

Tax in asset management: International tax

Transcript

SPEAKERS:

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ERIC COOMBS: Welcome to the Grant Thornton podcast, where we share information about the latest trends and business issues of the day.

I'm Eric Coombs, Tax Services Leader for Grant Thornton's asset management practice.

As part of our series on key tax issues in the asset management industry, I'm speaking today with Cory Perry from our Washington National Tax Office that focuses on international tax. So Cory, thanks for taking some time to chat with us today. Appreciate you joining the podcast.

CORY PERRY: Yeah. Thanks for having me, Eric.

ERIC COOMBS: Maybe we'll just start at sort of the macro level. What are the sort of hot topics in the international tax space that are impacting asset managers?

CORY PERRY: Yeah, absolutely. There are a lot of issues in the international tax space, and it's been developing pretty rapidly over the past couple of years, but I'll just hit on two of the topics that I'm speaking to clients about most currently.

That's YA Global. YA Global is a case that deals with U.S. trade or business issues, and the reason this case is particularly significant is it's an area where we really haven't had any law or authoritative guidance for decades, so any guidance in this area certainly is a major development. And that combined with the potential increase in IRS enforcement that we've been seeing — there's the IRS audit campaign for loan origination on inbound investors.

There's also the IRS's focus on BBA and partnership audits.

The two of those combined makes that a very significant item for asset management firms. And beyond that, the other item I would hit is global tax transparency and really Pillar 2, which is a global minimum tax, and although you wouldn't think of this one as being a direct impact on asset management clients, it can actually have a direct impact as well as an indirect impact. So it's certainly one to have on the top of your mind when you're considering some of the developments for 2024.

ERIC COOMBS: Fantastic. So diving down into some greater detail on each of those issues. Let's start, maybe with the YA Global case.

Are there any key takeaways from that case that we can sort of expand to broader application within the asset management space?

CORY PERRY: Yeah, sure. There's a number of key takeaways. As I said, there hasn't been really any authority in this space for a number of years, and although this is a unique case, it is a situation where we now do have something to look to, to sort of understand the direction the IRS might go in enforcement. And it certainly presents an opportunity for asset managers to take a look at what they're doing.

I think a lot of people have focused more on what market's doing and what market is doing has sort of laxed a little bit, I'll be honest, because there hasn't been much authority and there's been a belief that there hasn't been much risk out there, and in many structures, I think that remains to be the case.

But certainly I think a fresh look is in order, and it may help, Eric. if I just hit some of the highlights of the case.

ERIC COOMBS: Yeah.

And even if you could point out some of the sort of red flag issues that that might have resulted in a negative outcome for YA Global that our listeners might be able to take back and apply in their own facts and circumstances.

CORY PERRY: Yeah, absolutely. So the case, in YA Global, the Tax Court ruled in favor of the government, and they found YA Global to be engaged in a U.S. trade or business. And they also found YA Global to be a dealer in securities.

And what the IRS focused on was whether it generated U.S., what we call effectively connected income, which at its core is, did it have enough activity in the U.S. to be engaged in a trade or business such that its income — either some or all, and I'll talk a little bit more about that, is subject to U.S. tax and most of these structures trying to take the position, they're usually set up as partnerships with a blocker — usually a Cayman corporation that the foreign investors come in through.

They attempt to take the position that they're not engaged in a trade or business and that the income of the fund is not subject to U.S. tax. In this case the fund filed the Form 1065, but importantly did not file any withholding forms like Forms 8804 or 8805, which you generally use to report effectively connected income. And so the court found that although this was in 2006 through 2008 and the statute may have otherwise closed, they found the statute to be open because they didn't file those forms, which is an important item to take note of.

Normally these funds will file Form 1065s, but they often don't file protective Forms 8804, and

that's something I think the industry is kind of coming around to and starting to think more about.

So in the case, it's a little bit unique here in the facts in the way that they operated.

So YA Global was a Cayman Island fund, and it provided capital to portcos, and it did that through two items.

It did debt offerings — a fairly considerable amount, which is usually problematic — and it also purchased convertible bonds and entered into what they called standby equity distribution agreements or SEDAs.

And those are unique instruments in that they're effectively buying at a discount and looking to quickly sell those. So our normal private equity client, they're looking for long-term holds, right, capital gains, and usually you don't associate that with a trade or business.

The unique fact here is that they were entering into almost like these margin transactions where they're buying stock at a discount and looking to quickly sell those in order to capitalize the company more quickly.

So unique fact there, obviously not a standard type of business activity for these types of funds. But beyond that, the other items in the case that were interesting was that there was a management agreement between YA Global and Yorkville.

Yorkville was the manager, and they found for a variety of reasons that Yorkville was an agent of YA Global, and therefore they could attribute the activity of Yorkville to YA Global. There was a long discussion about agency relationship, and in particular why Yorkville was a dependent agent, but the one item I would point out here, and it was an interesting item in the case, is they spent some time on fees and the fees arrangement.

