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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 risk, 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.

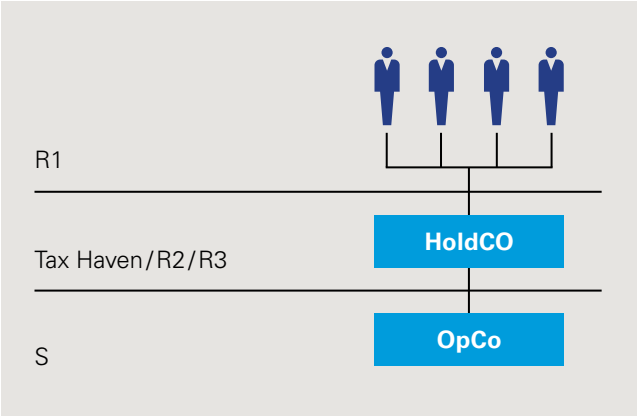
Issues to consider

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

Members of a family decide 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. Members of the Family reside in State R1.

To acquire the shares in OpCo, Family members consider setting up a holding vehicle (HoldCo) either in a tax haven jurisdiction, in State R2 or in State R3. State S concluded IIAs with States R1, R2 and R3 respectively whereby under the latter, investment disputes could not be submitted to arbitration. States R2 and R3 concluded DTTs with both State S and State R1.



Who is entitled to DTT and BIT protection?

Locating HoldCo in State R2 or State R3 may at first sight not be appealing as this entity would be subject to tax in these jurisdictions. This said, it could claim the application of DTTs to avoid double taxation both for the dividends paid by Opco to HoldCo and, in turn, by HoldCo to its shareholders. Tax leakage at the level of HoldCo would be quite limited, as that it would likely benefit from a participation exemption regime. HoldCo would also be entitled to rely on the IIAs entered into by State R2 and State R3 on the one hand, and State S on the other hand.

By comparison, incorporating HoldCo in a tax haven may seem attractive as this entity would presumably not have to pay tax on either income received from OpCo or on dividends paid to its shareholders. That said, this entity would not be in a position to claim the application of any DTTs, so that withholding taxes levied in State S on payments (dividends, management fees, etc.) made by OpCo or on the gain resulting from its disposal may seriously affect return on investment. The tax law of State R1 may also include provisions to prevent the use of entities located in tax havens by its own residents. From an IIA standpoint and provided that its shareholders are citizens of State R1, HoldCo could possibly rely on the investment treaty entered into by State S with State R1.

Are there any economic substance requirements for corporate investors?

Several IIAs include clauses on economic substance, whereby entities may claim IIA protection only if carry out actual economic activities. This requirement may also arise from anti-abuse rules such as, in the area of DTTs, the above-mentioned PPT rule.

It may therefore be necessary take a close look at the reasons why HoldCo was set up in State R2 or State R3, how this fits into the wider business or investment activities conducted by the Family, the type of activities carried out by HoldCo, whether HoldCo has hired local qualified personal and office premises, how it is financed, etc.

What about litigation if things turn sour?

Incorporating HoldCo in State R3 may be less interesting to the Family because HoldCo's ability to lead an investment dispute through an arbitration court may be contingent on the IIA concluded by States S and R1.

Overall assessment

Issues	Location of HoldCo		
	Tax haven	**State R2**	**State R3**
Tax position of Family members	= to −	=	=
Tax leakage at the level of HoldCo	=	=	=
Tax leakage at the level of OpCo	−	+	+
Availability of investment treaty protection	Maybe	Yes	Yes
Availability of arbitration procedure for investment disputes	Maybe	Yes	Maybe

− Negative + Positive = Neutral

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 new 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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