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Civil Unrest: Collective Investment Vehicles and the OECD 6

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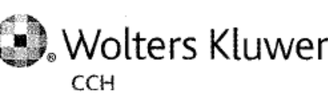
ACB ADJUSTMENTS FOR FOREIGN AFFILIATE SHARES HELD THROUGH PARTNERSHIPS

— Geoffrey S. Turner, Davies Ward Phillips & Vineberg LLP

Recent CRA comments at the May 2014 IFA International Tax Seminar[1] and a subsequently released CRA technical interpretation[2] highlight anomalies in the application of subsections 92(4) and (5) of the *Income Tax Act* (Canada) (the "Act").[3]

These provisions address the situation where shares of a foreign affiliate are held by a partnership of which a corporation resident in Canada is a partner.[4] If the foreign affiliate has previously paid a pre-acquisition surplus dividend to the partnership, and the partnership then disposes of the shares of the foreign affiliate or the Canadian corporation disposes of its partnership interest, a deemed gain will arise. The problem is that this deemed gain will arise even where the disposition occurs under a rollover provision that is otherwise intended to provide a tax-deferred result.

This article first briefly compares the treatment of dividends and capital distributions paid by foreign affiliates directly to a Canadian corporate shareholder and those indirectly paid through a partnership holding structure. Where a pre-acquisition surplus dividend is paid on foreign affiliate shares held through a partnership, there is no reduction in the relevant adjusted cost base ("ACB"), and, consequently, subsections 92(4) and (5) will



[13] There is no net reduction in the Canadian corporation's ACB of its partnership interest because the pre-acquisition surplus dividend is included in the Canadian corporation's income, resulting in an increase in ACB that is offset when the pre-acquisition surplus dividend is distributed by the partnership to the Canadian corporate partner. Perhaps this could be addressed by a rule that would "shut-off" the subparagraph 53(1)(e)(i) increase in ACB of a partnership interest where the income allocated to the partner is in the form of a pre-acquisition surplus dividend.

CIVIL UNREST: COLLECTIVE INVESTMENT VEHICLES AND THE OECD

— *Matias Milet and Jeff St. Aubin, Osler, Hoskin & Harcourt LLP*

Overview

Collective investment vehicles ("CIVs") and other types of investment funds (collectively, "Funds") have been drawn into the backdraft of the headlong push by the Organisation for Economic Co-Operation and Development ("OECD") to counter base erosion and profit shifting ("BEPS") by multinational enterprises. In particular, the proposals under Action 6 (treaty abuse), which are of broad application, could result in the denial of treaty benefits for Funds in circumstances where there is no treaty shopping or other form of perceived abuse. This article presents an update on the Action 6 proposals as they apply to Funds (CIVs, in particular), placing those proposals in the context of the considerable work the OECD has done in recent years regarding treaty benefits for CIVs.

Collective Investment Vehicles

The OECD has defined CIVs as funds that are widely held, hold a diversified portfolio of securities, and are subject to investor-protection regulation in the country in which they are established.[1] The pooled nature of CIVs provides economies of scale that allow small investors to access the expertise of money managers and to achieve domestic and international diversification that would not otherwise be feasible.[2] The CIV market has grown substantially, and at the end of 2013 worldwide investment through CIVs was US$30 trillion.[3]

The challenge in the context of international taxation is that many CIVs do not fit neatly into the traditional treaty model, as the CIV itself can take various legal forms and the identity of underlying investors is often unknown because interests in a CIV are often held through chains of financial intermediaries. Also, the investor base varies across jurisdictions. In some countries, like the United Kingdom, United States, or Canada, the securities laws, tax laws, and/or population size of the country together result in the investor base of locally resident CIVs typically being composed largely of treaty residents. In other countries, like Ireland or Luxembourg, a large proportion of the investors are located in different countries.[4]

The value of CIVs as an efficient means of accessing capital markets, coupled with the difficulties a CIV may face in accessing treaty benefits, led the OECD to specifically address CIVs in a 2010 report, with the predominant theme being one of tax neutrality, whereby investors should not be disadvantaged by investing through a CIV, as compared to direct investment. The subsequent BEPS initiative has raised and is seeking to address additional concerns, specifically the prospect of Funds, including alternative funds like hedge funds or private equity funds and their holding vehicles, being used as a means of treaty shopping.

