Investment Protection

Careful consideration of cross-border investments pays off

Current market situations offer some very interesting business opportunities for investors. However, investments, particularly when they are made in a foreign jurisdiction, are fraught with risks.

With a view to foster cross-border investments and economic exchanges, States concluded more than 3,000 bilateral **double taxation treaties** (DTTs), as well as regional tax treaties aiming at preventing double taxation. Covering another aspect of international investments, a similar number of **investment agreements** (international investment agreements or IIAs) lay the groundwork for investors to challenge measures, such as exchange control, the cancellation of subsidies or concessions, the forced waiver of intellectual property rights or even expropriation, which can significantly deplete the value of investments.

In a post-COVID environment where States will be eager to make up for higher budget deficits, it is likely that benefiting from the protection of DTTs and IIAs will be high on investors' agendas. This will mostly depend on how assets are owned. To that end, it is critical to **analyze new as well as existing ownership structures from an investment protection and tax perspectives.**

Recent developments

International taxation

In 2015, the OECD defined measures to prevent aggressive tax planning. In this context, 95 jurisdictions signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* to modify more than 1,200 DTTs. This convention includes the Principal Purpose Test (PPT rule), a **new general anti-abuse rule** which forms part of a minimum standard that contracting jurisdictions have committed to apply to their tax treaties.

The PPT rule focuses on the reasons why a specific arrangement or transaction was implemented or is maintained. Essentially, it stipulates that the benefit of DTTs shall be denied if one of the principal purposes of the arrangement or transaction was to obtain such benefits. This new rule therefore entails significant implications on the design of ownership structures.

Investment treaties

On 5 May 2020, EU Member States terminated all intra-EU IIAs. This followed a ruling rendered by the Court of Justice of the European Union in the Achmea case on 6 March 2018. In this landmark decision, the court considered that arbitration clauses included in IIAs are incompatible with EU law.

As a result, a European company will no longer be in a position to submit an investment dispute with an EU State to an arbitration court but would need instead to litigate before local courts. This raises concerns for investors as some of them may perceive domestic tribunals as being more politized and less independent than a private arbitration panel. The EU Commission envisage to adopt legislative proposal in the fourth quarter of 2021.

Issues to consider

Some of the typical issues which need to be addressed from an investment protection and tax perspective can be illustrated with the following example.

A listed group headquartered in State R1 (ListedCo) decides to invest in a business (OpCo) located in State S. This jurisdiction is known for offering fantastic business opportunities, which are however associated with significant political risks.

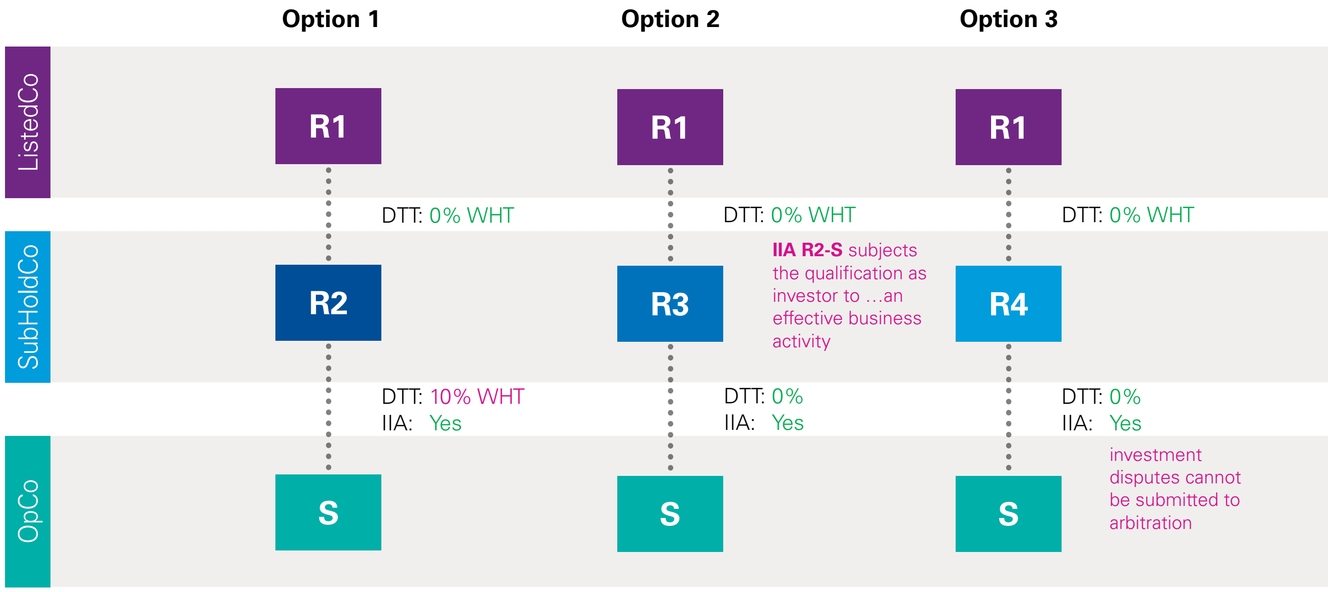
ListedCo considers making the investment through one of the various sub-holdings of the group (SubHoldCo) located in States R2, R3 and R4. State S concluded IIAs with States R2, R3 and R4 respectively whereby under the latter, investment disputes could not be submitted to arbitration. The IIA between States S and State R3 furthermore subjects the qualification of a company as an investor to the condition that it carries out an effective business activity.

