Base Erosion and Profit Shifting (BEPS)

Public Discussion Draft

BEPS ACTION 6

Discussion Draft on non-CIV examples

6 January-3 February 2017

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FOLLOW-UP WORK ON THE INTERACTION BETWEEN THE TREATY PROVISIONS OF THE REPORT ON BEPS ACTION 6 AND THE TREATY ENTITLEMENT OF NON-CIV FUNDS

Paragraph 14 of the final version of the Report on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*) indicated that the OECD would continue to examine issues related to the treaty entitlement of non-CIV funds to ensure that the new treaty provisions included in the Report on Action 6 address adequately the treaty entitlement of these funds.

As part of the follow-up work on this issue, on 24 March 2016 the OECD published a consultation document on the treaty entitlement of non-CIV funds which included a number of specific questions related to concerns, identified in the comments received on previous discussion drafts related to the Report on Action 6, as to how the new provisions included in that Report could affect the treaty entitlement of non-CIV funds as well as possible ways of addressing these concerns. The comments received in response to that consultation document were published on the OECD website on 22 April 2016.

This discussion draft has been prepared to provide stakeholders with information on the subsequent developments in the work on the interaction between the treaty provisions of the report on BEPS Action 6 and the treaty entitlement of non-CIV funds, including the conclusions reached at the May 2016 meeting of Working Party 1[1] and the subsequent work on the development of examples related to the application of the principal purposes test (PPT) rule included in the Report on Action 6 with respect to some common transactions involving non-CIV funds. The discussion draft invites comments on three draft examples under consideration by the Working Party for inclusion in the Commentary on the PPT rule.

The Committee invites interested parties to send their comments on these three examples. The draft examples and the comments received will be discussed by Working Party 1 at its February 2016 meeting.

Comments should be sent by **3 February 2017** at the latest by email to taxtreaties@oecd.org in Word format (in order to facilitate their distribution to government officials). They should be addressed to the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

Please note that all the comments received on this discussion draft will be made publicly available. Comments submitted in the name of a collective "grouping" or "coalition", or by any person submitting responses on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

The draft examples included in this discussion draft do not, at this stage, represent the consensus views of the CFA or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment.

1 Working Party No. 1 on Tax Conventions and Related Questions is the subsidiary body of the OECD's Committee on Fiscal Affairs responsible for the tax treaty-related work, including the follow-up work on BEPS Action 6.

FOLLOW-UP WORK ON THE INTERACTION BETWEEN THE TREATY PROVISIONS OF THE REPORT ON BEPS ACTION 6 AND THE TREATY ENTITLEMENT OF NON-CIV FUNDS

1. The objective of the work that was done with respect to the interaction between the treaty provisions of the Report on BEPS Action 6 and the treaty entitlement of non-CIV funds was set out in paragraph 14 of the Report on Action 6. As that paragraph notes:

> "… there is a need to continue to examine issues related to the treaty entitlement of non-CIV funds ***to ensure that the new treaty provisions that are being considered adequately address the treaty entitlement of non-CIV funds***. The continued examination of these issues would also address two general concerns that governments have about granting treaty benefits with respect to non-CIV funds: that non-CIV funds may be used to provide treaty benefits to investors that are not themselves entitled to treaty benefits and that investors may defer recognition of income on which treaty benefits have been granted." (*Emphasis added.)*

2. This objective is the reason why Working Party 1 and the March 2016 consultation document focused on how the limitation-on-benefits (LOB) and principal purposes test (PPT) rules included in the Report on Action 6 might inadvertently affect non-CIVs and why the most urgent issue was how to address any such inadvertent effects before the inclusion of these rules in the multilateral instrument that was under negotiation to implement the tax treaty-related BEPS recommendations (the MLI).

3. The text of the MLI was adopted on 24 November 2016 (see the news release on the adoption of the MLI and the text of the MLI). As can be seen from the provisions of the MLI, whilst the MLI includes the PPT rule and the provisions of the simplified LOB rule that were included in the final version of the Report on Action 6, it does not include the provisions of the detailed LOB rule that was included in that report. This reflects the conclusion that, given the number of bilateral decisions that are involved in designing a detailed LOB rule (including decisions related to the content of the CIV subparagraph of the definition of "qualified person"[2]), the multilateral instrument was not an appropriate instrument for the implementation of the detailed LOB rule.

4. At its May 2016 meeting, Working Party 1 discussed the main themes raised in the public comments submitted in response to the March 2016 public discussion draft. The Working Party concluded that since the MLI would not include the provisions of the detailed LOB rule, this removed the pressure to design a multilateral solution to the issue of the treatment of non-CIV funds in the detailed LOB provision, noting that a statement concerning the need to address the issue bilaterally could be included in the next update of the OECD Model Tax Convention on Income and on Capital (the OECD Model), which is tentatively scheduled for mid-2017.

