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The Other Eighty Percent: Private Investment Funds, International Tax Avoidance, and Tax-Exempt Investors

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The taxation of private equity managers' share of funds' profits—the twenty percent "carried interest"—received much attention in academic literature and popular discourse. Much has been said and written about the fact that fund managers' profits are taxed at preferred rates. But what about the other eighty percent of funds' profits? This Article theorizes that the bulk of such profits are never taxed. This is a result of a combination of three factors: First, private equity, venture capital, and hedge funds (collectively, Private Investment Funds, or "PIFs") are major actors in cross-border investment activity. This enables PIFs to take advantage of international taxation planning schemes not available in a purely domestic context. Second, PIFs are aggressive tax-planners. The Article summarizes some existing evidence that suggests that PIF-controlled multinational enterprises ("MNEs") are more likely to engage in aggressive international tax behavior when compared with MNEs that are not PIF-controlled. The result is that PIF-controlled entities are uniquely situated to avoid tax at the source jurisdiction. Lastly, PIFs are dominated by tax-exempt investors. This enables PIF profits, which escaped source taxation, to also escape taxation at the jurisdiction of residence. The result is that most private equity gains from cross-border investment activity are taxed nowhere. The Article concludes, therefore, that PIF-controlled entities should be a target of international tax policy making. However, such policymaking must be grounded in better understanding of PIFs' international tax behavior. This is a difficult task, since PIF operations are rarely subject to public disclosure requirements. The Article proposes opening PIF international tax planning to public scrutiny through a revision of the country-by-country reporting (CBCR) standards adopted under Action 13 of the BEPS Project. It is hoped that information garnered from such increased

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reporting will assist in developing anti-tax-avoidance policies that are better targeted at PIF-controlled MNEs.

INTRODUCTION

This Article links two seemingly separate academic discourses in taxation which, for the most part, have run parallel courses without significantly engaging each other. The first is the discourse on the taxation of private equity funds,[1] hedge funds,[2] and venture capital funds,[3] collectively referred to as private investment funds ("PIFs"). The second is the discourse on international tax avoidance.[4]

The common characteristic of all PIFs is that they pool funds from private investors with significant financial capability and use such funds to invest in portfolio companies.[5] The fund managers—who sponsor the funds and raise capital from investors—are paid certain fees[6] and receive a share of the fund's profits if the fund is successful.[7]

There is a large volume of literature on the taxation of PIFs.[8] The bulk of the discourse, however, is focused on the taxation of PIF

1. *See*, *e.g.*, Gregg D. Polsky, *A Compendium of Private Equity Tax Games*, 146 TAX NOTES 615 (Feb. 2, 2015) [hereinafter: Polsky, *Compendium*]; Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers With Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071 (2008); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008).

2. *See*, *e.g.*, David S. Miller & Jean Bertrand, *Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers*, 65 TAX LAW. 209 (2012); Alan L. Kennard, *The Hedge Fund Versus the Mutual Fund*, 57 TAX LAW. 133 (2004).

3. *See*, *e.g.*, James M. Poterba, *Venture Capital and Capital Gains Taxation*, *in* 3 TAX POLICY AND THE ECONOMY 47 (Lawrence H. Summers ed., 1989), http://www.nber.org/chapters/c10945.pdf.

4. *See* Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS*, 6 HARV. BUS. L. REV. (forthcoming 2016); Michael P. Devereux & John Vella, *Are We Heading Towards a Corporate Tax System Fit for the 21st Century?*, FISC. STUD. (forthcoming 2016); Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55 (2014).

5. THOMAS MEYER & PIERRE-YVES MATHONET, BEYOND THE J CURVE: MANAGING A PORTFOLIO OF VENTURE CAPITAL AND PRIVATE EQUITY FUNDS 1–40 (2005) (describing private equity fund operating models); *see also* Miller & Bertrand, *supra* note 2, at 311–24. It is important to note that private equity funds and venture capital funds share more common tax features with each other than with hedge funds, and in some instance the discussion herein may be more relevant to the first two. However, all three share the most important features for purposes of this Article, which are (1) the pooling of private investors' funds, (2) management compensation related to performance, and (3) significant cross-border activity.

6. *See* discussion *infra* Section I.A.

7. *Id*.

8. *See supra* notes 1–3 and accompanying text.

managers.[9] Academic literature frequently discusses the preferential tax treatment accorded to the taxation of fund managers' twenty percent profits interest (known as "carried interest")[10] or the conversion of management fees from ordinary income to capital gains.[11] Relatively little attention is given to the taxation of portfolio companies held by PIFs[12] or of PIF investors that earn the other eighty percent of the PIFs' investment returns (left after the managers claimed their part of the profits). Literature on PIF taxation also rarely takes into account international tax considerations.

The purpose of this Article is to make first strides in filling this gap. PIF investments account for a substantial part of cross-border investment activity.[13] PIFs and their portfolio companies are able to take advantage of multiple international tax planning opportunities that are not available in a purely domestic context.[14] Thus, PIF-controlled entities are uniquely situated to engage in aggressive income stripping in the jurisdictions in which they operate, eliminating source taxation.[15] Moreover, since a significant portion of PIF investors are tax-exempt,[16] income stripped at the source is never taxed at the residence jurisdiction of the investors.[17] PIFs are thus particularly successful vehicles of so-called "double nontaxation."[18] It

9. *See* discussion *infra* Section I.B.

10. Polsky, *Compendium*, *supra* note 1, at 616 ("[T]he carried interest loophole has already been the subject of intense debate and scrutiny . . . .").

11. Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743 (2009) [hereinafter Polsky, *Fee Conversions*].

12. For one of the rare example of a discussion of portfolio-level tax planning, see Gregg D. Polsky, *The Untold Story of Sun Capital: Disguised Dividends*, 142 TAX NOTES 556 (June 2, 2014) [hereinafter Polsky, *Disguised Dividends*].

13. *See infra* notes 158–162 and accompanying text.

14. *See* discussion *infra* Part II.

15. "Source taxation" or "taxation at source" refers to the ability of the jurisdiction where meaningful economic activity takes place to tax profits from such activity.

16. *See* Polsky, *Compendium*, *supra* note 1, at 616 ("[L]imited partners generally do not pay U.S. taxes, either because they are tax-exempt or foreign"). The magnitude of PIF investor-base tax exemption is discussed further *infra* at Section IV.C.

17. "Residence taxation" refers to the ability of the jurisdiction where investors reside to tax the profits earned by such investors.

18. By "double nontaxation," this Article refers to the violation of the "single tax principle," under which income from cross-border activity should be taxed once (not more than once, but also not less than once). *See*, REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME 40–42 (2007) (discussing the Single Tax Principle). "Double non-taxation" violates the "single tax principle," since income is taxed nowhere (meaning, "less than once").

is therefore somewhat surprising that the international aspect of PIF tax planning has escaped discussion thus far.

This state of affairs is even more curious given the centrality of international tax avoidance to tax policy discourse over the last few decades. International tax avoidance has played a major role in international policymaking at least since the 1990s, when the Organisation for Economic Co-operation and Development ("OECD") launched an effort to combat "harmful tax competition."[19] More recently, the OECD has been engaged in the Base Erosion and Profits Shifting ("BEPS") Project.[20] The BEPS Project is probably the largest ever internationally-coordinated effort to address tax avoidance by MNEs.[21]

However, within the context of BEPS (as well as other international initiatives to combat tax avoidance), the role of PIFs has been largely neglected. Current discourse is focused on tax planning schemes executed by corporate MNEs, and on governmental practices that may facilitate MNEs' tax avoidance. This means that the focus is on entity-level taxation, but the role of investors and corporate managers in facilitating entity-level outcomes is largely ignored. MNEs' international tax avoidance behavior may be affected by those who control MNEs.

In the context of source taxation, this Article proposes that PIF-controlled MNEs are more likely to display aggressive international tax behavior compared with MNEs that are not PIF-controlled. It supplements previous empirical studies supporting this assertion[22] by offering possible explanations to PIF-controlled MNEs' tax-

19. ORGANISATION FOR ECONOMIC COOPERATION & DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998).

20. *See Base Erosion and Profits Shifting*, OECD, http://www.oecd.org/ctp/beps.htm (last visited Nov. 1, 2016).

21. *See History*, OECD, http://www.oecd.org/about/history/ (last visited Nov. 1, 2016) (stating BEPS comprised of thirty-nine countries accounting for eighty percent of world trade and investment). Under the BEPS framework "over 100 countries and jurisdictions are collaborating to implement the BEPS measures and tackle BEPS." *See* OECD, http://www.oecd.org/tax/beps/ (last visited Oct. 14, 2016).

22. *See* C. S. Agnes Cheng et. al., *The Effect of Hedge Fund Activism on Corporate Tax Avoidance*, 87 ACCT. REV. 1493 (2012) (finding that firms backed by activist hedge-fund investors engage in more tax avoidance than similar firms not backed by hedge-funds); Brad A. Badertscher et al, *The Separation of Ownership and Control and Corporate Tax Avoidance*, 56 J. ACCT. & ECON. 228 (2013) (finding that firms backed by private equity funds engage in more tax avoidance than similar firms management-owned firms).

aggressiveness and concludes that PIF-controlled MNEs have fewer constraints on source tax planning compared with other MNEs.

For example, some studies have found that MNEs' tax behavior may be somewhat constrained by reputational issues.[23] PIFs, on the other hand, are rarely subject to public disclosure requirements. Such opacity makes PIFs less vulnerable to reputational constraints. Moreover, since the investment horizon of PIFs is limited,[24] management of portfolio MNEs may be less affected by long term reputational risks. In addition, even if a PIF-controlled MNE suffers negative reputational consequences due to aggressive tax behavior, it seems unlikely that the PIF itself will be tainted; rather, the MNE and its future shareholders are likely to bear the reputational risk.

A short investment horizon may also operate to negate MNEs' interest in the long-term economic health of the source jurisdiction. While MNEs have a clear interest in reducing their tax liability at the source, they may also have an interest in the financial health of the jurisdiction in which they operate. MNEs benefit from an environment of developed infrastructure, skilled labor, and legal certainty. In other words, MNEs' tax planning may be constrained by their interest in the source jurisdiction's long-term public outlays.[25]

23. *See generally* Michelle Hanlon & Joel Slemrod, *What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News About Tax Shelter Involvement*, 93 J. PUB. ECON. 126 (2009) (finding that share prices sometimes react negatively to news of corporate involvement in tax controversies, though generally to a limited extent); John R. Graham et. al., *Incentives for Tax Planning and Avoidance: Evidence from the Field*, 89 ACCT. REV. 991, 991 (2014) (surveying tax executives and finding that "69 percent of executives rate reputation as important and the factor ranks second in order of importance among all factors explaining why firms do not adopt a potential tax planning strategy"); Victor Fleischer, *A Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581 (2006) (discussing the effect of reputational considerations on the structuring of tax-planning schemes). *But cf.* Birgit Huesecken et. al., *Capital Market Reaction to Tax Avoidance: Evidence from LuxLeaks* (2016) (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2848757 (finding that investors react positively to news about firm's tax avoidance).

24. *See* discussion *infra* Section I.A.

25. *See*, *e.g.*, REUVEN AVI-YONAH, NICOLA SARTORI & OMRI MARIAN, GLOBAL PERSPECTIVES ON INCOME TAXATION LAW 139 (2011) (explaining that reduced taxation may incentivize foreign direct investment, but at the same time may hurt public outlays on infrastructure, which creates a disincentive for foreign direct investment); Joshua D. Moore, *The Economic Importance of Tax Competition for Foreign Direct Investment: An Analysis of International Corporate Tax Harmonization Proposals and Lessons from the Winning Corporate Tax Strategy in Ireland*, 20 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 345, 375 (2007) ("[B]ecause MNEs benefit from tax expenditures and provisions of public goods and services, they are unlikely to drive the rates to zero").

PIF-controlled MNEs, however, are not similarly constrained by such considerations. Since a PIF will necessarily exit the jurisdiction within a relatively short, known timeframe, its interest in the long-term economic health of the source jurisdiction seems not as strong.

Another tax planning constraint that PIF-controlled MNEs avoid is associated with the identity of their investors. Aggressive tax behavior by MNEs may adversely affect shareholder-level taxes.[26] Shareholder interests may negate aggressive corporate-level tax planning, to the extent planning creates investor-level tax burden.[27] Most PIF investors, however, are tax-exempt. As such, PIF investors have little concern with shareholder-level tax, and in fact share the manager's interest in reducing portfolio-level tax. The only significant taxable "investors" in PIFs are the fund managers, whose incentive pay is subject to taxation. The result is that PIF portfolio-level tax planning is largely driven by management-level tax considerations.

Finally, PIFs are rarely taxable entities themselves. They are usually organized as pass-through entities, and as such are not viewed as potential targets of tax policymaking. This may contribute to the opacity in the context of PIF portfolio tax planning, which may enable aggressive behavior to go unnoticed.

The fact that PIFs are particularly aggressive in source tax planning is exacerbated by the fact that income is also rarely taxed at residence. Under conservative assumptions,[28] about two-thirds of PIF interests are owned by tax-exempt investors. PIF returns thus remain largely untaxed at residence.

