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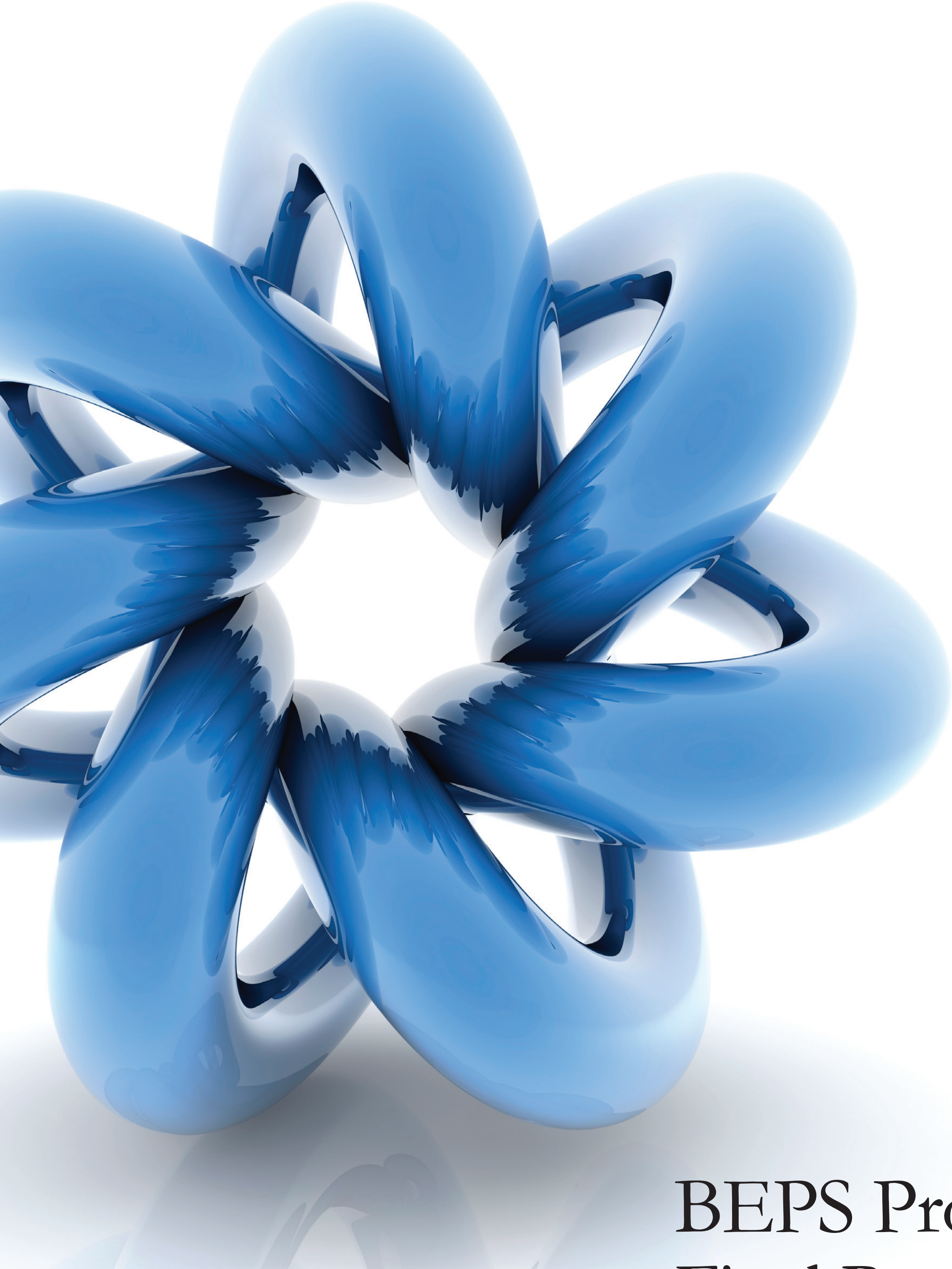


BEPS Project Final Reports

Issues for the Investment Funds Sector

Background

The base erosion and profit shifting (BEPS) project was launched by the OECD, at the request of the G20, in July 2013 with a view to addressing perceived flaws in international tax rules. In particular, BEPS will limit or restrict the effectiveness of tax planning structures intended to shift profits from high tax jurisdictions to low tax jurisdictions. The OECD published its final reports on 5 October 2015, setting out its recommendations in relation to fifteen different areas or "Actions".

