Latin American Private Equity on the Rise

by Daniel Chavez

According to recent figures provided by the Latin American Private Equity and Venture Capital Association, 2013 was a record year for private equity in Latin America, with approximately $8.9 billion of total investments (a six-year high and a 13 percent increase over the previous year), $5.5 billion of funds raised and $3.7 billion in proceeds generated by exits. The data also show that the market is still dominated by Brazil (with 43 percent of funds raised and 68 percent of total amount invested), while Mexico, Colombia, Peru and Chile continue to experience increasing activity.

Despite the disappointing performance of some of the region's economies in the last couple of years, Latin America continues to be an attractive market for private equity investors. During the past decade, robust economic growth in the region as a whole, civil stability and sound policy-making have created solid investment opportunities in Latin America, and strong macroeconomic fundamentals support the region's continued growth prospects.

Population growth and increasing urbanization rates in the region continue to drive up demand for power and public infrastructure. At the same time, strategic reasons and the need to find effective hedges against inflation are still driving international investors towards Latin American markets, which can offer a steady supply of minerals and other raw materials. This growing demand for infrastructure, natural resources and power in the region has created substantial investment opportunities for private equity investors.

Additionally, a growing and young middleclass population in the region's largest markets continues to fuel investors' appetite for middle-market opportunities in industries such as consumer products, retail, health care and financial services.

A large presence of family-run businesses and fragmented industries in Latin American economies, as well as the fact that public markets in the region are still dominated by natural resource companies and banks, create a need and an opportunity for private equity, local and foreign, to fill in the investment gaps.

An Improving Regulatory Environment

The regulatory environment for private equity funds and investors in the major Latin American markets continues to improve. On the fundraising side, ongoing efforts by local regulators to ease the restrictions for institutional investors in private equity have resulted in increased private equity allocations by pension funds and insurance companies. However, there are still some challenges for fund managers trying to raise funds from institutional investors in these markets. For example, some large pension funds in Brazil still demand a seat on the investment committee as a condition for investing in a fund. Whereas, countries such as Chile and Mexico only allow their pension funds to invest in locally registered funds, forcing foreign fund managers to set up local feeders to attract investment from institutional investors. Despite recent efforts in some jurisdictions (most notably Mexico and Peru) to reduce the number and complexity of procedures to form new investment vehicles and to register local feeder funds with securities regulators, these processes are still more burdensome and time consuming than those in more developed markets.

Restrictions on foreign investments in the region are gradually disappearing. With the unfortunate exceptions of Argentina, Cuba and Venezuela (where tight exchange controls and reporting requirements continue to hinder foreign investment), all Latin American countries have eliminated exchange controls, as well as minimum stay and reserve requirements. Foreign investments in these countries are no longer subject to prior approval, although they must still be registered with the central banks in order to guarantee access to foreign currency for repatriation.

Capital markets in Latin America also continue to develop, thereby providing investors a greater supply of securities, larger sources of funding and a feasible exit strategy that were not available before (outside of Brazil and Mexico). The integration in 2011 of the stock exchanges of Chile, Colombia and Peru in what is called the Latin American Integrated Market has created the second biggest market of Latin America in market capitalization, behind Brazil's BM&FBOVESPA. In 2013, the region saw eight private equity-backed initial public offerings in Brazil, Mexico and Chile, and the number is expected to increase in 2014.

Another favorable development in the region is the increasing adoption by major markets of international accounting standards. Chile, for example, has recently made International Financial Reporting Standards (IFRS) mandatory for both listed and private companies. Other countries, such as Argentina, Brazil, Mexico and Peru, require listed companies to use IFRS and, although they do not formally allow private companies to use these standards, they have been gradually incorporating international principles into their local accounting standards. On the other hand, Colombia, whose national accounting standards diverge significantly from IFRS and U.S. generally accepted accounting principles, is still lagging behind other counties in the adoption and implementation of international standards.

Remaining Challenges

Despite enjoying an increasingly favorable regulatory environment in the region, private equity investors still face significant challenges in Latin America. For instance, weak record-keeping practices and inadequate internal reporting systems in some industries combined with deficient public records complicate investors' due-diligence efforts; also, the prevalence of family-controlled companies where ownership and management are closely tied together can hamper post-acquisition integration in some cases.

With the notable exception of Chile and Uruguay, where the levels of perceived corruption (according to Transparency International) are comparable to those of developed countries such as the United States or Japan, rampant corruption is still a major concern for investors in Latin America in spite of recently enacted anticorruption legislation in Brazil, Mexico and Peru. Investors in regulated industries, as well as those who make use of local agents and consultants to secure government contracts or approvals, need to conduct serious pre-acquisition due diligence and be ready to implement robust post-acquisition compliance programs in order to mitigate their exposure in this regard.

