nordic tax Treaty.

Cross border issues

- Cross border scenarios involving Denmark
 - Danish legislation on carried interest applies to a Danish partner and capital gains are still treated as capital gains in source state
 - CFC-like taxation of yield if holding company
 - EU law aspects? – Pickling up tax benefit from owning a foreign company - Comparability?
 - Taxation as personal income if direct investment – higher taxation than other capital gains and dividends - but no reclassification
 - Impact of article 13(7) of the Nordic Tax Treaty
 - » Hardly any practical impact – ie no right to impose withholding tax on capital gains on shares.
 - » Therefore it seems that there is no conflict with the Nordic tax treaty
 - Danish legislation on carried interest does not apply to a Danish partner but carried interest is reclassified as salary in the state of the Fund/portfolio company
 - Classification conflict?
 - Danish legislation on carried interest applies to a Danish partner and carried interest is reclassified as salary in the state of the Fund/portfolio company

Swedish partner in Norway (GP AS)

- If taxed as business income at the hand of GP AS;
 - GP in Norway: GP AS taxed on all its earnings.
 - GP in third low tax country: no Norwegian tax for the Swedish partner, unless GP has a PE in Norway or is Norwegian tax resident.
- If taxed as business income at the hand of Advisory AS (reallocation);
 - No particular tax issue arises, Advisory AS taxed on all its earnings. However, there could be company law problems with distributing those “earnings” as they are only deemed for tax purposes and not backed by actual increased equity in the balance sheet. Also Swedish tax credit issues?
 - What if reallocated to the individual partner level? No PE
- If taxed as salary;
 - The Swedish partner has not performed any work in Norway and should not be taxable to Norway. No deemed salary deduction for that part. Or, could it be turned around, Norway deeming a salary deduction also for the Swede and taxing partner by reference to NTT art 15? Treaty override?
 - The Swedish partner will suffer for the cost of employers social contribution, is that a double tax or a commercial issue? Or neither?

Norwegian partner in Sweden (GP AB)

- If reclassified and taxed as business income at the hand of GP AB;
 - Can Norway still reclassify as salary?
 - If yes – Sweden would not have to allow a corresponding deduction. Result double taxation. And hence in conflict with the treaty? Economic and not juridical double taxation?
 - What about tax credit in Norway? Personal owner in GP AB – dividends & WHT later
- If reclassified and reallocated as business income at the hand of Advisory AB;
 - More problems with tax credit?
 - Could be company law problems with distributing those “earnings” as they are only deemed for tax purposes and not backed by actual increased equity in the balance sheet?
- If taxed as salary in Sweden
 - Assume Sweden would not reclassify for the Norwegian partner.
- No particular problems arise if treated as business income in both countries.

Advisory AB in Sweden, GP A/S in Denmark, Norwegian partner

- Assumingly only Norway would consider to tax the Norwegian resident partner based on «deemed salary». The example rather illustrates that re-allocation as business income from the GP to the Advisory Co could create problems in cross border cases.

Cross-border issues for non-resident partners (Danish partner in Finnish GP)

- A non-resident partner's share of the partnership's profits is considered as taxable Finnish source income.
- The profit share of a non-resident partner is, however, taxable in Finland only to the extent that the partner would have been subject to taxation in Finland on a corresponding direct investment if:
 - the partnership is engaged solely in venture capital activities; and
 - the partner resides in a tax treaty country and the tax treaty is applicable to the partner.
- In practice, non-resident partners residing in a tax treaty country are subject to tax (WHT) only on dividends from Finnish portfolio companies, whilst capital gains and interest are tax-exempt.
- Carried interest is part of the partnership's profit distribution, and the general partner will be taxed upon its computational profit share.
- Carried interest may thus technically include elements of dividends, capital gains and interest; tax treatment of dividends may differ from the tax treatment of capital gains and interest.
- If carried interest is reclassified as salary, how does it affect the tax treatment of any investment return not within the scope of carried interest? How should the adjustments be made to the various sources of income from a tax point of view?
- Would Finland reclassify for a non-resident partner?

Cross-border issues for resident partners (Finnish partner in Swedish GP)

- If reclassified as salary in Sweden, but no corresponding reclassification in Finland.
 - No tax credit available?
- If no reclassification in Sweden, can Finland still reclassify as salary?
 - Tax credit issues?