We have considered the final reports from the perspective of a typical private investment fund that focuses on illiquid assets such as private equity, infrastructure or real estate. Some of the reports contain proposals that, if they are adopted by jurisdictions in which the funds operate and invest, could require a restructuring of the fund. This is because there is a risk that some widely-used structures will cease to be efficient from a tax perspective, or that the rules will impose a heavy additional compliance and monitoring burden on the operators of the fund.

The publication of the final reports represents a very important staging post in the process. However, there is still significant uncertainty about the full impact. In particular, much will depend on the manner in which certain governments adopt the BEPS recommendations (if at all) and the reports recognise that further work needs to be done in relation to agreeing how some of the recommended actions should apply to investment funds. As most of the OECD's recommendations are not minimum standards to be fulfilled by all participating jurisdictions, but instead are best-practice and non-binding recommendations, there are likely to be many differences as to how and when jurisdictions will implement the BEPS recommendations. As a result, it will be extremely important for fund managers to monitor the implementation of the BEPS recommendations in the domestic laws and the tax treaties of any jurisdictions in which their fund structures operate.

Summary of the key proposals

The recommendations include proposed amendments to double tax treaties as well as domestic law rules to be introduced by participating jurisdictions. In the context of private funds, the most significant areas are likely to include:

– Treaty Abuse – Action 6 proposes certain changes to be made to double tax treaties to ensure that they are not available in "inappropriate circumstances". These could impact on the ability of fund holding structures to benefit from double tax treaties.

– Interest Deductions – Action 4 recommends the introduction of domestic rules that limit the availability of tax deductions on all debt (including third party debt) by reference to earnings ratios. This could substantially increase the tax leakage on some leveraged acquisition structures.

– Hybrids – Action 2 sets out a series of domestic and treaty measures designed to neutralise the effects of "hybrid mismatch arrangements". These are cross-border arrangements that are characterised differently for tax purposes in different jurisdictions. Action 2 could impact on the efficacy of certain instruments that are used by funds to repatriate profits to investors.

– Permanent Establishments – Action 7 proposes changes to the treaty definition of permanent establishment (**PE**) to expand significantly the scope of activities that may be treated as giving rise to a permanent establishment. In some cases, this may result in advisory services provided to fund entities being treated as giving rise to a taxable presence for those entities in the jurisdiction from which the advice was provided.

Typical Fund Structure

Typically, a private fund is constituted as a tax transparent limited partnership. This entity cannot generally rely on treaty benefits itself and it is common for it to establish a master holding company (**a master holdco**) in a jurisdiction such as Luxembourg or the Netherlands. It is generally the intention that master holdco will have sufficient substance to be able to access the benefit of treaties between its home jurisdiction and that of the investments. In many cases it would be possible in principle for investors to rely on their own treaty status, but the administrative burden of requiring each investor to do so for each investment would make it difficult in practice. Investment advice would often be provided by the sponsor of the fund, often to the general partner of the fund vehicle as well as to other entities in the structure.

The nature of the acquisition structure for each asset will be determined by reference to its own individual characteristics and will need to take account of matters such as regulatory and company law, requirements of lenders and providing effective incentives to key staff. From a tax perspective, the principal motivation will generally be to achieve tax neutrality for investors: that is, to ensure that the investors' share in the returns generated by the funds' investments are not subject to a higher overall rate of tax than would have been the case had the investor acquired the asset directly.

