

KEYNOTE INTERVIEW

Transparency extends to tax as PE evolves



The private equity industry needs to be ready for more stringent disclosure regulations, including on taxation, say Travers Smith partners Sam Kay and Elena Rowlands

Fund managers have had to comply with an ever-increasing list of disclosure and transparency requirements in recent years. Regulators are focused on ensuring that protections are in place for investors, while investors themselves are scrutinising managers' practices in areas from taxation to sustainability reporting.

Sam Kay, partner in the funds department at Travers Smith, and Elena Rowlands, partner in the firm's tax department, tell *Private Equity International* that the direction of travel is towards even greater levels of transparency so that private equity is not that 'private' anymore. While tax has often been overlooked in the narrative around ESG, investor demands for

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sustainable tax practices will be an increasingly important consideration for managers in the years ahead.

Q Why are transparency and disclosure becoming more important?

Sam Kay: Transparency is certainly not an entirely new issue. This has been a focus in the UK private equity industry at least since the introduction of the Walker Guidelines in the late 2000s. And, of course, investors have always wanted to know more about the portfolio and to have information

on the portfolio. Also, some investors are public organisations and may be subject to Freedom of Information requests, or simply have policies to disclose certain terms – so private equity firms accept that if they have certain investors in their fund, there will be an element of public disclosure.

Disclosure and transparency are moving up the agenda now, partly because there is far more focus from regulators on this issue. They increasingly require private equity firms to make disclosures, either to the regulators themselves, or to investors or the wider public. The UK was at the forefront of this, but other regulators are catching up – the US Securities and Exchange Commission, for example, is insisting

Q Will the democratisation of private funds be another factor in driving greater transparency?

SK: There's a definite trend towards private equity having access to broader pools of capital. In the US, it's all about access for private equity to company-sponsored retirement plans. In the UK, there's the new long-term asset fund structure, which is being introduced to encourage defined contribution pension funds to invest into private equity. That is a clear driver towards private equity not being quite so private anymore. We will have a much broader range of institutions, some that are not necessarily sophisticated, that can get access to private equity.

We should accept this could lead to more regulation and more oversight. After the last financial crisis there was a perception that investors needed more protection when they invest into private equity. Now, with the democratisation of private equity, we can expect a renewed focus on investor protection.



Regulators will be willing to impose greater transparency and disclosure requirements on private equity, to help protect investors, but we are still in the foothills of what the regulators will do. Like tax authorities, regulators are sucking up as much information as possible and they may use this to impose more stringent or more tailored tests on the industry.

on more prescriptive reporting by fund managers and investment advisers. Across the board, regulators are increasingly defining the disclosures that need to be provided to investors, especially on areas such as conflicts of interest.

Sustainability reporting requirements are also on the immediate horizon for private funds, notably through the Sustainable Finance Disclosure Regulation in the EU. Large parts of these rules are focused on disclosure and reporting, which is partly designed to deal with the problem of investment vehicles engaging in 'greenwashing' to attract investors.

Q How are tax transparency requirements changing?

Elena Rowlands: On the tax side, it's a similar story. Over the last few years, we have seen a host of new tax rules aimed at increasing the amount of transparency and disclosure.

Tax authorities have focused on strengthening requirements for disclosure of information, particularly where information must be shared between

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tax authorities on an international basis. That trend generally started with the US Foreign Account Tax Compliance Act back in 2010 and then it expanded with the Organisation for Economic Co-operation and Development's Common Reporting Standard and, more recently, mandatory disclosure rules.

These provisions are designed to

allow the exchange of information between tax authorities of different countries to help stop tax avoidance and evasion. This created a huge administrative burden for private equity fund managers. New developments, such as the new base erosion and profit shifting framework known as BEPS 2.0, will likely result in firms having to provide even more information.

