Update on BEPS for Alternative Investment Funds

Asset Management Insights

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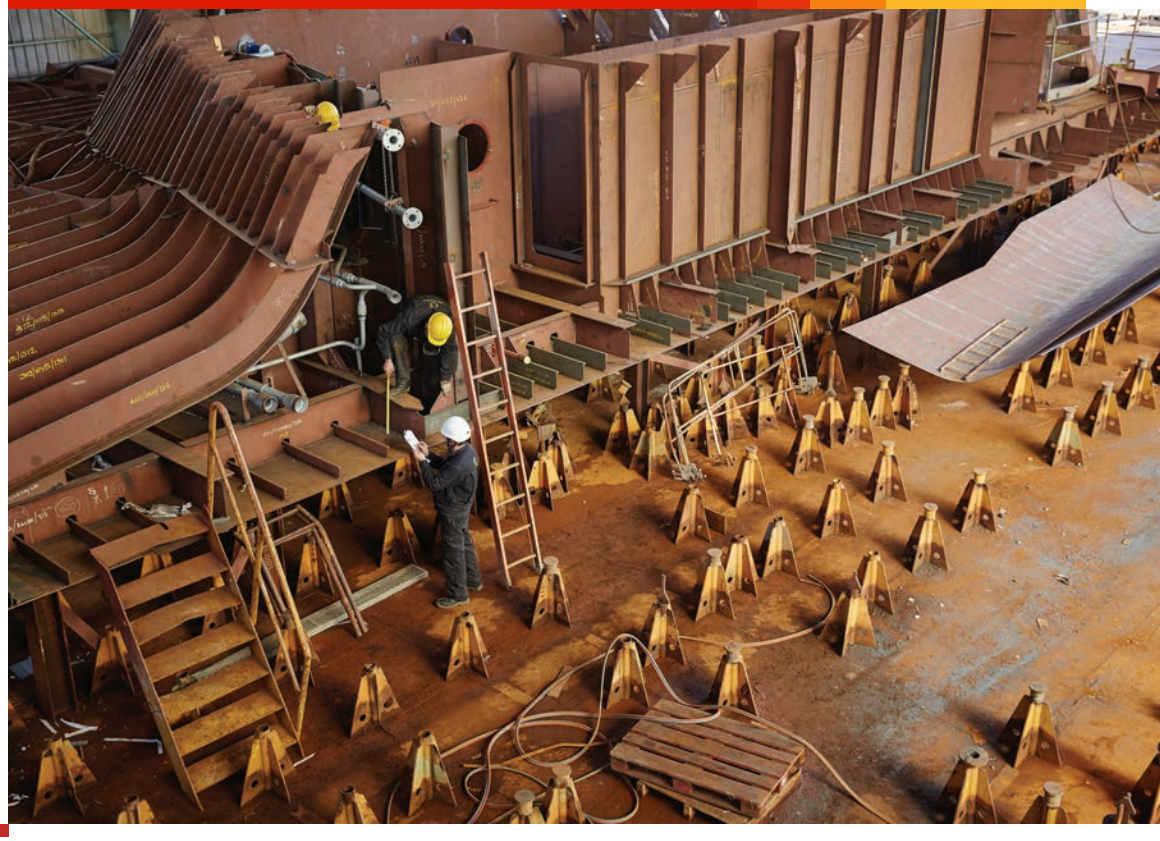