Potential Impact of BEPS Proposals

Treaty Abuse

The principal focus of Action 6 has been on designing model provisions for double tax treaties that combat treaty shopping. There has been disagreement amongst OECD members as to which of two different types of rules would best achieve this: either a formulaic "limitation on benefits" (**LOB**) rule that sets out a series of criteria that must be satisfied by a person to demonstrate that it has sufficient connection with its home jurisdiction in order to be entitled to claim the benefit of the treaty; or a more subjective "principal purpose test" (**PPT**) that denies treaty benefits if one of the main purposes of the transaction or arrangements is to obtain those benefits, unless granting the benefits would be in accordance with the object and purpose of the treaty. The US has traditionally favoured LOB provisions, while major Western European economies such as France, Germany, Italy and the UK seem to be more inclined towards including a PPT provision.

The inclusion of either of these rules (or both) may impact on the ability of a master holdco to rely on the benefit of the treaty between its home jurisdiction and the jurisdiction in which asset holding companies are established. LOB rules in particular may be difficult for such entities to apply, as these may require a privately-held investment entity to show that it is ultimately beneficially owned by other residents of its home jurisdiction. This is unlikely for a master holdco. Indeed, given the multi-national nature of fund investors in many cases there would be no holding jurisdiction in which these requirements could be satisfied.

While the final report provides for different options in the LOB provisions to ensure that investment funds that have a large investor base and hold a diversified pool of assets (which the OECD refers to as CIVs) may obtain treaty benefits, it acknowledges that the LOB rules do not work well with non-CIV fund holding structures, such as private equity funds. Further work is therefore needed to see if these issues can be reconciled with the concern expressed (although not fully explained) by some governments that proposed amendments to address these issues could give rise to opportunities for treaty shopping and deferral of tax on income.

One possible option is the inclusion of "equivalent beneficiary" provisions that would allow an entity to benefit from treaty entitlements if a particular proportion of its ultimate investors were resident in jurisdictions that would have enabled them to access the same (or better) treaty benefits had they invested directly. Equivalent beneficiary rules could help to address concerns in this area. However, this would require the sponsor to track the status of the investors in the fund in order to determine whether a sufficient number would have qualified for equivalent benefits in each target jurisdiction, with the ultimate ownership often being traced up through several layers of intermediate holding vehicles. This would be a particularly difficult exercise for an open-ended fund.

The inclusion of a PPT rather than LOB provisions may be less challenging for fund structures. Although, even that will depend on the manner in which each jurisdiction interprets the test: investment funds have to pool their investors' cash somewhere, and all other things being equal it makes commercial sense to do so in a jurisdiction that provides access to a wide treaty network. If the jurisdiction of an investment target treat accessing the benefit of those treaties as one of the main purposes of the arrangements, and do not consider that providing the benefits would be in accordance with the object and purpose of the treaty, then access to the treaty might be denied. A master holdco that invests into several jurisdictions and that has adequate substance and resources to carry out its activities may be less exposed in this regard.

It should be noted that the OECD has concluded in its final report on Action 15 that it is both feasible and desirable to implement some of the treaty related measures against BEPS by amending tax treaties in bulk through a multilateral treaty. It is currently not clear what specific BEPS measures this multilateral treaty would cover and how such multilateral treaty would cater for different options, as there are complex questions public international law still to be settled. Potentially, it might include the PPT and/or the LOB provisions (or a simplified version of the LOB provisions).

Interest Deductions

The OECD has proposed in Action 4 that domestic law rules should be introduced to limit the availability of tax deductions for interest, as the inherent mobility and fungibility of money makes financing transactions one of the prime sources of BEPS.