Another important obstacle for foreign private equity investors is the prevalence of slow, inefficient and sometimes corrupt judicial systems in Latin America. While private contracts are generally upheld, judicial disputes are lengthy and cumbersome, which has promoted the use of international arbitration in cross-border transactions. Nevertheless, enforcing such arbitral decisions can be costly and problematic in some countries.

To be fair, these challenges are not different from, and in most cases not worse than, those encountered by investors in other emerging markets. But investors looking to enter Latin America would be well advised to seek the help of partners and advisors with specific experience in those countries in order to navigate the new landscape and to mitigate the risks involved.

Conclusion

Favorable macroeconomic trends and positive regulatory developments continue to make Latin America an attractive destination for private equity investors looking for acceptable returns in relatively stable emerging markets. Not surprisingly, some challenges remain for foreign private equity investors entering the region, but most of these risks should be manageable for investment teams and advisors with sufficient experience in those jurisdictions.

Tax Considerations When Acquiring Non-U.S. Portfolio Companies—Mitigating Subpart F Inclusions

by Robert A. Clary II, Jeffrey C. Wagner, Thomas P. Ward and Daniel N. Zucker

Overview

It is important for private equity purchasers to mitigate the creation of Subpart F income in structuring the acquisition and holding of the stock of a non-U.S. portfolio company. This article will explore what Subpart F income is, why it should be mitigated and the structuring techniques that can accomplish that goal.

Subpart F income is certain categories of income generated by non-U.S. entities that are classified as controlled foreign corporations (CFCs). Generally, this is income of a passive nature (*i.e.,* dividends, interest, rents, royalties, capital gains). Subpart F income also includes certain income of a CFC from related party transactions, such as related party sales or services transactions.

Subpart F income is unattractive because it can be triggered in unfavorable circumstances and is subject to higher U.S. tax rates. The income is taxed to certain private equity (PE) fund investors irrespective of whether the investor actually receives cash. Said differently, Subpart F income is dry income—the recipient is in the unfortunate position of having a taxable event without necessarily having an associated cash inflow. In addition, for U.S. individual investors [whether through direct investment or investment through a flow-through vehicle, such as a limited liability company (LLC), limited partnership or S corporation], Subpart F income is taxed at ordinary income rates rather than the preferential rates that generally apply to capital gains and dividends. A U.S. investor in a PE fund will generally expect capital gains treatment (a top rate of 20 percent) on all income generated through a PE investment (with the exception of any interest income that is contemplated). Therefore, incurring a dry income inclusion at ordinary U.S. income tax rates (a top rate of 39.6 percent) as a result of a Subpart F inclusion is very unattractive. In addition, the 3.8 percent surtax on passive income enacted as part of the Affordable Care Act applies to Subpart F income. Thus, before taking into account any U.S. state or local taxes that may be due, a U.S. individual investor in a PE fund could be subject to a 43.4 percent U.S. federal tax on each dollar of Subpart F income that is created through the holding of a non-U.S. portfolio company by a PE fund. Furthermore, as noted above, it is unlikely the investor will have received any cash to pay the tax bill.

Base Case Example

To help illustrate the ill effects and structuring alternatives to mitigate Subpart F income in connection with an investment by a PE fund in a non-U.S. portfolio company, we'll discuss various alternatives based on the hypothetical, but common, example below.

> PE Fund is organized as a U.S. limited partnership. PE Fund's investors consist of: (1) U.S. taxable individuals and flow-through entities owned by U.S. taxable individuals (*e.g.*, LLCs and S corporations); (2) U.S. taxable corporations; (3) U.S. tax-exempt investors and (4) non-U.S. investors. PE Fund wishes to invest in a UK portfolio company, UK Target, and will acquire 90 percent of the equity of UK Target, with UK Target management receiving a 10 percent equity stake in UK Target going forward. UK Target owns multiple subsidiary companies around the world, including certain U.S. subsidiaries. To acquire the UK Target, the PE Fund establishes an acquisition vehicle in Luxembourg (LuxCo). LuxCo in turn establishes an acquisition vehicle in the United Kingdom. (UK TopCo) to acquire UK Target. PE Fund capitalizes LuxCo with cash in exchange for common equity and convertible preferred equity certificates (instruments generally characterized as equity for U.S. tax purposes, but debt for Luxembourg purposes). LuxCo then capitalizes UK TopCo with cash in exchange for common equity (90 percent) and debt (generating an interest deduction in the United Kingdom) of UK TopCo. Management of UK Target rolls over into UK TopCo. UK TopCo then acquires the stock of UK Target.