2010 OECD Report Addressing CIVs

In 2010, the OECD Committee on Fiscal Affairs adopted a detailed report on "Granting Treaty Benefits with respect to the Income of Collective Investment Vehicles" (the "CIV Report"). The CIV Report considered how CIVs would typically be treated under the traditional treaty model,[5] under which a CIV would be entitled to benefits if it is (1) a person; (2) a resident of a contracting state; and (3) in the case of interest and dividends, a beneficial owner of the income received. This analysis identified that a CIV would generally be entitled to access treaty benefits if (usually based on its legal form) it is recognized as a person for treaty purposes; potentially subject to taxation in (and thereby a resident of) a contracting state; and if management has discretionary power to manage the assets (thereby qualifying the CIV as the beneficial owner of dividend and/or interest income). However, it was also recognized that some CIVs would fail to

qualify for treaty benefits, and this differential treatment of economically similar structures could be viewed as violating the principles of neutrality and a lack of reciprocity between Contracting States.[6]

The OECD recognized that in some instances it may be appropriate to treat CIVs differently, but the overarching objective should — consistent with the tax policy informing most domestic taxation regimes applicable to CIVs in OECD member states — be neutrality between direct investment and investment through a CIV.[7] Given the multiplicity of legal forms that CIVs can take and the various tax characterizations of CIVs by different countries, the OECD necessarily concluded that a single approach to the treatment of CIVs in all bilateral treaties between member states was not possible or appropriate. Accordingly, the CIV Report proposed several approaches to dealing with CIVs which were incorporated, along with general guidelines, in the Commentary to Article 1 of the 2010 OECD Income and Capital Model Tax Convention (the "OECD Model Treaty") as paragraphs 6.8 to 6.34. The potential approaches to expressly address CIVs in specifically designed treaty provisions included the following:

- (A) *Approaches Not Requiring Looking to Treaty Entitlement of Investors*:
  - (B) Recognizing as treaty residents and beneficial owners, generally without further requirements to qualify for treaty benefits, categories of CIVs in each contracting state expressly identified by the two contracting states[8] (for example, if Canada were to adopt such a provision, it might, for instance, say that a CIV for this purpose, "in the case of Canada, includes a mutual fund trust, mutual fund corporation, and . . .", or else, the provision could be drawn up more descriptively, naming the features that a qualifying CIV must have, such as being widely held, having a diversified portfolio, and issuing fixed interests to investors)
  - (B) Recognizing as treaty residents and beneficial owners, generally without further requirements to qualify for treaty benefits, publicly traded CIVs[9] (a provision which would apply to exchange-traded funds and many REITs)
- (A) *Approaches Involving Looking to Treaty Entitlement of Investors*: Instead of (or as well as) two contracting states agreeing *ex ante* to treat certain CIVs as always being residents and beneficial owners, as in the provisions mentioned above, the contracting states could agree to a provision that grants treaty benefits to any given CIV based on the composition of the treaty residence of its investors. The CIV Report provided different variants of such a provision:
  - (B) The CIV's eligibility for treaty benefits could be based on investors being "Qualifying Investors", which the CIV Report suggested could be required to be either:
    - (C) residents of the State in which the CIV is established,[10] or
    - (C) equivalent beneficiaries.[11]

The term "equivalent beneficiary" for purposes of a particular treaty is defined as a resident of the contracting state in which the CIV is established, or a resident of any other state with which the source state has a bilateral tax treaty that provides for effective and comprehensive information exchange, who would, if he or she received the particular item of income for which benefits are being claimed, be entitled under that treaty, or under the domestic law of the source state, to a rate of tax with respect to that item of income that is at least as low as the rate claimed under the particular treaty by the CIV with respect to that item of income.

  - (B) The proportion of the CIV's income that would be eligible for treaty benefits could vary as such:
    - (C) the CIV would be partially entitled to treaty benefits, in proportion to the number of its investors that were Qualifying Investors, and
    - (C) the proportional approach described above could be supplemented (not replaced) by an accompanying clause that would provide that 100% of a CIV's income could be eligible for treaty benefits if the proportion of Qualifying Investors exceeds a specified numerical ownership threshold[12] (a Safe Harbour Provision).

