EXPERT COMMENTARY

As tax authorities' ability to analyse information grows, gathering and reporting investor tax information is becoming an increasingly important issue for private equity funds, says Emily Clark, tax partner at Travers Smith

Why tax data is rising up managers' agendas

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Fund managers of private equity funds are being increasingly required to gather tax-related data and pass it on to tax authorities, even though the funds they manage are typically not subject to tax on income or gains. A key aspect of this has been the spread of international automatic exchange of information regimes, starting with the US's Foreign Account Tax Compliance Act regime and moving on to the Organisation for Economic Co-operation and Development's Common Reporting Standard, designed to prevent investors hiding their overseas investments from their domestic tax authorities. After significant initial difficulties in understanding the requirements of, and building processes to comply with, these regimes, fund managers and investors are generally comfortable with their requirements.

However, it is now becoming clear that the introduction and early years of the FATCA and CRS regimes should be seen as the first phase of a journey for fund managers that will increasingly require them to gather further investor data and, potentially, see tax authorities use that information and more sophisticated analytical techniques to investigate fund and investment structures.

In this article we discuss how fund managers are dealing with current AEOI regimes and consider their effectiveness from the point of view of national tax authorities before turning our attention to new regimes which will require, and already are requiring, fund managers to gather further information from investors.

Finally, we briefly consider the circumstances in which fund managers can find themselves providing further information to tax authorities. In an article of this length it is not possible to deal with regimes in all jurisdictions and so our focus is on the UK but, as will be seen, the regimes discussed are typically international, or at least European, in scope and so similar issues arise elsewhere. Similarly, we will be concentrating on private equity, but the regimes we discuss are not just relevant to those funds.

Current AEOI regimes and fund managers

The need for private equity funds to gather information about investors and report it to tax authorities is not a new phenomenon. For example, the UK has for a long time required its limited partnerships to file a partnership tax return setting out details of its investors. However, the modern trend can be traced back to March 2010 and FATCA, which was enacted in the US as part of the Hiring Incentives to Restore Employment Act.

FATCA originally envisaged all financial institutions reporting information about their investors to the Internal Revenue Service in the US but this ran into early difficulties as other jurisdictions complained that this would lead to financial institutions breaching their domestic laws, for example, in relation to data protection. The solution found was the introduction of bilateral intergovernmental agreements between the US and many other countries. Most IGAs (including those for the UK, Luxembourg, Guernsey and Jersey), broadly, require financial institutions in a jurisdiction to report investor information to their domestic tax authority which then exchanges that information with the tax authority of the other jurisdiction.

It did not take other jurisdictions long to cotton on to the benefits of FATCA-style reporting and CRS, a global common reporting standard, was approved by the OECD in July 2014.

As CRS has now been operational in most major fund jurisdictions (aside from the US) in respect of periods since either 2016 or 2017 (and FATCA reporting has been required for periods since 2014), fund managers are now familiar with their obligations and have appropriate processes in place.

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Typically, the on-boarding process will require potential investors to provide relevant information and the fund documentation will give the manager the rights to require investors to provide it with relevant information relating to AEOI obligations and to disclose such information to relevant tax authorities to facilitate compliance with such obligations.

Has it been worth all the hassle?

So, has the time and effort expended by financial institutions and investors (as well as governments and tax authorities) on implementing and complying with AEOI regimes been well spent? This is a question for national tax authorities, but HM Revenue & Customs appears very happy. According to its report *No safe havens 2019*, in 2018 it received 5.67 million CRS records on UK taxpayers' offshore financial accounts. This built on 2017, when it received 1.63 million records – these related to accounts held by 1.3 million individuals, and around 100,000 held by others, in around 40 jurisdictions.

That being said, it is one thing to receive information, it is quite another to make use of it. In the UK, HMRC has a powerful analytic tool, Connect, at its disposal. In the report, HMRC says that Connect cross-references more than 22 billion lines of data, including information received under CRS and identifies more than 500,000 cases (onshore and offshore) for HMRC to enquire into each year. This ability to analyse "big data" is only likely to increase over time, and so it is unsurprising that national tax authorities are imposing ever greater reporting requirements as their confidence that they will be able to make use of the information grows.

New information gathering issues for fund managers

In parallel with the growth of tax authorities' ability to analyse information, international tax rules have been evolving at an increasing pace, in no small part driven by the OECD's Profit Shifting and Base Erosion Project that seeks to counter tax avoidance at an international level. The BEPS final reports were published in 2015 and their recommendations include express actions relating to information reporting to tax authorities as well as actions whose effect is prompting fund managers to gather additional taxpayer information. Therefore, as BEPS recommendations are being implemented by jurisdictions, the fund management industry is increasingly having to consider what information it will need from taxpayers in order to be compliant with the new obligations.

Anti-hybrids rules

BEPS Action 2 recommended that

jurisdictions take steps to neutralise the effects of hybrid mismatch arrangements. Broadly, the recommendations relate to arrangements under which an entity or financial instrument is treated differently in different jurisdictions and this mismatch gives rise to a tax benefit. For example, an instrument might be treated as debt in the jurisdiction of the payer such that returns paid on it are treated as tax deductible interest payments but as equity in the jurisdiction of the recipient such that returns received are treated as tax exempt dividends.

Although the UK anti-hybrids regime came into effect in January 2017, the EU-wide regime is more recent, being introduced (via local implementation of the EU's Anti-Tax Avoidance Directive) in two main stages, the deadline for the second of which was 1 January this year. The rules are highly complex and to work out if they are applicable to a structure it is commonly necessary to understand the wider arrangements of which it forms part, including the tax position of those with more remote or indirect interests or involvement in them. In particular, fund managers will often need to understand the tax position of investors in order to assess whether fund and investment structures are within the regime.

