BEPS - Base Erosion and Profit Shifting

The global infrastructure community faces possibly its most significant tax issue: uncertainty surrounding the implementation of the OECD's BEPS initiative and associated tax reforms in the countries from, through and in which investments are made. Global infrastructure represents a large source of capital investment with many governments recognising this in an attempt to narrow the infrastructure investment gap. Countries such as the US, Australia and India, for example, consider investment in infrastructure to be crucial to the stimulation of economic growth and are committed to the implementation of tax regimes that facilitate this. However, it is still largely unclear if/how some OECD member countries will amend their domestic laws to take into account the BEPS recommendations, and if so, whether such tax reforms will introduce barriers to investment for infrastructure.

The BEPS initiative is not targeted at infrastructure businesses, which represent stable and steady streams of taxation revenues for source countries and are markedly different from non-tangible assets based businesses (e.g. IP), in which profits are more easily capable of being artificially shifted between jurisdictions. However, infrastructure businesses are by nature capital-intensive and there is an expectation of regulators for such businesses to maximise the utilisation of debt instead of more expensive equity to reduce the overall cost of essential services to the consumer, which typically leads to substantially higher levels of debt than in other sectors. In addition, the global nature of infrastructure investors (typically pension funds and sovereign funds from around the world investing directly or through collective investments), coupled with the long-term nature of infrastructure investments (usually acquired on a 'buy and hold' basis) results in a steady stream of cross-border cash returns to investors. These features of naturally high leverage and cross-border cash flows means there is a very real risk that infrastructure investments are adversely impacted by a number of the BEPS changes, thus damaging countries' long-term infrastructure ambitions.

Some governments have acknowledged and sought to reduce the unintended consequences of this through various consultation processes. For example, some intend to reflect exemptions/concessions for infrastructure projects in domestic law (such as the UK's 'public benefit infrastructure exemption'). For other countries, it is not yet clear how many of the rules will apply to infrastructure businesses. As set out below in more detail, GIIA – the association created to represent the voice of global infrastructure investors - is focused on understanding how countries are interpreting various recommendations and engaging with various tax authorities and regulators in representing the collective views of its member base. Our aim is to foster certainty, transparency and stability for the mutual benefit of providers of long-term private capital and the public users of essential services.

BEPS – what is it?

"BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid."

Led by the OECD, the BEPS initiative is a multi-step plan to co-ordinate the reshaping of international tax regimes in an effort to reduce tax avoidance and increase the tax transparency of organisations. Arrangements which are particularly under scrutiny are where groups:

- Deliberately use unnecessarily complex structures and financing instruments;
- Recognise taxable profits in countries with low tax rates, with no regard to the source/origin of those profits;
- Raise interest bearing debt in low interest-rate countries and structures internal funding arrangements to leverage up disproportionately subsidiaries in higher-tax jurisdictions; and
- Use arbitrary holding jurisdictions for investments in order to minimise tax.

In October 2015, the OECD issued a final report outlining 15 suggested BEPS Action Points for member countries to adopt, with the intention that this would assist in the reduction of BEPS on national tax revenues. The G20 approved the Action Plan and agreed to implement it as quickly as possible.

Measures most relevant to infrastructure investors are:

- Interest deductions – limitations on net interest deductions claimed by a group based on a percentage of its earnings ('Action 4');
- Treaty abuse – to tackle treaty shopping and prevent the granting of treaty benefits in inappropriate circumstances ('Action 6');
- Hybrids – aims to neutralise the effects of hybrid mismatch arrangements and instruments (for example, where payments on particular instruments give rise to deductions with no corresponding taxable inclusion due to the tax laws of one country treating a particular cross-border arrangement differently from the treatment of the arrangement from the tax laws of another country) ('Action 2'); and
- Country-by-country reporting – to develop rules regarding transfer pricing documentation to enhance transparency for tax administration, including requiring large multinational businesses to provide relevant governments with specific information on their global allocation of income, economic activity and taxes paid amongst countries ('Action 13').

BEPS - Why is this important for infrastructure investors?

There is a significant risk that the implementation of a number of these actions would result in tax limits/restrictions to long-term investment arrangements. This disruption would affect the availability of long-term capital and impact the types of infrastructure investment arrangements available. It is therefore important that a solution is found to facilitate continued growth of long-term investment into infrastructure through as many routes as possible (including joint ventures, consortia, and funds alongside other like-minded investors).

Many governments already recognise that private investment is essential if countries are to narrow the infrastructure investment gap, and are to some degree conscious of balancing the implementation of BEPS with the continued encouragement of investment in global infrastructure. Infrastructure funds serve an important social purpose in the raising and pooling of capital from a number of sources, including pension funds and sovereign wealth funds, which are themselves important sources of long-term capital and investment. The nature of this model, with funds needing to raise significant capital up front (often funded with debt) and pool it in various holding jurisdictions, could unintendedly be captured under the BEPS recommendations. This could result in damaging consequences for both the public users and private owners of infrastructure, in the absence of specific engagement with governments on behalf of the infrastructure investor community. As one example, under Action Plan 6, treaty benefits could potentially be denied simply because consortium members have invested through a vehicle which pools their investment.

Some countries have already taken steps to implement a number of the recommendations. The UK, for example, has drafted legislation to be introduced from 1 April 2017 implementing interest deductibility restrictions. In doing so, UK Treasury and the UK tax authority (HMRC) have made substantive progress in engaging with industry during the consultation process. Pertinently, in recognition of the importance of certain UK infrastructure projects and specific capital requirements for infrastructure projects, HMRC have considered detailed submissions from industry to include an exemption for 3rd party debt in public benefit infrastructure businesses that captures a full range of the infrastructure ‘spectrum’ from publicly procured social infrastructure to a range of regulated/licenced economic infrastructure.

BEPS - What is GIIA doing about it?

The scale and pace of change in the international tax environment as a result of the OECD recommendations is unprecedented. The real challenge now is keeping appraised of how countries are interpreting the various OECD recommendations. In a bid to maintain momentum on this, GIIA seeks to:

- Through the GIIA Tax Working Group, continue engagement with tax and regulatory authorities to represent the collective views of its member base, working to mitigate detrimental decisions arising from poorly informed debate, rushed BEPS measures, or tax authority engagement that is not constructive (or timely);
- Educate tax authorities on the structure of typical infrastructure investment commercial and economic models to bring awareness around the use of certain structures and to highlight that they are designed for a multitude of 'non-tax' reasons;
- Bring awareness of the impact of various BEPS measures and their potentially unintended consequences on the infrastructure community and investors; and
- Encourage dialogue between investors, regulators and various government tax authorities to protect investor confidence and prevent major barriers to investment.

For more information contact GIIA via info@giia.net.

Last updated: 9 March 2017