States R2, R3 and R4 concluded DTTs with both State S and State R1. As regards inter-company dividends, all treaties provide exclusive taxing rights on dividends to the shareholder's State of residence, except DTT between State R2 and State S (residual rate of 10%). At the domestic tax level, States R2, R3 and R4 all provide for an effective participation exemption regime.

dividends paid by OpCo. The residual tax rate of 10% on such dividends provided by the DTT concluded between State R2 and State S would however likely reduce the return on investment, should SubHoldCo be located in State R2.

Are there any economic substance requirements for corporate investors?

Several IIAs include clauses on economic substance, whereby entities may claim IIA protection only if they carry out actual economic activities. That is for instance the case of the IIA between State R3 and State S, which could at first sight be seen as a disadvantage compared to States R2 and R4. That said, economic substance and/or coherence with an existing business model will likely need to be complied with in all three States should SubHoldCo wish to rely on DTTs concluded with State S (see above-mentioned PPT rule).



Who is entitled to BIT and DTT protection?

As State R1 did not conclude an IIA with State S, the group would significantly increase investment protection by making the acquisition through a corporate vehicle located in a State that has a IIA in place with State S. States R2, R3 and R4 all satisfy this condition. Yet, the IIA between State R4 and State S would unfortunately not offer to SubHoldCo the possibility to bring a potential dispute with State S before an independent panel of arbitrators, so that the group would be left to litigating before local courts. This could potentially be perceived as a significant drawback of State R4 as a location for SubHoldCo.

ListedCo would be in a position to avoid any tax leakage in State R2, R3 and R4 on dividends received from SubHoldCo on the basis of the DTT concluded by R1 with these three States. In States R3 and R4 SubHoldCo would be in a similar position as regards tax leakage in State S on

It may therefore be necessary to take a close look at the reasons why a SubHoldCo located in State R2, R3 or State R4 was used to make the acquisition, how this fits into the wider business model of the group, the type of activities carried out by SubHoldCo, whether SubHoldCo avails of local qualified personal and office premises, how it is financed, etc.

What about litigation if things turn sour?

Using a SubHoldCo in State R4 may be less interesting to the group because SubHoldCo's ability to lead an investment dispute through an arbitration court might be possible only on the basis of an IIA concluded by State S and State R1. Indeed, IIAs often provide that they may also apply to companies located in a third State that are controlled by an investor of a contracting party. Such IIA between State S and State R1 does however not exist in the present instance.

Overall assessment

	Option 1	Option 2	Option 3
Tax position of ListedCo	+	+	+
Tax leakage at the level of SubHoldCo	+	+	+
Tax leakage at the level of OpCo	–	+	+
Availability of investment treaty protection	Yes	Yes	Yes
Availability of arbitration procedure for investment disputes	Yes	Yes	No

\+ Positive
= Neutral
– Negative

How can KPMG help

More than ever, ownership structures should be analyzed considering risks in a holistic manner. We regularly assist clients:

– with the identification and implementation of the best legal structures, arrangements and jurisdictions to acquire, own and sell cross-border investments;
– with revisiting existing ownership structures to ensure that they are best suited to protect investments from various risks.

We benchmark various types of ownership structures and jurisdictions, considering among other things the specific features of all available DTTs as well as IIAs in consideration of the investors' particular circumstances.

With our global network, KPMG is ideally placed to advise individual and corporate clients on such complex issues. We closely monitor developments in all the jurisdictions where we are present. And because our clients expect us to provide them with a long-term perspective, we are also involved in and contribute to tax policy work drawn up by international organizations such as the OECD, the UN and the EU.

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