Debevoise & Plimpton

What You Need to Know About Structuring Your Fund in the BEPS Era

To misquote *Star Trek*, “It’s life, Jim, but not as we know it.” And so we must think of the global tax landscape as we head into a BEPS (base erosion and profit shifting) era. The BEPS Project, the brainchild of the OECD and the G20, is aimed at preventing tax avoidance caused by base erosion and profit shifting by multinationals. Over 100 countries, including the United States and most European countries, are collaborating in implementing some or all of the BEPS Project, meaning every fund is likely to be touched by the changes in some way (see our implementation tracker at http://beps.debevoise.com that follows the progress made by each of the United Kingdom, France, European Union and the United States).

BEPS appears frequently in private equity news and is commonly asked about by investors during fundraising and beyond. This article aims to provide readers with a working understanding of the BEPS Project and its potential impact on fund structures. You may also wish to view our 2.5-minute animated explainer video at http://beps.debevoise.com/#video1.

Key terminology

Base erosion

An entity’s tax base is the income, profits or gains (or other determining factor) against which tax is charged. At a basic level, corporate tax is calculated by:

[tax base] x [tax rate]

Base erosion is the process of reducing an entity’s tax base. This can obviously occur simply by not being profitable, but the base erosion targeted by the BEPS Project is erosion that has been “aimed for” or structured.

Profit shifting

Profit shifting is the practice of moving a multinational group’s profits from one (typically high tax) country to another (typically low/no tax) country (for example, through royalty payments or intercompany debt).

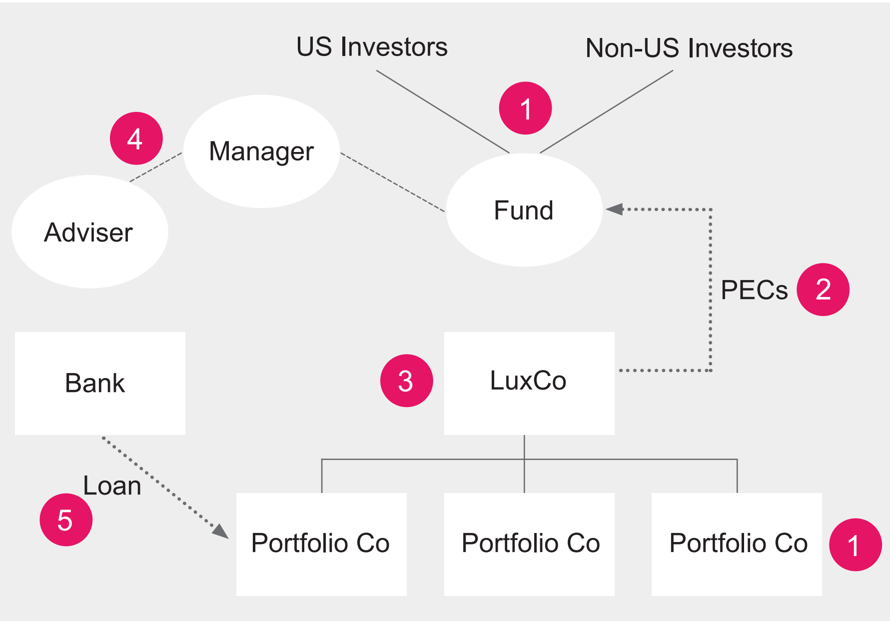
The BEPS Project framework

The BEPS Project consists of a 15-point Action Plan. The Actions are wide-ranging and consider, among other things, hybrid entities and instruments, interest deductibility, double tax treaty abuse, permanent establishment status and transfer pricing.

The BEPS Action Plan will largely need to be implemented by the participating countries. This means that, although there may be a multinational consensus as to the general approach that needs to be taken, the actual BEPS rules may change from country to country. The European Union has published its own response to BEPS in an Anti-Tax Avoidance Package and seeks to implement many of the BEPS Actions. This should bring some uniformity into how the 28 member states (27 following Brexit) will implement the BEPS Action Plan. In addition, the United States has already implemented some parts of the BEPS Project and may implement more (see our implementation tracker at http://beps.debevoise.com).