5. At the same time, Working Party 1 concluded that, as regards the provisions of the simplified LOB rule, the derivative benefits provision included in that rule,[3] which does not include any limit on the number of equivalent beneficiaries, any base-erosion test or any requirement related to intermediate owners, meant that few non-CIV funds would fail to qualify for treaty benefits under that rule. The

2 See paragraphs 31 to 43 of the Report on Action 6.

3 The derivative benefits test in the simplified version of the LOB provision provides as follows:

> 3. A resident of a Contracting State that is not a qualified person shall nevertheless be entitled to a benefit that would otherwise be accorded by this Convention with respect to an item of income if persons that are equivalent beneficiaries own, directly or indirectly, more than 75 per cent of the beneficial interests in that person.

Working Party recognised, however, that the practical application of that provision raised a number of compliance and administrative issues related to the determination of the identity and treaty entitlement of investors (i.e. the determination of investors' status as "equivalent beneficiaries"). A number of commentators' submissions addressed these issues. The Working Party observed that the TRACE project deals with similar issues in relation to CIVs and that, although the model mutual agreements drafted as part of the TRACE project apply only to CIVs, the overview that accompanies those model mutual agreements in the TRACE implementation package[4] provides that "governments may wish to have a comprehensive mutual agreement that covers all types of investment vehicles including those that do not meet the above definition of CIV". This, in conjunction with the approaches suggested in the responses received on this issue, could form the basis for a future consideration of solutions for non-CIV funds.

6. As regards the application of the PPT rule, the March 2016 discussion draft indicated that a realistic approach to concerns related to the application of the PPT rule to non-CIV funds could be to add one or more examples on non-CIV funds to paragraph 14 of the Commentary on the PPT rule (as it appears in paragraph 26 of the Report on Action 6). Commentators were therefore invited to suggest new examples to illustrate the application of the PPT rule to common types of arrangements or transactions entered into by non-CIV funds that do not raise concerns related to treaty-shopping or inappropriate granting of treaty benefits.

7. At its May and September 2016 meetings, the Working Party examined the examples suggested by commentators with a view to developing additional examples that could be added to the Commentary on the PPT rule. Whilst the comments received contained approximately 50 examples, these examples were found to be either too long, too specific or too controversial for inclusion in the Commentary on the PPT rule.

8. When discussing the possible inclusion of additional examples related to non-CIV funds in paragraph 14 of the Commentary on the PPT rule, the Working Party considered that paragraph 14 currently contains ten examples to illustrate the application of the PPT rule (including one example to illustrate the application of the PPT rule to a CIV). It therefore decided that it would be inappropriate to add a large number of additional examples and considered that it would be possible to add up to three examples that would pick up various elements found in the commentators' suggested examples that dealt with common transactions.

9. The following draft examples were discussed extensively by the Working Party. Whilst no final agreement has yet been reached on the inclusion of these examples, it was agreed that these examples could be publicly released for comments with a view to determining whether or not they usefully clarify the application of the PPT rule to common transactions involving non-CIV funds.

1. Regional investment platform example

> Example [*XX*]: RCo, a company resident of State R, is a wholly-owned subsidiary of Fund, an institutional investor that is a resident of State T and that was established and is subject to regulation in State T. RCo operates exclusively to generate an investment return as the regional investment platform for Fund through the acquisition and management of a diversified portfolio of private market investments located in countries in a regional grouping that includes State R. The decision to establish the regional investment platform in State R was mainly driven by the availability of directors with knowledge of regional business practices and regulations, the existence of a skilled multilingual workforce, State R's membership of a regional grouping and use of the regional

4 See pp. 113-115 of the TRACE Implementation Package (approved by the OECD Committee on Fiscal Affairs on 23 January 2013).

grouping's common currency, and the extensive tax convention network of State R, including its tax convention with State S, which provides for low withholding tax rates. RCo employs an experienced local management team to review investment recommendations from Fund, approve and monitor investments, carry on treasury functions, maintain RCo's books and records, and ensure compliance with regulatory requirements in States where it invests. The board of directors of RCo is appointed by Fund and is composed of a majority of State R resident directors with expertise in investment management, as well as members of Fund's global management team. RCo pays tax and files tax returns in State R.

RCo is now contemplating an investment in SCo, a company resident of State S. The investment in SCo would constitute only part of RCo's overall investment portfolio, which includes investments in a number of countries in addition to State S which are also members of the same regional grouping. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30 per cent to 5 per cent. Under the tax convention between State S and State T, the withholding tax rate on dividends is 10 per cent.