All of the suggested explanations for PIFs' aggressive international tax behavior demand further scrutiny. In order to address this issue, we must better understand PIF international tax behavior. But such a task is impossible given PIFs' tax opacity. The main recommendation, therefore, is to increase the transparency of PIF international tax schemes. Transparency indeed seems to be a common theme of tax reforms these days.[29] The OECD is currently engaged in the BEPS Project aimed at addressing international tax avoidance. The most

26. *See* discussion *infra* Section III.C.

27. *See* Inder K. Khurana & William J. Moser, *Institutional Shareholders' Investment Horizons and Tax Avoidance*, 35 J. AM. ACCT. ASSOC. 111 (2013) (finding that long-term institutional shareholders have a mitigating effect on corporate tax planning).

28. *See* discussion *infra* Part IV.

29. *See* discussion *infra* Part III.

important contribution of the BEPS Project to international taxation is probably the introduction of the CBCR requirement, which will impose an increased reporting burden on MNEs, and is expected to significantly increase tax transparency.[30] While CBCR is potentially applicable to PIFs, this Article argues that under the current formulation, most PIFs will not be subjected to CBCR. It is therefore proposed to expand CBCR to include most PIFs. Increased transparency will hopefully constrain aggressive tax planning by PIF-controlled MNEs and provide better information, which is necessary for formulating new tax policies that target PIFs' aggressive cross-border tax behavior.

This Article is structured as follows: Part I explains some common characteristics of PIFs' operations and provides a brief background on the taxation of PIFs. Part II explains the role of PIFs in the international context. It uses a database of recently leaked documents to explain the mechanics of international tax avoidance by PIF-controlled entities. Part III suggests possible explanations to PIF-portfolio international tax behavior, and explains the importance of such issues to international tax discourse. Part IV turns the focus to PIF-investors' residence taxation, assessing the size of PIFs' tax-exempt investor base. Finally, Part V recommends expanding the newly created tax transparency requirements, such as CBCR, to include PIFs.

I. THE BASICS OF PIF TAXATION

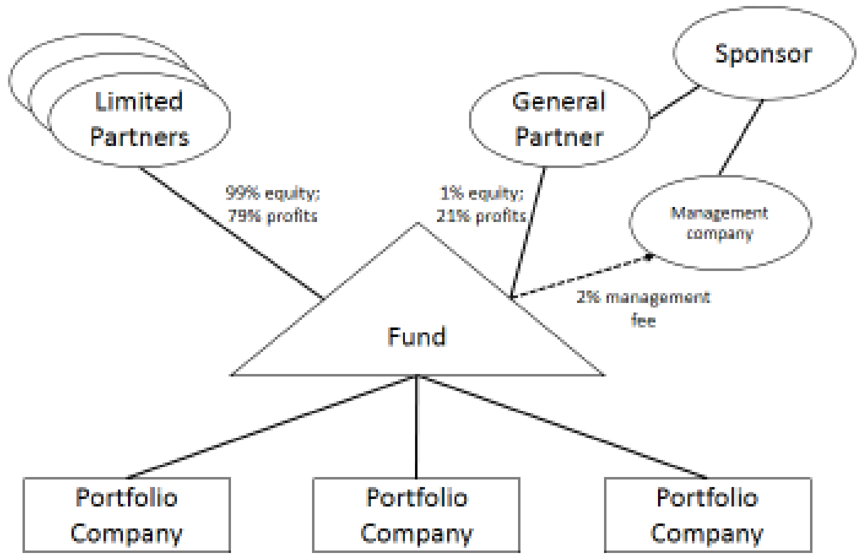
This Part provides a brief background on the operation and taxation of PIFs. Section A discusses the basic structure of PIF operations. Section B briefly summarizes some of the tax consequences to fund managers. Section C considers some of the tax consequences to the portfolio companies.

A. PIFs: The Basic Structure

While PIFs vary in legal structure and investment strategies, their basic operative model is similar.[31] Consider the following basic structure:

30. *See* Brauner, *supra* note 4, at 105 (calling CBCR "a major achievement of the BEPS project").

31. For a review of private equity and venture capital funds' business structure and operations, see MAYER & MATHONET, *supra* note 5, at 27–40.



A fund's sponsor raises funds from investors who commit capital to the fund. The sponsor then uses the funds to identify and purchase portfolio companies (or other investment opportunities), manage them, and eventually dispose of them, hopefully at a profit.

The fund itself is typically structured as a partnership for tax purposes. The investors invest in the fund as limited partners.[32] The limited partners' capital commitments to the fund typically account for ninety-nine percent of all capital commitments in the aggregate. The additional one percent comes from the general partner, an affiliate of the fund's sponsor.[33] The one percent commitment from the sponsor is intended to align the interests of the fund sponsor with that of the limited partners by having the sponsor share some of the investment risk.

Another affiliate of the sponsor, the management company (or simply the "manager"), is tasked with the actual management of the fund's portfolio. In return for the management services, the manager receives a management fee. The fee is typically calculated on an annual

32. *Id.* at 11 (referring to the limited partnerships as the "dominant form" of PE funds).

33. *Id.* at 34 ("Typically, investors in private equity funds see 1% as standard and acceptable.").

basis, usually at a level of two percent of all committed capital.[34] The management fee is usually paid on a quarterly basis.

The management fee is not the sponsor's main monetary incentive. Rather, if the fund is successful, the sponsor shares in the profits. Once the fund investments are disposed of,[35] the realized proceeds will first be distributed to the limited partners to pay them back their capital investment, plus a pre-agreed rate of return (known as the "hurdle," which is typically set at eight to ten percent).[36] Any remaining profits are distributed eighty percent to the investors (this includes one percent to the general partner on account of its capital investment), and the remaining twenty percent to the general partner as incentive pay. Such incentive pay is known as "carried interest."[37]

The fund life is limited in duration. The manager usually raises funds from the investors to finance investment during an "investment period" that typically lasts up to five years.[38] The manager commits to dispose of the investments and distribute the proceeds within a period that typically lasts no more than five years after the commitment period. Thus, a typical fund rarely exists for a period that lasts more than ten years.[39] As a consequence, the investment horizon of PIFs is limited.

B. PIF Managers' Tax Consequences

The tax consequences of fund managers have been addressed at length elsewhere.[40] The purpose here is to provide only the necessary background for PIFs' management taxation, and not to add to this voluminous literature.[41]

34. Fleischer, *supra* note 1, at 8 ("A general partner (GP) manages the partnership in exchange for an annual management fee, usually two percent of the fund's committed capital.").

35. In some funds this is done on an investment-by-investment basis.

36. MAYER & MATHONET, *supra* note 5, at 33 (discussing the hurdle rate).

37. *Id.* at 32–33 (discussing the carried interest).

38. *Id.* at 11 ("The main part of the capital is drawn during the 'investment period', [sic] typically 4 or 5 years, where new opportunities are identified.").

39. *Id.* ("The fund usually has a contractually limited life of 7–10 years. The fund manager's objective is to realise all investments before or at the liquidation of the partnership. Often there is a provision for an extension of 2–3 years.").

40. *See supra* notes 1–3 and accompanying text.

41. For an excellent recent summary of this literature, see Polsky, *Compendium*, *supra* note 1.

Probably the most well-known aspect of funds' management taxation is the taxation of carried interest. This incentive pay, amounting to twenty percent of profits, represents the bulk of the gain to successful fund managers. Carried interest is clearly paid in return for services rendered by the fund manager (that is, the successful management of the fund investment). However, under current law, the carried interest is not subject to taxation on the fund managers' personal marginal tax rate like regular wage income. Rather, it is taxed as if it represents a return on capital investment and taxed at the preferential tax rates imposed on capital gains.[42]

The management fees paid by the fund to the manager are taxed as ordinary income to the fund manager, and are deductible to the fund. This is a straight forward outcome, which is not particularly favorable to the fund managers because the fee income is taxed at the manager's personal tax rate. While the payments are deductible to the fund, the fund has little use for such deductions. The reason is that the funds are usually organized as partnerships, which are transparent for tax purposes. The deductions thus flow to the investors, who may use them to offset their own income. However, most fund investors are tax-exempt,[43] and thus have little use for such deductions.

Fund managers have therefore engaged in a tax planning strategy known as management fee waivers. Fee waiver schemes vary in terms and complexity, but generically involve managers waiving their two percent management fee in return for priority allocations of fund gains of the same amount. Managers then take the position that the fees are treated as capital gains, rather than ordinary income. Commentators have suggested that such schemes are extremely aggressive, and potentially illegal.[44] The Treasury has recently addressed management fee waivers by promulgating regulations to shut down most such schemes.[45]

C. PIFs Portfolio Tax Planning

Business entities are naturally interested in reducing their tax liability to the extent legally allowed. However, the unique business

42. For an analysis of the taxation of carried interest, see Fleischer, *supra* note 1, at 9–15.

43. For a discussion of this strategy, see Polsky, *Fee Conversions*, *supra* note 11.

44. *Id.* at 743 (arguing that fee waivers planning is "extremely aggressive and subject to serious challenge by the IRS").

45. Disguised Payments for Services, Prop. Treas. Reg. § 1.707-2, 80 Fed. Reg. 43652 (Aug. 19, 2015).

model of PIFs may suggest there is something special about the tax planning of entities controlled by PIFs. This issue has been largely neglected in academic literature.

One exception to the dearth of literature on PIF portfolio planning involves fees paid by the portfolio companies to the funds that control them. Professor Gregg Polsky explains that fund managers may charge portfolio companies fees for so-called "management services" provided by the fund (or the fund managers) to the companies.[46] Such fees, known as "monitoring fees," are used to offset the management fees so as not to alter the economic deal of the fund.[47] However, while the economic substance remains unchanged, the monitoring fees are deductible at the portfolio company level, thus eliminating some of the portfolio-level tax liability. The fund's tax-exempt investors also benefit, since deductions that are of no use to them are converted to portfolio-level deductions. This presumably enhances the fund's net return.

Except for the discussion of monitoring fees, there is almost no doctrinal analysis of schemes aimed at reducing the entity-level taxation of PIF portfolio holdings. To summarize, academic discussion of PIF tax planning is almost exclusively focused on management-level tax planning. There is very little discussion on PIF portfolio-level planning. Moreover, cross-border tax issues are virtually absent from such discussion.

II. PIFs and the Mechanics of International Tax Avoidance

The purpose of this Part is to consider PIF-portfolio tax planning in the international context. Section A explains the motivation for this Article's question, a dataset of documents leaked in a scandal known as "LuxLeaks." An analysis of the leaked documents points to the central role played by PIF-controlled entities in international tax avoidance. Section B explains the mechanics of PIF portfolio planning in the LuxLeaks context. It explains how PIF-controlled MNEs eliminate taxation at both the source and residence. Section C considers whether there is a broader-than-LuxLeaks argument to be made, by surveying additional research pointing to PIFs' aggressive portfolio tax behaviors.

46. Polsky, *Disguised Dividends*, *supra* note 12, at 557–59 (explaining the monitoring fees scheme).

47. *Id.*

A. PIFs and the LuxLeaks Scandal

1. LuxLeaks: Background

In late 2014, the International Consortium of Investigative Journalists (ICIJ) made public hundreds of advanced tax agreements (ATAs) granted by tax administrators in Luxembourg to multinational taxpayers.[48] The ATAs were leaked to the ICIJ by two former employees at the PricewaterhouseCoopers (PwC) Luxembourg office. The two employees were prosecuted and convicted for violating Luxembourg trade secrecy laws.[49] An appeal is currently outstanding.

ATAs are by no means unique to Luxembourg. In transactions where the tax consequences are uncertain, many jurisdictions allow taxpayers to ask the tax authorities for a clarifying ruling that secures the tax treatment of the transactions.[50] However, the Luxembourg rulings did much more than simply secure the tax treatment of complex transactions.

A previous article investigated the Luxembourg ruling practices at length, and found that by securing a tax ruling in Luxembourg, MNEs were able to reduce their tax liabilities in jurisdictions *other than Luxembourg*.[51] Specifically, Luxembourg inserted itself as a conduit jurisdiction between the source and residence jurisdictions. Instead of financing a foreign investment directly, an investor would finance the

48. *See Luxembourg Leaks: Global Companies' Secrets Exposed*, INT'L CONSORTIUM OF INVESTIGATIVE JOURNALISTS, https://www.icij.org/project/luxembourg-leaks (last visited Sept. 23, 2016).

49. *See LuxLeaks Scandal: Luxembourg Tax Whistleblowers Convicted*, BBC NEWS (June 29, 2016), http://www.bbc.com/news/world-europe-36662636.

50. In the United States, such rulings are known as Private Letter Rulings or PLRs. *See* Rev. Proc. § 2.01, 2016-1 I.R.B. 01 (defining letter ruling).