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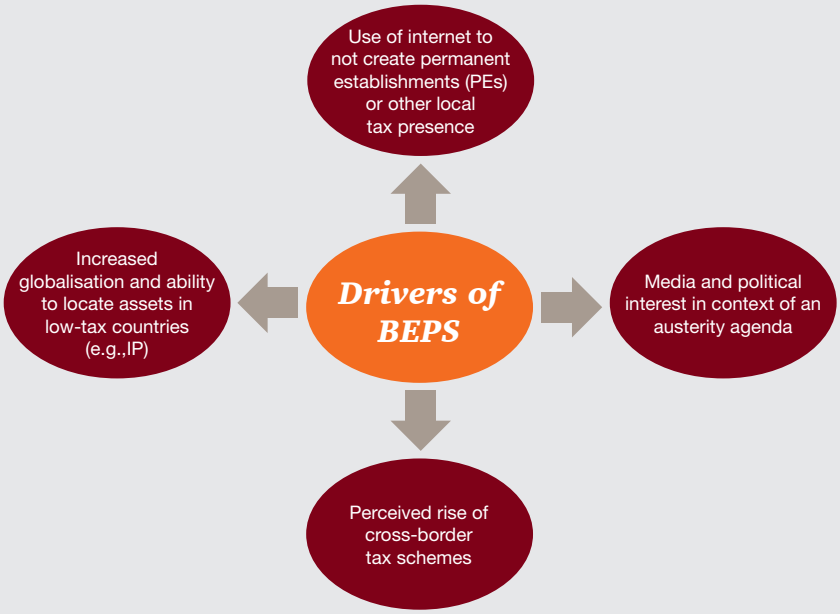
How countries are reacting and what fund managers should start doing now

Addressing base erosion and profit shifting (BEPS) has become a key priority for governments around the world, particularly in light of weak economic growth, reduced tax revenues, and concerns that international tax rules have not kept pace with changes in global business operations, permitting multinational enterprises to reduce taxes in ways governments did not intend. On Monday 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final recommendations. The objectives of the final recommendations are clear: protect the tax base, offer certainty and predictability to taxpayers, eliminate double non-taxation and provide comprehensive consensus-based rules to address BEPS.

Figure 1: Drivers of BEPS



While many of the OECD recommendations are likely to affect the alternative investment fund (AIF) industry, the recommendations covering transfer pricing, permanent establishment, treaty abuse, and hybrid mismatch arrangements require more immediate attention and action by AIFs. For purposes of this discussion, AIF refers to hedge funds, private equity and real estate funds. We note at the outset that the OECD has deferred concluding on any unique treatment for collective investment vehicles (CIVs), which the OECD loosely defines as widely held vehicles used to invest in portfolio securities deriving income and capital gains; that definition should cover AIFs. Accordingly, we are unsure how the final recommendations specifically will apply to AIFs once they become effective.

What macro changes might BEPS lead to?

Jurisdiction to tax

- Harder to deal with tax authorities and secure agreements
- Shift to greater source-based approach and potentially some clear winners (China, India) and losers (UK and Switzerland)
- Increased use of CFC regimes by tax authorities
- Treaty-shopping based structures under greater focus.

Transfer pricing

- Much more focus on substance (e.g., shift in TP to people-based confirmatory tests derived from Article 7)
- Extended services PE test for digital business and greater focus on rep offices (prep and auxiliary exemption)
- Increased scrutiny of intangible property and beneficial ownership
- Purpose of capital and risk?
- Documentation and disclosure changes to come.

Leverage

- Impact on capital structure (including hybrid instruments)
- Focus on debt financing and guarantees
- Conduit financing structures.

Anti-avoidance

- Short-term anti-avoidance measures
- General anti-avoidance approach by the tax authorities
- Increased cases where new rules developed with strong anti-avoidance agenda – e.g., OECD proposals on beneficial ownership, PE threshold and IP.

Irrespective of the potential applicability of CbC reports for AIFs, the OECD recommendations on transfer pricing would also require the filing of a local file and master file for all taxpayers with cross-border controlled transactions.

In details:

Final recommendation on permanent establishments (PEs). The recommendations on PEs are intended to make it more difficult for AIFs to employ agents in various jurisdictions without triggering a PE. AIFs have long relied on the dependent agent exemption, under which a PE typically was not triggered by an agent unless the agent was concluding contracts in the particular jurisdiction. The recommendations involve both narrowing of the dependent agent exemption, and broadening the type of activities undertaken by agents that could trigger a PE in a given country, resulting in an allocation of income and corresponding tax to that country. Currently, the independent agent test for the purposes of establishing a PE is largely based on the legal and economic independence of the agent, to the extent that they direct and control the work they are undertaking on behalf of the AIF. However, this is likely to change.

