Private Equity Information Brief

Content

<table>
<thead>
<tr>
<th>Introduction</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer pricing in the world of Private Equity</td>
<td>3</td>
</tr>
<tr>
<td>Investment Entity Exemption: another flexible alternative?</td>
<td>3</td>
</tr>
<tr>
<td>Incentive schemes</td>
<td>4</td>
</tr>
<tr>
<td>FATCA update</td>
<td>5</td>
</tr>
<tr>
<td>Luxembourg aims to enhance its position as the International RMB Centre for the Euro Zone</td>
<td>5</td>
</tr>
<tr>
<td>The BEPS Action Plan: what are the implications for Private Equity industry?</td>
<td>6</td>
</tr>
<tr>
<td>CRD IV impacts on investment firms</td>
<td>6</td>
</tr>
<tr>
<td>The VAT authorities announce that risk management services for funds are VAT exempt</td>
<td>7</td>
</tr>
<tr>
<td>New Government coalition programme</td>
<td>7</td>
</tr>
<tr>
<td>PwC Academy’s Private Equity training</td>
<td>7</td>
</tr>
</tbody>
</table>

Contacts | 8 |


**Introduction**

Welcome to the 14th and for this year already last edition of PwC Luxembourg’s Private Equity Information Brief.

2013 is nearly over, and new challenges will have to be faced in Luxembourg in 2014. The most important change is the nomination of a new government in Luxembourg. Xavier Bettel, the new Prime Minister, took office at the beginning of December, and has already spoken to set the tone for the coming years. The coalition has also published its programme for the life of the government. For business, the policies are very positive – the government has a strategy for the short, medium and long term to guarantee Luxembourg’s international competitiveness building on Luxembourg’s reputation for tax stability. Private Equity features explicitly in the government’s plans – the government has said it will do more to attract large Private Equity funds.

On behalf of our Private Equity Team I wish you a very festive season and a prosperous and healthy New Year

Vincent Lebrun

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**Vincent Lebrun**

Private Equity Industry Leader

PwC Luxembourg
Transfer pricing in the world of Private Equity

As Private Equity firms (“PE firms”) have become increasingly international in their outlook and operations, the correct application of transfer pricing legislation becomes a higher priority. Also, the transfer pricing arrangements of PE firms are becoming more complex, with the key value drivers of a business increasingly being shared between a number of jurisdictions, often on an integrated basis. This, combined with the growth of Private Equity as an asset class and the media attention to its role in corporate actions, have contributed to a marked upturn in tax authority activity.

The transfer pricing arrangements that are implemented by PE firms need to match the underlying value chain of the business, and the commercial contribution of each of their global offices. The diversity of cross-border related party transactions between the offices run by PE firms has increased during recent years, as more offices expand from preliminary research and general marketing service providers to a wider range of activities such as deal sourcing, investment committee representation, investment process, investor relations, capital-raising, fund administration, and back office support activities. This cross border integration of the business has resulted in a number of difficulties and complexities when determining the appropriate transfer pricing within PE firms.

We have worked with a large number of PE firms to help ensure that their transfer pricing arrangements are correctly determined and implemented. Each cross border transaction needs to be reviewed in conjunction with the functions performed, assets utilised, and risks assumed by each of the offices involved, to determine appropriate transfer pricing methodologies and subsequently to apply these to determine the arm’s length compensation.

Implementing a robust transfer pricing methodology for a PE firm is challenging. This is due to factors such as scarcity of data to benchmark the pricing of the cross-border transactions, the differing views of tax authorities and variations in the importance of functions at different points in the fund investment cycle.

For example, a transfer pricing methodology that has been commonly applied in the Private Equity industry is the “cost plus” method. Here, the income of support operations is set on the basis of a recharge of the local costs plus an arm’s length mark-up, which provides a profit subject to tax in that jurisdiction.

The sustainability of such methodology becomes more difficult as each local operation matures, and both the scope of activities and level of influence that are provided from that location increases. This is due to the fact that the cost plus approach relies on the benchmarking of comparable companies providing the same or similar services or functions: more sophisticated services or joint working arrangements are less often found between independent parties, making it hard for such benchmarking analysis to be conducted.

