The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
www.hflawreport.com | Volume 9, Number 15 | April 14, 2016

FATCA

Steps That Alternative Investment Fund Managers Need to Consider to Comply With the Global Trend Toward Tax Transparency (Part Two of Two)

By Dmitri Semenov, Jun Li, Lucas Rachuba and Carter Vinson
Ernst & Young LLP

In response to increased demand for transparency and reporting, alternative investment funds (AIFs) and other financial institutions can improve their positions in a competitive market by proactively addressing reporting and planning issues arising from recent global initiatives. Fully addressing these issues requires a combination of immediate action and long-term planning.

In a two-part guest series, Dmitri Semenov, Jun Li, Lucas Rachuba and Carter Vinson of Ernst & Young (EY) highlight challenges and steps that AIFs should consider taking to address the global planning and reporting issues associated with increased transparency demands arising from global initiatives including U.S. Foreign Account Tax Compliance Act (FATCA), U.K. Crown Dependencies and Offshore Territories (CDOT), Common Reporting Standards (CRS), Base Erosion and Profit Shifting (BEPS), State Aid and the European Union (E.U.) anti-avoidance measures. The following diagram provides a high-level summary of some of these issues:

Reporting considerations
Immediate areas of focus

- **CRS** requires AIFs to conduct diligence (55 countries starting in 2016 and another 40 starting in 2018) and report (starting in 2017) on their investors. FATCA will continue to apply to diligence of U.S. investors as long as the U.S. does not agree to follow the CRS regime, but this may change in the future.
- **CDOT** requires diligence (starting in 2014) and reporting (due May 31, 2016) on specific U.K. persons investing in U.K. and CDOT entities. CDOT will be replaced with CRS in 2018.
- **BEPS country-by-country reporting (Action 13)** requires companies to use a consistent three-tier framework for providing information on global allocation of income, economic activity and intercompany pricing across all of a company's global operations.

Planning considerations
Long-term considerations

- **BEPS treaty access (Action 6)** aims to restrict treaty abuses and limit treaty access to qualifying persons only and/or to transactions where obtaining the benefits of the tax treaty is not a main purpose.
- **BEPS permanent establishment (Action 7)** focuses on defining the concept of permanent establishment to create key value drivers and decisions.
- **BEPS finance deductions and hybrids (Actions 2 and 4)** aim to prevent tax advantages relating to hybrid instruments or entities and excess interest deductions (relative to taxable profit) being deductible in a jurisdiction.
- **BEPS harmful tax practices (Action 5)** provides guidance on what qualifies as a ruling and best practices for cross-border rulings, as well as a framework for the compulsory spontaneous exchange of information on rulings.

©2016 The Hedge Fund Law Report. All rights reserved.

This second article discusses the planning considerations and other long-term issues for hedge funds and other AIFs to consider. The first article addressed global reporting considerations and areas on which AIFs should immediately focus.

For more on tax transparency, see "*A Checklist for Updating Hedge Fund and Service Provider Documents for FATCA Compliance*" (Feb. 21, 2014). For analysis from other EY professionals, see "*Eight Key Elements of an Integrated, Efficient and Accurate Hedge Fund Reporting Solution*" (Nov. 13, 2014); and "*Daniel New, Executive Director of EY's Asset Management Advisory Practice, Discusses Best Practices on 'Hot Button' Hedge Fund Compliance Issues*" (Oct. 17, 2013).

Key BEPS-Related Action Items

In addition to country-by-country reporting (CbCr or Action 13 – covered in the previous article in this series), the following are the key BEPS-related action items that AIFs and their managers need to focus on:

- *Policy Impact Assessment:* Understand the tax policy implications of the action items that are likely to have a significant impact on AIFs, including tax treaty access (Action 6), permanent establishment (Action 7), finance deductions (Action 4) and hybrid instruments (Action 2) (discussed in more detail below).
- *Local Country Implementation:* Determine how specific countries where AIFs operate will implement BEPS and develop a short- and long-term country-specific plan.
- *Investment Decision Process Changes:* Consider BEPS action items as part of the investment decision process and the overall effective tax rate impact (e.g., the structure of intercompany leverage, management decisions and acquisition structuring).
- *Short- and Long-Term Focus Areas for Existing Structure and Processes:* Develop a list of focus areas to consider potential changes that may be warranted with respect to how an organization is managed on a global basis (e.g., the activities of local personnel and how various data is collected).

Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Action 6 aims to prevent the abuse of double tax treaties and will have an impact on the ability of AIFs to take treaty-based positions with respect to their investment structures, including those in Luxembourg, the Netherlands and Ireland. If they are implemented in their present form, the limitations of benefits (LOBs), principal purposes test (PPT) and other anti-abuse provisions contained in Action 6 will likely disallow treaty benefits under many structures in place today.

However, the timing and scope of implementation of these rules will be different for different source countries. Therefore, it is very important to review the impact of Action 6 in light of specific local country implementation considerations.