There are also greater requirements to disclose information to taxpayers who need that information for their own tax compliance purposes. In a private equity context, portfolio companies will often require information about fund structures, as well as the profile of investors, to file their own tax returns, for example where anti-hybrid rules are in point. That has been a real headache, because typically private equity fund managers are reluctant to disclose information about their investors out of concern for confidentiality.

Then there are requirements to disclose tax information to the public. This is quite a new area. For example, the UK introduced rules which require large businesses to publish their

tax strategy and set out their approach to tax planning. Similarly, the EU is introducing public country-by-country reporting rules. This will result in enhanced public scrutiny of large businesses and their tax positions.

Q How does tax transparency fit into investor expectations on ESG?

ER: People often forget tax when it comes to ESG, but it has emerged as an important element. Investors focused on ESG now expect fund managers and their portfolio companies to conduct their tax affairs in a sustainable manner. That's measured in terms of good tax governance and in companies paying a fair share of tax. Public disclosure of funds' approach to tax, the amount of taxes they and their portfolio companies pay and where those taxes are paid are all important elements of sustainable tax practices.

Generally, private equity doesn't always have the best reputation amongst the public from a tax perspective, particularly where a fund is established in an offshore low tax jurisdiction. But there is a fundamental misunderstanding around how private equity is structured. The key aim from a tax perspective of any fund structure is that investors shouldn't be worse off going into a fund structure versus going into the underlying portfolio companies directly.

So, there will be more scrutiny, but that should be matched by a better understanding among the public about what private equity is trying to achieve. After all, a private equity fund structured as a Cayman limited partnership will be tax transparent in the same way as an English limited partnership or a Luxembourg limited partnership.

Determining the right approach to tax transparency can be quite complicated and there isn't yet a commonly agreed standard as to what constitutes good tax transparency reporting. Some investors have introduced their own tax policy and require specific tax terms

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when investing in private equity funds.

We increasingly see investors asking for side letter provisions on tax, which is a relatively new trend. In the side letter, the investor will outline its tax policy and state its expectation that the manager conducts the affairs of the fund in accordance with that tax policy. This can be difficult in practice given the aim to maximise investor returns and the obligation of the manager to act in the best interest of all investors rather than one particular investor.

Q Are private equity firms well-prepared for the continued strengthening of transparency and disclosure requirements?

SK: The private funds market has grown and become integral to investment strategies of a broad range of investors over many years. Part of that must be connected to an acceptance and an understanding of the industry, which has come about through private equity firms being relatively transparent with what they are doing and how they are doing it.

That said, there is a balance here. Private equity firms will always seek to protect the value within portfolio companies. If they disclose too much, if they disclose the value that they put on a particular underlying investment,

then that is potentially damaging. If that value is publicly available, then when the private equity firm is seeking to sell that asset, a counterparty may be able to find out exactly the value that they attribute to it, which is not helpful. Private equity firms are going to try to avoid that level of disclosure.

ER: International tax rules have been evolving at an increasing pace. BEPS 2.0 will create a paradigm shift in the international tax system and will enable governments to access even more information and much-needed tax revenues. Within those rules, there are exclusions for investment funds, but that doesn't necessarily exclude the portfolio companies that they own. That is something that private equity firms will need to get on top of and will take some time.

Q Is the time and effort spent on complying with transparency regimes well spent?

ER: It depends on who you ask. From a fund manager perspective, FACTA and other rules on tax disclosure have significantly increased the administrative burden. However, from a tax authority perspective, the amount of information they are receiving is proving useful. When tax disclosure rules were first introduced, the key question was what tax authorities would do with all the data. Yet tax authorities now have increasingly sophisticated IT systems that allow them to analyse and make use of the information. This ability to analyse big data is only likely to grow over time, so it's unsurprising that we are seeing a marked rise in the number of tax authority disputes.

The message for fund managers is that disclosure requirements are only going to increase. They need to make sure their tax affairs are in order, because if they are not, the tax authorities have the information and the tools to use that information to raise enquiries. ■