Fund managers are therefore increasingly putting express wording in fund documentation requiring investors to provide them with the information that they require to assess the hybrids position of their own fund and investment structures.

Coming soon: DAC 6

BEPS Action 12 calls for mandatory disclosure rules for aggressive tax planning schemes. Responding to this recommendation, the EU enacted directive 2018/822 (DAC 6) under which member states are obliged to introduce by 1 July this year a new tax reporting regime. Despite Brexit, it will also be introduced in the UK.

The regime applies to "cross-border" transactions that satisfy certain "hallmarks" and aims to ensure that tax authorities across the EU receive information about tax planning at an early stage, to enable swift challenges or changes to the law to counteract aggressive tax planning. However, the hallmarks are widely drafted and are likely to catch transactions which do not have a tax avoidance motive. It should also be noted that the regime has an element of retrospectivity as reporting will be required of arrangements where the first implementation step took place on or after 25 June 2018. The obligation to initially report arrangements is on "intermediaries" (such as law firms and other tax advisers) but transfers to the taxpayer if no intermediary is required to report. Under DAC 6, jurisdictions can also impose ongoing reporting requirements on taxpayers about their use of relevant arrangements, and the UK has chosen to do this.

Despite its imminent implementation, it is still unclear exactly how relevant tax authorities will interpret the DAC 6 obligations in practice. However, what seems certain is that fund managers will need to dedicate additional time and resource to ensuring DAC 6 compliance and that at least some arrangements entered into by investment funds, their holding companies and/or their portfolio companies will need to be disclosed.

In this regard, the recent placing of the Cayman Islands on the EU's list of non-co-operative jurisdictions for tax purposes (often called the EU "blacklist") may lead to the disclosure of payments made to Cayman funds. This is because one of the DAC 6 hallmarks is the making of deductible cross-border payments between associated enterprises where the recipient is resident in a blacklisted jurisdiction.

Therefore, depending on the approach of the relevant EU/UK jurisdiction to the meaning of "associated" and the particular fund structure, common structures which involve tax deductible interest or royalty payments from portfolio companies to Cayman funds may be automatically reportable. Many are expecting the Cayman blacklisting to be short-lived, but this cannot be guaranteed, and DAC 6 reporting

Putting procedures in place

The gathering and reporting of investor tax information is one of the less exciting aspects of managing a private equity fund but is becoming increasingly important. Tax authorities are now seeing all the hard work invested in implementing current AEOI regimes bearing fruit.

This, combined with tax authorities' growing ability to harvest big data effectively and a consensus amongst major jurisdictions that increased tax transparency has an important role to play in the fight against tax avoidance, makes it unsurprising that the number of regimes requiring fund managers to gather investor tax data is increasing. A corollary of this is that we are seeing fund managers being involved in more enquiries from tax authorities in relation to investors.

Managers should therefore ensure that they have adequate procedures in place to comply with their data gathering and reporting obligations and, at an early stage, prepare for how they will deal with any future tax authority enquiries.

will be especially relevant to it unless and until is it removed from the list.

If it is concluded that an arrangement is disclosable, the timetable for reporting is tight. Reports must generally be filed within 30 days of the earlier on which the arrangement is made available (or is ready) for implementation and the date on which the first step is taken (or in the case of certain intermediaries, 30 days after they first provided aid, assistance or advice).

Fund managers should therefore be putting in place procedures and policies to ensure compliance, including deciding whether structures implemented since 25 June 2018 or which they envisage implementing are disclosable and, if so, (i) who are the relevant intermediaries and taxpayers and (ii) how reporting will be co-ordinated in practice if multiple intermediaries and/or jurisdictions are involved.

Further provision of information to tax authorities

From a fund manager's perspective, the ideal position in relation to a tax reporting regime is that it puts effective compliance processes in place, provides the information required and hears nothing in response from the tax authority. However, things may not always work out that way. A tax authority's interest may have been piqued by information provided, and this can lead to further information being requested from the fund manager.

The tax authority that ultimately wants the information may not be the one to which the fund/fund manager made its initial report (for example, it may be a different one where an investor or portfolio company is located). However, generally, tax authorities do not seek third-party information directly from a person located in another jurisdiction, and instead rely on the tax authority in that other jurisdiction to ask for the information and pass it on to them. This exchange of information occurs pursuant to one of the international regimes that facilitate exchange of information between tax authorities (for example, the "exchange of information" provision in a double tax treaty). Therefore, a fund manager is likely to find that follow-up queries come from the tax authority to which it made the initial CRS (or other) report.

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The extent to which a tax authority is entitled to further information (either on its own account or on behalf of another tax authority) will depend on the third-party information powers granted to it under its domestic laws.

In the UK, HMRC has relatively wide powers to gather information from third parties and, increasingly, we are seeing them being used proactively (both for data ultimately wanted by other jurisdictions and for domestic tax issues). A discussion of how to handle such enquiries is outside the scope of this article but given the increasing likelihood of them arising in practice it is worth observing that fund managers should be considering at the fund formation stage how they will handle such enquiries if they arise, as the passing of their data to tax authorities can, unsurprisingly, be a sensitive issue for investors.

Such early consideration will facilitate the smooth handling of enquiries if they arise (and prevent fund managers from having to make unexpected and difficult decisions in the potentially more pressured environment of a live enquiry) and enable the fund documentation to be drafted to facilitate the chosen approach. ■