Adapting to change
The global tax landscape

October 2013

pwc
In the new era of economic deficits and increased demand for fiscal revenues by governments around the world, Sovereign Funds, like other global investors such as pension, private equity and hedge funds are exposed to the ever-changing and increasingly complex global tax landscape. That said, there are also a number of pro-growth tax changes, as a result of increased competition for inbound capital.

The taxation of Sovereign Funds varies depending on the underlying investee jurisdiction. A handful of jurisdictions incorporate the concept of sovereign immunity to varying degrees in their domestic tax law/regulations or in certain Double Tax Treaties (“DTTs”), thereby exempting certain types of income generated by Sovereign Funds. Jurisdictions with sovereign immunity exemptions include the U.S., Canada, the UK, Australia, Nigeria, and Singapore.

The trends/developments discussed in this Article impact a broad range of asset classes and trading strategies, including liquid, private equity, real estate and infrastructure type investments.

Managing global tax risks
Tax authorities around the world are increasingly sophisticated and adopting a substance-over-form approach. Further, there has been an increase in audit activity and Tax Information Exchange Agreement (“TIEA”) requests, including more challenges to sub-holding companies which have historically been entitled to benefits under relevant DTTs.

On July 19, 2013, the Organisation for Economic Co-operation and Development (“OECD”), following a request from the G20, published its Action Plan on Base Erosion and Profit Shifting (BEPS) with a view to addressing perceived flaws in international taxation. While the Action Plan focuses on international taxation in general, many of its proposed actions could directly impact traditional operating models used by global asset managers, including Sovereign Funds. The Action Plan addresses a broad array of issues including Treaty access and interest deductibility rules. While the outcome of this Action Plan remains unknown, the initiative serves to illustrate that international tax reform is an area of significant focus around the world.

These recent global trends, outlined in more detail below, coupled with Sovereign Funds being subject to increased media attention, reinforce the need to carefully examine current and future investment arrangements to ensure compliance with ever evolving global tax policies.

Changes to the conventional holding structure regime
Sub-holding companies have historically been employed by investment funds, including Sovereign Funds, for a variety of tax and non-tax reasons, including proximity to local investee markets, capital pooling, centralising financial and management functions and access to a wider range of tax treaties.

However, the use of sub-holding companies to obtain treaty protection and other tax benefits is becoming subject to heightened scrutiny by taxing authorities across the world, who are increasingly focused on the substance and business purpose of such companies.

With the wave of tax audits and scrutiny of traditional offshore holding companies, Sovereign Funds should consider reviewing whether their existing investment models remain fit for purpose and whether alternative arrangements would be more sustainable given the global tax trends and the increased focus on business purpose.

Substance and beneficial ownership
Substance and beneficial ownership are two areas tax authorities are extremely focused on. We have seen governments employ different approaches to tackle these issues. Some countries are enacting specific economic substance rules in their domestic tax legislation (such as codification of the “economic substance” rules in the United States). Other countries have enacted General Anti-Avoidance Rules (“GAAR”) to deny tax benefits to transactions that lack substance or business purpose (examples are the U.K., Australia, India and China).

Demonstrating sufficient substance and beneficial ownership for tax purposes can give rise to practical difficulties and challenges, particularly as there are no agreed-upon standards. Tax authority practice is a very important aspect of determining whether the level of substance in a holding company is sufficient, and access to tax treaty benefits can be vulnerable to sudden changes in tax authority practice. What constitutes sufficient substance is highly fact-specific and must be assessed on a case-by-case basis. In this regard, many source country tax authorities have been aggressively challenging treaty positions on the basis that the claimant entity lacks requisite substance.

‘Super’ holding company platforms
One increasingly used and potentially viable alternative is the use of “super” holding companies where substance can be considered in a single entity, rather than across many. Such companies are generally more scalable to maintain and robust from a tax perspective particularly when and where they are implemented as part of a broader commercial strategy to establish a presence outside of a Sovereign Fund’s home jurisdiction.

Managing “Permanent Establishment” (PE) Risk
Operating in an overseas location invariably exposes a fund to a certain degree of PE risk, i.e. the risk that a taxing authority could deem the fund to have a taxable presence, either because it conducts its business through a fixed place of business or through a dependent agent.

The global nature of investment portfolios means Sovereign Fund professionals are increasingly mobile and often undertake their duties in multiple locations throughout the year. A critical question is whether this behaviour could create a taxable presence (i.e. a PE) for a Sovereign Fund? Given the significant consequences associated with a PE finding, managing PE risk should be a core component of the Sovereign Fund’s overall risk management strategy.

PE risk—management and control
Tax residency risk, i.e. the risk that an entity could be considered tax resident (i.e., managed and controlled) outside of its jurisdiction of incorporation and subject to tax on its worldwide income, is another important risk that should be carefully managed.

Tax residency risk is typically managed through the development of operating protocols and implementation of sound corporate governance arrangements.

Transparency and information reporting
The significant deficits and the sustained pressure on governments to raise revenue have resulted in the introduction of new or more far-reaching investor reporting regimes. Perhaps the most well-known is Foreign Account Tax Compliance Act (“FATCA”), a statutory solution in the U.S. to the battle against the perceived under-reporting of income by U.S. persons and tax evasion. Sovereign Funds should carefully plan to ensure that they, and their investment structures, including portfolio investments, are FATCA compliant.
Opportunities

The changing tax and regulatory landscape presents Sovereign Funds with considerable opportunities. Many Sovereign Funds are repositioning themselves and redefining their strategies in order to succeed in the new environment. By analysing and understanding the impact of the global tax and regulatory changes on their business, Sovereign Funds will be better positioned to not only withstand the increased scrutiny from tax authorities, but to respond to the elevated transparency standards.

The challenging post-crisis tax environment has also given countries that are looking to attract foreign capital incentives to enact favourable tax rules to provide a competitive advantage. For example, in a quest to become financial centres of choice, some jurisdictions have liberalised their trading safe harbours and in some cases introduced a plethora of domestic exemptions designed to entice asset managers (including Sovereign Funds) to migrate or establish their operations onshore.

A number of economies have liberalised certain of their tax rules in order to attract foreign capital, including certain benefits specifically applying to Sovereign Funds. Recent examples include the inclusion in the Australian “investment manager regime” of a special concession for Sovereign Funds treating them as per se widely held entities for purposes of claiming benefits under such regime, a proposed amendment to extend an exemption to Brazilian interest withholding tax applicable in certain real estate/infrastructure related debt transactions to Sovereign Funds, as well as the introduction of special REIT regimes (e.g. Mexico and Spain) designed to attract inbound real estate capital in an asset class which traditionally subjected non-residents to taxation in the jurisdiction where the underlying real property is located.