

# Sovereign Investors

Navigating tax transparency in Europe

# Introduction

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In the aftermath of COVID-19 and the resulting low-yielding environment, sovereign actors are looking more than ever to real estate, infrastructure, private equity, private debt and other alternative assets for strategic investment opportunities.

Although typically tax-exempt in their home countries, the investment activity of sovereign actors has global reach and their investment structuring is sophisticated and increasingly varied in form. As such, sovereign investors, like most other market participants, are exposed to all manner of profound changes taking place in the wider tax landscape. Actions at OECD, EU and local country levels continue to generate changes of law at an unprecedented rate. Such measures drive at increasing tax transparency, eliminating artificial divergence of profits and instituting minimum levels of tax.

Governments of European countries are presently seeking to drive post-pandemic growth with a particular focus on investing into renewable energy and digital infrastructure. Sovereign actors are, with their deep pockets and long-term investing horizons, a key source of capital for such investments. However, at the same time, these governments are under pressures at home. They have to rebuild their public finances following the economic upheaval caused by the pandemic and manage public

distrust about whether big business is paying its "fair" share of tax. This means that new tax anti-avoidance and disclosure measures continue to be a prioritised policy for administrations across the continent.

From the perspective of sovereign investors, given their generally tax-exempt status, increased taxation at the investee jurisdiction level directly affects the bottom line on investment returns. Just as importantly, however, the complex and evolving tax landscape demands that the in-house tax teams of these sovereign actors are able to institute tax risk management and reporting strategies that align with their organisation's broader governance and sustainability goals. Each tax team has the difficult task of protecting the sovereign investor and home state from the disclosure of potentially sensitive information, whilst also managing the real reputational and political risks that may stem from failure (whether actual or perceived) to observe another state's laws.

The law changes in the EU and the UK that require these increased tax disclosures come in different guises. Some demand increased tax diligence between the sovereign investor and its investees or between the sovereign investor and its investing partners. Others give rise to disclosure requirements by the sovereign actor to tax authorities, governments or, most onerously, the general public.

## Disclosures between sovereign investors and investees - Anti-hybrid rules (EU ATAD II and UK anti-hybrid rules)

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Following the recommendations of Action 2 of the G20 / OECD BEPS (1.0) project, the UK implemented anti-hybrid rules for periods commencing on or after 1 January 2017. Similarly, Council Directive (EU) 2017/952 of 29 May 2017, commonly known as ATAD II, required EU Member States to implement legislation giving effect to anti-hybrid provisions also based on Action 2 from 1 January 2020.

The purpose of these rules is to counteract the benefit of tax mismatches (i.e., a tax deduction on a payment with no corresponding income inclusion, or a double deduction) created through the use of hybrid entities (being vehicles, such as partnerships or "checked" entities, regarded as tax-transparent in one jurisdiction, but opaque in another),

or hybrid financial instruments (for example, instruments treated as tax deductible debt in one jurisdiction, but equity in the other). Where the rules are triggered, they deny a tax deduction in respect of payments made under the hybrid structure or they render taxable a tax-transparent entity to the extent necessary to neutralise the mismatch effect.

Since the implementation of these provisions, there has been a noticeable shift away from the use of financial instruments with potentially hybrid characteristics, given that they no longer confer the tax benefits they used to. However, the use of tax transparent fund or joint venture vehicles (e.g. English or Luxembourg limited partnerships) continue to be essential

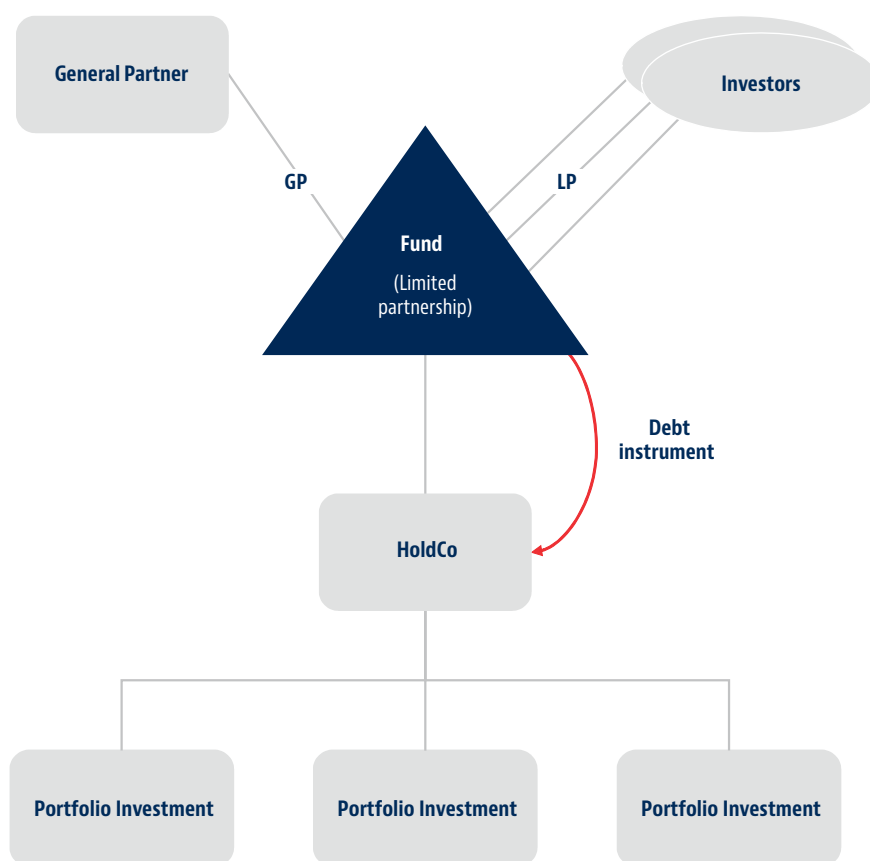
mechanisms for pooling capital and holding investments. In particular, for sovereign actors, the tax transparency of such vehicles may preserve access to sovereign immunity from taxation in the investee jurisdiction or mitigate withholding tax leakage and local compliance obligations. These vehicles may be hybrid entities, if they happen to be characterised differently for tax purposes in the investor and investee jurisdictions. If so, deductions on payments made to or by the vehicle, may be disallowed (e.g. payments by the "HoldCo" to the "Fund" on the debt instrument in the diagram below) or tax-transparent entities may become subject to tax (e.g. the "Fund" in the diagram below), but crucially this should only be the case where it is the hybridity that causes the offending tax mismatch.