51. *See* Omri Marian, *The State Administration of International Tax Avoidance*, 7 HARV. BUS. L. REV. (forthcoming 2016) ("[A] process in which a national tax administration in one jurisdiction, is consciously and systematically assisting taxpayers to avoid taxes in other jurisdictions."); *see also* INGA HARDECK & PATRICK WITTENSTEIN, ASSESSING THE BENEFITS AND COSTS OF TAX HAVEN RULINGS – EVIDENCE FROM THE LUXEMBOURG LEAKS (2016), http://ssrn.com/abstract=2709629 (finding that although MNEs with Luxembourg ATAs were able to reduce their global effective tax rate in comparison to MNEs without Luxembourg ATAs, they were also subject to higher risk of audit); BIRGIT HUESECKEN & MICHAEL OVERESCH, TAX AVOIDANCE THROUGH ADVANCE TAX RULINGS - EVIDENCE FROM THE LUXLEAKS FIRMS (2015), http://ssrn.com/abstract=2664631 (finding that by engaging in an advance tax ruling through Luxembourg, firms have lower effective tax rates compared to non-ruling firms).

investment through Luxembourg.[52] As explained at length below, the main outcome of Luxembourg's ruling practices was to generate tax planning opportunities that would not have been available had the investor financed the investment directly.

2. PIFs and LuxLeaks

A previous article addressed Luxembourg practices in issuing Advanced Tax Agreements ("ATAs"). The study used a hand-coded a sample of 172 ATAs. The documents were selected based on the order of appearance in the online database, which is arranged alphabetically according to the name of the taxpayer sponsoring the submission.[53]

The leaked ATAs were made available by the ICIJ in two batches. The first, which included 548 documents issued to 340 MNCs, was made public in November of 2014. The second batch of documents—which was significantly smaller than the first—was made public in December of 2014, and included ATAs as well as other documents issued to thirty-three MNCs. While the ICIJ states that the first batch of leaked ATAs contains 548 documents, the exact number of the second batch of documents has not been explicitly stated by the ICIJ. Moreover, the 548 figure attached to the first batch is not accurate for purposes of the study. Not all of the leaked documents are ATAs. Some of the documents consist of tax returns, tax preparation materials and other documents contained in PwC's client files. Such documents are excluded from the sample. On the other hand, multiple ATA submissions contain previously-issued ATAs as attachments. Attached ATAs were coded as separate cases. Some sampling problems that are associated with the dataset and the coding process are discussed at-length elsewhere.[54]

Among the variables coded in the project were characteristics of the taxpayers who sponsored the rulings. Figure 1, summarizes the industry segment of the ATA sponsors. For that purpose, a "sponsor" is defined as the ultimate owner of the Luxembourg entity in respect

52. Marian, *supra* note 51.

53. A caveat is that the dataset only contains ATAs submitted in English. The absolute majority of the ATAs, however, are issued in English. During the coding, we came across eleven non-English rulings: nine were in French and two were in German (the exclusion of which reduces the potential sample size from 183 to 172). Since non-English rulings represent only about six-percent of the full sample, we believe a sample of English-only rulings is still suitable for a non-generalizable exploratory analysis intended to identify administrative practices.

54. Marian, *supra* note 51.

of which the ATA is issued. In most cases, ATA submissions explicitly stated the identities of the owners.

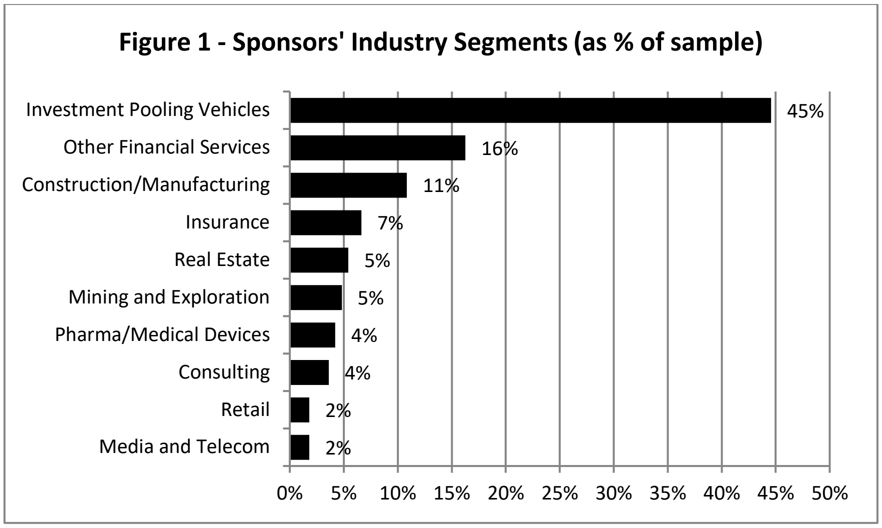


Figure 1 demonstrates the central role played by PIFs in sponsoring Luxembourg ATAs. Private equity, venture capital, and hedge funds (noted in the Figure as "investment pooling vehicles") sponsored about forty-five percent of ATAs, more than any other industry segment. Other financial services firms, which may include other types of private asset managers, account for sixteen percent of the ATAs.

This finding is quite striking considering current discourse of international tax avoidance, especially within the context of the BEPS Project. Currently, the discourse is largely dominated by an attempt to shut down tax schemes executed by multinational corporations (MNCs) from research-dependent industries such as pharmaceuticals and high technology.[55] Such MNCs are almost unaccounted for in the sample. PIFs— which dominate the sample—however, seem to have avoided scrutiny in the context of BEPS. This striking finding, which demonstrated the central role played by PIFs in tax schemes through Luxembourg, was the main motivating factor for this Article.

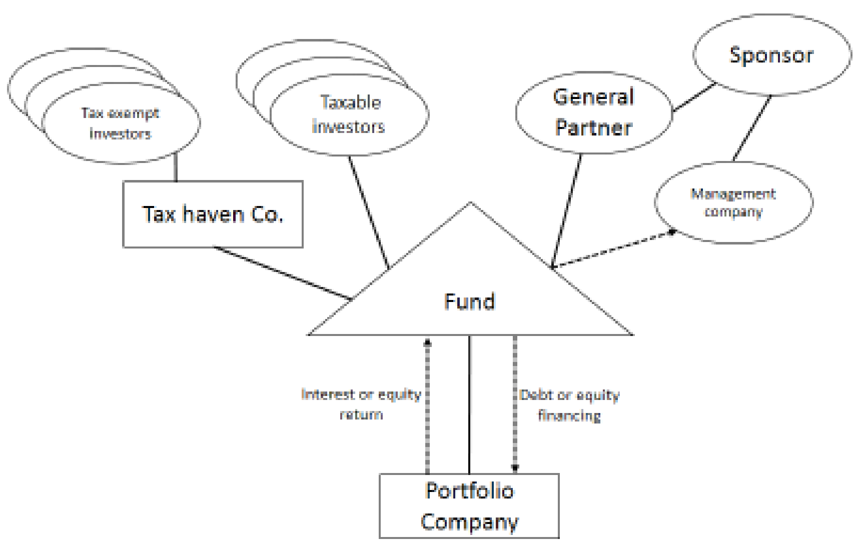
55. *See, e.g.*, Andrew Blair-Stanek, *Intellectual Property Law Solutions to Tax Avoidance*, 62 UCLA L. REV. 2, 4 (2015) ("Intellectual property (IP) has become the leading tax-avoidance vehicle.").

There may be multiple explanations to the large representation of PIFs in the LuxLeaks dataset. It is possible that PwC had particular expertise in serving PIFs, or that for some reason more PIF ATAs were leaked than other ATAs. It is also possible that PIFs have non-tax reasons to set up legal structures in Luxembourg. Nonetheless, the sheer number of PIF-sponsored ATAs suggests a systemic practice of international tax avoidance by PIF-controlled entities.

B. A Simplified Example of a Luxembourg PIF-Portfolio Tax Structure

Given the apparent frequency of PIF's portfolio-related international tax avoidance, it is worth considering the mechanics of this phenomenon. To launch a discussion on PIF-Portfolio tax planning and its place within the BEPS framework, a simplified example is presented. The example is based on a frequent planning scheme in the LuxLeaks documents: conduit-financing with debt/equity arbitrage.

Consider the following graphic illustrating basic PIF international investment structure.



The basic structure discussed in Section I.A. is now altered in two important ways. First, the structure segregates the LPs into groups based on their tax stances. For example, domestic taxable investors, such as individual or corporate taxpayers, will generally be subject to tax upon liquidation of their investment in the fund. Tax-exempt investors, such as pension funds, governmental entities, and university endowments, are—as a rule of thumb—not subject to taxation on income from passive investments (that is, investment not actively managed by such investors).

PIFs are structured to accommodate investors' heterogeneous tax preferences. For example, under U.S. tax law, tax-exempt investors may face unwelcome tax consequences if they debt-finance investments. Profits on debt-financed investments are taxable as "Unrelated Business Taxable Income" (UBTI).[56] Since the fund itself is treated as a partnership—which is mostly transparent for tax purposes—any fund-level debt will be allocated to the partners (including the tax-exempt partners).[57] This may result in UBTI to the tax-exempt investors.

One option to avoid this consequence is to prevent the fund from borrowing. This is a serious limitation on the fund operations, which is unlikely to be acceptable to the managers or the other (non-exempt) partners. In order to address the UBTI issue, and at the same time allow the fund to debt finance investments, tax-exempt investors would normally invest in the fund through a "blocker" corporation organized in a tax haven.[58] Any fund borrowing can be done "below" the blocker level, and as such, the debt is never treated as incurred by the tax-exempt investors (but rather by the blocker corporation). Since the blocker corporation is organized in a tax haven, the blocker is unlikely to incur any corporate-level taxes.

Blocker corporations may also be used by foreign investors in funds that operate in the United States. For example, foreign investors in the United States may have to file U.S. tax returns and pay taxes on income that is "effectively connected" with a "United States Trade or Business" ("USTOB").[59] If a partnership, such as the fund, is engaged in a USTOB, partners are also considered to be so engaged.[60] In order

56. I.R.C. §§ 512, 514 (Supp. 2015).

57. I.R.C. §§ 704, 752.

58. For a discussion of the use of blocker corporations in fund structuring, see ANDREW W. NEEDHAM, PRIVATE EQUITY FUNDS (TAX MANAGEMENT PORTFOLIO 735), Part VIII.D ("Avoiding UBTI/ECI with a Blocker").

59. I.R.C. §§ 871, 882 (2012).

60. I.R.C. § 875.

to prevent such risk, foreign investors may also use a blocker corporation to invest in funds that hold U.S portfolio investments.[61]

The second new aspect introduced to the structure, is to add a cross-border element into it. That is, we now assume that the portfolio investment is located in a jurisdiction that is different from the jurisdiction of the LPs, the managers, or both.

1. *The choice of financing structures*

Assume now that the fund identifies an investment opportunity. The fund now considers how to finance such an investment. Generally speaking, the fund can finance the investment either with equity or debt (or a combination of both). The tax consequences will depend on such financing.

Assume the fund finances the portfolio company with equity and that the investment is successful. Operating profits generated by the portfolio company will likely be taxable at the source jurisdiction. For example, if the investment is organized as a local corporate entity, tax will be imposed at the local corporate tax rate. Dividends paid from the portfolio company to the partners would normally not be deductible to the corporation.

Dividends are unlikely to be taxable to the LPs upon receipt, or only lightly taxed. There are several reasons for it: First, most jurisdictions in the world would not impose tax on dividends received from foreign corporations, if the shareholder holds a required "participation" in the subsidiary corporation (usually ten percent of the stock value).[62] Such systems, known as "territorial jurisdictions," generally only tax profits to the extent earned within their territory.[63] Thus, dividends that flow through the fund to the investors would normally not be taxable at the jurisdiction of residence for the taxable investors.

61. Using foreign corporations as vehicles for investment in the United States must take into account additional considerations, such as branch taxes. *See* I.R.C. § 884.

62. Most U.S. trading partners have in place international tax laws that exempt all or most foreign income earned by domestic corporations. For a recent survey, see Philip Dittmer, *A Global Perspective on Territorial Taxation*, TAX FOUND. (Aug. 10, 2012), http://taxfoundation.org/article/global-perspective-territorial-taxation ("Overwhelmingly, developed economies are turning to the territorial approach.").

63. For a discussion of common themes of territorial taxation and participation exemption, see HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 466–74 (3d ed. 2010).

Second, dividends received by the blocker corporation would probably not be taxable to the blocker given that the blocker is organized in a tax haven. When the tax-exempt investor withdraws the dividends from the blocker, the dividends will not be taxable to those investors because of their tax-exempt status. Lastly, even jurisdictions that tax profits on a worldwide basis—like the United States—offer ample opportunities to reduce taxation on equity returns. For example, the United States would not tax foreign earnings until repatriated, which enables taxpayers to enjoy deferral.[64] This reduces the effective rate of taxation on equity returns. Moreover, equity returns are many times accorded favorable treatment in the form of reduced rate of taxation on "capital gains" or "qualified dividends".[65]

Another issue to consider in the context of dividend distributions during the time the investment is held by the PIF is withholding taxes. Most countries impose some form of withholding tax on outgoing payments, such as dividends, at a gross rate.[66] Presumably, dividends paid from the portfolio company to the fund are subject to withholding taxes at the source jurisdiction.