One key recommendation stipulates that an agent acting exclusively or almost exclusively on behalf of one or more 'closely related businesses' shall no longer be considered independent for purposes of analysing whether a PE exists. What this means for AIFs is if an agent concludes contracts or habitually plays a principal role in leading the conclusion of contracts, without major modifications by management at the AIF, the activities of that agent may create a PE for the AIF. The recommendations also limit the activities that do not create a PE (i.e. 'specific activity exemption') to activities that are of a preparatory or auxiliary character. These activities typically would include bookkeeping, secretarial, and various administrative tasks.

If these recommendations are adopted and implemented in their current form, AIFs will need to make changes to how they employ agents outside the jurisdiction of their home office. AIFs should be aware of these risks to their current operations and how their operations might need future modifications. Particular care will be needed around how contracts are negotiated and entered into and how related decision making protocols are established and executed on an operational basis.

Next steps: Understand the impact of agents on your global footprint. The forthcoming changes as a result of the recommendations are likely to impact AIFs' marketing and distribution as well as capital raising and deal sourcing activities, whether through representative offices or 'fly-in' team. It would be prudent for an AIF to review its global substance (including personnel, decision making, and other key areas) and operations to understand where it might trigger a PE by having agents or other personnel in jurisdictions outside of the AIF's home country. AIFs might also need to reassess issues related to potential profit attributions to such PEs following the updates to transfer pricing principles under the various BEPS action items.

Final recommendations on transfer pricing and reporting. The recommendations on transfer pricing reflect a continued push to enhance transparency for tax administrations by providing them with detailed information to conduct transfer pricing risk assessments and examinations. The recommendations will require AIFs to track and report tax-sensitised data to tax authorities that may be shared globally. These requirements will apply to management companies and, in some cases, to funds. The OECD has established a threshold of greater than EUR750m annual 'consolidated group revenue' to trigger a country-by-country (CbC) filing requirement. How to calculate the EUR750m consolidated group revenue in the AIF context is not entirely clear at this point. Certain questions related to the definition of consolidated group revenue within the AIF context – such as whether consolidation of revenue between holding companies, funds and their related management company and GPs would be necessary – remain unanswered.

For groups that are above the EUR750m threshold, the OECD proposed the filing of CbC reports for organisations with a global presence beginning with tax years starting on or after January 1, 2016. The first CbC reports would be filed with the jurisdiction in which the organisation's parent entity is located no later than December 31, 2017 (i.e., one year from the close of the related tax year). Organisations with tax years ending on a date other than December 31 would be required to file 12 months after the close of the relevant tax year.

The OECD has introduced a package of measures for the implementation of a new CbC report plan consisting of:

- model legislation requiring the ultimate group parent entity to file the CbC report in its jurisdiction of residence, including backup filing requirements when that jurisdiction does not require filing, and
- a model competent authority agreement to facilitate the exchange of CbC reports between jurisdictions.

Irrespective of the potential applicability of CbC reports for AIFs, the OECD recommendations on transfer pricing would also require the filing of a local file and master file for all taxpayers with cross-border controlled transactions. This reporting is likely to be required for most AIFs. The master file and local file are to be filed locally with each tax jurisdiction in which an organisation operates. The local file will look similar to current transfer pricing reports, although some new and more detailed information will be required, such as annual local entity financial accounts and reconciliation of financial data used. The master file will require a more holistic and detailed description of an organisation's global operations. For example, the master file will require detail on intangible property, including customer lists, relationships, internally developed software or methodologies used for trading or risk management, annual consolidated financial statements, and certain tax rulings. As formal disclosure is required in the master file, each AIF should have a defined and complete view of the fund's intangibles and key value drivers.

Finally, from an economic pricing standpoint, the recommendations focus on aligning substance with the location of profits with a particular emphasis on clarifying the returns associated with risks, capital and intangibles. The key theme is a continued shift away from focus on legal form alone, to evaluating form against the people-based substance and, using this comparison to evaluate if legal form is to be respected. There is an introduction of concepts around legal risk, financial risk, and operational risk, and an implied view that operational risk elements may garner the highest returns and that financial risk may, at best, get risk-adjusted returns (as opposed to residual returns).