Oftentimes when we're trying to separate the manager from the fund, the fund won't be entitled to any of the ordinary returns from fees, just sort of the more investment-focused returns.

And in this situation, the offshore fund and the manager were effectively sharing the fees. The manager was collecting the fees, netting costs, taking a small return and sharing those fees with the funds.

So I would say that certainly requires some fresh look at some structures where there's fee sharing going on or fee offsets. Certainly, I don't think this case upsets those arrangements in most cases, but I do think it's worth a fresh look, particularly if you have a unique fee-sharing arrangement.

So a lot to take in there, Eric, but that's a rough summary with some of the items to think about.

ERIC COOMBS: Yeah, no.

Certainly can appreciate the fact that this was a fairly unique case and a fairly unique fact pattern, but certainly some themes in there that our audience may want to be aware of, and to

your point, perhaps a good time for some self-reflection and ensuring that your organization is properly structured so as to avoid a negative outcome of something like this case happening.

Fantastic. So we talked about YA Global. You mentioned Pillar 2 is being sort of the second hot topic.

Maybe if you wouldn't mind, you could just expand upon what is Pillar 2, and how is that impactful to our asset management clients and the asset management industry as a whole?

CORY PERRY: Yeah, absolutely.

Pillar 2 is unique.

The U.S. has not adopted Pillar 2 yet, but the rest of the world, for the most part, has begun to move forward, particularly the EU, but many other countries as well.

And just to level set here, what Pillar 2 is, is it was a base erosion provision that was brought about by the Organisation for Economic Cooperation and Development, or the OECD, and at its core it's a global minimum tax of 15%.

That's an effective rate.

So any company, this is large multinationals, generally, and we'll come back to that obviously, but that pay tax, they're looking to ensure that that rate is at least 15%, no matter where those profits are, no matter if it's the Cayman Islands, whether it's Ireland, whether it's United States or somewhere else, the idea is that all profits are subject to 15% and you have this level playing field.

Now it only applies to large entities, at least \$750 million in consolidated global revenue that are subject to tax in at least two jurisdictions. So it doesn't apply to smaller entities, but it does apply broadly to anyone that meets that threshold.

It operates through a three-pronged approach and it's a little unique in the way it does that. It starts at the lowest level, which is the local jurisdiction. Those jurisdictions may implement QDMTT or Qualified Domestic Minimum Top-up Taxes.

That's effectively a local tax that would get you to 15%.

So think Ireland, tax is 12 1/2%. If below 15%, if they're in scope, Ireland will tax them up to 15% and there's no further tax in the system.

The next is an income inclusion regime for those familiar, that's similar to our GILTI system.

That's a top-up tax. So if you have a parent that has a subsidiary that isn't locally taxed at 15%, either under the QDMTT or otherwise, this system will tax it up to 15% at that parent level.

The last mechanism is the backstop, the undertaxed profit rule, which effectively looks at all income of the consolidated group.

If it's not subject to 15% tax under one of those other two mechanisms, it determines what the

tax should be and it shares it amongst all member countries that have enacted Pillar 2 laws. So through one of those three mechanisms, Pillar 2 looks to tax income at 15%.

So that's the background. Why should asset management companies and funds care about this?

Well, there's two ways in which it can impact the industry.

There's a more direct impact that can occur, although there's large carveouts for investment funds and other similarly situated or similar-type vehicles, there are certain fund structures that can get caught in certain situations. Although rare, there are consolidation rules that can pull in other entities that you may not expect, but I think more likely is fund managers, in particular, fund managers themselves can be subject to this, and there's a number of taxpayers that are that are large fund managers.

They have boots on the ground in multiple countries and they exceed that \$750 million. They likely could be subject to these taxing rules? It depends on where they're located and a number of other factors, but it's certainly something to think about for the management structure.

Then there's the indirect impact, which can also apply. In particular there what I mean is your portcos, if you're a private equity fund, might be subject to these rules.

Now again, we may not be mixing portcos because it works off of financial statement consolidation and oftentimes different portcos may not be required to consolidate, but nevertheless, within those portcos, if you meet that threshold, your investment could be subject to this.

So if there's low tax planning that you've contemplated on your return of that investment, that that may not have as much longevity because these rules are targeting that, that type of planning. Some major items to think about from a Pillar 2 perspective, Eric.

ERIC COOMBS: Fantastic. And when does this all generally go into effect?

CORY PERRY: Yeah.

So 2024 is the first year that it could apply for the QDMTT, the local tax and the income inclusion regime.

So those come online first in most jurisdictions, and then the undertaxed profit rule would come online in 2025.

There are some exceptions for smaller jurisdictions where the rules can be deferred to 2029, but most major countries are implementing in 2024 or 2025 depending upon the rule in question.

ERIC COOMBS: Great, Cory, so you've given us a lot to think about there between the YA Global case and implementation of Pillar 2 reporting requirements. So appreciate you taking some time to chat with us and explain these topics a bit further to our audience. And for our audience, if you want to learn more, please log in to [gt.com](https://www.gt.com) for additional information. Thank

you.