However, withholding taxes may be relieved by the operation of bilateral tax treaties or other international instruments.[67] Under common interpretation of tax treaties, the fund itself (assuming it is treated as a partnership) is not entitled to enjoy treaty benefits given its transparent status, but the investors are. Thus, if the taxable investors come from jurisdictions that have a bilateral tax treaty with the jurisdiction of the portfolio company, dividend withholding taxes may be significantly relieved. Moreover, if the taxable investors and the portfolio companies are both from member states of the European Union, withholding tax is eliminated under an EU directive known as the "Parent Subsidiary Directive."[68]

It is also possible for a fund to claim treaty benefits without making the fund itself a taxable entity. Different countries have

64. For a detailed discussion of deferral and its benefits, see, for example, J. Clifton Fleming, Jr. et. al., *Worse Than Exemption*, 59 EMORY L.J. 79, 85–110 (2009).

65. I.R.C. § 1(h) (Supp. 2014).

66. *Id.* at 510 ("All of the systems here under consideration impose a gross-based withholding tax on certain categories of income.").

67. AVI-YONAH, *supra* note 18, at 74–75 (discussing reduced rates of withholding on dividend payments, including through bilateral tax treaties).

68. Council Directive 90/435/EEC of 23 July 1990 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States.

different entity classification rules for tax purposes.[69] It is possible to organize the fund as an entity that is transparent from the point of view of the country in which it is organized, but as a corporation from the point of view of the source country. Thus, when dividends are paid to the fund, the source country would view the dividends as paid to a corporation entitled to treaty benefits, but the residence jurisdiction would view the fund as a transparent entity that is not the beneficial owner of the dividends.[70]

In order to prevent withholding taxes on payments that are attributable to the blocker corporation, such corporations may be organized in a tax-haven jurisdiction that enjoys withholding relief (for example, UK tax-haven territories such as Gibraltar, which is considered part of the UK for purpose of the application of the Parent Subsidiary Directive).[71]

Upon disposition of the portfolio company, the gain will generally not be taxable at the source jurisdiction. The reason is that the gains are capital gains, which are generally attributable to the place of the residence of the investor.[72] If a taxable fund investor is a resident in a territorial jurisdiction, such gains will not be taxed to the investors, since territorial jurisdictions generally do not tax capital gains from the disposition of foreign corporations as long as the participation threshold is met.[73] Tax-exempt investors will not be subject to taxation

69. For example, in the United States, the tax-classification of business entities is determined by a set of rules promulgated in Treas. Regs. §§ 301.7701-1 through -3 (the "check-the-box regulations"). A foreign entity that is classified as a corporation for tax purposes, under the law in the entity's state of incorporation, may nonetheless be classified as partnership for U.S. tax purposes under the check-the-box regulations and vice versa.

70. For a discussion of the use of such hybrid entities in the tax treaty context, see Philip E. Postlewaite, Stephanie R. Hoffer & Matthew T. Kemp, *The Adaptation of U.S. Tax Treaties to Changing Business Forms: A Case Study of Hybrid Entities*, 34 INT'L TAX J. 33 (2008).

71. On June 23, 2016, UK voters decided in a referendum that the UK should leave the EU (commonly known as "Brexit"). *See UK Votes to Leave EU After Dramatic Night Divides Nation*, GUARDIAN (June 24, 2016), https://www.theguardian.com/politics/2016/jun/24/britain-votes-for-brexit-eu-referendum-david-cameron (last visited Oct. 18, 2016). This may have a significant effect on corporate tax planning involving Gibraltar. *See* Jeannette Neumann, *In Gibraltar, Brexit Vote Stirs Fears of a Rocky Road*, WALL ST. J. (June 19, 2016), http://www.wsj.com/articles/in-gibraltar-brexit-vote-stirs-fears-of-a-rocky-road-1466238118 (discussing the potential Brexit effects on Gibraltar's tax attractiveness as an access point into the EU market).

72. For example, under U.S. law the sale on non-depreciable, non-inventory personal property (such a corporate stock), is sourced at the place of the residence of the taxpayer. *See* I.R.C. § 865 (2012).

73. *See supra* notes 62–63 and accompanying text.

on disposition gains on account of their tax-exempt status. For taxable investors from worldwide jurisdictions, tax will likely be imposed at preferred (or deferred, as explained above) capital gains rates.

To summarize, in the case of equity financing, income from a successful investment is taxed once in the form of corporate-tax (and potentially a small withholding tax on dividends) at the jurisdiction of source. Income is generally not taxed again at the jurisdiction of residence,[74] either as a result of the operation of the territorial tax system, or on account of the fund investors being tax-exempt. Gains to taxable investors are generally taxed at the residence jurisdiction at preferred capital gains rates upon receipt.

The consequences are somewhat different if a fund chooses to debt-finance the investment. In such a case, a successful portfolio company would make interest (rather than dividend) payments to the fund (as before, such payments would flow through to the investors). Unlike dividends, interest payments are generally deductible to the portfolio company and would therefore eliminate much of the taxable income at the source jurisdiction.[75]

On the other hand, interest receipts from foreign investment are generally taxable to the creditors, which, in the case of a PIF, would be the investors.[76] The result would be that, as in the case of equity financing, the income will be taxed once. But this time, the income will be taxed to taxable investors at their residence jurisdiction. Tax-exempt investors would generally be exempt from paying tax on interest receipts. This is certainly true of the interest collected by the blocker corporation, since the blocker is organized in a tax-haven. This means that, in the case of debt-financed investment allocated to a tax-exempt investor, income is taxed nowhere.

74. In worldwide jurisdictions, income will be taxed only upon repatriation, since the corporate subsidiary is a separate taxpayer. Only upon distributions from the corporate subsidiary or upon the sale of its stock, may investors in the fund have income attributable to that investment.

75. Many countries subject the amount of deductible interest paid to related parties to deductibility limitations in order to preserve the tax base. In the United States, such anti earning-stripping rules are found at I.R.C. § 163(j) (2012). However, it is possible to structure deductible payments to the fund in other ways (such as royalties or services fees) that avoid the limitation on interest deduction.

76. For taxable investors, interest receipts are rarely exempt from taxation. *See* AULT & ARNOLD, *supra* note 63, at 467 (discussing classes of foreign exempt income and noting that foreign passive income such as interest and royalties are generally not exempt from taxation in territorial jurisdictions).

As in the case of equity financing, upon disposition of the investment the capital gains will not be taxable to investors in territorial jurisdictions. Also as in the case of equity financing, withholding taxes on outgoing interest payments to the fund may be relieved under the portfolio company's local law,[77] international law,[78] or by bilateral tax treaties. To summarize, in the case of debt financing, income is also taxed once (but only to taxable investors), but this time by the investors' residence jurisdiction.

The following matrix summarizes the tax results in each of the source and residence jurisdictions, in the case of equity or debt financing.

Investor/ Financing	Tax burden on taxable investors (including the manager) from worldwide jurisdictions	Tax burden on tax-exempt investors	Tax burden on taxable investors from territorial jurisdictions
Equity	Source: Yes Residence: Yes (Low)	Source: Yes Residence: No	Source: Yes Residence: No
Debt	Source: No Residence: Yes	Source: No Residence: No	Source: No Residence: Yes

Since most PIF investors are tax-exempt, one might expect investor-level tax considerations to play a minimal role in PIF tax-structuring. Presumably, a PIF could simply debt finance investments, and extract all profits in the form of interest (or other deductible) payments. Interest payments would strip income at the source, while at the same time generate little residence taxation due to the investors' tax-exempt status. However, such a financing scheme ignores the fact that all PIFs have one very important taxable "investor" who may dislike that result—the fund manager. As demonstrated in the matrix

77. For example, the United States exempts from withholding most U.S.-source interest paid to foreign lenders. *See* I.R.C. §§ 871(h), 881(c).

78. The EU exempts from withholding most interest paid between companies in different member states. *See* Council Directive 2003/49/EC of 3 June, 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States, 2003 O.J. (L 157) 49 (EU).

above, the manager would rather draw its share in the fund profits as equity, taxed at capital gain rates, assuming this compensates for the loss of source-jurisdiction deduction. If significant parts of the manager's incentive pay are received as interest, the manager would face very high tax burdens, which might outweigh the benefits of source-deduction. The issue of the managers' and investors' tax position in respect of portfolio financing is discussed at length below.[79] Taxable investors from territorial jurisdictions share similar preference with that of the manager, since interest receipts would be taxable to them, while equity receipts would not.

2. *What we learned from LuxLeaks: international tax consequences with conduit financing through Luxembourg*

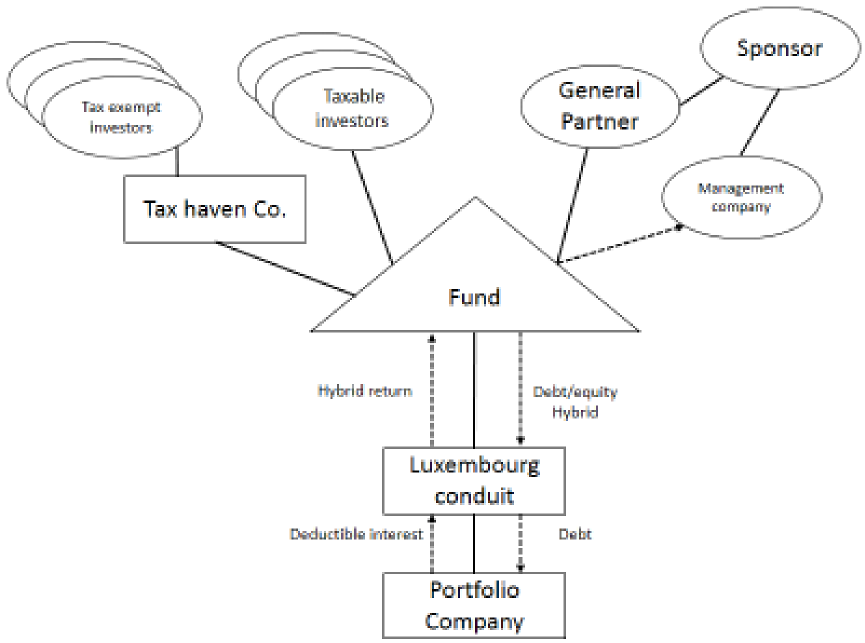
It would be very convenient for the fund and its taxable investors (particularly the manager) if the fund could finance investments with hybrid financing instruments. A savvy fund manager might attempt to structure an instrument that is classified as "debt" under the tax laws of the source jurisdiction (where the investment is located), but as equity under the tax laws of the jurisdiction of the fund manager (or other taxable investors). In this case, payments from the portfolio company to the fund would be classified as interest payments under the law of the source jurisdiction, making them deductible at the source. The receipts by the taxable investors, on the other hand, would be classified as dividends under the laws of the residence jurisdiction, and will be taxable at preferred rates (or not taxable at all if the taxable investors reside in a territorial jurisdiction). Thus, the profits from the investment would be taxed at low rates at the residence jurisdiction (or not taxed at all). Unfortunately for the fund and its taxable investors, such arbitrage opportunities are rarely available, since most jurisdictions would uniformly classify the same instrument as either debt or equity.[80]

This is where Luxembourg enters the planning picture. Instead of financing the portfolio investment directly, many funds finance their

79. *See infra* Section III.C.2.

80. For analysis of debt or equity classification for tax purposes, see DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS Ch. 1 (2011).

investment through Luxembourg, with a back-to-back financing instrument, as depicted in the (much simplified) structure below.[81]



As described in detail in previous research,[82] the fund could form a Luxembourg entity, and finance such entity with an instrument (the "top instrument") that is designed to imitate equity risks and return. The Luxembourg entity, in turn, would use the funds received from the fund to finance that portfolio investment with a debt instrument. This debt instrument would generate deductible interest payments that would strip much of the tax base in the source jurisdiction.

81. Julien Bieber, Gaëlle Auger & Linda Taing, *Private Equity Structuring in Luxembourg – Key Tax Aspects*, TAX PLANNING INT'L REV. 5 (June 5, 2011) ("Many [Luxembourg entities] are financed through so-called 'hybrid instruments', which provide for a divergent qualification of the instrument at the level of the [Luxembourg entity] and at the level of the investors, in a view to optimise the cash repatriation and the overall tax charge."). For an analysis of an actual example of such financing structure, see Marian, *supra* note 51.

82. Marian, *supra* note 51, at 23–43.

Presumably, the interest received in Luxembourg should be taxable in Luxembourg to the conduit entity (Luxembourg's corporate tax rate is about twenty-nine percent, national and local combined).[83] However, as described in the previous research, for a small fee, Luxembourg would issue a favorable ATA to the fund. Under the ATA, Luxembourg would agree to classify the top instrument as "debt" for Luxembourg tax purposes, even though the instrument is clearly structured to generate equity-like risks and returns.[84] As a result, any payment made by the Luxembourg entity to the fund would be deductible in Luxembourg. Since the debt instrument and the top instrument are structured as back-to-back positions, the deduction would completely eliminate the income in Luxembourg (except for a small fee discussed below).