Therefore, where the business within a PE firm is so integrated that some key value-adding functions (e.g. capital raising and investor relations, deal sourcing and origination, investment management, structuring, portfolio management etc.) are performed in more than one jurisdiction, the application of the “profit split” method may provide the solution. The “profit split” method identifies the profits recognised within the group as a whole, and utilises a profit split factor, based on each stakeholder’s contribution, to share the profits amongst the stakeholders on an arm’s length basis.

While on one hand there are more situations where “profit split” methods need to be used to reward each operation’s contribution to a global Private Equity business, routine functions, such as support services and fund administration, are often still most appropriately priced so the provider achieves a small, but guaranteed, profit. The profit margin calculated is usually set by reference to the levels of profits achieved by independent entities providing the same or similar services to the market.

In conclusion, PE firms look out onto an evolving landscape, with increasingly global business models and more sophisticated tax authority audits making simple, centralised transfer pricing arrangements more difficult to sustain.

A clearly documented transfer pricing analysis of the PE firm’s value chain, and the contribution of each office, has become critical. Finding a methodology which recognises high value inputs from a number of locations, while challenging, is necessary to meet the growing requirements of territories where PE firms typically base their operations.

Should you have any questions on the above, please contact:
• Caroline Goemaere (+352 49 48 48 3002)
• Shunji Kiyokawa (+352 49 48 48 3084)

Investment Entity Exemption: another flexible alternative?

Significant amendments1 to the IFRS regarding exemption from consolidation obligations, which may impact the Private Equity sector, were endorsed earlier this month by the European Union (amendment to IFRS 10 “Consolidation of Financial Statements”, related to Investment Entities). The objectives are to align IFRS standards more closely with US GAAP for investments companies, by providing exemptions for consolidation of investments. The amendments also address fund business concerns which argue that consolidation of investments does not provide investors with added value on

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1Amendments to IFRS 10 “Consolidated financial statements”, IFRS 12 “Disclosure of interests in other entities” and IAS 27R “Separate financial statements”.
2Refer to the IPEV Guidelines for valuation technics, and IFRS 13 “Fair Value Measurement”.
The amendment allows investment entities to account for subsidiaries at fair value through profit and loss in the consolidated accounts.

The amendment introduced the concept of an investment entity. An investment entity is defined by the following main characteristics: “obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services”, “commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both; and measures and evaluates the performance of substantially all of its investments on a fair value basis.”

Once an entity begins to apply IFRS 10 (at the latest in 2014; early adoption is optional), Management will have to assess whether the definition of investment entity is met. When the entity is considered to be an investment entity, subsidiaries are no longer to be consolidated on a line by line basis, but accounted for at fair value through profit or loss in its consolidated accounts (except for subsidiaries that render investment related services). This accounting treatment is not optional.

This assessment is a critical decision that Management has to take. It requires a strong evaluation involving not only the accounting department but also the Board of the company, the Management and all departments related to legal and tax matters.

The consequences of this potential change to the presentation of the financial statements have to be analysed, as key ratios derived from the standard consolidated numbers might not be available if subsidiaries are to be accounted for at fair value. It is important for Management to assess the impact on the information required by suppliers, banks for covenants and other readers to understand the performance of the group. Other areas should also be considered such as local regulatory requirements.

It should also be noted that there are currently on-going discussions at IFRIC level on how this new amendment can be applied or clarified. This might impact the Private Equity world with regards to the following aspects:

- What is the exact definition of investment related services? IFRS 10 requires that a subsidiary which provides such services must be consolidated in the investment entity.
- Is this exemption available to an intermediate parent entity, if its ultimate parent is an investment entity? The standard requires a parent entity to present consolidated financial statements. However, IFRS 10 provides an exemption so that a parent does need not present consolidated financial statements if the entity meets certain criteria. One of the criteria is “its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRS”.

It is the right time to address this new challenge and to keep in mind going forward.