The anti-hybrid rules generally require that the investors reach certain minimum voting, capital or profit right thresholds (in Luxembourg, 50% for hybrid entity provisions, 25% for hybrid instruments provisions) in the structure. The interests of different types of investors, even if apparently not related, can be aggregated and reach such thresholds if they are deemed to be "acting together".

Specific carve out rules may apply preventing certain investment funds and their investors from suffering

the effects of part of the rules mentioned above. In Luxembourg, for instance, investors holding less than 10% in certain widely-held investment funds may benefit from a presumption that they do not act together with other investors and therefore anti-hybrid rules do not apply. Also, the rules according to which tax-transparent entities may become subject to tax do not apply to certain tax-transparent widely-held investment funds.

In order to assess the tax deductibility of payments made by them, funds or portfolio companies now request certain information, often in the form of a pro-forma questionnaire, about the tax treatment of the potentially hybrid vehicle and payments in the hands of their investors to assess whether there may be a tax leakage that could potentially reduce the profitability of the investment structure and, therefore, the profits distributable to investors. A relevant part of this assessment aims to collect information to support the case that different investors are not "acting together". As a result, sovereign actors are having to carefully diligence the tax characterisation of their investment structures under their local laws, notwithstanding that such analysis has previously been unnecessary where they benefit from tax-exempt status. Their tax-exempt status is furthermore likely to yield a tax



mismatch result on payments (i.e., a tax deduction on the payment at investee level with no taxable income inclusion at investor level). However, this in and of itself should not trigger a disallowance, because the reason for the mismatch is not the hybrid nature of any instrument or vehicle in the structure. Sovereign investors must, therefore, determine whether a tax mismatch exists beyond the tax exemption from which they benefit and compile a response with the appropriate detail to satisfy the investee's diligence processes. In addition, sovereign actors may also, as a matter of diligence, seek to understand whether the tax treatment of certain payments or certain entities in the jurisdiction of residence of other investors under their commonly used investment structures causes the anti-hybrid rules to be triggered and whether a tax leakage can arise for the structure.

Sovereign actors may seek to ensure that costs arising from deductions denied or taxation triggered for the investment structure owing to hybrid mismatches caused by treatment in the hands of other investors are passed on to or incurred by those investors only.

The information requests used by investees tend to be broadly drafted and often solicit more information than may be necessary to conclude on the anti-hybrids risk of payments made to any specific investor. Given the desire of sovereign actors in particular to minimise unnecessary

disclosures, it would be a worthwhile exercise to prepare and maintain in view of any commonly used investment structures, a standard statement setting out the sovereign investor's tax position. Such statement would have the benefit of being reviewed and signed-off in advance from a governance and risk perspective and could be supplied to the investee in lieu of responding to separate information requests for each investment.

This diligence by sovereign actors to detect hybrid mismatches potentially affecting the structures in which they invest often builds on a broader assessment regarding the suitability of the structures to stand scrutiny from an overall anti-abuse tax perspective. The trend is for sovereign actors investing as limited partners or as co-investors with minority interests to carefully diligence the substance, the business rationale of the overall structures proposed by the sponsors in order to anticipate tax risks that could give rise to reputational implications in light of the ever-demanding anti-abuse tests. In this respect, the so-called "ATAD 3", the EU legislative initiative to neutralize the misuse of shell entities (legal entities and structures without a substantial business presence), will likely raise attention and scrutiny over the topic of the economic substance of EU investment structures, whatever the outcome of the initiative.

## Disclosures to government - DAC 6

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The 6th amendment to the EU's Directive on Administrative Cooperation in the Field of Taxation (known as DAC 6) aims to increase transparency by requiring intermediaries and, in certain circumstances, taxpayers, to report to their local tax authorities cross-border transactions meeting certain "hallmarks", which are deemed to represent aggressive tax planning. The majority of EU jurisdictions commenced DAC 6 reporting requirements as of 1 January 2021.