At the jurisdiction of residence of the investors (or the fund manager), payments on the top instrument are properly treated as equity returns (since the top instrument is substantively an equity instrument). If the investors reside in a territorial jurisdiction, the result is that the returns are not taxable to the investor. If the investor resides in a worldwide jurisdiction, returns are likely accorded preferred treatment and taxed at low rates.[85] Funds with taxable investors from worldwide jurisdictions may also structure their affairs to defer tax payments. For example, the top instrument could *accrue* payments for Luxembourg tax purposes but not *make* actual payments until liquidation of the investment. The accrued but unpaid liabilities may nonetheless be deductible in Luxembourg under the ATA.[86] In the residence jurisdiction, however, no tax will be imposed until payments are actually made, since most jurisdictions do not impose tax on notional equity returns. Tax-exempt investors are not taxed at the jurisdiction of residence.

83. Corporate tax rates are taken from the OECD corporate tax database. OECD, TABLE II.1 CORPORATE INCOME TAX RATE, http://stats.oecd.org//Index.aspx?QueryId=58204 (last visited Oct. 18, 2016).

84. Marian, *supra* note 51 at 28–43 (describing the process of debt/equity arbitrage manufacturing).

85. In the United States, for example, most dividends would qualify for taxation at capital gains rates. *See* I.R.C. § 1(h) (2012).

86. Under certain circumstances accrued liabilities are deductible even if not paid. *See* PETER MOONS, BUSINESS OPERATIONS IN LUXEMBOURG (TAX MANAGEMENT PORTFOLIO 971), Part IV.F.4(a) [hereinafter LUXEMBOURG BNA] ("[Future] profit distributions and accrued interest, are deductible.").

The result is that the profits from the investment are taxed nowhere (or at very low rates at the jurisdiction of residence). By issuing an ATA, Luxembourg effectively manufactured an arbitrage opportunity that would not have been available had the fund invested directly in the source jurisdiction. The implications of this practice are profound, and discussed at length elsewhere.[87] Such manufactured arbitrage opportunities seem to have been utilized by the PIF industry more than by any other industry.[88]

Luxembourg does not offer such tax avoidance service for free. In the ATA, Luxembourg demands that the sponsor of the rulings book income in Luxembourg based on a margin. The margin depends on the face amount of the back-to-back financing.[89] The margin booked in Luxembourg is then taxed at the Luxembourg tax rate. The margin decreases as the amount of financing increases, much like fees that are charged as a percentage of the amount of a bank wire transfer. Hence, one may refer to such payment as a fee paid for tax avoidance services.

The effective tax rate (ETR) on the profits channeled through Luxembourg can be calculated as follows:

$$ETR = \frac{m \cdot T}{i}$$

Where m is the pre-agreed margin, T is the Luxembourg corporate tax rate, and i is the return of the portfolio investment. The highest margin charged by Luxembourg in the documents exposed by the LuxLeaks scandal was 0.25% (for financing through Luxembourg of EUR 25 million or less).[90]

Assume that a portfolio investment of EUR 25 million generates a 10% rate of return. If the 0.25% margin is taxed at the Luxembourg 29% corporate tax rate, the effective tax rate on the fund investment would be:

87. Marian, *supra* note 51, at 45–50 (discussing the implications of arbitrage manufacturing).

88. *See supra* Figure 1.

89. Marian, *supra* note 51 (discussing margin determination).

90. *See id*. (discussing profits margins typically taxable in Luxembourg).

$$\frac{0.0025 \cdot 0.29}{0.1} = 0.725\%$$

By securing a tax ruling through Luxembourg, the fund is thus able to avoid source taxation in the jurisdiction where income is generated (for comparison purposes, note that the unweighted average statutory corporate tax rate in OECD countries was about 25.5% in 2010, while the average effective tax rate for 2008 was about 23.3%).[91] Instead, the fund is burdened by an absurdly low effective source tax rate of 0.725%. If the taxable investors reside in a territorial jurisdiction, no additional tax is imposed. If the taxable investors reside in a worldwide jurisdiction (like the managers), they will be taxed at preferred rates on equity returns, on a deferred basis. Tax-exempt investors do not suffer any additional tax burden.

C. Are PIF-Controlled MNEs More Tax Aggressive than Other MNEs?

The discussion of the LuxLeaks scandal provides anecdotal evidence that PIF-controlled entities engage in aggressive international tax avoidance. PIF-controlled MNEs account for almost half of the LuxLeaks dataset. There is additional evidence suggesting that PIF-controlled MNEs are more tax-aggressive when compared with MNEs not controlled by PIFs.

Two studies questioned whether PIF-controlled entities are more aggressive in their tax behavior, compared with similar non-PIF-controlled entities. Badertscher et al. "compares the income tax avoidance of management-owned and [private equity]-backed private firms."[92] Using a sample of private firms with public debt, they compare PIF-backed firms with management-owned firms on several measures of corporate tax-avoidance.[93] They find that management-owned firms "avoid significantly less income tax than [private equity]-backed firms."[94]

91. *See* JANE G. GRAVELLE, CONG. RESEARCH SERV., R41743, INTERNATIONAL CORPORATE TAX RATE COMPARISONS AND POLICY IMPLICATIONS 3 (2014).

92. Badertscher et al., *supra* note 22, at 229.

93. *Id.*

94. *Id.*

Cheng et al.,[95] take a different methodological approach. Using a sample of hedge-fund "activist events," they consider whether hedge-fund activism causes hedge-fund portfolio companies to change their tax behavior.[96] When compared with a control group of non-hedge-fund-backed firms, they find that "target firms have lower tax avoidance levels than control firms before hedge fund intervention."[97] The implication is that active fund managers seem to pursue aggressive tax planning for their portfolio holdings.[98]

The empirical studies noted above use several financial measures as proxies for the level of firms' tax avoidance. Most such measures do not necessarily measure tax avoidance in the international context. However, some of the findings do suggest that PIF-controlled MNEs make extensive use of cross-border tax strategies. For example, Badertscher et al. examines the use of tax-haven subsidiaries as a measure for the level of tax avoidance, and indeed finds that "[non-PIF-owned] firms have significantly fewer subsidiaries in tax haven countries than PE-backed private firms."[99]

To summarize, although research on PIF-portfolio planning is in its infancy, current studies strongly suggest that PIF-controlled companies are more aggressive in their tax planning than other companies. The anecdotal evidence stemming from the LuxLeaks research complements and supports such findings, particularly in the international tax context.

III. What Makes PIF-Controlled MNEs Successful International Tax Avoiders?

Thus far the Article explained PIF international portfolio tax planning and argued that PIF-controlled MNEs may reasonably be perceived to be more tax-aggressive than other MNEs, particularly in the international context. This Part considers possible explanations for this phenomenon. Section A examines some of the explanations suggested in previous studies. Section B offers new explanations associated with the PIF operating model.

95. *Supra* note 22.
96. *Id*. at 1495–96.
97. *Id*. at 1495.
98. *See id*. at 1495–96.
99. Badertscher, et al., *supra* note 22, at 246.

A. Existing Explanations for Tax Avoidance by PIF-Controlled MNEs

Existing literature provides several possible explanations for why PIF-backed MNEs are more tax aggressive than other MNEs.

1. Separation of ownership and control

Badertscher et al. hypothesizes that ownership structures may have an effect on firms' tax strategies.[100] Particularly, they suggest that "when equity ownership and corporate decision-making are concentrated in just a small number of decision-makers, these owner-managers will likely be more risk averse and thus less willing to invest in risky projects."[101] Since tax-avoidance is a risky activity, they expect that "firms with more highly concentrated ownership and control . . . avoid less income tax than firms with less concentrated ownership and control."[102]

This explanation makes sense in the specific context of Badertscher et al. which compares private equity-backed-firms with private firms that are controlled by management. But such a particular comparison lacks explanatory power when comparing private equity-backed firms with publicly traded firms where, in many instances, ownership and control are also separated.

2. PIFs' tax planning expertise

Another explanation for PIFs' portfolio tax planning, offered by Badertscher et al. concerns PIF management tax expertise. Since fund managers tend to "retain authority over tax planning,"[103] they "have substantial experience in owning and monitoring a broad set of portfolio companies and their tax strategies."[104] As a result, they predict that PIFs "have the ability to generate economies of scale and scope for tax avoidance at PE-backed firms."[105] In other words, the marginal tax planning costs for PIF-controlled firms are lower than

100. *Id.* at 233 ("In particular, we examine whether firms with more concentrated ownership and control avoid less income tax than firms with less concentrated ownership and control.").

101. *Id.* at 229.

102. *Id.*

103. *Id.* at 234.

104. *Id.*

105. *Id.*

those of other firms, which may explain some of the difference in tax behavior.

This explanation seems sensible in the context of Badertscher et al.'s narrow comparison of PIFs to privately held, management-owned firms. It is not surprising to find that the cost of tax planning for PIFs is lower than those of privately owned firms. However, there is little reason to expect that PIF managers apply any more expertise in tax planning, compared with tax managers of large multinational firms. Such firms are not part of Badertscher et al.'s sample. MNEs creative tax planning is well-documented. There is no evidence suggesting that PIF managers are any better tax planners than the tax directors of large MNEs.

Moreover, most PIFs have rather small internal tax operations. Most tax planning work is outsourced to accounting firms and law firms. On the other hand, large MNEs can handle most tax planning activity in-house. The tax department at General Electric was reported at one point to be almost 1,000 strong.[106] Under such circumstances, it is difficult to believe that the marginal cost of PIFs tax planning is lower than the marginal cost of any sophisticated large MNE.

3. PIFs as experts in value creation

Cheng et. al. suggest a different explanation for why PIF-controlled entities exhibit particularly aggressive tax behavior. They assert that "hedge funds' informed monitoring is associated with improvements in target firms' tax efficiencies."[107] PIFs are expert at identifying firm inefficiencies. If a manager identifies an unexploited tax-planning opportunity in one of its portfolio companies, the manager will make sure the company takes advantage of that opportunity.

This explanation makes sense, but again does not account for the sophistication of tax professionals at non-PIF-controlled firms. It is difficult to imagine that tax directors at large MNEs will fail to identify tax-minimizing opportunities. Rather, as explained below,[108] when similar opportunities are available to both PIF and non-PIF controlled

106. Jeff Gerth, *GE's Taxes: A Case Study*, FORTUNE (Apr. 4, 2011, 1:00 PM), http://fortune.com/2011/04/04/ges-taxes-a-case-study ("About 20 years ago, GE's tax employees totaled a few hundred and were decentralized. Today, there are almost 1,000.").

107. Cheng et al., *supra* note 22, at 1496.

108. *See* discussion *infra* Section III.B.

firms, non-PIF controlled firms may face certain constraints that prevent them from taking advantage of such opportunities.

B. PIFs Business Model and International Tax Avoidance

While existing explanations for the aggressive nature of PIF-backed companies' tax behavior may offer some insights, they present two shortcomings. First, they do not identify behaviors that are more likely to occur in PIF-backed firms than in large MNEs. Tax expertise, low cost of tax planning, and the separation of ownership and control all exhibit themselves in many MNEs, not only in PIF-backed MNEs. It is therefore unclear whether such explanations account for PIFs' seemingly unique portfolio tax behavior. A second shortcoming of such explanations is that they do not consider the unique operational structure of PIFs, and whether that structure has some bearing on PIF portfolio tax behavior. This Section, therefore, offers additional explanations to PIF-backed MNEs tax behavior, taking into account the international context in which PIFs operate. It concludes that PIF-backed firms face fewer constraints on their international tax planning, compared with non-PIF-backed firms.

1. Short investment horizon

Unlike other MNEs, PIFs' investments are limited in durations by the very terms of PIFs' operative agreements. As explained above, it is unlikely that a PIF will hold an investment for a period longer than five to seven years.[109] A short-term investment horizon may have several effects on PIFs' tax behavior.

To begin with, the limited investment term puts much pressure on PIF managers to turn profits in a relatively short period of time. This may induce an aggressive tax stance to support the quick generation of net profits. Moreover, the PIF management, which guides the portfolio firm tax planning, may not be deterred by potential tax audits. Unlike tax managers in other MNEs, it is likely that by the time tax assessments against the portfolio-firm materialize, the PIF will have long-since disposed of the portfolio firm. PIF managers are unlikely to have to face tax authorities. At most, they will face demands from the buyer of the portfolio company to indemnify it for any tax-associated losses. Of course, such tax risk should normally be priced

109. *See* discussion *supra* Section I.A.

into a transaction in which a PIF disposes of its investment. But pricing an unknown tax risk is an extremely difficult undertaking.

A short investment horizon may also alleviate the effect of reputational constraints. In 2015, Walgreens' public image suffered gravely after it was announced that the company considered changing its tax residence to the U.K. in a move intended to avoid U.S. taxes.[110] Eventually, it seems that public relation considerations pushed Walgreens to scrap its tax plan.[111] Walgreens had to consider the fact that most of its stores are in the United States and a public relations disaster might affect long term relations with its customers. Indeed, several studies suggest that reputational considerations may constrain aggressive firm-level tax planning.[112]

PIFs are probably less sensitive to such long term reputational effects. A portfolio company held by a PIF will be disposed of within a short period. Any negative reputational effects of the company are likely to burden the next owner of the company, not the PIF. A small PIF-portfolio company is unlikely to appear on the radar of public political consciousness during this short ownership period. Further, PIF managers often reside in a jurisdiction other than the jurisdiction of the investment and thus may not be completely sensitive to political pressure originating in the jurisdiction. These special circumstances suggest that PIF managers are less likely to take into account long-term reputational effects of aggressive tax planning.