Incentive schemes

Incentive schemes may have multiple objectives: tax optimisation of variable remuneration, retention of employees, alignment of employees’ remuneration with their employer’s economic performance. It is thus possible to implement an incentive scheme to achieve one particular objective of an employer. Typically, incentives schemes fall into two categories:

- short-term incentive schemes; and
- long-term incentive schemes.

Short-term incentive schemes

In practice, short-term incentive schemes are implemented in order to optimise the tax treatment applicable to variable remuneration. As an example of this kind of scheme, a “warrant scheme” involves the granting of a financial instrument, the warrant, in lieu of a cash payment. Provided that the warrant scheme is correctly implemented and certain conditions are respected, the grant of warrants may benefit from a favourable tax treatment.

Indeed, the Luxembourg income tax law (administrative circular LIR n°104/2 dated 20 December 2012) provides for a lump sum valuation method to determine the fringe benefit linked to the grant of warrants.

Long-term incentive schemes

Long-term incentive schemes are implemented in order to encourage employee retention, and to create a direct link between variable remuneration and the economic performance of the employer.

One of the most commonly used long-term incentive schemes is the stock-option plan. Within this type of scheme, beneficiaries are granted, often at no cost, an option to acquire a company’s shares at a pre-determined price. As the underlying value of the option is based on the value of the company’s shares, this kind of scheme is recommended for fast growing companies because the gain is directly linked to the company’s performance.

There are various forms of stock-option schemes with specific characteristics (e.g. conditional or unconditional grant) that will have an impact on the Luxembourg tax treatment in the hands of the beneficiaries. From a Luxembourg tax perspective, a grant of options generates a fringe benefit in the hands of the beneficiaries which is categorised as employment income and is subject to income taxation at Luxembourg progressive income tax rates (up to a maximum of 43.6%). If the options granted are unconditional and freely tradable (and also subject to other certain conditions), the benefit is taxable at the date of grant of the options (upfront taxation) on a reduced basis determined by applying a lump sum valuation method. If on the other hand the options granted are conditional, the benefit is taxable at the date of exercise of the options, and on the gain realised between grant and exercise.

An alternative to a stock-option plan is a “phantom shares” plan. This plan involves a grant, at no cost, of virtual units, where their value represents the value of a company’s shares. After a locked-in...
Another type of scheme is the share ownership scheme. In such a scheme, beneficiaries are immediately granted, at no cost, shares in the employer company. If an employer wants to avoid equity dilution due to share distributions, a certificate scheme may be implemented. A certificate scheme is a variant of a share ownership scheme, and involves granting of financial instrument the value of which represents the value of a specific business line or of a reference asset.

From a Luxembourg tax perspective, the benefit is taxable when the shares/certificates are granted. This is taxed in the hands of the beneficiaries as employment income at Luxembourg progressive income tax rates (up to a maximum of 43.6%). If the shares/certificates are “blocked” (i.e. cannot be disposed of) for a certain number of years, the value of the benefit on grant is reduced by 5% per blocked year (maximum 20%). Upon subsequent sale of the shares/certificates, the capital gain is exempt so long as the shares have been held for more than 6 months. However, do note that such schemes may be considered as more risky for the beneficiaries, because they would pay tax upfront on the shares/certificates without being aware of the future economic performance of the company.

### Update on FATCA

FATCA was already a topic in one of our previous Information Briefs, and becomes even more important as time passes by. The FATCA provisions will be effective as from 1 January 2014, and entities should therefore ensure that they are prepared. As Luxembourg will sign an Intergovernmental Agreement (IGA) Model 1 likely before the end of 2013, relevant provisions will be implemented into Luxembourg law.

Many entities in the Private Equity industry, namely funds and most holding companies, qualify as Foreign Financial Institutions (FFIs) under these rules, meaning that they will be in scope for FATCA purposes, and most likely subject to FATCA obligations under local law. FATCA may also have an impact on the general partner of Private Equity structures.

In addition, withholding tax on US-sourced income might be an issue for investment vehicles that are transparent for US tax purposes.