Perhaps in an attempt to ensure that CIVs would not be entitled to the lowest rate of withholding tax on dividends available to corporations in certain cases under Article 10(2)(a) of the OECD Model Treaty, the above suggested approaches all proposed to treat a qualifying CIV not merely as a resident of a contracting state but specifically as an individual who is so resident.

The CIV Report recognized that any approach that required a CIV to determine its eligibility for treaty benefits based

on the composition of its investors could be difficult to implement in practice, given the frequent change in ownership of CIV interests and the role of financial intermediaries in the distribution and holding of CIV interests. Accordingly, the CIV Report and corresponding changes to the OECD Commentary recommended that contracting states be willing to accept "practical and reliable approaches" that do not require daily tracing, such as annual or no greater than quarterly determinations of the composition of a CIV's investor base.[13]

An initiative that was related to the work leading to the CIV Report was the OECD's treaty relief and compliance enhancement ("TRACE") project, which was modelled on the US "qualified intermediary" concept, wherein a financial intermediary (for example, a broker whose clients' brokerage accounts include foreign securities generating withholdable payments) agrees to undertake withholding and information reporting obligations in relation to withholding taxes on portfolio investments, so that (a) the ultimate investors are able to obtain the treaty relief to which they are entitled, but (b) it is not necessary for payors or other intermediaries to have knowledge of the investor's identity for the correct treaty rate(s) to be applied to a payment. The TRACE Implementation Package, which was endorsed in January 2013 by the OECD's Committee on Fiscal Affairs, included model mutual agreements designed to implement the conclusions of the CIV Report.

The CIV Report also recognized that some CIVs would fail to qualify as "residents of the Contracting State" in which they are established, but recommended that mechanisms be made available whereby such CIVs could claim treaty benefits on behalf of their investors.

Base Erosion and Profit Shifting Action Plan — Action 6

The BEPS Action Plan, published in July 2013, identifies 15 actions to address BEPS and sets deadlines to implement these actions. Action 6 of the BEPS Action Plan is to design treaty rules and recommend domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. In September 2014, the OECD released a report on Action 6 (the "2014 Report") that recommended that G20/OECD countries adopt certain measures in their bilateral tax treaties to counter treaty abuse, including a comprehensive limitation-on-benefits ("LOB") rule and/or a principal purpose test ("PPT").

An early discussion draft of the 2014 Report, issued in March 2014, had drawn much protest from various investment fund industry groups, who pointed out that the work on BEPS Action 6 seemed to entirely ignore the work done by the OECD leading to the CIV Report and the TRACE Implementation Package. Indeed, this early discussion draft did not mention Funds,[14] which generally would have difficulty establishing their satisfaction of conditions for being "qualifying persons" as defined in the proposed LOB provision. As well, given the exclusion of making or managing investments from what qualifies as an active business, accessing treaty benefits under the LOB on the basis of having derived income from an active business would be foreclosed.

The Report provides model LOB and PPT rules (and draft commentary on the rules), noting that there is consensus that, as a "minimum standard", countries should agree to: (i) include in their tax treaties an express statement that their common intention is not to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements; and (ii) implement that common intention through either the combination of an LOB rule and PPT rule, or only one of those rules but with a stand-alone LOB rule being supplemented by an "anti-conduit" mechanism.

However, the 2014 Report was released in draft rather than final form, as the OECD noted that further work was required in certain areas. In particular, the 2014 Report noted that further consideration was needed regarding potential exceptions from an LOB or PPT rule for CIV and non-CIV Funds.

The majority of the 2014 Report's discussion with respect to CIVs was addressed in the draft commentary on the LOB rule, which contained a placeholder sub-category for CIVs as one type of "qualifying person", but deferring the question as to whether CIVs need be qualifying persons under the LOB and, if so, what conditions would then need to be met. Though saying little in the draft model LOB provision about CIVs, the 2014 Report contains an extensive, if somewhat

awkward, discussion of how CIVs might be approached in the LOB provision. The discussion cross-references the CIV Report frequently, noting that a CIV that qualifies as a treaty resident under one of the provisions suggested in the CIV Report will be deemed to be an individual. Such a CIV would therefore be a "qualifying person" like any other individual resident in the applicable contracting state and would accordingly not need to be separately addressed by a CIV specific qualifying persons clause in the LOB rule.

