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Maintaining infrastructure investment in an era of tax morality

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A dynamic tension is developing between investors and governments seeking to collect a "fair share of tax". Moving forward, pension and sovereign wealth investors must be prepared to inform governments about their unique role in the infrastructure ecosystem and they must also anticipate the need to explain their tax positions to tax authorities and the media. For their part, governments must better understand and address the special needs of these investors if they wish to attract the foreign investment capital they require for major infrastructure development.

Tax morality has become a political hot topic over the past three years. Media and politicians are challenging legitimate tax optimization planning techniques, in part because countries are struggling with deficits and funding requirements while multi-national corporations seem to be paying relatively little direct income tax in the countries where they have operations. Historically, there has been a general acceptance of a taxpayers' right to plan their affairs to optimize their tax position. That fundamental principle is now being challenged by media and politicians highlighting apparently profitable companies operating in their countries without making contributions to tax revenues at a level they deem appropriate.

In a bid to address these political concerns about perceived tax abuse and to obtain increased transparency regarding tax payments globally, the OECD (Organisation for Economic Co-operation and Development), as mandated by the G20, has developed an Action Plan on Base Erosion and Profit Shifting (BEPS). Very generally, the BEPS initiative seeks to revise the international tax standards to address certain perceived abuses. While the origin of the project and the interim recommendations are largely oriented to multi-national corporations, many of the measures being proposed may impact significantly cross-border investment in infrastructure. In particular, the BEPS Action Plan calls for measures to: (i) eliminate the tax advantages of hybrid mismatch arrangements (e.g., instruments that give rise to a deduction to the payor and no taxable income to the recipient); (ii) limit the deductibility of interest payments; (iii) deny tax treaty benefits in cases of perceived abuse; and (iv) require greater reporting of the global activities and tax arrangements of groups of affiliated companies.

Pension, sovereign wealth and investment funds could be subject to certain unintended and adverse consequences of these efforts. And investments in the infrastructure sector are by no means immune. In fact, a number of infrastructure related characteristics could serve to intensify the dynamic.

For instance, infrastructure investments often attract public attention. Many such investments require substantial initial capital, sometimes with no positive aggregate return anticipated for years. This is because investments in infrastructure generally do not have a liquid market, and investors generally must take

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> **Sovereign wealth funds, pension funds and fund managers may be inadvertently adversely impacted, and should take steps to mitigate those impacts.**

a long-term position. The BEPS developments will result in (yet unknown) changes to certain tax and reporting regulations and thus introduce an element of risk for potential investors. To the extent that the BEPS actions result in increased taxation of these investments, that increase in tax could significantly impact the returns from such investment, and may lead to a re-pricing of assets in some markets. Further, the size and complexity of infrastructure projects and investor pools can necessitate the use of sophisticated, multi-entity structures. These structures are required for a wide range of business and regulatory needs. Nevertheless, such investments can be easy targets for media and politicians raising "fair share" claims or be impacted by the BEPS initiative. Indeed, a number of pension investors recently received publicly scrutiny in relation to their tax burden as it related to a European development project.

Achieving equilibrium in the infrastructure ecosystem

Fortunately, investors can take steps to address these evolving dynamics.

First, investors should anticipate and address the concerns of their stakeholders, governments and media. For instance, being able to present a full picture of all social benefits flowing from the actual or proposed investment, including direct benefits such as jobs created through engineering and construction projects, as well as the comprehensive taxes incurred will orientate discussions in a more constructive direction.

Secondly, communication and direct engagement in relation to OECD and local government developments will be key. Given the unique role that institutions play in funding global infrastructure, dialogue amongst the infrastructure participants – investors, governments and the OECD - is needed to inform the development of the regulatory landscape in a way that accommodates the valid concerns of all involved. It is critical that investors undertake direct participation with the OECD and national governments to help inform policy makers as they develop policies and legislation. Preliminary efforts in this regard have been well received, with a clear interest by regulators to further understand industry concerns; however, many groups are requesting special treatment and there is a risk that without continuous effort the concerns of pensions and sovereign wealth funds may go unheeded.

Finally, investors should address change risk through sensitivity analyses. This will ensure that, where necessary, investors have the ability to restructure holdings and investments if adverse developments do appear.

Five questions for pension and sovereign wealth funds to consider:

1. Is your organization prepared to respond to media and government queries concerning your investment structures?
2. Are you fully up to speed with BEPS and related national tax developments?
3. Are you confident in the internal tax governance of your own organization and the investment funds you work with?
4. Have you reviewed your existing investment structures for possible adverse impact? Are you developing responses to adverse changes?
5. Are you taking into account adverse change risk in your investment decisions?

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