Foreign Financial Institutions located in Luxembourg will be divided into two categories: Reporting FFIs and Non-Reporting FFIs. A Reporting FFI will have full obligations under FATCA, whereas a Non-Reporting FFI will have significantly reduced FATCA obligations. In order to qualify for one of the different Non-Reporting FFI categories, the FFI needs to meet certain conditions, depending on the applicable category and in particular the investor structure and distribution policy.

However, it is essential to recognise that not having US investors does not mean that FATCA is irrelevant for the entity. On the contrary, every entity has to be prepared for the fact that from the first half of 2014, their counterparties, potential investors, and banks, as well as entities in which they invest, will increasingly ask for the FATCA status of the entity.

Insofar as they have not already done so, entities must immediately take the decisions and actions necessary to analyse their FATCA status, and become “FATCA compliant” in order to avoid risks for business, investor relation and reputation.

In particular, registration with the IRS through an online portal might be required, depending on the FATCA status of the entity. Following such registration, which can be done as from 1 January 2014, entities should receive a Global Intermediary Identification Number (GIIN). FFIs wishing to be included on the first FFI list, being published by the IRS on 2 June 2014, need to finalise their registration by 25 April 2014.

If you have any further questions, please do not hesitate to have a look at our website [http://www.pwc.lu/en/fatca/](http://www.pwc.lu/en/fatca/) which provides you with further information and the latest updates on FATCA.

Should you have any questions on the above, please contact:

* Michiel Roumieux (+352 49 48 48 3055)
* Eric Paques (+352 49 48 48 3165)

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Luxembourg aims to enhance its position as the International RMB Centre for the Euro Zone

Luxembourg already serves as a hub and entry point for Chinese and international investments into the European single market and, conversely, as a conduit for European investments into China. With a stock of approximately USD 9bn at the end of 2012 (Source: MOFCOM, Statistical Bulletin of China’s ODI, 2012), nearly half of China’s overseas direct investments in Europe are made through Luxembourg.

Luxembourg offers Chinese investors a sound business environment with economic stability, a proven legal and fiscal framework to ensure bureaucratic expediency and tax predictability, a skilled and multilingual workforce and a favourable geographic location and adherence to the Euro Area.

In addition, Luxembourg is home of European headquarters of three of the largest Chinese banks: Bank of China, Industrial and Commercial Bank of China (ICBC) and China Construction Bank (CCB). These banks are using Luxembourg to expand their network throughout the European single market and as a basis for their cross-border RMB activities in Europe.

As the Chinese authorities have been easing RMB transactions for the last decade, Luxembourg is also positioned as the most important RMB centre in the Euro zone with nearly 56bn in RMB deposits and over RMB 67bn loans. With RMB 228bn assets in investment funds, Luxembourg is also the main domicile country in Europe. For more information, please refer to the web portal dedicated to the development of RMB activities in Luxembourg: [www.rmb-business.com](http://www.rmb-business.com) for investments in China. Recently the CSSF approved for the first time in Europe
increased segregation between the location
where taxable profits are separated from the
profits can inappropriately escape tax or
action plan aims to prevent cases in which
July 2013 of the BEPS Action Plan. This 15
its way as from publication by the OECD in
The biggest reform of global tax system is on
to locations with low taxes, resulting in little
"disappear" for tax purposes, or to shift them
different jurisdiction in order to make profits
refers to tax planning strategies that use
erosion and Profit Shifting (BEPS). BEPS
Co-peration and Development) is currently
France, as indicated in the new government
Given the accelerating internationalisation
profitability and competitive advantage for financial firms
positioned themselves accordingly. In this
respect Luxembourg’s position and initiative
contributes strongly to the internationalisation
of the RMB and supports financial firms in their
take advantage of this global
trend.

**The BEPS Action Plan: what are the implications for Private Equity industry?**

The OECD (Organisation for Economic Co-operation and Development) is currently working on solutions with regards to Base Erosion and Profit Shifting (BEPS). BEPS refers to tax planning strategies that use gaps and mismatches in the tax rules of different jurisdiction in order to make profits “disappear” for tax purposes, or to shift them to locations with low taxes, resulting in little or no overall corporate tax being paid.