Investment horizons have also been found to affect investors' oversight over corporate tax planning. One study found "that firms with higher levels of long-term institutional ownership exhibit significantly lower levels of tax avoidance."[113] In PIFs, no investor owns a portfolio company for the long term, and hence, such constraints on tax avoidance are absent.

Finally, short investment horizons may have an additional effect on PIF-portfolio tax planning. A firm's long term operation within a jurisdiction is affected by the financial health of the jurisdiction. Firms

110. Bruce Japsen, *Walgreens Says HQ Won't Leave U.S., Never Intended 'Inversion'*, FORBES (May 28, 2015, 11:31 AM), http://www.forbes.com/sites/brucejapsen/2015/05/28/walgreens-says-hq-wont-leave-u-s-never-intended-inversion/#68c44c754381.

111. Alexander C. Kaufman, *How Americans Scared Walgreens Out Of A $4 Billion Tax Dodge*, HUFFINGTON POST (Aug. 7, 2014, 2:26 PM), http://www.huffingtonpost.com/2014/08/07/walgreens-tax-inversion_n_5655934.html.

112. *See supra* note 23 and sources cited therein.

113. Khurana & Moser, *supra* note 27, at 113.

may have interest in operating in an environment of legal stability, developed infrastructure, and skilled labor force.[114] Because of this, a firm may be willing to share some of the burden associated with government outlays that finance public goods.

However, due to short investment horizon, PIF-controlled entities are less likely to be constrained by such considerations. Any benefits of successful tax planning quickly materialize. The cost of tax avoidance to the jurisdiction in which the PIF-backed investment operates is unlikely to be felt by the PIF owners and managers, who will have disposed of the investment long before such long-term effects take root.

2. Aggressive tax personalities

Recent research suggests that "executives who appear willing to push the envelope for personal tax savings appear to do the same at the firms they manage."[115] Chyz identifies a sample of executives who manipulatively exercised stock options for personal tax gains and classifies such executives as "suspect" of aggressive tax personalities.[116] He then compares firms on several measures of firm-level tax avoidance, in times when suspect executives were present versus times when they were not.[117] Chyz finds "that suspect executive presence is positively associated with tax sheltering"[118] at the firm level.

Since PIF fund managers retain control of portfolio firms' tax decisions, it is reasonable to expect that their personal tax tendencies may affect their portfolio firms' tax behavior. There is no study that looks at the tax aggressiveness of fund managers in particular. However, there is plenty of anecdotal evidence showing that fund managers frequently take particularly aggressive tax positions. This is most evident in the context of management fee waivers, where multiple fund managers regularly took the position that their waived fee allocations should be taxed at the capital gains rate rather than at ordinary income rates. The mechanics of such arrangements are

114. *See supra* note 25 and accompanying text.

115. James A. Chyz, *Personally Tax Aggressive Executives and Corporate Tax Sheltering*, 56 J. ACCT. & ECON. 311, 311 (2013).

116. *Id.*

117. *Id.* at 315–18.

118. *Id.* at 322.

complex.[119] Suffice it to say that capital gain rates are usually reserved for risky returns, while allocations on account of fee waivers often came close to being guaranteed payments.[120] Guaranteed payments from a partnership (the fund), to the partner (the manager), are taxed at ordinary rates.[121] Such aggressive tax planning led commentators to question whether fee waiver strategies pass muster under tax law,[122] and it was eventually shut down.[123]

If fund managers represent a class of aggressive tax personalities, then Chyz's study gives us reason to believe that such aggressive behavior will trickle down to the funds' portfolio companies. This effect is exacerbated by the fact that fund managers' tax interests dictate the funds' portfolio planning.[124] Given that most investors are tax-exempt, fund managers are unlikely to be constrained by investors with adversarial tax considerations.

3. *Opacity*

A final issue that may contribute to PIF aggressive portfolio tax planning is the opacity with which they operate. Most PIFs are not publicly traded, and as such are not subject to public disclosure requirements. At most, publicly listed PIF portfolio companies are subject to disclosure requirements in their own capacity. There is no consolidated disclosure of PIF operations. This differs from any publicly traded MNE, which must include consolidated disclosure of its global financial outcomes.[125] Previous research shows that there is a negative correlation between the quality of public disclosure and the extent of aggressive tax behavior.[126] Opacity also further diminishes

119. For a discussion of fee waivers, see Polsky, *Fee Conversions*, *supra* note 11.

120. *Id*. at 766 (arguing that "a priority allocation of quarterly net gain is analogous to the gross income allocation that was treated as a section 707(c) guaranteed payment . . . .").

121. I.R.C. § 707 (2012).

122. *See supra* note 44.

123. Recent regulation promulgated under I.R.C. § 707 have shut down the most aggressive forms of fee-waiver tax planning. *Supra* note 45 and accompanying text.

124. *See supra* Section II.B.1.

125. Publicly traded corporations report their worldwide financial results on a consolidated basis. Moreover, under Action 13 of the BEPS Project, certain multinational entities will be required to report certain worldwide information to tax authorities. *See* discussion *infra* Section IV.B.

126. *See generally* Ole-Kristian Hope, Mark (Shuai) Ma & Wayne B. Thomas, *Tax Avoidance and Geographic Earnings Disclosure*, 56 J. ACCT. & ECON. 170 (2013) (finding that managers perceive opacity in geographical reporting as masking tax aggressive behavior).

the constraints on tax planning that may be imposed by reputational considerations. To summarize, the opacity in which PIFs operate may enable aggressive tax planning to take root.[127]

Moreover, PIFs themselves are rarely taxable entities. Most PIFs are organized as partnerships, and, as such, are not subject to taxation at the entity level. This, in turn, may obscure the role of PIFs in driving tax behavior.

IV. PIFS' INVESTOR BASE AND INTERNATIONAL TAX AVOIDANCE

The previous Part explained the role of the PIF business model in international tax avoidance. This Part turns the focus to the identity of PIF investors. Many of the limited partners in PIFs are tax-exempt investors.[128] Such investors include pension funds, sovereign wealth funds, university endowments, and other institutions not subject to taxation on passive investments. This Part argues that the presence of non-taxable investors significantly affects PIFs' tax behavior in two important ways. First, the presence of non-taxable investors significantly affects funds' portfolio-level tax planning. The essential argument is that taxable investors may have different tax interests compared with that of the fund manager, and that such interest may mitigate aggressive tax planning. Such constraint is largely eliminated when most investors are tax-exempt. In the international context this analysis is particularly potent because taxable investors may become tax-exempt in a cross-border transaction if they come from territorial jurisdictions. Thus, any tax effect associated with a large tax-exempt investor base is amplified in the cross-border context. Second, a large tax-exempt investor base suggests that income that is not taxed at the source, is also not taxed at the residence.

127. Opacity may be mitigated when PIF holds a publically traded portfolio investment, or when a disposition is made through an IPO. But in the case of an IPO, disclosure will only happen with connection of the disposition. Tax planning during the holding period remain opaque.

128. *See* Fleischer, *supra* note 1, at 13 ("many LPs in private equity firms are tax exempt, such as pension funds and university endowments"); *see also* Polksy, *Compendium*, *supra* note 1, at 616 ("[T]he limited partners generally do not pay U.S. taxes, either because they are tax exempt or foreign.").

A. Prior Analysis of the Importance of Non-taxable LPs to PIFs' Tax Planning

The interplay between the fund and its non-taxable investors has been subject to some analysis.[129] For example, if the fund managers were to take all their profits from the fund as compensatory fees, the managers would be taxed immediately at ordinary tax rates. Instead, by taking their economic interest in the fund as a profits interest (the "carried interest"), managers can defer gain recognition until the fund's liquidation, at which time the gain is taxed at preferential capital gains rates. While this result is beneficial to the fund managers, it may be detrimental to taxable fund investors. This is because, had the managers opted to take the bulk of their compensation as management fees, those fees would be deductible, flowing through to the investors. Taxable investors value deductions and may be upset with fund managers who deny them of those tax benefits. However, tax-exempt investors have no use for tax deductions. When most LPs in a PIF are tax-exempt, investors have no adverse tax interest to that of the managers' use of carried interest. In fact, the investors probably share in the managers' benefit in the form of lower fees paid to the managers.[130]

The analysis above concerns fund-level planning that benefits the manager without harming other investors. There is very little analysis of portfolio-level tax planning in the presence of tax-exempt investors. One exception to this dearth of literature is Gregg Polsky's analysis of fund "monitoring fees."[131] Fund managers typically charge a two percent annual fee from the fund.[132] This fee is deductible by the fund and flows through to the limited partners. However, such deductions are of little use to the tax-exempt limited partners.

In order to prevent the deduction from going to waste,[133] fund managers have engaged in a type of planning that converts portfolio companies' distributions into "monitoring fees."[134] PIFs may charge

129. Polsky, *Compendium*, *supra* note 1.

130. *See* Sanchirico, *supra* note 1, at 1151–52 (describing how tax-exempt investors share their benefits in the form of lower management compensation).

131. Polsky, *Compendium*, *supra* note 1, at 622–25 (discussing monitoring fees).

132. *Supra* note 31 and accompanying text.

133. *Id.* at 622 ("If there's anything a tax lawyer hates, it's to see a perfectly good deduction go to waste.").

134. For a discussion of management fee conversions, see Polsky, *Disguised Dividends*, *supra* note 12.

their portfolio companies certain "monitoring fees" for "management" and other services provided by the fund to the companies. Presumably, under a typical fund economic deal, such fees would be paid to the fund investors, pro-rata to their capital contributions to the fund, as a return on investment. Instead, under monitoring fee schemes, the monitoring fees are paid to the fund managers to offset the two percent management fees otherwise paid by the fund to the managers. Thus, the economic deal is not changed (the investors lose the monitoring fees, but their management fee liability is reduced by the same amount). However, a nondeductible fund-level management fee is now converted to deductible fees paid by the portfolio companies to the fund manager. Therefore, the fund managers suffer no tax detriment (both the management fees and the monitoring fees are taxable to the fund managers at ordinary rates), but the after-tax return on investment is increased.

B. Tax-exempt Investors in the Context of International Portfolio-Level Tax Planning

The same game played with monitoring fees can efficiently be recreated in the context of international tax planning. The idea is to generate portfolio level deductions without creating additional inclusions to investors or the fund managers. But in the context of the tax rules applicable to cross-border transactions, this can be done to a much greater extent than in the context of monitoring fees. Monitoring fees convert a two percent management fee payment into a portfolio-level deduction. International tax rules can do the same to the bulk of a fund's profits.

Consider, for example, a PIF with taxable investors from a territorial jurisdiction investing in another jurisdiction. Taxable investors would rather withdraw their return from the fund as equity, which will not be taxable in their home jurisdiction. For foreign equity returns purposes, such investors are effectively tax-exempt. This change of status from taxable to non-taxable return is triggered by the international nature of PIF investment and would not happen in a purely domestic context. Taxable investors who would invest in their own jurisdiction would be taxed in their own jurisdiction.

Payments that represent equity returns (such as dividends or distributions that are treated as return on capital), however, are not deductible to the portfolio companies. In effect, taxable investors are faced with a choice between avoiding tax at the source jurisdiction (debt financing) or at the residence jurisdiction (equity financing). If the source jurisdiction tax rate is higher than the rate at residence, a taxable investor would rather avoid taxation at the source by financing with debt. PIF may seek to improve such outcome by turning equity returns to portfolio-level deductible expenses through debt/equity arbitrage.

If investors are "true" tax-exempt investors (meaning, the exemption is not conditioned on the investment being classified as an equity interest), such planning is, in theory, made even easier. The fund could simply charge the bulk of the return from the portfolio company as deductible payments (such as interest, royalties or service fee payments). This deduction would eliminate much of the portfolio-level tax base, but will not be taxed to the investors since they are tax-exempt. If the fund organizes its affairs wisely, the deduction would also avoid any withholding taxes at the jurisdiction of source. Many countries exempt certain types of deductible payments from withholding tax (in particular withholding on interest payments or payments of royalties are frequently exempt).[135]

This brings up a second order question: if "most" PIF investors are tax-exempt, why would funds go through the trouble of engaging in aggressive schemes such as the ones exposed by LuxLeaks? Why not just finance investments with debt? Why not simply charge portfolio-companies intercompany deductible payments? Why does it seem that the interest of some *taxable* investors dictates portfolio level planning?

The answers to these questions may be related to the fact that the most significant taxable investor of *any* fund is also managing the fund. The fund manager's carried interest is probably the largest taxable fund interest (twenty percent of the fund profits).[136] The fund manager is able to push such planning particularly because such tax scheme has no effect on the investor-level outcome of tax-exempts or taxable investors from territorial jurisdictions (these investors do not care whether investment return is classified as debt or equity return).