The core proposal is a rule to limit the availability of deductions for payments of interest and other equivalent financial payments by reference to a fixed percentage of EBITDA – with the final report recommending an acceptable ratio of between 10 and 30 per cent. These restrictions would apply not only to related party debt, but also to commercial finance from third parties. The conventional leveraged acquisition model would often contemplate financing costs far in excess of that ratio, especially for high quality fixed assets that produce reliable cash flows such as prime real estate or public infrastructure projects. In an infrastructure context, there is a proposed exclusion for "public benefit projects", but this is subject to stringent conditions. Some jurisdictions, such as Germany and Italy, already have interest ceiling rules (in both those cases, using a 30 per cent. ratio), so if implemented these proposals would effectively represent an expansion of those rules across other jurisdictions. In this regard, it is notable that on 21 October, the UK Government issued a consultation paper on interest deductions in which it appeared to endorse the OECD's recommendations, introducing the possibility of the enactment of an interest ceiling in the UK with effect from 2017

Action 4 also contemplates an optional group ratio concession and the report notes that jurisdictions may wish to combine this with a fixed ratio interest deduction rule. This is intended to provide a concession to groups that are highly leveraged with third party debt and would allow an entity to claim deductions in excess of the fixed ratio interest ceiling if the group's total percentage of net third party interest expense exceeded that level. This could help to mitigate some of the concerns for funds, although given the operational separation of different investments, it may still result in arbitrary restrictions by linking the debt raised against a high quality asset to the wider group, which may include less leveraged investments. The proposals contemplate that a group for these purposes should refer to the consolidated group for accounting purposes. If the fund does not consolidate all of its investments, then it may be that this linkage will not result in disallowances.

One helpful recommendation is that both the fixed ratio and group ratio ceiling rules would only apply to net interest expenses, i.e. interest expenses of the entity would first be set off against interest income of the entity before the interest ceiling rules would kick in. In general therefore, back-to-back financing arrangements should not be affected by the proposed interest deduction ceiling rules. Countries may further opt to include carry forward and/or carry back provisions for disallowed interest expenses or unused interest capacity, which would mitigate, at least to certain extent, the issues described above.

Hybrids

Action 2 is targeted at cross-border transactions that result in the parties being able to exploit inconsistencies in the treatment of a transaction or an entity between the different jurisdictions involved either to give rise to a deduction in one jurisdiction for a payment that does not increase the taxable income for the recipient in another or to generate a deduction in more than one jurisdiction for the same expense. A good example of this is an instrument characterised as debt by the issuer (for whom coupon payments are treated as interest and are deductible) but equity by the investor. An example of a hybrid entity would be an entity that is treated as a transparent branch or partnership in one jurisdiction, but an opaque corporation in another. Broadly, the OECD recommends that jurisdictions implement specific rules into their domestic law to neutralise the effects of hybrid mismatch arrangements. The nature of these rules depends on the type and outcome of the hybrid mismatch arrangement. The rules are designed to neutralise the effects of the hybrid mismatch arrangement even when only one jurisdiction concerned by an arrangement has implemented the recommended rules. They are meant to be applied in a specific order to avoid double taxation when more than one jurisdiction has such rules in place.

There are a number of instruments that are widely used in the funds sector that might fall within the ambit of these provisions. For example, CPECs issued by a Luxembourg company will generally be deductible for the issuer, but may be treated as equity in the hands of investors in some jurisdictions and therefore benefit from a full or partial dividend exemption or similar relief for economic double taxation (for example, an indirect foreign tax credit). The primary response in those scenarios would be a full or a partial denial of the interest deduction at the level of the issuer of the instruments. Sometimes, the sole benefit for using such instruments is to ensure that the investors are not exposed to "dry" tax charges, with the investors being subject to tax only when amounts are actually paid out under the instrument, but with the issuer being able to claim a deduction on an accruals basis. Helpfully, the proposals acknowledge that the rules should not attack timing differences such as this, provided that the tax authorities are satisfied that they will be recognised as income within a reasonable time. Interestingly, an instrument would not qualify as a hybrid financial instrument under the OECD recommendations if the deduction/non-inclusion outcome is solely attributable to the fact that the recipient is established in a non-tax jurisdiction such as the Cayman Islands or Bermuda.