AIFs should also monitor potential implementation of multilateral instruments that could accelerate the changes under Article 6. Potential action steps AIFs could undertake with respect to Action 6 are outlined in the diagram below. Each of these action items creates opportunities and uncertainties, but further BEPS guidance and developments will be necessary before AIFs can effectively determine the benefits and disadvantages of each.

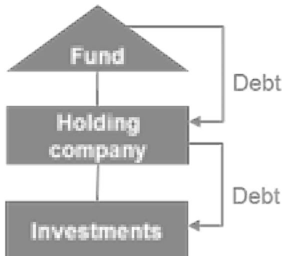
©2016 The Hedge Fund Law Report. All rights reserved.

The HEDGE FUND LAW REPORT

The definitive source of actionable intelligence on hedge fund law and regulation

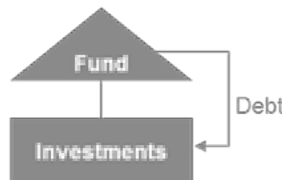
www.hflawreport.com Volume 9, Number 15 April 14, 2016

Align holding company location with operating substance footprint



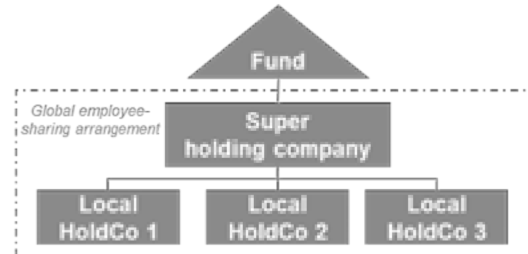
- Consider establishing a holding company in a jurisdiction where discretionary investment management professionals are present (*e.g.*, the U.K. or Singapore).
- Using that jurisdiction as a holding platform jurisdiction may strengthen arguments that a treaty PPT may not apply, as the platform is likely to have significant substance.
- The U.K. is likely to be more appropriate for E.U.-inbound private equity investments (which are more likely to be covered by the U.K.'s participation exemption from capital gains).

Consider transparent structure and investor treaty eligibility



- One approach to managing treaty access is to utilize the treaty access of the investors themselves, as opposed to using a treaty platform.
- There may be additional administrative burdens relating to identifying the tax residency of each investor, and certain filings may be needed on an investor-by-investor basis.

Consolidate holding companies under one umbrella



- Super HoldCo is the "host" employer, but all employees can be seconded to Local HoldCos under a global employee-sharing arrangement. Local HoldCos therefore have employees who are able to undertake activities locally, thus providing substance. PPT is less likely to be met where significant substance exists locally.
- This structure is appropriate where one fund makes all of the investments or more than one fund co-invests in the same proportions, but not in a multi-fund manager situation.
- This structure may have additional CbCr implications, since the separate holding vehicles will be aggregated under one umbrella (see discussion of Action 13 in the prior article in this series).

Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

Action 7 aims to redefine the level of activities required to create a taxable Permanent Establishment (PE) by focusing on value-creating activities and the location of the key decision-makers. AIFs should focus on mitigating potential PE risk related to their management entities, funds and investment individuals. These concepts are not new, but they are being brought into a sharper focus because Action 7 aims to ensure that the profits are taxed on the global basis consistently with the location of the key decision-makers.

AIFs should still be able to rely on existing trading safe harbors in various jurisdictions such as Australia, Hong Kong, Singapore and the U.K. AIFs also should develop, implement and monitor specific guidelines for their employees that focus on the various phases of the decision-making and deal-making processes (i.e., origination, execution and post-closing activities) to ensure that all the essential elements are monitored to mitigate potential PE risk.

Actions 2 and 4: Neutralizing the Effects of Hybrid Mismatch Arrangements and Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

Action 2 focuses on curing the use of hybrid financial instruments – which are often used to produce a deduction in one jurisdiction without creating taxable income in another, or to create two deductions with respect to a single expense. Action 4 aims to restrict the use of debt leverage to erode local tax bases, often via intra-group debt.

To mitigate exposure to negative implications of these actions, AIFs should review their current structures and hybrid arrangements to identify potential risks. If AIFs

©2016 The Hedge Fund Law Report. All rights reserved.

determine that their current hybrid arrangements are at risk or that there is a potential limitation on their interest deductions, they should consider whether a different structure or jurisdiction could potentially protect against these risks.

As implementation takes place, AIFs need to assess any impacts on their current tax structures and financing approaches, as well as develop proper processes to address their additional responsibilities from a due-diligence and global-reporting perspective.

E.U. Anti-Avoidance Package

On January 28, 2016, the E.U. released an anti-tax avoidance package with four documents:

1. a proposed E.U. Anti-Tax Avoidance Directive (ATA Directive);
2. a proposed directive implementing the automatic exchange of country-by-country reports (CbCr Directive);
3. a communication proposing a framework for a new E.U. external strategy for effective taxation (External Strategy Communication); and
4. a recommendation on the implementation of measures against tax-treaty abuse.

The ATA Directive and CbCr Directive both remain in draft form, and unanimous agreement of all member states will be required before they can be implemented. Although there appears to be strong political support for an ATA Directive among member states, it is possible that the form of the final directive will differ significantly from the current draft and that the timetable set for agreement by July 2016 may not be met.