In making its decision whether or not to invest in SCo, RCo considers the existence of a benefit under the State R-State S tax convention with respect to dividends, but this alone would not be sufficient to trigger the application of paragraph 7. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 7 applies to an investment, it is necessary to consider the context in which the investment was made, including the reasons for establishing RCo in State R and the investment functions and other activities carried out in State R. In this example, in the absence of other facts or circumstances showing that RCo's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCo.

2. *Securitisation company example*

Example [*XX*]: RCo, a securitisation company resident of State R, was established by a bank which sold to RCo a portfolio of loans and other receivables owed by debtors located in a number of jurisdictions. RCo is fully debt-funded. RCo has issued a single share which is held on trust and has no economic value. RCo's debt finance was raised through the issuance of notes that are widely-held by third-party investors. The notes are listed on a recognised stock exchange, which allows for their trading on the secondary market, and are held through a clearing system. To comply with regulatory requirements, the bank also retained a small percentage of the listed, widely-held debt securities issued by RCo. RCo currently holds 60 per cent of its portfolio in receivables of small and medium sized enterprises resident in State S, in respect of which RCo receives regular interest payments. The bank is a resident of a State T which has a tax treaty with State S that provides benefits equivalent to those provided under the State R-State S tax treaty. Under the tax treaty between State R and State S, the withholding tax rate on interest is reduced from 30 per cent to 10 per cent.

In establishing RCo, the bank took into account a large number of issues, including State R's robust securitisation framework, its securitisation and other relevant legislation, the availability of skilled and experienced personnel and support services in State R and the existence of tax benefits provided under State R's extensive tax convention network. Investors' decisions to invest in RCo are not driven by any particular investment made by RCo and RCo's investment strategy is not driven by the tax position of the investors. RCo is taxed in State R on income earned and is entitled to a full deduction for interest payments made to investors.

In making its decision to sell receivables owed by enterprises resident in State S, the bank and RCo considered the existence of a benefit under the State R-State S tax convention with respect to interest, but this alone would not be sufficient to trigger the application of paragraph 7. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 7 applies to an investment, it is necessary to consider the context in which the investment was made. In this example, in the absence of other facts or circumstances showing that RCo's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCo.

3. Immovable property non-CIV fund example

Example [*XX*]: Real Estate Fund, a State C partnership treated as fiscally transparent under the domestic tax law of State C, is established to invest in a portfolio of real estate investments in a specific geographic area. Real Estate Fund is managed by a regulated fund manager and is marketed to institutional investors, such as pension schemes and sovereign wealth funds, on the basis of the fund's investment mandate. A range of investors resident in different jurisdictions commit funds to Real Estate Fund. The investment strategy of Real Estate Fund, which is set out in the marketing materials for the fund, is not driven by the tax positions of the investors, but is based on investing in certain real estate assets, maximising their value and realising appreciation through the disposal of the investments. Real Estate Fund's investments are made through a holding company, RCo, established in State R. RCo holds and manages all of Real Estate Fund's immovable property assets and provides debt and/or equity financing to the underlying investments. RCo is established for a number of commercial and legal reasons, such as to protect Real Estate Fund from the liabilities of and potential claims against the fund's immovable property assets, and to facilitate debt financing (including from third-party lenders) and the making, management and disposal of investments. It is also established for the purposes of administering the claims for relief of withholding tax under any applicable tax treaty. This is an important function of RCo as it is administratively simpler for one company to get treaty relief rather than have each institutional investor process its own claim for relief, especially if the treaty relief to which each investor would be entitled as regards a specific item of income is a small amount. After a review of possible locations, Real Estate Fund decided to establish RCo in State R. This decision was mainly driven by the political stability of State R, its regulatory and legal systems, lender and investor familiarity, access to appropriately qualified personnel and the extensive tax convention network of State R, including its treaties with other States within the specific geographic area targeted for investment. RCo, however, does not obtain treaty benefits that are better than the benefits to which its investors would have been entitled if they had made the same investments directly in these States and had obtained treaty benefits under the treaties concluded by their States of residence.

In this example, whilst the decision to locate RCo in State R is taken in light of the existence of benefits under the tax conventions between State R and the States within the specific geographic area targeted for investment, it is clear that RCo's immovable property investments are made for commercial purposes consistent with the investment mandate of the fund. Also RCo does not derive any treaty benefits that are better than those to which its investors would be entitled and each State where RCo's immovable property investments are made is allowed to tax the income derived directly from such investments. In the absence of other facts or circumstances showing that RCo's investments are part of an arrangement, or relate to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the tax treaties between RCo and the States in which RCo's immovable property investments are located.