Three Years, Two Pillars and One New Headache for Investment Funds

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Fund sponsors, investment advisors and other financial market participants would be forgiven for not concerning themselves with tax initiatives originally targeted at the digital economy. However, with the latest technical reports released by the Organisation for Economic Co-operation and Development (OECD) that include the prospect of a global minimum effective tax rate, such firms will need to consider whether they are within the scope of the new rules proposed in these reports and navigate the potential impacts.

OECD Blueprints and the Pillars

On October 12, 2020, after three years of focus on the digital economy, the OECD officially released its "blueprints" for Pillars 1 and 2 (Blueprints). Pillar 1 and Pillar 2 (the Pillars) are the two key sets of principles around which OECD's proposed global taxation framework is organized. The Pillars seek to reform the international tax system by proposing the key elements of a consensus-based solution for the challenges posed by digitalization of the economy. While draft versions of these documents began circulating in late August 2020, their publication marks an important official signposting toward the future development of a new international tax landscape and the most comprehensive explanation to date of what the rules themselves could look like if consensus at the OECD is reached in 2021.

Coming to a swift global consensus on both Pillars is for many a necessary outcome. In recent days, the International Chamber of Commerce and other international organizations have called for increased collaboration on these matters. Nearly all commentators appreciate that, if adopted, the Pillars could materially change both the operation of taxation and the amount of tax payable by many taxpayers, and we expect countries to move carefully as they attempt to assess the impact of the Pillars on their tax revenues. This cautious approach has been demonstrated by Ireland; while Ireland accepts that change is inevitable, its Minister for Finance noted that any agreement would "present challenges" for Ireland and likely reduce the levels of profits taxable there.

What Do the Pillars Aim To Achieve?

Pillars 1 and 2 focus on the taxation of multinational enterprise (MNE) groups and, as noted above, grew out of the OECD's work on the tax challenges of the digitalization of the economy undertaken as part of its base erosion and profit shifting (BEPS) project (most notably, its BEPS Action 1 Report). Pillar 1 seeks to introduce rules that reallocate profits of MNE groups to market jurisdictions where existing international tax rules mean such profits are currently difficult or impossible to tax. Pillar 2 seeks to introduce a global minimum effective tax regime for income and profits of MNE groups that will apply regardless of where the MNE group is established or operative so as to hinder the shifting of profits to jurisdictions where they are subject to little or no tax. Pillar 2 would operate through an income inclusion rule and an undertaxed payments rule (the GloBE Rules).

The Pillars and Investment Funds

Although Pillar 1 has the potential to impact some investment management groups where the intellectual property (*e.g.*, for automated trading platforms) is separately housed and licensed into a regulated manager, it is unlikely to be material for most structures and, in any event, Pillar 1 is expected to contain an exclusion applicable to much of the asset and investment management industries. Pillar 2, on the other hand, could directly or indirectly have a greater impact on the industry, as summarized below.

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Both the definition of MNE Group for the purposes of Pillar 2 and the scope of Pillar 2 are broadly cast in the relevant Blueprint:

- An "MNE Group" is defined as any group that includes two or more enterprises that have tax residences in different jurisdictions or includes an enterprise that is tax resident in one jurisdiction and subject to tax with respect to business carried out through a permanent establishment in another jurisdiction.
- A "group" means any group of enterprises related through ownership or control that are required to prepare consolidated financial statements under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public securities exchange (the Consolidation Condition).

Many investment funds and market participants that utilize fund-like structures may expect to be out of the scope of these definitions, particularly given the Consolidation Condition. Furthermore, many other structures may also be out of the scope on the basis that only transparent entities that are required to be consolidated on a line-by-line basis for financial reporting purposes as part of an MNE Group (or simply with their controlling "parent" company) are caught by the GLoBE Rules.

However, a number of non-transparent investment funds and their holding structures could otherwise still be considered MNE Groups as defined. The OECD has anticipated this, and the Blueprints specifically include Investment Funds in the category of "excluded entities" from these rules. However, the definition of an Investment Fund is very specific, and the definition currently in the Blueprints has retained some elements that were flagged as potentially problematic by respondents during an initial consultation on the rules. The Blueprints define an "Investment Fund" as an entity or arrangement that meets all of the following criteria below:

a. it is designed to pool assets (which may be financial and non-financial) from an excluded entity or a number of investors (at least some of which are not connected);
b. it invests in accordance with a defined investment policy and/or to reduce transaction costs and research and analytical costs, and/or to spread risk collectively;
c. it is primarily designed to generate investment income and/or gains or protection against a particular or general event or outcome;
d. investors have a right to return from the assets of the fund or income earned on those assets, based on the contributions made by those investors;
e. the fund, or the management of the fund, is subject to the regulatory regime for investment funds in the jurisdiction in which it is established or managed (including appropriate anti-money laundering and investor protection regulation); and
f. it is managed by fund management professionals on behalf of the investors.

