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Private Equity: Cross-border acquisition structures in the line of fire?

Proposed changes to international tax rules could have a major impact on private equity structures

In a discussion document published 21 November 2014, the Organisation for Economic Co-operation and Development (the **OECD**) has acknowledged an issue which has been causing increasing concern in the international private equity community.

As many readers will know, the OECD has been asked by the G-20 Governments to develop a plan for reframing the international tax system. This is the so-called "Base Erosion and Profit Shifting" project (**BEPS**). The BEPS project has arisen from concerns amongst governments and tax authorities that the international tax system has not kept pace with the development of international business and capital structures. Public outcry and media attention (whether or not well-informed) about the tax affairs of some high profile corporations has pushed this work towards the top of the international political agenda.

One of the action plans which the OECD has been developing is a plan to counter "Treaty Abuse" – i.e., transactions and business structures which (in the OECD's view) unfairly allow taxpayers to claim relief from taxes under international tax treaties.

A key proposal in this area is that countries participating in the BEPS project should be encouraged to amend their tax treaties to include a "limitation on benefits" provision (an LoB). The United States generally seeks to include LoB provisions in its tax treaties and has done so for some years, but very few other countries in the world follow that practice. In particular, LoB provisions are very rare in tax treaties within Europe.

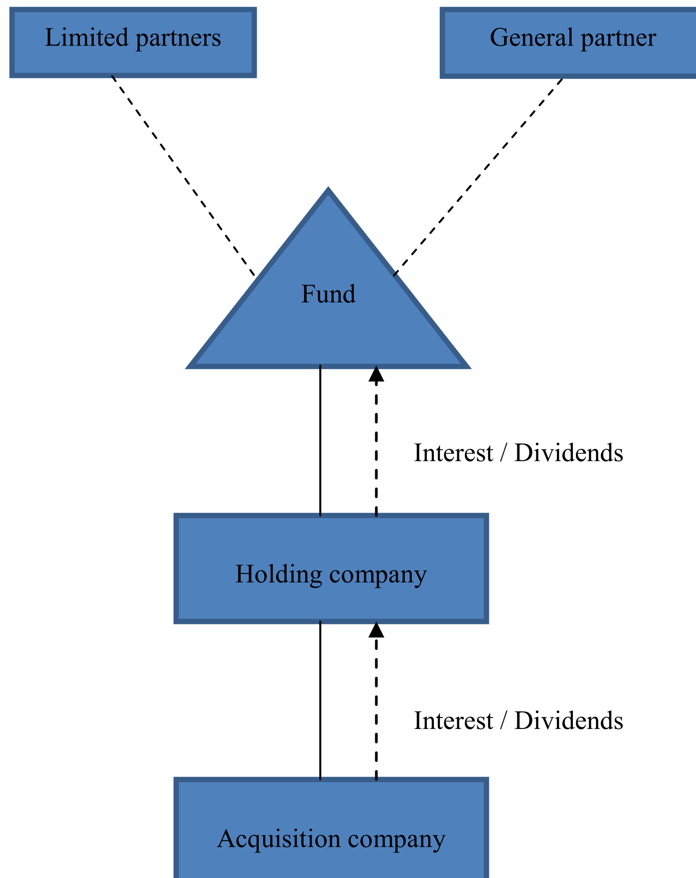
The OECD's LoB proposal would essentially prevent a taxpayer from claiming benefits under a tax treaty unless the taxpayer satisfies one of a number of conditions, the main conditions being that:

- the taxpayer's shares (or other ownership interests) must be listed and actively traded on a recognised stock exchange; or
- the taxpayer must carry on an active trade or business in the country in which it is tax resident.

Impact on Private Equity

This is an important issue for private equity investors and fund managers, because it is common for acquisition and holding vehicles used in European private equity acquisition structures to claim benefits under tax treaties, particularly to avoid the

imposition of withholding taxes on interest and dividend flows. (See the very simplified illustration of a private equity acquisition structure below.)



A large number of these kinds of acquisition and holding vehicles will fail to qualify for treaty benefits under the LoB provision currently proposed by the OECD, because:

- typically, neither the acquisition or holding vehicle nor the private equity fund that ultimately owns it will be listed or actively traded on a recognised stock exchange; and
- the acquisition or holding vehicle will normally be holding investments, rather than carrying on an active trade or business (the holding or managing of investments is specifically excluded from the concept of an active trade or business under the OECD's current proposals).

The result would be that many European private equity structures would suffer a significantly higher tax burden, resulting in reduced post-tax returns for investors. Fund managers would need to consider whether those tax costs could be mitigated through restructurings (see further below).

Representations about this issue have been made to the OECD by a number of private equity representative bodies and fund managers.

The OECD has now at least acknowledged publicly that this important concern has been raised by the private equity sector. However, the OECD's discussion document published 21 November 2014 does not propose any

solutions for private equity. It merely invites comments on whether there is indeed a problem for private equity here and how to address those concerns without creating opportunities for treaty abuse.

The OECD has previously suggested some ways in which the LoB proposal could be amended to address the position of "mainstream" investment funds (i.e., widely-held funds including retail funds). Most of those suggestions revolve around asking fund managers to determine the treaty entitlements of their investors. Those proposals remain under discussion with the "mainstream" funds sector, but if applied to the private equity sector they would present severe practical problems for most private equity funds, which generally have no straightforward means of establishing the treaty entitlements of their investors. The problem is particularly acute in "fund of funds" cases, where private equity funds may effectively have to look through higher tier fund structures, possibly tracing through to thousands of ultimate investors.

Restructurings?

Private equity fund managers may wish to consider possible restructuring steps which could mitigate the impact of the BEPS proposals. For example, restructurings might enable holding or acquisition vehicles to rely on domestic exemptions from withholding taxes, rather than claiming treaty benefits.

The outcome of the OECD's action plan could ultimately incentivise funds to undertake more fundamental restructurings – for example, to divide into funds of treaty eligible investors and non-treaty eligible investors and to allocate investments in high tax jurisdictions to the former where possible – but most funds will no doubt wish to wait until there is greater clarity about the outcome of the BEPS proposals before undertaking such a restructuring.

Fund documents

In any event, general partners and fund managers may wish to consider including provisions in new fund documentation, and amending existing fund documentation, to assist fund managers in the onerous task of obtaining information from investors about their treaty entitlements, in case that effectively becomes necessary as a result of the OECD's action plan.

FOR MORE INFORMATION:

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