Taxing questions for European private equity

The OECD's base erosion and profit shifting (BEPS) initiative may seem like a technical tax matter that is of little consequence to private equity firms. A panel of experts, however, explain why this tax policy could have a significant impact on how the asset class operates in the future.

Photography *Richard Gleed*


The panel debate the implications of BEPS

The OECD recently released final proposals for its base erosion and profit shifting (BEPS) initiative. Before moving on to how this could impact private equity, what exactly is base erosion and profit shifting and why has the OECD made a point of targeting it?

Walsh: As a result of the recent press regarding multinational companies' perceived ability to have economic substance in a particular country, yet pay minimal corporate income tax in that country – i.e. base erode/profit shift – the OECD, with the support of member governments, has developed a 15 point action plan to address this.

The OECD has now reported on the majority of these actions plans and the task now lies with governments to implement them into local and international tax rules to effect a reduction in companies' abilities to base erode and profit shift. We are starting to see governments respond and consult on a number of the proposed changes.

When I speak to funds and tax directors in both the US and Europe, they have been following this very closely. There is an appreciation that it will impact both funds and the portfolio companies they invest in. We are carrying out sensitivity analysis for clients as to the impact on transactions and future fund structuring.

What you can say is that it will definitely have implications for major corporates and it could also impact the private equity industry at fund level and at portfolio company level.

So what exactly will the impact for private equity be? Why is BEPS something that limited partners and general partners should pay attention to?

Crossley: The basic idea of a fund is that you shouldn't put your investors in a position where they would be worse off than if they invested directly. That is the golden rule for any fund. So there is obviously investee country taxation. There is non-resident capital gains tax, dividend withholding tax and interest witholding tax.

Now investee jurisdictions outside of the US generally don't have very sophisticated systems, so they don't look through funds and they look to the individual investors instead, and most of these investors wouldn't suffer these taxes if they invested directly. So you can end up in a situation where a fund puts investors in a worse position than if they had invested directly.

What private equity funds try and to do is structure themselves to avoid investee company taxation, and that is often done by investing through holding structures. These structures can then access tax treaty benefits.

Now one of the big things about BEPS is to what extent intermediate holding companies held by collective investment scheme can access treaty benefits. That is the big issue that firms are concerned about. We don't know what is going to happen yet but investors are really concerned that BEPS comes along and that these holding structures don't work any more.

Walsh: In addition to the impact at the fund level, we are already seeing BEPS impacting the pricing of deals. I was recently advising a fund in a competitive auction situation where the target already had a high effective tax rate because of where its profits were generated. We then


Nigel Williams, Royalton Partners

modelled for the impact of potential BEPS changes and the tax rate went up substantially. So even though these BEPS measures are only coming in in a few years, we are seeing it impacting deals today.

Robins: We have been trying to assess BEPS from a Jersey perspective and understand how it will all shake out. We are not generally known as a double taxation agreement jurisdiction. Rather we offer a tax transparent, tax neutral environment. Yes, we do have zero-tax rated companies for international investment and some fund houses use those as their holding companies. Sometimes, very commonly, you will have a Jersey fund limited partnership with Luxembourg holding companies beneath for making tax efficient European investments.

The whole point of the BEPS initiative was to address the taxation of multinational corporations around the world, and from our point of view there needs to be a very sensible focus on enshrining treaty benefits for investors entitled to those benefits.

If you look at BEPS and what it is trying to achieve, the focus is on getting rid of abuse. The sensible solution is to do that, but also recognise that, for certain types of pooled investment activity, achieving neutrality and diminishing the risk of double, or triple taxation is entirely acceptable.

ROUNDTABLE

At the table

- **Ben Robins,** partner Mourant Ozannes and Jersey Funds Association chairman
- **Nigel Williams,** managing partner, Royalton Partners
- **Bridget Walsh,** UK & Ireland head of private equity, EY
- **Damien Crossley,** head of tax, Macfarlanes
- **James Bermingham,** general counsel, Aztec Group

Ben Robins, Mourant Ozannes and Jersey Funds Association

> THE FOCUS OF BEPS IS MULTINATIONALS. THEY ARE VERY DIFFERENT TO ASSET MANAGERS SERVICING A GLOBAL INVESTOR BASE

Q So what is the private equity industry doing, or what can it do, to comply with BEPS without losing the benefits of existing fund structures?