DAC 6 carries a certain sensitivity for sovereign investors since the reporting obligations it contains weighs primarily on intermediaries (e.g. tax advisers, banks, etc.). In theory, therefore, the nature and extent of transactional

information submitted to the tax authority of another state may escape the control of the sovereign investor, notwithstanding that the investor will want to monitor closely any disclosure of a reportable cross-border arrangement that may be perceived as aggressive tax planning and thus carrying reputational and political risk.

The fact that the application of this legislation is not harmonised amongst the EU Member States adds further complexity and requires sovereign investors to ensure overall consistency between all intermediaries in cross-border transactions.<sup>1</sup>

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<sup>1</sup> Click [here](#) a more detailed analysis of DAC 6.

# Proposed regulations to address distortions caused by foreign subsidies facilitating the acquisition of EU companies

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The European Commission has recently adopted a proposal aimed at closing the current regulatory gap in the EU Single Market, whereby subsidies granted by non-EU governments go largely unmonitored, while subsidies granted by EU Member States are subject to close scrutiny.

The overall objective of the proposed instrument is to ensure that foreign subsidies do not confer an unfair benefit to their recipients when acquiring stakes in EU companies, either directly by linking a foreign subsidy to a given acquisition or indirectly by de facto increasing the financial strength of the acquirer. It is expected that “foreign subsidy” will be defined widely and may capture tax exemptions granted to a sovereign investment fund or preferential financing conditions, such as unlimited guarantees or low/zero interest funding.

Companies benefitting from the financial support of a non-EU government would need to notify their acquisitions of EU companies, above certain thresholds, to the European Commission. Although thresholds should be set relatively high to capture only material cases, sovereign investors may nevertheless find themselves to be a frequently affected class of investor given their appetite for deploying large capital tickets.

Crucially, transactions would not be able to be completed whilst a review by the European Commission remains pending. Should the supervisory authority find that the acquisition is facilitated by the foreign subsidy and distorts the EU’s Single Market, it could either accept commitments by the notifying party that effectively remedy the distortion or, as a last resort, prohibit the transaction.

Even if the European Commission is unlikely to find that there had been a concerning distortion, in-scope investors may nevertheless be required to make a notification depending on the scope of the final legislation. Not only might this require sensitive information to be disclosed, but due to the potential impact on transaction timelines, sovereign investors may find their access to time-sensitive transactions affected by such a notification requirement.

Sovereign investors’ tax teams should be monitoring the legislative progress of these proposed regulations in order to be able to efficiently diligence the parameters within which their fund may be subject to a requirement to notify, whilst also keeping their deal teams abreast of the potential commercial ramifications.

## Public Country-by-Country Reporting

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Whilst public country-by-country reporting (“CbCR”) has been on the EU policy agenda since 2016, a provisional political agreement was finally secured and a directive proposal put forward on 1 June 2021. The legislative process has just been closed with the approval of the proposed directive by the European Parliament on 11 November 2021. After transposition into national law by each EU Member State, businesses will need to comply with the CbCR rules by mid-2024.

The objective of the public CbCR regime is to provide transparency on where large multinational groups pay tax and how much. Even if no tax avoidance exists, there is always the potential for disclosed information to be misinterpreted by the public, such that there may be heightened reputational risk for

players associated with reportable investment structures as a result of a public CbCR requirement.

The directive requires both EU-based companies and non-EU based companies doing business in the EU through a branch or a medium-size and large subsidiary, with consolidated revenues exceeding EUR 750 million for each of the last two consecutive years, to publicly disclose income taxes paid and other information, such as a breakdown of profits, revenues, business activities and employees, on a country-by-country basis for each EU Member State, as well as for certain third countries on the EU list of non-cooperative jurisdictions.

There are no reporting exemptions for any specific type of investment funds and related structures or for sovereign



investors. The determining trigger for public CbCR is the minimum consolidated revenues threshold of EUR 750 million.

Public CbCR may apply at different levels depending on which entities are required to consolidate their accounts. Guidance from the OECD in the context of the non-public CbCR (originating from Action 13 of the OECD BEPS project) indicate that the general principle to determine whether CbCR applies to investment funds, partnerships and sovereign investor structures is to follow accounting consolidation rules.

For instance, certain EU companies or investments in which sovereign investors invest could fall under the public CbCR

rules if they are required to consolidate under the accounting rules and consolidated revenues meet the minimum threshold of EUR 750 million. If the EU top investment entity or fund is not required to consolidate its accounts, reporting may be due at the level of a holding or sub-holding company (often used as “blockers”) required to consolidate the accounts of one or several portfolio companies in different jurisdictions provided that the consolidated group would meet the EUR 750 million revenues threshold. If none of the entities of an investment structure is required to consolidate under accounting rules, most likely no public CbCR would be required based on the proposed directive. This must, however, be assessed on a case-by-case basis.

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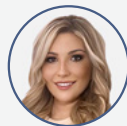


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