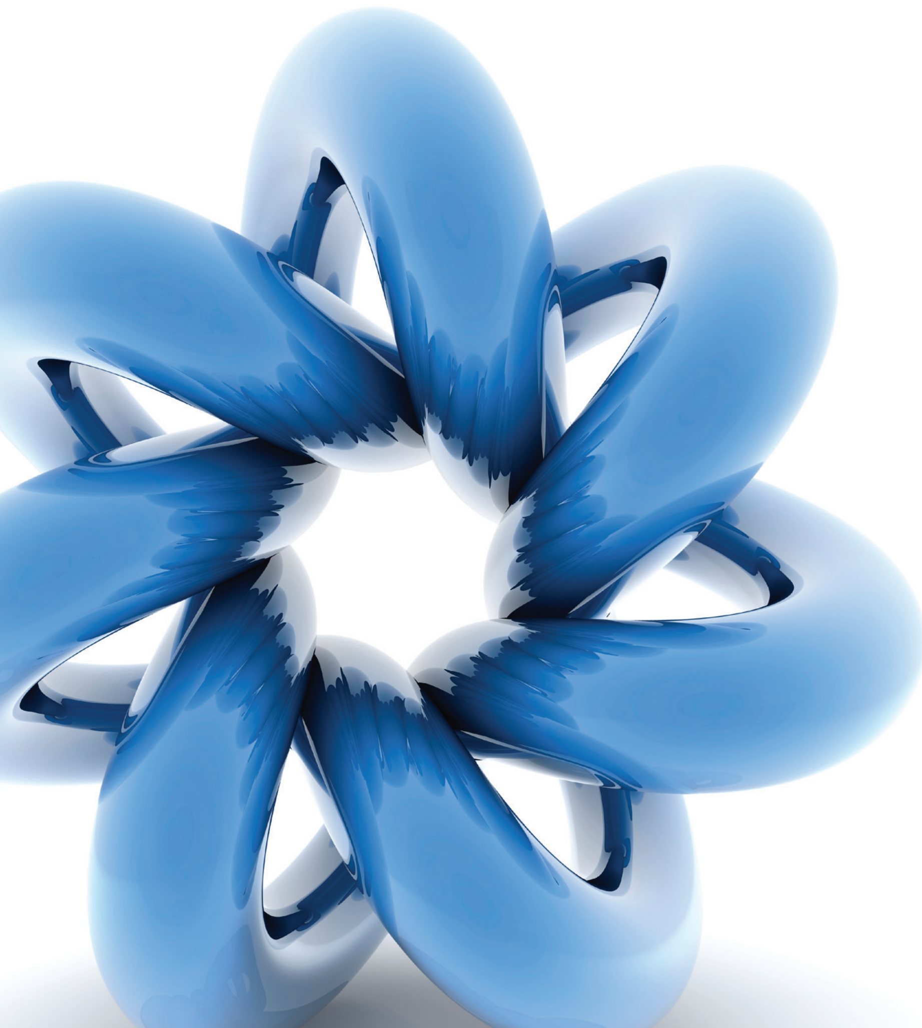
The rules are only expected to apply in related party situations or in relation to "structured arrangements". An arrangement between unrelated persons is considered to be "structured" either if the tax benefits of the arrangements are priced into the terms of the arrangement, or if the facts and circumstances (objectively) indicate that the arrangements have been designed to produce the mismatch. One of the concerns with these proposals in a funds context is that it may require a fund to have a clear understanding of the tax status and characteristics of its investors in order to determine whether or not these rules could be in point.

Permanent Establishments

One of the principal areas of concern in relation to BEPS has been structures adopted by multinational enterprises that enabled them to operate, and often generate significant turnover, in high tax jurisdictions without having a PE there. Indeed, such structures are one of the principal targets of the UK's diverted profits tax, which was introduced earlier this year and which many saw as "jumping the gun" on BEPS Action 7 in this area.