In the structure above, because each of LuxCo, UK TopCo, UK Target and any non-U.S. subsidiary of UK Target constitute a CFC, Subpart F income risks exist. To the extent

Subpart F income is generated, the taxable U.S. investors (individuals and corporations) in PE Fund will be subject to U.S. taxation on such income. First, under current law, the interest income on the loan from LuxCo to UK TopCo would constitute Subpart F income. Similar loans between CFCs in the structure could generate Subpart F income. Further, dividends paid from the non-U.S. subsidiaries of UK Target to UK Target could constitute Subpart F income under current law. In addition, sales or service arrangements between UK Target or one or more of its subsidiaries could give rise to Subpart F income. Finally, as PE Fund eventually looks to monetize its investment, an exit whereby LuxCo disposes of its shares of UK TopCo could generate Subpart F income.

Mitigating Subpart F

The recent expiration of certain U.S. tax provisions preventing Subpart F income on interest or dividend payments between related non-U.S. companies has created new challenges in mitigating the negative consequences of generating that type of income. During the last several years, a helpful provision has been Internal Revenue Code section 954(c)(6), which generally allows for dividends, interest, rents and royalties to be paid to related CFCs without creating Subpart F income. Under section 954(c)(6), the interest on the loan from LuxCo to UK TopCo in the base case example above would not be Subpart F income. However, section 954(c)(6) was enacted as a temporary provision and expired on December 31, 2013. While it is largely anticipated that the provision will be extended retroactively to the beginning of 2014 as part of the extension of a package of similar temporary measures (including, for example, the research and development tax credit), this provision is currently unavailable. Therefore, under current law, the interest on the loan from LuxCo to UK TopCo (and potentially others loans in the structure between related CFCs) constitutes Subpart F income.

One mechanism that is currently available to manage Subpart F income is through tax rules commonly referred to as "check-the-box" rules, allowing for the elective tax classification of non-U.S. entities. Specifically, these provisions allow taxpayers to choose the classification of a non-U.S. entity as between a corporation, partnership or branch (disregarded entity). As discussed above, Subpart F income can arise as a result of transactions between related companies. Thus, there is often a preference to make elections for U.S. tax purposes to treat entities as branches (or disregarded entities) of a single non-U.S. company such that transactions between the entities are disregarded for U.S. tax purposes. In the base case, it would likely be possible to check-the-box to treat all the entities below UK TopCo as disregarded entities. This strategy would allow transactions between subsidiaries of UK TopCo to be disregarded for U.S. tax purposes and limit the situations where Subpart F income can be created. However, because UK TopCo has two owners (LuxCo and management), an election cannot be made to treat it as a disregarded entity for U.S. tax purposes. Rather, under the check-the-box rules, UK TopCo can only be classified as a corporation or partnership. Therefore, there will continue to be risk of Subpart F income on the interest income of LuxCo on the loan to UK TopCo.

Separate from tax elections of the acquired entities themselves (and the holding company structure above them), proper fund structuring can mitigate Subpart F risks, as well. As discussed above, the Subpart F rules are only applicable to the extent one or more non-U.S. entities in the target's structure are characterized as CFCs. A CFC is a non-U.S. entity that is owned more than 50 percent (by vote or value) by "U.S. Shareholders." A U.S. Shareholder is any U.S. person (U.S. individual, corporation or partnership) that owns 10 percent or more of the voting stock of the CFC. Complex attribution rules apply to determine whether the above-described threshold is met. In the base case example, LuxCo, UK TopCo, UK Target and other non-U.S. subsidiaries of UK Target will be characterized as CFCs because PE Fund is organized as a U.S. partnership. PE Fund is a U.S. person that owns 10 percent of the voting stock of LuxCo (and, as a result, 10 percent of the voting stock of its subsidiaries, including UK TopCo and UK Target), which means PE Fund is a U.S. Shareholder. Further, PE Fund owns more than 50 percent by vote and value of the stock of LuxCo (and, as a result, 50 percent by vote and value of the stock of its subsidiaries, including UK Topco and UK Target), which means LuxCo and its subsidiaries are CFCs.

The characterization of the above non-U.S. entities as CFCs creates Subpart F risk for all of the taxable U.S. investors in the PE Fund, irrespective of their economic interest in PE Fund. However, it could be and is likely the case that if the PE Fund were not organized as a U.S. partnership, the entities would not be characterized as CFCs. For example, assume that 50 percent of the Fund's investors were non-U.S. investors and 50 percent of the investors consisted of 10 U.S. investors, each with a 5 percent stake. Under this example, if the investors owned the stock of LuxCo directly (or were treated as doing so for U.S. tax purposes), neither LuxCo nor any of its subsidiaries would be characterized as a CFC, thereby eliminating Subpart F concerns. Therefore, to mitigate Subpart F risks, PE Fund may want to consider creating a parallel fund or other alternative investment vehicle, such as in the Cayman Islands, for its investors to invest through (rather than a U.S. partnership).