If the fund had a majority of taxable investors, it is not at all clear that all taxable investors would approve of such debt/equity

135. *See supra* notes 77–78 and accompanying text (discussing relief on withholding taxes on interest payments). Withholding on royalties is also many times relived. For example, the OECD model tax treaty recommends no withholding on royalties in most cases. *See* OECD COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, Art. 12(1) (2010). Inter-EU royalties and interest payments are also relieved from withholding under an EU directive. *See* Council Directive 2003/49/EC, 2003 O.J. (L 157) 49 (EU).

136. *Supra* notes 35–37 and accompanying text.

conversions. Different taxable investors have different tax positions and may be affected differently by portfolio-level planning.[137] Consider, for example, a taxable investor who has loss carryovers.[138] This investor may prefer receiving interest returns, which will be offset by the investor's loss carryovers, rather than equity returns taxed to the investor at capital gains rates. As another example, consider a taxable U.S. corporate investor. It is not clear whether such investor would rather receive interest or dividends from the portfolio company because both interest and dividends may be taxable to the corporate investor at the thirty-five percent corporate tax rate. Interest would be deductible at the portfolio-company level, while dividends would not. On the other hand, in some instances, dividends from foreign companies may carry with them foreign tax credit to be used against the investor's U.S. tax liability.[139] A fund manager, in his or her individual capacity, cannot use such credits. This creates an adverse tax interest to that of the corporate investor. The bottom line is that in the presence of taxable investors, the fund managers must navigate through potentially adverse investor-level tax interests, which are affected directly by portfolio-level tax planning. However, that constraint is largely eliminated when most investors are tax-exempt.

C. Assessing the Size of PIFs' Tax-exempt Investor Base

Arguments about the effect of tax-exempt holdings in PIFs rely on the assumption that most PIF investors are tax-exempt. Surprisingly, there is very little current research on the tax interests of PIF investors. In 2006, Professor David Weisbach estimated that about thirty-eight percent of private equity investors in the United States were taxable investors (and as a consequence, up to sixty-two percent are tax exempt).[140] A recent article that explored the size of tax-exempt investors in U.S. corporations assumed, for methodological purposes, that seventy-five percent of PIF investors

137. Omri Marian, *Reconciling Tax Law and Securities Regulation*, 48 MICH. J. L. REFORM 1, 10–13 (2014) (discussing investors' heterogeneous tax preferences).

138. Taxpayer may, under certain circumstances, carry forward past losses and use them to offset future taxable gains. *See* I.R.C. § 172 (Supp. 2014).

139. *See* I.R.C. § 902 (2012).

140. David A. Weisbach, *The Taxation of Carried Interest in Private Equity*, 94 VA. L. REV. 715, 722 (2008).

are tax-exempt, but did not actually investigate the matter.[141] Executing a full-blown research project to accurately measure actual investors' holdings in non-public entities is methodologically complex and certainly beyond the scope of a symposium article.[142] Instead, this Section uses recent data to try to provide a reasonable assessment of the current level of tax-exempt holdings (in terms of capital investment) in both U.S. and European PIFs.

For European PIFs, data is available online from Invest Europe (formerly known as the European Private Equity and Venture Capital Association, or EVCA). Invest Europe publishes annual fundraising reports that include, among others, the sectors of investors committing capital European PIFs. Full data is available on Invest Europe's website for years 2007 to 2015.[143]

For purposes of this analysis the following investor categories in the EVCA data are classified as tax-exempt investors: Endowment and Foundations, Government Agencies, Pension Funds, and Sovereign Wealth Funds. Each of these investors are regularly treated as tax-exempt under the laws of most developed jurisdictions. The following categories of investors are treated as taxable for purposes of this analysis: Banks, Corporate Investors, Insurance Companies, and Private Individuals. For most years, categories that were clearly categorized as exempt or taxable account for about two thirds of all PIF investors.

The methodological difficulty arises in the context of the remaining investor categories, whose tax status is unclear ("unclassified categories"). These investor categories include Capital Markets, Family Offices, Other Asset Managers, and an Unclassified category. The reason for the inclusion of Other Asset Managers in this category is that many of them may be investment intermediaries

141. Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, 151 TAX NOTES 923, 933 (2016).

142. For a recent paper that identifies the owners of pass-through entities in the United States, see Michael Cooper et. al., *Business in the United States: Who Owns it and How Much Tax Do They Pay?*, NAT'L BUREAU OF ECON. RES. (Working Paper No. 21651, 2015). They find that about 10.9% of U.S. partnerships' income is accrued to tax-exempt and foreign taxpayers. There is good reason to assume that the share of tax-exempt investors in PIF partnerships is much larger. Moreover, tax-exempt and foreign partners that invest in U.S. PIFs generally invest through foreign vehicles which are not captured by their study.

143. The data is available at http://www.investeurope.eu/research/activity-data/annual-activity-statistics/.

themselves, or funds of funds (PIFs that invest in other PIFs).[144] Family Offices are included in this category because family offices, at many times, invest through non-taxable trusts that enable their beneficiaries to avoid or substantially defer gain recognition. Capital Markets are included in this category because Invest Europe does not provide a definition for that category of investors, and it is therefore not clear whether such investors should be counted as taxable or nontaxable.

In order to assess the size of the ratio of taxable to nontaxable investors in the unclassified category, the analysis takes two approaches. One is to assume that the same ratio of taxable/nontaxable investors in the classified categories applies to the non-classified categories. This approach is reasonable, since many of the unclassified categories of investors are private investment pooling vehicles themselves (such as funds of funds or asset managers). It is reasonable to expect similar investment patterns are shared across similar types of private investment vehicles. The alternative approach—following Rosenthal & Austin's estimation of taxable holdings in U.S. equities held through pass-through entities[145]—is to simply assume that half are taxable and half are not.[146] The fifty-fifty assumption is more conservative than the methodology used by Rosenthal & Austin, who, for purposes of their study, assumed that seventy-five percent of PIF investors are tax-exempt.[147] The two methods thus create a range of outcomes, which is summarized in Figure 1 below.

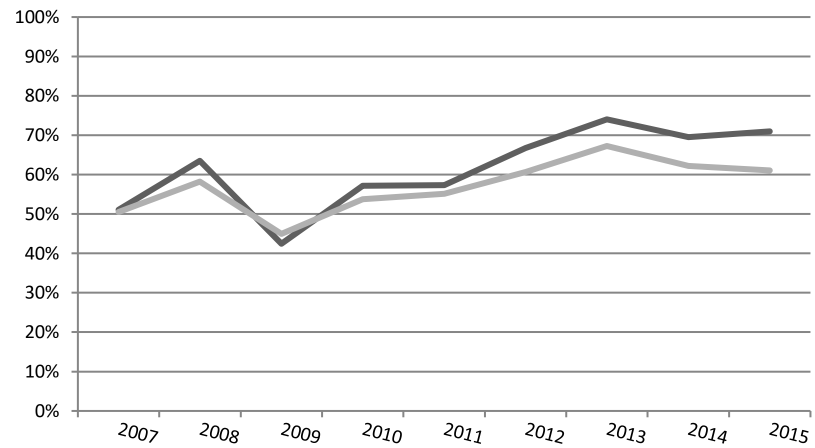
144. Weisbach counts funds of funds as "taxable" in his estimation. This causes Weisbach to overestimate the size of the taxable sector since many funds of funds' investors are also tax exempt.

145. Rosenthal & Austin, *supra* note 141.

146. *Id.* at app. 2.

147. *Id.* at 934, Table A2.

Figure 1 - Size of Tax-Exempt Investor Base in European PIFs



The dark line in Figure 1 represents an estimation based on assigning the unclassified category with the same ratio of taxable to nontaxable investors in the known categories. The lighter line shows the estimated size of the nontaxable investor base based on a fifty-fifty assignment of taxable to nontaxable investors in the unknown category.

Save for a drop in nontaxable investment following the 2008 financial crash, it seems that the size on the nontaxable sector of PIF investors regularly outweighs the size of the taxable sectors, and that the size of the nontaxable sector gradually increases over time. For 2015, nontaxable investors account for about sixty-one to seventy-one percent of all PIF investors. Even with these striking figures, the relative investment by tax-exempt investors to that of taxable investors is probably understated. The reason is that, as explained above, taxable investors from territorial jurisdictions are probably tax-exempt with respect to returns from PIF investment, since the returns are drawn as capital gains or other types of equity returns.[148]

148. Indeed, at least in the United States, tax-exempt and foreign LP investors seem to withdraw most of their partnership income in the form of capital gains. *See* Cooper et. al., *supra* note 142, at 38, Figure 8.B.

A similar method is applied to U.S. PIFs. Unfortunately, U.S. data is not as freely available as in Europe. For purposes of this analysis, data for the U.S. is derived from the Securities and Exchange Commission's (SEC) Private Funds Statistics Reports.[149] Since 2012, private fund managers are required to report certain information to the SEC.[150] Such information includes the classes of investors in privately managed funds. The information is available on the SEC's website at the Division of Investment Management page. Full data is available beginning with the first quarter of 2013.[151]

For most periods, just under seventy percent of all investors in U.S. PIFs can be reasonably classified as taxable or tax-exempt, with a reasonable level of confidence. The following investor categories are classified as tax-exempt for purposes of the U.S. analysis: Pension Plans, State/Municipal Pension Plans, Non-Profits, Sovereign Wealth Funds, Non-U.S. Individuals, Unknown non-U.S. Investors, SEC-Registered Investment Companies, and State/Municipal Government Entities. Foreign investors are classified as tax-exempt, because such investors many times come from territorial jurisdiction, and are rarely taxable in the U.S. on passive income earned in the United States.[152] SEC-registered companies are classified as nontaxable because such entities are frequently treated as RICs ("Regulated Investment Companies") under the Internal Revenue Code.[153] RICs are accorded beneficial tax treatment that generally eliminates RIC-level taxation.[154]

149. Sec. and Exch. Comm'n Div. of Inv. Mgmt., *Private Funds Statistics Third Calendar Quarter 2015,* Feb. 16, 2016.

150. For a discussion of these recent disclosure requirements, see, Chris William Sanchirico, *As American as Apple Inc.: International Tax and Ownership Nationality*, 68 TAX L. REV. 207, 264–65 (2015).

151. *See*, *e.g.*, Sec. and Exch. Comm'n Div. of Inv. Mgmt., *supra* note 149, at 2 n.2, ("The Commission began receiving Form PF filings from Large Hedge Fund Advisers in July 2012. A full data set was not received until March 2013.").

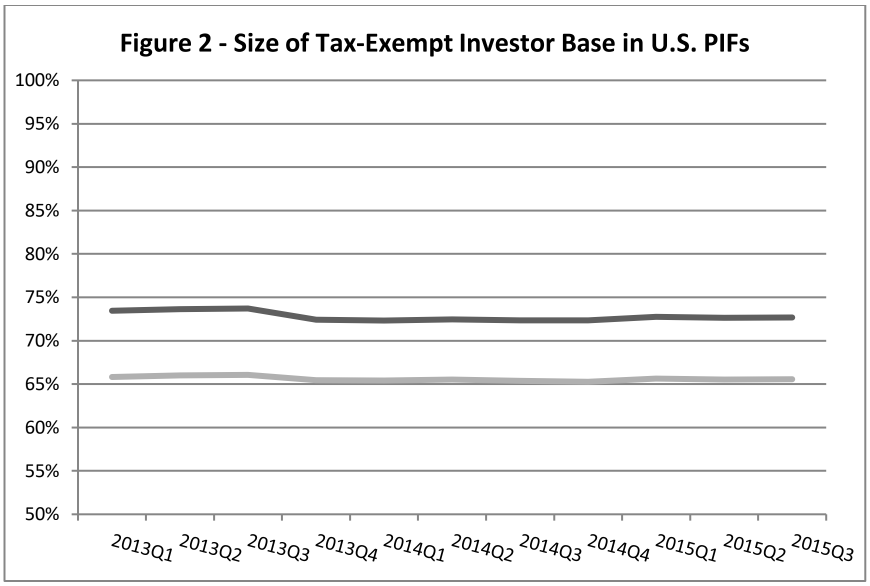
152. Most industrialized jurisdictions employ some form of territorial taxation. *See* Philip Dittmer, *A Global Perspective On Territorial Taxation*, TAX FOUND. Special Report No. 202, Aug. 10, 2012, at 3 (Investment income sourced in the United States is rarely taxable to foreign investors); *see* Avi-Yonah, *supra* note 18, at 68 (discussing how little revenue is collected from foreign investment income in the United States, concluding that the exceptions for withholding tax on investment income "overshadow the rule itself").

153. I.R.C. §§ 851–855 (2012 & Supp. 2014).

154. RICs are required to pay most of their earnings as dividends, and may deduct dividends paid. This effectively eliminates most of the entity-level taxable income. While RIC shareholders may be taxable, an RIC's ownership is dispersed (for example, mutual funds are RICs), and the tax interests of particular RIC holders are unlikely to affect the tax behavior of an investment fund held by the RIC.