ATA Directive

The ATA Directive is much more controversial because it includes elements that are arguably wider than anti-BEPS measures. However, those elements in fact represent a compromise between the E.U. Common Consolidated Corporate Tax Base proposal and a common E.U. response to BEPS.

CbCr Directive

The CbCr Directive – which is more closely aligned with the Organisation for Economic Co-operation and Development's (OECD's) CbCr recommendations but within an E.U. context – would require member states to implement the exchange of CbCr between competent authorities in relation to multinational enterprises for fiscal years beginning on or after January 1, 2016.

It is clear that the future implementation of all or parts of either directive, in current form or as may be amended, will have a significant impact on the taxation of multinational companies and will trigger an unprecedented change in European taxation.

Anti-Treaty Abuse Measures

Finally, the European Commission (EC) also considered OECD BEPS Actions 6 and 7 in implementing measures to tackle tax treaty abuse in two ways. First, the EC asked member states to adhere to the new proposed provisions of Article 5 of the OECD Model Tax Convention as it relates to defining a PE in upcoming tax treaty negotiations with member states or third countries. The second measure is to modify the general anti-avoidance rule (based on the PPT) to require genuine economic activity in order to claim a treaty benefit from a transaction.

State Aid

State aid generally refers to situations in which the EC has determined that an E.U. member state has selectively granted a tax advantage to an entity or individual. It is theorized that, when a company receives government support, it invariably gains a competitive advantage within the market. A number of challenges have been raised by the EC against companies obtaining tax benefits from advance tax rulings (e.g., Luxembourg and the Netherlands).

For instance, in October 2015, the EC requested that Luxembourg and the Netherlands recover unpaid taxes from Fiat and Starbucks, respectively, to remove the unfair competitive advantage they have enjoyed and

©2016 The Hedge Fund Law Report. All rights reserved.

restore equal treatment to similar companies. The EC revealed that a 2012 tax ruling issued by Luxembourg to Fiat Finance and Trade has unduly reduced Fiat's tax burden by some €20-30m. In particular, Fiat's tax base was reduced via economically unjustifiable assumptions and downward adjustments, which resulted in taxes being paid on only a small portion of its actual accounting capital.

Similarly, a 2008 tax ruling issued by the Netherlands to Starbucks Manufacturing EMEA BV unduly reduced Starbucks' tax burden by some €20-30m. Starbucks' tax base was reduced via inflated transfer pricing payments made to its Swiss affiliate for coffee beans and to its U.K. affiliate for roasting know-how. The EC believed that the arrangement, although completely legal and sanctioned by the advance rulings, did not reflect economic reality and that Starbucks was given an unfair competitive tax advantage.

These two announcements came just seven months after the initial proposal in which E.U. member states unanimously passed tax transparency legislation to implement the automatic exchange of information on cross-border tax rulings. As recently as December 3, 2015, the EC announced that it was formally investigating what it preliminarily believes to be another improper state aid agreement. This time the target is McDonald's and its advance tax ruling from the Luxembourg tax authorities. McDonald's has paid virtually no corporate tax in Luxembourg since 2009, despite earning an estimated €250m in 2013 profits.

Although these challenges are very fact-specific and may not have broad implications for AIFs with rulings in these countries, they are instructive regarding the focus of the EC on tax rulings and the overall substance and business purposes considerations of AIF treaty structures. These need to be closely monitored in the future.

The views expressed in this article are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or any other member of Ernst & Young Global Limited.

The authors would like to thank Stacey Hertz, Lindsay Raulli and Will Stanley for their assistance with this article.

Dmitri Semenov is a partner in Ernst and Young LLP's international tax services practice. He based in New York in the financial services organization. Dmitri has more than 17 years of experience with U.S. cross-border planning initiatives related to alternative investment funds and U.S. and non-U.S. multinational groups. Dmitri specializes in structuring cross-border investments of alternative investment funds and their management companies.

Jun Li is a partner in Ernst and Young LLP's wealth and asset management practice. He is based in New York in the financial services organization. Jun has more than 17 years of experience serving the financial services industry including hedge funds, private equity funds and international banks. He has significant experience with a wide range of federal and inbound tax-related issues affecting funds, including U.S. domestic and offshore fund structuring, tax-efficient securities investing strategies, partnership allocation issues and fee deferral arrangements.

Lucas Rachuba is a principal in Ernst & Young LLP's international tax services practice. He is based in San Francisco in the financial services organization. Lucas has more than 15 years of experience providing tax services to sponsors of and investors in private equity, hedge fund and venture capital funds. His primary focus is on all aspects of U.S.-international taxation – inbound and outbound – including ECI, FIRPTA, FATCA and U.S. and non-U.S. withholding and tax treaty issues.

Carter Vinson is a principal in Ernst & Young LLP's international tax services practice. He is based in Boston and is the director of international tax services for asset management clients in the financial services organization. Carter counsels clients in the private equity fund, real estate and alternative investment fund industry concerning the tax structuring of new investment funds and fund managers, as well as U.S. inbound and non-U.S. investments.

©2016 The Hedge Fund Law Report. All rights reserved.