FUNDS & LOANS REGULATION

GIBRALTAR - THE KEY TO EUROPEAN PRIVATE EQUITY FUNDS

*By James G. Lasry**

Recent reforms in Gibraltar's tax and fund legislation, including the phasing out of the tax exempt company regime as a result of pressure from the European Commission and the introduction of the Experienced Investor Fund regime, have granted investors and their advisers a simple and effective way to structure funds and enabled Gibraltarian companies and funds to access the benefits of the European Parent Subsidiary Directive[1] turning Gibraltar into the jurisdiction of choice for European private equity and property funds.

THE PRIVATE EQUITY TAX DILEMMA

The classical private equity tax dilemma is how does a fund (or any investment structure for that matter) extract dividends from its investee companies without being subject to the double taxation of withholding tax at the investee company level and corporate tax at the fund (or holding) company level. While any tax liability can often be minimised through the use of tax treaties and, with respect to European investee companies, the Parent Subsidiary Directive, it is difficult to find a solution where the profits from the investment will not be taxed at the holding company level. Jurisdictions such as Luxembourg, the Netherlands and Cyprus have been used with some success but there are certain inherent difficulties in each solution. The "Netherlands Antilles Sandwich" used to be a very effective way of extracting dividends from the European structure without any withholding or corporate tax leakage. Changes in the Dutch and Netherlands Antilles tax regime some years ago, however, do cause some tax leakage in the structures at present.

The use of Luxembourg holding companies can be an effective solution but a problem can arise as a result of the obligation on Luxembourg companies to withhold tax on dividends to shareholders. There are par-

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1. Directive 2003/123/EC.

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tial solutions to avoid this tax one requiring a delay of one year for the extraction of dividends. This is usually unacceptable to investors. Another solution is a dual and triple Luxembourg company structure whereby the profits of the Luxembourg companies are sent to their investors by liquidating the company and interposing another company in its stead. Luxembourg does not charge withholding tax on the proceeds of liquidation. This can be an expensive method for the distribution of profit. Still another solution involves the use of complicated profit participation loans that use an interest rate that corresponds with the level of profit on equity. The profits are therefore distributed as interest payments.

The ideal solution is for investors to be able to extract dividends from the Luxembourg company via a company or fund established in a jurisdiction that, on the one hand does not impose a withholding tax on dividends to its investors and on the other hand can take advantage of a mechanism that allows it to avoid any withholding tax on such dividends as a result of a tax treaty or the European Parent Subsidiary Directive.

Funds and companies established in the Channel Islands do not have access to the Parent Subsidiary Directive as the Channel Islands are not part of the European Union and thus they must resort to the costly and/or cumbersome solutions referred to above.

The Gibraltar Solution

The solution is to establish the fund or investment vehicle in Gibraltar. This opens up substantial opportunities for private equity or property funds. If the fund is incorporated in Gibraltar, and it incorporates a wholly owned subsidiary in Luxembourg, the fund will effectively have the benefits of Luxembourg's tax treaties as well as access to the Parent Subsidiary Directive. As a result, dividend distributions by a Luxembourg companies to its Gibraltar parent will not suffer withholding tax.

For example, if the fund invests in a German company (as a wholly owned subsidiary or at least with a relevant participation as per the Parent Subsidiary Directive) then the German company—after paying any German taxes on its income, whether it be rental income on a commercial property or commercial income from a business—can pay its dividends to its Luxembourg parent without paying any German withholding tax. Once the dividends reach the Luxembourg Company, those profits can be sent as dividends to the Luxembourg Company's Gibraltar parent without suffering any Luxembourg withholding tax. In Gibraltar, the dividends will not be taxed as they are generated from the proceeds of a European parent subsidiary relationship. There is no capital gains tax, wealth tax or estate duty in Gibraltar. Furthermore, there is no Gibraltar withholding tax on dividends paid to non-Gibraltarian resident shareholders of a Gibraltar company. The profits, therefore, of the German investment will have been effectively repatriated to the investors in the fund without any tax leakage (other than German internal tax on the company's earnings).

Cyprus' position is similar to that of Gibraltar although many clients seem to opt for the Gibraltar option due to the effective fund regime and Gibraltar's reputation as a well regulated finance centre. Indeed in May 2007 the International Monetary Fund praised Gibraltar as a well regulated jurisdiction that is superior to many of its larger competitors.

Part of the *quid pro quo* with the European Commission for the phasing out of Gibraltar's tax exempt company regime was that the European Commission communicated to the Member States that the Parent Subsidiary Directive should be applied to Gibraltar tax resident companies in the way that it would be applied to companies that are tax resident in any other member state. Gibraltar is, of course, within the European Union by virtue of Article 299(4) of the Treaty of Nice[2] and up until recently, many jurisdictions took the view that since Gibraltar is not an actual Member State, they would not apply the directive to Gibraltar companies even though European directives apply to Gibraltar and must be transposed into internal legislation. At present, some jurisdictions are either unaware of this development and some have even decided not to apply the directive to Gibraltar companies in contradiction to the Commission's notice.

Certain jurisdictions, including Luxembourg have taken a view that if the Gibraltar company is properly tax resident in Gibraltar and if it has a relevant participation in a Luxembourg company, the Luxembourg authorities will not tax dividends paid from a Luxembourg company to its Gibraltar parent.