The definition also includes and exempts from the application of the GLoBE Rules under Pillar 2 any entity or arrangement that is wholly owned or almost exclusively owned, directly or indirectly, by one or more Investment Funds or other excluded entity and that does not carry on a trade or business but is established and operated exclusively or almost exclusively to hold assets or invest funds for the benefit of such Investment Funds or other excluded entity.

It will be important for corporate entities that would otherwise be taxable in their home jurisdiction, save for specific domestic fund tax exemptions, to confirm they are within the above exclusion. Otherwise, there is a risk of the GLoBE Rules, if implemented, reverting the fund closer to its normal corporate tax levels. The most obvious entities that would not fall within the definition of an Investment Fund as currently drafted and would, therefore, not be excluded from the application of the GLoBE Rules by way of that definition are closely held investment vehicles, such as funds of one and family office structures, which may not be regulated or "managed by fund management professionals," as commonly understood. This appears to have been recognized in the Blueprints: The OECD acknowledges that the definitions do not comprehensively address the issues associated with controlled investment funds and that further technical rules may be required. The OECD appears to be open to input on these matters and has launched a consultation on the Blueprints (specifically highlighting questions relating to the Investment Funds definition), with comments due no later than December 14, 2020. Stakeholders and trade bodies, and other representatives of the investment fund community are likely to seek to use the limited time remaining before implementation to seek clarification on these points.

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Potential Impact of Pillar 2

Under the current proposal, Pillar 2 would apply to MNE Groups that have a total consolidated group revenue of €750 million or an equivalent amount in the preceding fiscal year. In-scope entities within the MNE Group would be subject to the GLoBE Rules. These rules are designed to ensure that the MNE Group pays a minimum level of tax on its income and profits globally. An MNE Group to which the GloBE Rules apply would be required to calculate its income and profits for the purposes of the GloBE Rules and the covered (in-scope) taxes that had been charged on that income and profit. These two figures would then be used to determine the MNE Group's effective tax rate (ETR) in each relevant jurisdiction. Put simply, if a jurisdictional ETR is less than the minimum tax rate (which is still to be determined), then the GloBE Rules would require that the MNE Group pay additional taxes up to the minimum tax rate. We note, however, that each jurisdiction will have discretion to decide whether and how to implement Pillar 2 and the GLoBE Rules, which itself could lead to further complications in structuring analyses.

Given that one of the core principles of structuring an investment fund is ensuring that participation in the fund by investors is tax-neutral, the prospect of a minimum tax rate applying to certain structures will force fund sponsors and their advisers to rethink their approach to a number of structuring and commercial positions. Absent any further clarification, structures that have been commonly used for funds of one and managed accounts may cease to be viable. Family offices and similar, closely held investment businesses will also need to consider whether restructuring is necessary. From a commercial perspective, fund sponsors will find that investors seek stronger reassurances on tax neutrality in relation to the structures that are to be implemented by a fund before they are willing to commit.

Irrespective of the impact of the GLoBE Rules on the tax neutrality of the principal investment aspects of a fund structure, fund sponsors and their advisers will need to consider the impact of these rules on a fund's portfolio investments and on any MNE Groups or stakes therein it holds. Even if a fund or its investment entities are not required to consolidate their accounts with a portfolio MNE Group, the GLoBE Rules are likely to apply to that MNE Group, and this may have potential ramifications for investor returns. Funds sponsors will, therefore, need to look at any MNE Groups held, the relevant ETRs, any applicable beneficial tax treatment (such as dividend withholding and participation exemptions) and any potentially base-eroding payments made within the MNE Group. We expect there to be pressure on funds to rethink and restructure such holdings. As a result, fund sponsors should understand that the application of the GLoBE Rules to a fund's investments is a priority.

As with previous challenges, we expect that the investment fund industry will find a way to navigate these issues should they arise, but there is undoubtedly some work to do to achieve a suitable outcome for both sponsors and investors.