This article sponsored by Debevoise & Plimpton originally appeared in Perspectives 2018 published by PEI in December 2017

CROSS-BORDER TAXATION

BEPS: LPs react to new tax environment

Investors are asking general partners some tough questions about the OECD's flagship tax avoidance project. Funds need to know how to address these worries, say partners Matthew Saronson and Richard Ward and associate Matthew Pincus of Debevoise & Plimpton

Big changes to the taxation of cross-border investment activity by private equity funds are coming into view. The Organisation for Economic Cooperation and Development and its member countries are reaching the conclusion of their base erosion and profit shifting initiative, known as BEPS, which seeks to address perceived methods of tax avoidance.

On the basis of the recommendations developed during the BEPS initiative, over 100 countries (including the members of the European Union) are collaborating on the implementation of a new international tax framework that fundamentally alters how transnational business operations and investment are taxed. While the US has signalled that, with a few exceptions, it does not intend to make legal changes in response to BEPS, substantial changes to its international taxation system are possible as part of the tax reform package currently working its way through the US Congress.

Even though the precise contours of the new tax regimes have yet to be fully delineated, investors are increasingly concerned as to how funds will adapt to the changing international tax environment. Investors and their tax advisors frequently raise questions in the due diligence process as to whether a fund's investment strategy and holding structures are vulnerable to challenge by tax authorities or may need to be altered on the basis of changes to international tax regimes. Sponsors need to stay up to date on how international taxation is evolving in order to respond to these concerns.

"General partners can often address investors concerns by being able to speak knowledgeably about BEPS

PUTTING BEPS INTO ACTION

BEPS seeks to address flaws in how tax regimes worldwide fit together that enable multinational companies and other international investors to either avoid tax or unfairly reduce their overall tax burden. The OECD argues the gaps and mismatches between the laws of different countries allow businesses that operate across borders to gain a competitive advantage over enterprises that have solely domestic operations. Furthermore, the OECD claims that allowing multinationals to reduce their tax liability by exploiting such gaps undermines voluntary compliance by taxpayers that do not operate internationally.

The aim of the BEPS project is to harmonise the tax rules between participating countries in order to ensure that income taxes are paid in the jurisdictions where the economic activities generating such income occur. To this end, the OECD has published a list of 15 Actions that encompass changes both to the domestic tax law of individual countries and to the tax treaties the participating countries have agreed with each other. These changes are currently being implemented by participating countries, even while the OECD is still finalising some of the fine details of its proposals.

Bringing these action points into force will impact many areas of tax law important to the structuring of fund investments, including the deductibility of interest, transfer pricing and permanent establishment status. Action 2 which concerns neutralising the effects of so-called "hybrid mismatch arrangements", is of particular importance for fund sponsors, since it directly challenges one strategy that funds often use to structure international investments in a tax-efficient manner.

A "hybrid mismatch" arises when entities or financial instruments are treated differently under the tax laws of different jurisdictions. For instance, a "preferred equity certificate" (a "PEC") issued by a Luxembourg

Saronson: *investors frequently raise queries*

Ward: *'hybrid mismatch arrangements' are closely watched*

Pincus: *tax treaties are being altered*

company may be treated as debt for Luxembourg tax purposes while simultaneously being treated as equity for tax purposes in other jurisdictions. The proposed rules are designed to prevent such mismatches from being used by related taxpayers to claim a deduction from taxable income in one country (eg, an interest deduction by a PEC issuer for an interest payment on a PEC) without claiming a corresponding income inclusion in another country (as may be possible for a corporation that holds the PEC, since corporations are often able to exclude dividends from their taxable income).

Some jurisdictions, including the UK, have already enacted legislation implementing Action 2, adding significant complexity to the already challenging task of returning proceeds from international investments to fund investors in a tax-efficient manner.

Countries participating in BEPS are also in the process of altering the terms of the tax treaties that they have agreed. Tax treaties are agreements between nations as to how they will tax the income of each other's residents, and generally are integrated into – or supersede – domestic law. Treaty planning is an important aspect of structuring fund investments, as tax treaties can help preserve tax neutrality for fund investors who would often be entitled to treaty benefits if they directly invest in the fund investments.

Action 6, which tries to prevent the granting of treaty benefits in "inappropriate circumstances", addresses the practise of "treaty shopping" – whereby a non-resident attempts to obtain the benefits of a country's tax treaty – by recommending that participating nations should revise their tax treaties to ensure that the benefits are not abused. Incorporating such provisions into treaties may result in the denial of tax treaty benefits for certain fund structures, impacting the tax costs of exits and distributions. Already, more than 60 countries have formally entered into an agreement known as the "multilateral instrument" whereby they have agreed to implement the treaty-based recommendations of the BEPS initiative, including the recommendations of Action 6.

Action 2 and Action 6 are only two facets of BEPS, which is wide-ranging and encompasses many other areas of law as well. Since large portions of BEPS are not yet fully incorporated into law, there is still significant uncertainty as to the full impact of BEPS on investment structures.

US OVERHAUL

Adding to the environment of uncertainty is the prospect of significant changes to the US system of international taxation. For the most part the US has not proposed changes to its tax treaties or domestic law in reaction to BEPS, primarily because the government takes the position that the concerns that the OECD is seeking to address are already reflected in its regulations. But even as we write, the US Congress, in concert with President Trump, is engaged in a high-speed effort to overhaul US tax law. Given the political environment in the US, it is not clear how extensively, if at all, this will affect investment structures. However, several changes that have been discussed – such as altering how interest expenses are deducted – could challenge strategies that are used widely for efficiently structuring the US investments of non-US residents.

Given this environment of uncertainty, investors are increasingly seeking assurances from general partners that they are scrutinising how international tax law is developing and that they are considering how to adjust their investment structures to address any changes in the law. Some investors are also asking that fund documentation include covenants to give due consideration to BEPS in investment structures.

In general, general partners ought to resist agreeing to such provisions where the precise compliance requirements are not yet clear. General partners can often address investors concerns by being able to speak knowledgeably about BEPS and other developments in tax law that are relevant to their investment strategies. Being able to do so, however, requires continual and dedicated monitoring of the legal environment. ■