A Robins: When you are facing a challenge like this at first there is panic, but then the lobbying starts and people start thinking about how to make this work in practice without creating a damaging dislocation in the market.

The smart way of approaching this is to achieve a proper distinction between taxation of asset management activity on the one hand and a multinational corporate activity on other. The real focus of BEPS is global multinationals, and they are very different to asset managers servicing a global investor base.

Crossley: Fund documents have what are known as alternative investment vehicle (AIV) provisions and often they are built around obtaining investor consent.

So if you find on a deal that a fund document doesn't work for you, you can do a different structure but investors have the choice on whether or not they can go into it or not.

So if people are very concerned about BEPS, you can use a very prescriptive AIV provision. If a situation does arise we can say to investors that they are altogether in this fund, but we want to split them out into different structures because of your different tax statuses.

Walsh: I don't think people are changing much today. There is a chance that your fund structures will change, but they are waiting for more detail.

Nigel Williams: I see the practical experience around BEPS quite differently. In Luxembourg we are seeing some of the big private equity funds that have offices in Luxembourg beefing those offices up, taking their holding companies in-house and administering those holding companies themselves. We are a small private equity firm, but we have decided to take all our holding companies in-house. They are now administered from our offices in Luxembourg and they have directors who are Luxembourg residents and they have employees. So they are not just companies that are holding companies. They are companies that have staff. That was all based on advice on how we should become BEPS compliant.

We are in a slightly different position as we are based in Luxembourg where many of the holding companies are based. It is relatively easier for us to become BEPS compliant. We are doing it and we have seen others do it.

Q On the point about substance, how important is that? Is that going to be the test for BEPS?

A Bermingham: Substance arguments are often misstated. A holding company is just a holding company wherever it is established. A holding company does not do very much by definition and should not be heavily taxed – if at all.

It does not matter whether the management of these companies is carried out in-house or by a third party administrator, AIFM or otherwise.

When considering substance in an international context, therefore, whether under tax treaty or EU law, the key is to understand the commercial reason for including a third country holding company and whether it enjoys full beneficial ownership of any relevant returns.

As the use of third country holding companies can sometimes be tax sensitive, it is important that their substance is not misrepresented. The distinction between tax planning, aggressive tax planning and tax evasion is incredibly fine.

Walsh: What I have heard from some of the funds is that they are concerned that the bar on substance could potentially be so high that they may struggle to meet it if they are using a Luxembourg structure, e.g. if you say you need to have actual deal-doers based there.

Williams: I think some of it is common sense. If you set up a company that is a letterbox company that has no employees, it has local directors who are appointed and it has no real link with the fund and the underlying investment, then I would have thought that under the BEPS legislation you are more likely to be at risk than if that company has a lot of substance attached to it.

Bermingham: It all depends on what you mean by substance? A trading company will obviously have more substance – and therefore pay more tax – but it is not straightforward creating real substance in a largely tax-exempt, standalone holding company by some form of loose association with a related business.

For example, we have seen holding companies managed directly by some of our clients challenged even where they have in place a team of 20 plus. That said, there are a


Damien Crossley, Macfarlanes


James Bermingham, Aztec Group


Bridget Walsh, EY

number of structural adjustments that can be made to reduce the risks of challenge in different situations. It is all about understanding what is likely to work, and why.

Williams: It depends if it has one investment or many investments and it depends on how it is run.

Crossley: The key point is whether there is a limitation on benefits provision. You have the US treaties, for example, where it is not about substance. It is about limitation of benefit.

So if more than half of your investors are from the US or a relevant jurisdiction it doesn't matter how much substance you have, because it just gets disregarded and you don't get treaty benefits.