Next steps: Prepare for increased compliance obligations. AIFs should review their current operations to determine whether their data and technology infrastructure will meet upcoming information reporting obligations for CbC reporting, master files and local files. These files should be prepared for the current fiscal year to assess any information gaps, ensure that current tax technology tracks the information needed, and address concerns before making the required reporting to the various tax administrations. AIFs should also continue to assess current structures and activities and be prepared to manage increased transparency, demands for information on beneficial owners and intangibles, increased global audit risk, and potential changes to transfer pricing methodologies, operations, and investment structures.

Final recommendations on treaty abuse and multilateral instruments. The recommendations on treaty abuse will make it more difficult for AIFs to gain access to certain countries' tax treaties in the future. The OECD has focused on the tax treaty entitlement of different types of organisations over the course of the BEPS project. The final recommendations on treaty abuse do not specifically recommend any treatment for CIVs and their eligibility for benefits under a treaty's limitation on benefits (LOB) provision. Instead, it surmises that countries – during their bilateral negotiations – can choose to include CIVs in the definition of 'qualifying persons' in the LOB provision. LOB provisions generally prohibit third-country residents from obtaining treaty benefits. For example, a foreign corporation may not be entitled to a reduced rate of withholding unless a minimum percentage of its owners are citizens or residents of the treaty country.

The OECD also recommended that a pension fund should be considered to be a resident of the jurisdiction in which it is organised regardless of whether it benefits from a tax exemption in that jurisdiction. As the recommendations are currently drafted, a pension fund will be regarded as a qualifying person of a jurisdiction only when at least 50% of all pensioners are resident in either contracting jurisdiction. The OECD has proposed relaxing this requirement by also including pension funds when:

- more than 90% of the beneficiaries are individuals resident in a contracting jurisdiction or another jurisdiction where they are entitled to treaty benefits and
- the pension fund itself would be entitled to the same or lower dividend and interest withholding tax if that pension fund would have been a resident of the other jurisdiction.

The OECD seeks participation from all member states on the development and negotiation of a multilateral instrument, which would serve to modify bilateral tax treaties, with over 80 countries participating as of 5 October 2015. As part of the final proposal, the OECD has proposed three approaches that countries can follow to prevent tax treaty shopping and abuse. These include a limitation on benefits (LOB) rule and principal purpose test (PPT), PPT only or LOB plus anti-conduit mechanism. Further work on entitlement of non-CIV funds and treaty benefits will continue in 2016. Concerns remain regarding how pension funds should be taken into account and treated for the purposes of applying treaty benefits under a multilateral instrument. This was highlighted by a submission to the OECD by a coalition of global pension funds.

Next steps: Evaluate where you currently rely on treaty benefits. AIFs should review the substance surrounding their current treaty structures and determine whether additional substance is required to continue relying on current benefits. As treaty benefits have come under increased scrutiny, the interest among the industry has increased in alternative investment structures, such as securitisation regimes and real estate investment trust (REIT) structures that qualify for preferential tax treatment in their country. While these structures may be more costly to set up and maintain, this cost may be outweighed by the increased certainty that these structures will be eligible for beneficial tax treatment today and in the future. AIFs should analyse whether treaty structures will stand up to scrutiny, the impact if treaty benefits were to be denied, and the feasibility of utilising alternative investment structures in the future.

Final recommendations on hybrids and interest deductibility. The recommendations on hybrid instruments and interest deductibility will require tracking interest expense and income inclusion when a hybrid arrangement is in place. The report focuses on the importance of coordination between countries in the implementation and application of the hybrid mismatch rules to ensure that the rules are effective. An example of a hybrid mismatch arrangement is one in which there is a deduction in one country with no corresponding income inclusion in the recipient country. The OECD is recommending rules that would deny a deduction to the payor under a hybrid mismatch arrangement to the extent the payment is not included in the income of the recipient. The OECD recommends that if a deduction is granted to the payor, the recipient should be required to include the payment in its ordinary income. Payments could be affected by these rules even when a hybrid does not result in deferral or a change in character.