The Gibraltar Experienced Investor Fund Regime

Gibraltar's Experienced Investor Fund (EIF) regime under the *Financial Services (Experienced Investor Funds) Regulations 2005 (*the EIF Regulations) is a very quick and efficient way to structure a fund, whether a hedge fund or a private equity/real estate fund where the intention is to market such fund to experienced high net worth investors. Experienced investors are defined in Gibraltar as investors who are generally demonstrably experienced in making investments or those who have a net worth in excess of one million Euro besides their principal place of residence or those who have invested 100,000 Euro or equivalent in the fund.

The EIF's board must include two Gibraltar-based resident directors who are authorised by Gibraltar's regulator, the Financial Services Commission (FSC), to act as directors of such funds. In practice having experienced independent directors on the board, who are answerable to both investors and the regulator for the decisions they take, helps to ensure there is "substance" to the fund's board which is important both from a fiscal and a regulatory perspective. As individuals who have been approved by the FSC are on the Board of the EIF it allows the FSC to oper-

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2. The Treaty of Nice (2001/C 80/01).

ate a "light touch" approach to regulation as the Commission can rely on the directors to notify them of any breaches of the EIF Regulations.

An EIF must have an authorised Gibraltar based administrator and must be audited annually by a Gibraltar-registered auditor. Custody of the assets is not restricted to Gibraltarian service providers and the funds assets may be kept with any authorised depository or broker that is deemed acceptable to the FSC. In certain cases, there are distinct legal advantages to using a Gibraltar-based custodian particularly with funds structured as Protected Cell Companies (see below). A closed ended private equity or real estate fund will generally own assets other than the fund's cash.

An EIF must produce a prospectus that complies with the EIF Regulations. One of the unique advantages of the EIF is that the fund can begin trading on the basis of the approval and issue of the prospectus by the Board of the fund as long as, within fourteen days of launch, the fund's prospectus, memorandum and articles of association and certain other documents are lodged with the FSC along with a legal opinion from a Gibraltar lawyer of at least five years' standing that certifies that the fund complies with the EIF regulations. These documents are presented to the FSC by the administrator along with a basic informational form and an application fee of 2,500 British pounds. The FSC may request further documentation or even on occasion, amendments to the prospectus. The huge significance of this is that there is no regulatory down time to the authorisation of a fund. If necessary, a fund can be set up in a matter of days as many of the service providers can offer turnkey solutions.

Legal Structure

Funds in Gibraltar are usually structured as closed or open-ended investment companies and as either "simple" companies or protected cell companies (see below). It is also possible to structure them as unit trusts and limited partnerships.

The fund can be managed by its directors or by investment managers. Investment managers that manage funds in or from Gibraltar require a licence from the FSC in Gibraltar to do so. Directors who manage a fund do not require any specific licensing, save for the Gibraltar resident directors in EIFs who must be approved to act as directors of such funds. Most funds have personal rather than corporate directors. Regular board meetings are held in order to ensure that management and control is fully exercised in Gibraltar. Any third party investment managers used by the fund must be authorised to provide such services in their jurisdiction of operation. Gibraltar funds may also be listed on a variety of exchanges. A stock exchange is currently being established in Gibraltar to allow for fund and company listing.

Protected Cell Companies

A further attraction of Gibraltar for private equity and property funds is the availability of Protected Cell Companies (PCCs). PCCs, established under the Gibraltar Protected Cell Company Act 2001, enable the statutory segregation of assets and liabilities in different cells. The PCC legislation allows a fund to be set up so that there is segregation of assets and liabilities in an umbrella structure (*i.e.,* that includes different subfunds) where it is essential to ensure that there is no liability contamination between sub-funds. Where non PCC multiclass funds rely on a purely contractual arrangement between shareholders as set out in the articles of association, the PCC Act gives a statutory basis for the segregation of assets that binds third parties as well. Sub-funds or cells can be used by separate investors or by one investor wishing to promote several investment strategies. PCCs may be licensed as either EIFs for professional investors or as licensed funds for retail investors.

The establishment of a PCC as an EIF has become a popular method of structuring property funds and private equity funds in Gibraltar. Segregated cells are established either for specific investments or for subscription over a certain time period for investment in multiple projects. Investment in PCCs is however by no means limited to property. A fund manager may establish a PCC has his or her personally branded business vehicle in order to provide a regulatory framework for investment. Individual cells may then be established according to investment strategy, geographical emphasis or even for certain clients such as insurance companies or pension funds that may require asset segregation under the terms of their own mandates. There is no limit to the number of cells a PCC may create.

Conclusion

The combination of Gibraltar's effective EIF regime and the ability of Gibraltar funds to make use of the Parent Subsidiary Directive provides a strong solution to private equity and real estate funds that plan to invest in Europe or indeed in countries within Luxembourg's formidable treaty network. Although it is still early days—the legislation is only two years old—Gibraltar has already managed to attract funds sponsored or advised by the likes of Goldman Sachs, Bear Sterns, Credit Suisse and Patron Capital, which recently launched a billion dollar property fund in Gibraltar.