Impact on funds

Set out below is a simple fund structure, highlighting some of the areas that may be impacted by the BEPS Project.



Hybrid entity 1

Action 2 aims to neutralize tax benefits that hybrid entities enjoy due to mismatched treatment by various tax jurisdictions. If a check-the-box election is made with respect to either a company or a partnership, this will make it a hybrid entity and therefore potentially subject to the Action 2 anti-hybrid rules. For a fund that is a partnership, these rules may be applicable if (i) the fund is checked to be treated as a corporation for US tax purposes, or (ii) there are certain investors in the fund for whom the fund is treated as opaque. If the Action 2 anti-hybrid rules apply, the investors may become subject to deemed taxable income. Alternatively, if there is an interest payment at the portfolio level in a participating country, the deductibility of this interest payment may be compromised. For a short animation explaining the anti-hybrid rules, see http://beps.debevoise.com/#video2.

Hybrid instrument ❷

A Preferred Equity Certificate (PEC) is typically treated as debt in Luxembourg but equity in the United States and is therefore a hybrid instrument. The anti-hybrid rules proposed under Action 2 may apply to disallow a portion of the interest deduction in LuxCo (or, surprisingly, could even impact interest deductibility at a portfolio company level). This may be the case even if the US investors are US tax exempt. For more on this, see https://www.debevoise.com/insights/publications/2017/06/the-anti_hybrids-rules_pe-fund-structures.

Treaty abuse ❸

One of the reasons many funds invest through a holding company is because of the treaty benefits offered by such holding company's jurisdiction (*i.e.,* the elimination of withholding tax on interest and distributions). BEPS Action 6 aims to prevent the granting of treaty benefits in inappropriate circumstances. Applying the anti-abuse provisions to a fund is tricky. One approach, the Limitation-on-benefits (LoB) rule, involves tracing through to all of the beneficial owners to establish whether they are obtaining better treaty benefits by investing through the fund. The other approach, the Principal Purpose Test (PPT) rule, tests whether one of the principal purposes of the arrangements is to obtain treaty benefits. Applying the LoB rule to a widely-held fund is administratively burdensome, and applying the PPT rule is technically challenging and will require a large degree of professional advice. The greater the holding company's substance, the easier the analysis will become. For a short animation explaining the anti-treaty abuse provisions, see http://beps.debevoise.com/#video4, and for further analysis on this area, see http://www.debevoise.com/insights/publications/2017/07/treaty-benefits-in-a-fund-context.

Transfer pricing ❹

The transfer pricing guidelines have been updated significantly in response to a number of BEPS Actions and have put more pressure on the analysis of payments for services between related parties. The amount of management fees that each of the manager and the adviser(s) are allocated may need to be reviewed, with particular focus on the activities undertaken by people in each relevant jurisdiction and the functions that such people perform. This will be of particular relevance to sponsors with an offshore manager supported by a substantive onshore adviser. Further, Action 13 seeks to introduce a requirement for multinational enterprises (MNEs) to produce transfer pricing documentation on a country-by-country basis. This will require MNEs to provide high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations. A detailed "local file" will be needed in each country of operation. Large MNEs will also be required to file a Country-by-Country (CbC) Report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax, and income tax paid and accrued. These MNEs must also report their numbers of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, the CbC Report requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities in which each entity engages.

Interest deductibility ❺

Action 4 seeks to limit "base erosion" through interest deductions, setting out a fixed ratio rule that will limit the deductibility of net interest costs to a percentage of EBITDA. Amounts above the fixed ratio may still be available to deduct for companies forming part of a worldwide group, where net interest expense will be deductible up to a level equal to the worldwide group's net interest/EBITDA ratio. Related-party debt, or debt that would not ordinarily benefit from interest deductibility, is likely to be excluded from the group net interest calculation. For a short animation considering interest deductibility, see http://beps.debevoise.com/#video3.

Conclusion

BEPS is here to stay and has real implications for funds. Changes will be needed and serious thought given to many tried and tested structures for both existing and new funds. BEPS represents the new now, and we have every expectation that, with care, the private equity industry should, in the (correctly attributed) words of Mr. Spock, “Live long and prosper.”

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Please contact BEPS@Debevoise.com to discuss further.