One of the ideas of BEPS is potentially overlaying a limitation on benefits provision in which case substance won't make a difference. It will just be look through. That is the concern. On the substance point specifically, however, I think Nigel has a point. Some jurisdictions will be more generous on substance than others. In some jurisdictions no level of substance will make a difference but in others it will.

Bermingham: This may be true but the law always provides an element of protection and there are some very obvious reasons to use Luxembourg, for example, as a primary investment hub: it has an optimum legal, regulatory and tax status; it is incredibly safe and straightforward for international investors; and it is a centre of excellence.

Luxembourg has become the familiar option for range of standard commercial transactions and holding companies are often introduced to reduce the operational complexity.

The tax sensitivities of these companies in a private equity context are often over estimated. Only one of the companies managed by us has received a foreign tax challenge since 2007.

Q What do you make of that Ben? What is the view on the substance question from the Jersey perspective?

A Robins: Asset management substance on the ground has long been a regulatory and tax requirement in Jersey but I think it may also become important, in the context of the limitation on benefits and principle purpose test, to establish the treaty status of your LPs. That exercise, and perhaps building it into FATCA or CRS information-gathering processes, may prove useful to undertake. Some of the fund management clients we have been talking to are saying that their investor base is around 95 per cent treaty qualified, so detailed assessments of substance may become irrelevant in those cases.

Bermingham: The focus in Jersey generally falls on the manager instead of the fund for the reasons that Ben gives. Historically, demonstrating local mind and management mattered more than substance arguments but, following the introduction of the AIFMD, there has been an increased emphasis on regulatory substance in the Island. This is a slightly different topic though.

Q How much does fund domicile effect this? Does that change things?

A Williams: It is an interesting point. If, say, you have a Delaware fund and then you put a Dutch or Luxembourg holding company underneath that, then everything isn't all in one place. Is there a sense from some of the early BEPS drafts that if everything is all in one place, and you only have a holding company because the fund is a limited partnership and you need a holding company to administer it, then it has a purpose and the whole thing is consistent? In so far as you have your fund somewhere else, maybe that is not consistent?

Walsh: That does make sense, but at a minimum BEPS will create a huge compliance burden. Consider the country-by-country reporting for example. These rules really have been designed for corporations to disclose what tax they are paying in each country, but our fund clients are looking at whether funds will have to comply with this and whether their information ends up becoming public because of it.

Bermingham: I am unclear why private equity funds should be caught by the country-by-country reporting rules. To explain, a typical private equity fund is a partnership that is best understood as a co-ownership arrangement between the different partners. A private equity fund may acquire different corporate groups, but it should not be understood as creating a single super-group.

Walsh: I see the point but there are two levels to this. You have the company that has been acquired and you absolutely do the test at that level, but then there is also the general partner and management level. These levels could fall within the thresholds.

Bermingham: It is unclear how the proposed thresholds would be applied to a partnership, or its partners, without double counting the portfolio groups. I am not at all sure on how it will work.

Robins: The answer is that you don't double count because it relies on an accounting definition – either IFRS or US GAAP – and it is investment accounting. Investment accounting would not include the portfolios. So when you look at it from a fund level, you would ask what the fund revenue is, and that would not include the revenues of the portfolio so it is not proportionate consolidation or anything like that.

Bermingham: But if it is just a private equity fund buying and selling assets, what is the revenue? It will be important that the OECD forms a clear picture of the different components that comprise a private equity fund.

The fund itself is not a business, but simply a platform that controls and directs the flow of international capital. The general partner does not actively manage the groups that the fund acquires; this is carried out by their respective management teams and advisers.

Q From the debate we have had so far it seems there is a lot of uncertainty as to what BEPS will eventually look like. How close are we to seeing BEPS finalised?

A Robins: The can has definitely been kicked down the road in terms of where we are going to end up on treaty benefits and their impact on non-CIV funds. You can hear the uncertainty around this table. Who knows exactly where will it land?

But even though it will be some time before the actual rules come into place, private equity firms are aware of it. None of them should be launching a fund without thinking about it. You just have to look at the PPMs that are going out at the moment. All of them will have a risk factor paragraph on BEPS. ●

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