Private Equity Funds at Higher Risk of Antitrust Fines

by Lionel Lesur, Veronica Pinotti, Nicolò di Castelnuovo and Martino Sforza

Recent trends in competition law enforcement in Europe show that private equity funds are increasingly exposed to potential liabilities for alleged infringements of their portfolio companies. Therefore, private equity funds investing in companies that operate in Europe should consider putting in place adequate measures to minimize such risks.

Breach of competition laws may result in serious fines of up to 10 percent of the group turnover of the company in question being imposed on those companies which are found to have participated in alleged infringements by the European Commission (the Commission) and/or the applicable national competition authorities in the European Economic Area. In addition, decisions of the Commission and/or national competition authorities are binding proof of a breach of competition law, which, in turn, can result in follow-on damage claims being brought before the national court of the applicable jurisdiction within the European Economic Area.

Under what is known as the “parental liability doctrine,” competition authorities can attribute liability to entities that exercise a "decisive influence” over a company or group of companies that have participated in an alleged infringement. As a consequence, the controlling entity or entities are considered jointly and severally liable for the fine imposed on the infringing subsidiaries.

Decisive influence is presumed by the competition authorities where there are wholly-owned or almost wholly owned subsidiaries, and it is extremely difficult for parent companies to rebut such presumption in practice. Where this is not the case, the competition authorities are required to prove that the parent company exercised decisive influence. Any economic, organizational or legal link between the two entities would, in principle, be sufficient to meet the decisive influence test and would, in principle, equally apply in cases of minority shareholdings. In addition, parental liability can be found between two entities even after the subsidiary involved in the infringement has been disposed of by the controlling entity and may arise even if the controlling entity was not involved in or aware of the infringement.

Past decisions of the Commission and the case law of the European courts show that private equity funds are not considered any differently from other businesses for the purposes of the parent liability doctrine. The fact that private equity funds are only involved in the high-level strategy and commercial policy of their portfolio companies does not exclude their potential liability, with respect to alleged infringements. To the contrary and as we expand on below, recent trends in competition law enforcement seem to indicate that private equity funds are increasingly exposed to potential liabilities for competition law infringements of their portfolio companies.

In its decision of April 2, 2014, in relation to the underground and submarine high-voltage power cables cartel case (COMP/39610), the Commission held the parent companies of the producers involved liable, on the basis that they had exercised decisive influence over the producers. The fines levied by the Commission in this case totalled €301.6 million. One of the businesses found liable was Goldman Sachs, the former owner of Prysmian, which is one of the companies that allegedly participated in the cartel.

Goldman Sachs had acquired a (minority/majority) stake in Prysmian in 2005 through its private equity fund and completely divested of it in 2010. The fact that Goldman Sachs no longer owned Prysmian did not prevent the Commission from fining the bank, holding that it was the entity ultimately exercising decisive influence over Prysmian at the time of the alleged infringements.

This is not the first time that the Commission has imposed fines on private equity funds for alleged infringements by their portfolio companies. In 2009, the Commission fined the German company SKW Stahl-Metallurgie (SKW) and its former parent companies, amongst which was the investment company Arques Industries, for alleged participation in the calcium carbide cartel from 2004 to 2007. During that period, SKW was owned by several parent companies, and the Commission held each one liable for its respective period of ownership. The Commission's decision was confirmed by the General Court of the European Union on January 23, 2014. However, the judgment was appealed on May 8, 2014, and the case is now pending before the Court of Justice of the European Union.

Private equity firms investing in companies operating in the European Union should take note of the recent decisions in competition law enforcement handed down by the Commission. In order to minimize potential risks, private equity firms would be advised to ensure that:

- Adequate due diligence is carried out that is sufficient to capture potential competition law infringements by prospective subsidiaries
- Existing and prospective subsidiaries have in place tailored and effective competition law compliance programs and codes of ethics, and that these are rigorously implemented. Such programs and codes should, amongst other things, provide for the dismissal of employees and directors who fail or refuse to comply with antitrust rules. In *Parker ITR* and *Parker-Hannifin v. Commission* T-146/09 (currently under appeal), the General Court dismissed Parker's argument that the conduct of its subsidiary's directors prevented Parker from exercising its control over the subsidiary. The General Court held that there was nothing to prevent Parker from dismissing the directors who deliberately ignored the group's code of ethics, which, amongst other things, prohibited its employees from taking part in collusive activities.
- Consider the feasibility of contractual arrangements that provide for allocation of liability between the portfolio companies and parent companies and/or an indemnity in favour of the parent companies

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