The OECD's recommendations address so-called 'excessive' interest and other financial payments. The OECD has identified two potential general rules, with work on further application guidance on these rules continuing into 2016:

- The primary rule is a fixed ratio test that would restrict interest expense based on net interest over EBITDA. Countries will be able to set the ratio between 10% and 30%.
- If the primary rule is exceeded, a higher interest deduction may be available in certain circumstances if the interest burden is higher at a group level. This is called the group ratio rule.

Some discretion has been suggested for countries to include implementing one or a combination of these rules, which may have a direct bearing on the acceptable capital structure or allowable interest deductions for investment vehicles.

Some states have gone beyond the draft BEPS recommendations. The Australian tax authority, for instance, has established a BEPS team, called the International Structures and Profit shifting (ISAPS) group, dedicated to battling perceived BEPS issues.

Next steps: Evaluate current hybrid arrangements. AIFs should evaluate current hybrid arrangements and understand whether the countries in which they operate are contemplating anti-hybrid legislation. As a result of the OECD recommendations, AIVs will potentially need to restructure existing arrangements to manage tax expense within their funds or corporate groups. Further, important opportunities remain regarding the use of supportable debt financing for AIF structures; while these are still available, they also are subjected to increased scrutiny and review by tax authorities given the increased discussion regarding the level and pricing of financial transactions. Detailed work around the pricing of financial transactions remains on the OECD agenda. Support and documentation continue to remain important; implementation of this action item could vary across countries and AIFs should monitor how these rules are developed and implemented in various jurisdictions.

Early adopters

Many jurisdictions have taken unilateral action to implement laws to combat perceived abuses that are addressed by the OECD's final recommendations. Some countries may be going well beyond the OECD recommendations to minimise the threat of BEPS to their tax regimes.

Germany and Spain have introduced legislation addressing hybrid instruments. In line with the OECD BEPS recommendations on hybrid mismatch arrangements, the draft German proposal would disallow the deduction of business expenses in Germany when there is no corresponding income inclusion, seeking to shut down certain so-called 'double-dip' structures.

The Spanish government introduced a similar provision that also targets the deductibility of payments treated as equity to the recipient. For example, interest paid by a Spanish company under a profit participating loan that is granted by a related party may not be deductible in Spain where, under Spanish commercial law, the instrument is treated as equity.

Mexico has enacted several provisions aimed at perceived BEPS. These provisions target double non-taxation and would deny the deductibility of certain related-party payments and require foreign parties to provide a sworn statement through a legal representative attesting that an item of income for which a treaty benefit is claimed otherwise would be subject to double taxation.

Spain, Australia and the United Kingdom have taken steps to enable the OECD's recommendations on CbC reporting. The UK legislation provides that UK-owned entities with operations abroad must provide CbC tax-related data to HM Revenue & Customs, which is expected to commence with tax years beginning on or after 1 January 2016. Australia also has signed on to combat BEPS through closer information sharing, announcing that it will implement the OECD reporting recommendations requiring a master file, a local file, and CbC reporting. These requirements will apply to entities with global revenue over AUS$1 billion, effective for tax years beginning 1 January 2016.

China has also demonstrated that it is among a few developing countries paying close attention to the BEPS project. Within just five days of the release of the last of the OECD's final reports, China's State Administration of Taxation (SAT) held a conference to present its stance on the BEPS package and future action plans. The SAT views transfer pricing-related actions as one of the most important to China, specifically ensuring that outcomes are in line with value creation. The SAT also recently introduced guidance on eligibility for income tax treaty benefits, imposing a 'beneficial ownership' assessment when an applicant claims benefits. Recent cases show that the Chinese tax authorities have been proactively denying treaty benefits claimed by non-beneficial owners.

European nations also are tightening the granting of treaty benefits. For instance, Russia passed an 'anti-offshore' law that includes a beneficial ownership concept for the purposes of applying treaty benefits. Hungary is pursuing another method of thwarting treaty abuse by negotiating and renegotiating tax conventions to include clauses that limit treaty benefits to parties that are 'subject to tax' in their country of residence. Some of these treaties are already in force, like the new UK-Hungary tax convention. Romania incorporated a principal purpose test into its domestic legislation for granting treaty benefits as well as an anti-hybrid rule along the lines of those set out in the European Union (EU) parent-subsidiary directive.