The biggest reform of global tax system is on its way as from publication by the OECD in July 2013 of the BEPS Action Plan. This 15 action plan aims to prevent cases in which profits can inappropriately escape tax or where taxable profits are separated from the location of the valuable activity where such profits are generated. The OECD has seen an increased segregation between the location
where actual business activities take place and
the location where profits are reported for tax purposes. Underlying the BEPS Action Plan is recognition that there should be tougher tests for assessment of any taxable presence, and
conversely the substance of business activities,
in a particular country. The lack of substance,
treaty shopping, abuse of law, etc. are each
critical areas on which the BEPS Action Plan
focuses.

In this respect, firms should consider carefully the emerging approaches of the
tax authorities of every country where
investments are made or targeted. A review of existing levels of operational substance
within Luxembourg or other jurisdictions
used for holding or financing activities
should be made, as a priority. The OECD has
flagged the inefficiencies in tax treaties as a
trigger of “double non-taxation”. One of the
fundamental purposes of double tax treaties
is to promote bilateral investment and trade.
However, even though the principal way
achieve this goal is to provide taxpayers
with greater clarity and certainty of the tax consequences of investing or doing business
in the source jurisdiction, many states do not
provide that. The aim of the OECD is now to
develop more limitation on benefits provisions
and to include them directly into treaties.
The OECD expects that future treaties will
increasingly include anti-abuse/anti-treaty
shopping clauses in specific articles, including the
business profits and capital gains articles.
The OECD has a real intention to clarify tax
policy considerations to be taken into account
prior to the signing of a tax treaty.

The BEPS Action Plan also intends to ensure
activity is optimised from a substance
perspective. In order to achieve this goal,
the OECD would like to revamp the work
on harmful tax practices with a priority
on improving transparency, including also
compulsory spontaneous exchange on
rulings related to preferential regimes, as
well as insisting on substantial activity before
any such regime can be seen as acceptable.
Actually, it seems that the major source of
the problem is the privileged tax regimes
created by states. Some regimes are harmful
and OECD seeks to develop a commentary
on them in order to discourage certain states
to adopt or maintain such regimes. However,
full transparency and sufficient economic
activity are also objectives that the OECD
endorses, meaning that countries should
be free to develop tax regimes to encourage
investment and such economic activity.

Furthermore, it is also very important to
keep in mind the arm’s length principle and
particularly when intra-group financing
arrangements are set up. Tax treatment
within a country should essentially be the
same whether payments are made to a group
entity or to a third party. As a further action
point, the OECD thus seeks to develop further
guidance on guarantees and other financial
instruments.

Investors might face claims when considering the
distribution of any income or the exit
from a low-tax jurisdiction. To avoid this,
governments will be looking to reinforce their
requirements regarding the substance of
companies, who in turn may need to consider
consolidation of their management functions
within the country.

**CRD IV impacts on investment firms**

The Capital Requirements Directive IV (“CRD IV”) package transposes into European law the
“Basel III” agreements. Basel III aims to put in place new sets of regulatory capital, liquidity and supervisory rules for banks and investment firms. For banks, the legislation will mostly involve higher capital requirements.

In this context CSSF Circular 13/575, on supervisory reporting applicable to investment firms, was implemented in Luxembourg on 18 November 2013.

According to the Circular the financial reporting (FINREP) and prudential reporting (Common solvency ratio Reporting - COREP) obligations will now be applicable to investment firms that fall within the scope of the Capital Requirements Regulation CRR - a European transposition of Basel III) and not only to credit institutions.

Investment firms that are allowed to deal, underwrite or place financial instruments for their own account, or any investment firm that
is authorised to provide the ancillary services of safekeeping and administration of financial instruments for the account of clients, will be subject to the so-called extended COREP Basel III prudential reporting. However, in some circumstances, investment firms with limited authorisation may be subject to a smaller subset of measures (i.e. liquidity, leverage, large exposures, forbearance and immovable property tables may be waived).