The following U.S. investor categories were treated as taxable for purposes of the analysis: U.S. Individuals, Insurance Companies, Banking/Thrift Institutions, and Broker-Dealers.

The following investor categories are regarded as unclassified for purposes of the analysis: Private Funds and Other. The same methodology used in the context of European PIFs is applied with respect to unclassified investors in U.S. PIFs. The results are summarized in Figure 2.



The investor base in U.S. PIFs is clearly dominated, at least in recent years, by tax-exempt investors. For the third quarter of 2015, between sixty-six and seventy-three percent of investment was made by tax-exempt investors.

Notwithstanding the fact that the results presented herein are merely estimates, they seem reasonable. They are consistent with previous estimates by Weisbach.[155] They are also similar to a recent estimate of tax-exempt investment holdings by Rosenthal & Austin, who estimate that only 24.2% of U.S. equities are held in taxable accounts.[156]

155. *Supra* note 140, at 722.

156. Rosenthal & Austin, *supra* note 141, at 923.

To summarize, this Section estimated that about two thirds of PIF investors are tax-exempt. This implies that PIF portfolio-level planning may be affected by the absence of taxable investors, whose investor-level tax interests may conflict with the interest of the fund manager. This effect is exacerbated by the fact that in the cross-border context, otherwise taxable investors are functionally tax-exempt. Moreover, the findings suggest that most earnings by PIFs are not taxed at the jurisdiction of residence. Combined with the fact that PIF-controlled entities are lightly taxed at the source jurisdictions, the inevitable conclusion is that most income earned by PIF investors from cross-border investment is simply never taxed.

V. ADDRESSING PIFS INTERNATIONAL TAX PLANNING

This Article has thus far established that PIF-controlled MNEs seem to be particularly aggressive in their cross-border tax planning, and considered some possible explanations to this phenomenon. PIF investors are able to avoid taxation both at the jurisdictions of source and residence. This Part considers why this is a problem worthy of attention, and how to start approaching this problem.

A. How Big is the Problem?

PIFs are major players in the global economy. Private equity and hedge funds' assets under management have consistently increased over the past few decades, to over $5 trillion combined in 2015.[157] According to a recent report by Bain & Company, in 2015 private equity funds raised $527 billion in new funds from investors,[158] made $282 billion of new buyout investment,[159] and realized $422 billion worth of portfolio investments.[160] To see how big these numbers are, consider that the global M&A activity for 2015 amounted to about $4.7 trillion.[161] In value terms, this means that almost nine percent of global M&A deals in 2015 involved an asset disposition by a private

157. *Id.* at 934.

158. BAIN & COMPANY, GLOBAL PRIVATE EQUITY REPORT 2016, at 2 (2016).

159. *Id.* at 9.

160. *Id.* at 20.

161. Maureen Farrell, *2015 Becomes the Biggest M&A Year Ever*, WALL ST. J. (Dec. 3, 2015, 6:58 PM), http://www.wsj.com/articles/2015-becomes-the-biggest-m-a-year-ever-1449187101.

equity fund. This data does not include all hedge funds and all venture capital funds.

With such huge deal values, significant tax revenues are at stake. It is impossible to estimate the revenue effects of PIFs' international tax avoidance in a short symposium article. However, it is worth noting that the revenue losses associated with carried interest planning in the United States alone have been estimated at anywhere between $18 billion to $180 billion for a ten-year period.[162] Such revenue losses are largely attributable to the tax planning associated with managers' carried interest. Namely, the revenue losses are attributable to the deferral in recognition of twenty percent of the funds' gains, and the conversion of such gains from ordinary income to capital gains. This Article addresses the rest of PIF gains, namely eighty percent, which to a large extent seems to go perpetually untaxed. Surely if the problem of fund managers' tax planning calls for such a vibrant academic discussion, so does international tax avoidance associated with PIFs' portfolios.

B. Improving Transparency

It is beyond the scope of a symposium article to offer a policy prescription to solve the issue of PIF international tax planning. This is so mostly because the problem is yet to be accurately defined. This Article identified some evidence suggesting that PIFs are particularly aggressive international taxpayers. It also offered some possible explanations to this phenomenon. However, while all the explanations proposed herein are plausible, none are proven. Much more research is required in order to understand the international tax behavior of PIFs. It is imperative to understand such behavior in order to try and tailor policy solutions that will not be easily avoided by creative tax planners, but also that would not unnecessarily stifle cross-border investment activity.

The bottom line is that we need more information. The impetus for this Article was a leak by a whistleblower that, for the first time, offered us an opportunity to systematically assess the international tax behavior of PIFs operating through one particular jurisdiction. And this short glimpse into the world of PIF international tax planning is

162. Victor Fleischer, *How a Carried Interest Tax Could Raise $180 Billion*, N.Y. TIMES (June 5, 2015), http://www.nytimes.com/2015/06/06/business/dealbook/how-a-carried-interest-tax-could-raise-180-billion.html?_r=0 (discussing the different revenue loss estimates attributable to the carried interest loophole).

troubling. But it seems unwise to rely on whistleblowers to formulate tax policy. Rather, a more thorough and systematic study is required. The problem, however, is that PIFs are rarely subject to reporting requirements and are rarely taxable entities themselves. There are currently no sources to provide the necessary data.

Luckily, this problem is not unprecedented nor without solutions. One of the greatest successes of the BEPS Project is the Country-by-Country reporting. For years, one of the main difficulties of tax administrators in auditing MNEs was the fact that administrators only had piecemeal information. MNEs engaged in aggressive planning involving intra-group transactions to reduce their tax bills. The pricing of transactions between affiliated entities were set so as to have income generated in high-tax jurisdictions reported in low-tax jurisdictions. The ability of each tax administration to tackle such issues on its own was very limited, since taxpayers were only required to provide information to each country as required by domestic laws. Each country saw only one side of the intercompany deal but never saw the big picture. Moreover, intercompany pricing reports are confidential, so the public did not see the full picture either.

It took several outrageous media exposés showing how intercompany pricing enabled multinational corporations to legally eliminate billions of dollars of tax liabilities and how opacity contributed to such schemes.[163] The BEPS Project engaged those issues with Action 13, which established the framework for CBCR. Under the CBCR framework, an MNE will be required to report its worldwide operations both in its countries of residence and its countries of operation. While the mechanics of such reporting are complex,[164] the idea is pretty simple: to let tax authorities have the full picture of MNE inter-company transactions. MNEs will have to report not only the taxable income they have in each jurisdiction, but must also report their activities, assets and employees in each jurisdiction and properly document the methods by which profits are split within the affiliated group. Thus, when a company with no assets or employees reports a gain of billions of dollars while an affiliate with factories on the ground reports no income, red flags will be raised.

163. Brauner, *supra* note 4, at 57 (describing media reports on corporate tax avoidance).

164. For the final CBCR report, see OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT, TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING, ACTION 13 - 2015 FINAL REPORT (2015), http://dx.doi.org/10.1787/9789264241480-en.

The adoption of the CBCR standard has been described as "the single most important achievement of the so-called civil society involvement with international tax policy shaping."[165] The OECD introduced model CBCR legislation, and several model international instruments including a convention for the exchange of CBCR information.[166] Some countries have also unilaterally adopted or intend to adopt CBCR rules.[167]

Unfortunately, it is not clear to what extent a PIF would be captured by the CBCR revolution. The reasons for this are twofold: First, conceptually, it is difficult to envision the implementation of CBCR in the PIF context. CBCR is largely intended to address intercompany transactions between affiliated corporations. This is sensible since corporations are taxable entities, whilePIFs, for the most part, are not. PIFs are transparent entities. The beneficiaries of PIFs' intercompany dealings are the investors, not the PIFs themselves. In other words, PIFs are not taxable "parents" of affiliated groups. To be sure, Action 13 specifically recommends that CBCR apply to "investment funds,"[168] and a recent CBCR directive proposed by the European Union seemed to be applicable to PIFs.[169] However, it is unclear how—as a conceptual matter—CBCR would apply to a non-taxable entity that does not have to report its worldwide income to any country, and, in many instances, is not even viewed as the owner of taxable gains. Unfortunately, Action 13 provides little-to-no guidance on how CBCR should be applied to pass-through entities.

165. Baruner, *supra* note 4, at 105.

166. OECD, MULTILATERAL COMPETENT AUTHORITY AGREEMENT ON THE EXCHANGE OF COUNTRY-BY-COUNTRY REPORTS (2015), https://www.oecd.org/tax/exchange-of-tax-information/cbc-mcaa.pdf. As of October 2016, 49 countries have signed this instrument. *See* OECD, SIGNATORIES OF THE MULTILATERAL COMPETENT AUTHORITY AGREEMENT ON THE EXCHANGE OF COUNTRY-BY-COUNTRY REPORTS (2016), https://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf.

167. For example, the Treasury Department recently proposed regulations to mandate CBCR for U.S. corporations. Country-by-Country Reporting, Prop. Treas. Reg. 109822-15, 80 Fed. Reg. 79795 (Dec. 23, 2015) (to be codified at 26 C.F.R. 1).

168. OECD, *supra* note 164, at 21 ("In particular, no special industry exemptions should be provided, no general exemption for investment funds should be provided, and no exemption for non-corporate entities or non-public corporate entities should be provided.").

169. *See* Attracta Mooney & Chris Flood, *New Tax Rules for Large European Funds*, FIN. TIMES (Apr. 24, 2016), http://www.ft.com/cms/s/0/29982114-07dd-11e6-a623-b84d06a39ec2.html#axzz4FAs5OGhr (discussing the application of CBCR to certain asset managers).

A second reason that PIFs may avoid CBCR is that CBCR is limited by a value threshold. For example, Action 13 recommends that CBCR will only apply to affiliated groups with an annual revenue of at least EUR 750 million.[170] Few (if any) PIFs meet that threshold. Most PIFs do not manage more than a few portfolio investments at a time. Fund managers raise capital, invest, dispose of investments, and then raise capital again for a new fund. Even if managers are successful, it is difficult to imagine that at any given time many PIFs generate EUR 750 million in annual revenue.

The main recommendation, therefore, is to extend the framework of CBCR to ensure that it applies to PIFs. More specifically, it suggests that CBCR should view PIFs as opaque entities. For reporting purposes, PIFs should be viewed as a corporate parent of an affiliated entity.

A second recommendation is to significantly lower the value threshold of CBCR for PIFs, or to aggregate it over a period of several years, so as to make sure that PIFs are captured by the reporting requirements.

Like in the context of multinational corporations, it is hoped that PIFs' compliance with CBCR would provide information to tax authorities, researchers and the public to better understand PIF tax behavior and enable the promulgation of PIF-specific tax policies.

CONCLUSION

This Article was motivated by a leak of hundreds of ATAs granted by Luxembourg to MNEs. An analysis of the leaked documents demonstrates that PIFs are the most active industry in seeking tax-reducing private rulings in Luxembourg. This finding is rather surprising when one considers current international tax discourse, which is almost exclusively focused on inter-company transactions between affiliated corporations, usually from IP-reliant industries. This raises the question: is systematic international tax avoidance by PIF-controlled entities something that requires the attention of tax policymakers?

The argument advanced herein is that the answer is "yes." PIF-controlled entities face fewer constraints on their international tax planning, compared with non-PIF-controlled entities. Short investment horizons mitigate the deterrent effects of tax audits,

170. OECD, *supra* note 164, at 39.

reputational considerations, and investors' oversight. Short investment horizons may also contribute to lack of commitment to the success of the jurisdictions in which PIFs invest. In addition, there is some evidence suggesting that aggressive tax behavior by PIF managers in their personal capacity may contribute to aggressive behavior by the portfolio company. Finally, PIFs are rarely subject to tax reporting requirements. This enables PIF to aggressively reduce source-jurisdiction tax.

The largely tax-exempt investor base also contributes to PIFs' aggressive tax behavior. Taxable investors' tax liabilities may be affected by PIF portfolio planning. Such investors may have tax interests adversarial to those of the fund managers, and, as such, may mitigate aggressive tax behavior at the portfolio level. Most PIF investors, however, are tax-exempt. In the international context, this problem is magnified because otherwise taxable investors become functionally tax-exempt. In fact, in most PIFs the only sizable taxable investor is probably the manager, whose carried interest is subject to tax. It is therefore reasonable to expect that the manager's personal tax stance drives PIF portfolio international tax planning. Most importantly, however, the sizable tax-exempt investor base suggests that income that was not taxed at the source jurisdiction remains exempt at the jurisdiction of residence. In other words, most income earned by PIFs in cross-border transactions is unlikely to ever be taxed.

It is difficult to address such issues given the lack of information we currently have about PIFs' tax behavior. PIFs disclose very little information. Research and resulting policy changes cannot seriously be expected to rely on the goodness-of-heart of whistleblowers. We need a systematic information collection system. Action 13 of the BEPS Project offers such an instrument in the form of CBCR. Unfortunately, as currently drafted, it is reasonable to assume that most PIFs would avoid the CBCR requirements. Therefore, CBCR should be expanded to ensure that most PIFs are included.