The elements of the proposals in the final report on Action 7 that are most likely to affect funds and their advisers relate to the circumstances in which an agent can create a PE for its principal. The very long-standing position has been that an agent can create a PE if it "habitually exercises authority to conclude contracts" on behalf of the principal, unless it is an independent agent acting in the ordinary course of its business. The report proposes changes to both limbs of this test. The first limb has been expanded, so that it is no longer just the conclusion of contracts, but also *"playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification"*. The carve-out for independent agents still applies, but the test of independence has been refined so that the carve-out will not be available where a person *"acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related"*.

Funds and their advisors will typically follow clear guidelines to ensure that the residence and PE status of the fund entities is not compromised by the activities of advisors. The fund's advisors will provide advice in respect of possible investments, and may be authorised to enter into discussions with counterparties on behalf of the fund. However, the advisors will make clear that all material decisions remain subject to authorisation by the directors of the relevant fund entity and that the advisor has no authority to bind it. All material contracts that it is proposed that an entity should enter into will then be properly scrutinised by appropriately qualified directors before signing. Depending on the role of the advisors in negotiations with counterparties, it may be possible for the tax authorities in the jurisdiction in which it was operating to argue that it played the *"principal role"*.



Allen & Overy Tax Contacts

Lydia Challen
Partner
Tel +44 20 3088 2753
Mob +44 7967 342416
lydia.challen@allenovery.com

Patrick Mischo
Partner
Tel +352 44 44 5 5429
Mob +352 621 263 527
patrick.mischo@allenovery.com

Vimal Tilakapala
Partner
Tel +44 20 3088 3611
Mob +44 7917 575062
vimal.tilakapala@allenovery.com

James Burton
Senior Associate
Tel +44 20 3088 2911
Mob +44 77 6616 6095
james.burton@allenovery.com

Amsterdam

Godfried Kinnegim – Partner
Tel +31 20 674 1120
godfried.kinnegim@allenovery.com

John Brouwer – Partner
Tel +31 20 674 1541
john.brouwer@allenovery.com

Jochem Kin – Counsel
Tel +31 20 674 1173
jochem.kin@allenovery.com

Brussels

Patrick Smet – Partner
Tel +32 2 780 2431
patrick.smet@allenovery.com

Dusseldorf

Marcus Helios – Partner
Tel +49 211 2806 7111
marcus.helios@allenovery.com

Frankfurt

Asmus Mihm – Partner
Tel +49 69 2648 5796
asmus.mihm@allenovery.com

Heike Weber – Partner
Tel +49 69 2648 5879
heike.weber@allenovery.com

London

Christopher Harrison – Partner
Tel +44 20 3088 3638
christopher.harrison@allenovery.com

Mark Middleditch – Partner
Tel +44 20 3088 3698
mark.middleditch@allenovery.com

Charles Yorke – Partner
Tel +44 20 3088 4925
charles.yorke@allenovery.com

Luxembourg

Jean Schaffner – Partner
Tel +352 44 44 55410
jean.schaffner@allenovery.com

Madrid

Carlos Albiñana – Partner
Tel +34 91 782 9962
carlos.albinana@allenovery.com

Milan

Francesco Guelfi – Partner
Tel +39 02 290 49659
francesco.guelfi@allenovery.com

Munich

Gottfried E. Breuninger – Partner
Tel +49 89 71043 3302
gottfried.breuninger@allenovery.com

New York

Jack L. Heinberg – Partner
Tel +1 212 610 6383
jack.heinberg@allenovery.com

Dave Lewis – Partner
Tel +1 212 610 1147
dave.lewis@allenovery.com

Paris

Jean-Yves Charriau – Partner
Tel +33 1 40 06 5360
jean-yves.charriau@allenovery.com

Mathieu Vignon – Partner
Tel +33 1 40 06 5363
mathieu.vignon@allenovery.com

Rome

Francesco Bonichi – Partner
Tel: +39 06 684 27566
francesco.bonichi@allenovery.com

Sydney

Ka Sen Wong – Counsel
Tel: +612 9373 7858
kasen.wong@allenovery.com

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