Only those investment firms that are neither allowed to perform any of the above-mentioned activities nor have the authorisation to provide safekeeping and administration of financial instruments for the account of clients could escape these obligations. Such firms may either be totally exempt from reporting, or remain subject to the obligation under current CSSF Circular 07/290, depending on their particular situation.

The new extended COREP templates will be applicable as of 1 January 2014, both on a stand-alone and (sub) consolidated basis.

Concerning the FINREP, only those investment firms subject to both the publishing of consolidated accounts under IFRS and to the supervision of a consolidated basis are currently impacted, as reporting on an individual basis or for firms under Lux GAAP remains, for the time being, unchanged.

With the increasing regulatory changes that affect the Private Equity industry, many firms are little by little becoming affected by the increasing weight, complexity and uncertainty of these reforms. PwC Luxembourg helps a range of banks and investment firms to get to grips with the practicalities of CRD IV, as well as seeing their interdependency with other regulations. We can look at all regulatory changes affecting your business. This approach helps financial institutions to minimise the impact of regulatory changes, and to look at how these changes may affect their business models.

The VAT authorities announce that risk management services for funds are VAT exempt

On 7 November 2013, the Luxembourg VAT authorities have issued a circular-letter where they set out their position on the concept of “management of special investment funds”, this activity being VAT exempt under the Luxembourg VAT law. This position has been taken as a follow-up to the amendments made to the VAT law in the context of the implementation of the Alternative Investment Fund Management Directive, and more specifically to the inclusion of alternative investment funds in the Luxembourg list of “special investment funds” qualifying for the exemption. Please refer to our previous PE newsletter for more information on this subject.

In this circular-letter, the Luxembourg VAT authorities indicate that risk management services provided to qualifying funds are part of their management, and are therefore exempt.

Where the risk management function is outsourced, this should remain exempt subject to certain conditions. The new circular-letter refers to the conditions briefly mentioned in a previous circular-letter dated 30 April 2010 (Circular n° 723bis), which itself refers to some principles laid down by EU jurisprudence.

This new development brings another welcome clarification to the Luxembourg VAT rules. However, as the VAT exemption clearly depends on the nature of the services, on the individual circumstances of the supply and as it is subject to specific conditions when outsourced, we nevertheless recommend a careful case-by-case analysis.

Should you have any questions on the above, please contact:

Laurent Grençon (+352 49 48 48 2060)

The new Government coalition programme

On 2 December 2013, the new Luxembourg Government released its coalition programme. PwC has made an analysis of the tax-related content of this programme.

As with statements made in recent months by other EU countries (such as Ireland and the UK), the measures announced by Luxembourg confirm the wish of the new Government to retain and build on Luxembourg’s reputation for tax stability and to guarantee its competitiveness in an international context, while at the same time complying fully and positively with international initiatives towards increased transparency, and the fight against tax fraud.

For more details, please find here PwC’s latest Flash News with our analysis. We hope you will enjoy reading it.


PwC’s Academy’s Private Equity training

PwC’s Academy is happy to present a poster of all our Private Equity Training. It gives you easy access to the know-how of our PwC experts in this field.

This poster, in an interactive version, is available on the PwC’s Academy website: http://www.pwacademy.lu/Lists/Publications/Poster%20Private%20Equity.pdf

We will be happy to send you copies of this poster by mail.

All of our open courses can also be organised as client specific sessions on request, in a language of your choice.

For more information, please see www.pwacademy.lu
To get started, call:

Vincent Lebrun
Tax Partner
Private Equity Industry Leader
+352 49 48 48 3193
vincent.lebrun@lu.pwc.com

Valérie Tixier
Audit Partner
Private Equity
+352 49 48 48 2117
valerie.tixier@lu.pwc.com

Véronique Lefebvre
Audit Partner
Assurance Private Equity Leader
+352 49 48 48 2019
veronique.lefebvre@lu.pwc.com

Jean-François Kroonen
Corporate Finance Partner and Advisory Leader
Private Equity
+352 49 48 48 2149
jean-francois.kroonen@lu.pwc.com

Laurent Grençon
Tax Partner - VAT services for Private Equity and Real Estate Structures
+352 49 48 48 2060
laurent.grencon@lu.pwc.com