As noted earlier, some states have gone beyond the draft BEPS recommendations. The Australian tax authority, for instance, has established a BEPS team, called the International Structures and Profit shifting (ISAPS) group, dedicated to battling perceived BEPS issues. It is tasked with conducting targeted audits of Australian taxpayers and it projects that it will raise AUS$1 billion from this process. Bulgaria has also exceeded the OECD BEPS recommendations by introducing restrictions on access to public funding and management of financial resources for companies that are registered in jurisdictions with a preferential tax regime or are related to such companies.

Ireland has passed legislation under which new companies incorporated in Ireland will be regarded as Irish tax residents unless the terms of a double tax treaty deem them otherwise. This prevents a new Irish company from being tax resident in a jurisdiction with which Ireland does not have a double tax treaty. This provision is aimed at effectively shutting down the so-called 'Double Irish' structure.

Perhaps most notably, the United Kingdom has introduced a diverted profits tax (DPT) that is not directly within the BEPS recommendations but is one that it considers consistent with the BEPS themes. The DPT is designed to counteract arrangements that result in the erosion of the UK tax base. The DPT is a 25% tax that applies when companies are thought to be trying to avoid a UK taxable presence or when entities or transactions lack economic substance. On 5 October 2015, the HMRC published a technical consultation on the CBC reporting regulations. This is to ensure that CBC will be implemented in the UK effective 1 January 2016. Australia is considering legislation with a goal similar to the UK DPT.

More recently, the Netherlands introduced detailed regulations for transfer pricing documentation, aiming to enable analysis of potential transfer pricing risks and issues in calculating the tax base. These regulations will become effective 1 January 2016 and incorporate the three-tiered filing approach found in the BEPS recommendations: CbC filing, a master file and local files. Specifically, CbC filing shall apply to multinational groups with a Dutch resident parent and a consolidated turnover of at least EUR 750 million. Also, consistent with requirements noted for other jurisdictions, Dutch group entities belonging to multinational groups without a Dutch resident ultimate parent company may also be obliged to submit a CbC report, including situations where the country of which the ultimate parent company is a resident has not introduced similar legislation or where there is no exchange of information agreement between the country of residence and the Netherlands.

In addition to unilateral adoption of the BEPS recommendations by countries around the globe, the European Commission (EC), the executive body of the EU, has also referred to the standards set out by the OECD's transfer pricing guidelines as part of their recent State aid decisions. These cases challenged specific transfer pricing agreements entered into between taxpayers and the tax authorities of Luxembourg and the Netherlands, alleging that preferential treatment was given to these taxpayers, in terms of the determination of the taxable base under these rulings. While it remains to be seen whether the EC will specifically adopt an arm's length standard that is in line with the OECD guidelines, arrangements based on TP rulings may be less vulnerable to the EC's criticism if they can be supported by a robust analysis based on the latest OECD guidelines.

As a result of the final recommendations, we anticipate that countries worldwide are likely to continue proposing provisions to prevent BEPS both by implementing the OECD recommendations and potentially going far beyond the OECD recommendations. Furthermore, inter-governmental bodies such as the EU may continue to look to the BEPS recommendations in shaping policies and standards.

In closing: Prepare for BEPS-driven rule changes

As of now, the BEPS recommendations are complete with the exception of a few items (e.g. pricing guidance on financial transactions). Many countries are already beginning to adopt these recommendations and making them effective.

Although this changing landscape raises uncertainty for AIFs trying to anticipate the future state of play and move towards complying with the new requirements and standards that the BEPS initiative will raise, trends are emerging in the industry and AIFs should start preparing now, if they have not yet started. In addition to the next steps already discussed, it is important to stay current and keep key people abreast of important developments.

BEPS developments – and some countries' responses – are moving fast. Knowing what is happening in the OECD, the European Union, and each jurisdiction where the AIF operates is critically important. AIFs should continue to monitor these developments and their widespread impact on structures and activities.

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