The 2014 Report envisages a scenario where countries have not addressed CIVs in their treaty but wish to do so in the LOB rule. This can be achieved through the inclusion of a CIV as a category of qualified person, and the bulk of the CIV discussion revolves around this approach. However, the potential approaches are largely a mirror image of those put forward in the CIV Report, with the major difference being that these criteria would now be built into the definition of a CIV as a qualified person. One substantive change that emerged in the 2014 Report is the option of a stand-alone Safe Harbour Provision,[15] as opposed to the safe harbour merely being an adjunct to the determination of proportional benefits based on investor residence, which was the case in the CIV Report.

The 2014 Report specifically noted that further work is required in relation to CIVs.

Follow-up Discussion Draft

On November 21, 2014, the OECD released a discussion draft (the "Discussion Draft") that deals with the principal outstanding items identified in the 2014 Report, including the application of treaty benefits for CIVs and non-CIV Funds. The Discussion Draft presents various views and proposals rather than making any conclusions, and includes specific questions on which comments from stakeholders are invited by January 9, 2015.

With respect to CIVs, the Discussion Draft specifically invites comments regarding whether the recommendations of the CIV Report remain adequate. Of particular interest are the comments related to a possible preferred approach:

> As part of the follow-up work on the Report on Action 6, it is intended to review these alternative approaches and to examine whether it would be possible to suggest a single preferred approach not only with respect to the application of the LOB to CIVs but also with respect to the more general question of the treaty entitlement of CIVs, taking into account developments since 2010 and, in particular, the results of the work on the treaty relief and compliance enhancement (TRACE) project.[16]

This statement is contrary to the OECD view in the CIV Report, where it stated, categorically, that "it is not possible to propose a single approach for the treatment of CIVs that could apply in all cases".[17] This is a potential area for interesting developments moving into 2015, and one can understand why the OECD is now considering a simplification and narrowing of options (the 2014 Report offered multiple and parallel options both under an LOB rule and elsewhere in a treaty for achieving similar results). It is conceivable that the OECD could come to a consensus view as to whether CIVs ought to be addressed within the LOB or elsewhere in the OECD Model Treaty — say, in Article 4 (Residence). However, it is not clear how a further narrowing toward a preferred approach could be achieved given the wide variety across jurisdictions (and, even occasionally, within a single jurisdiction) in terms of relevant factors like CIV managers' access to investor identity and treaty residence, and the extent to which a CIV is marketed and distributed to non-resident investors.

It is heartening to see that the OECD is taking the TRACE project into account as part of its deliberations on the extent to which treaty benefits should be made available to CIVs. One of the public comments the OECD received on the March 2014 draft report was:

> In the absence of TRACE (treaty relief and compliance enhancement) being implemented across all the OECD (and non-OECD) jurisdictions, an Equivalent Beneficiaries element is frankly unworkable where funds investing in multiple jurisdictions are not closely held.[18]

Such a statement is particularly true in the case of publicly-traded CIVs (e.g., ETFs), and is also true to varying extents of widely held unlisted mutual funds organized in certain jurisdictions. Where a CIV's manager has knowledge only of

the financial intermediaries in whose names interests in the CIV are held, the implementation of TRACE would go a long way to allowing the CIV to be able to certify its compliance with tests that make the eligibility of treaty benefits depend on the treaty status of its investors.

Pension Funds, Sovereign Wealth Funds, and Private Equity Funds

The treatment of non-CIV Funds, such as pension funds, sovereign wealth funds, and private equity funds is outside the scope of this article. While the issues that the Discussion Draft addresses relating to pension funds and sovereign wealth funds are fairly circumscribed, this is not the case for private equity funds and other alternative funds. The challenge for policymakers will be whether a provision clarifying under what circumstances a CIV would be entitled to treaty benefits should be crafted broadly enough to cover alternative funds. A risk for alternative funds, which face some of the same difficulties in establishing entitlement to treaty benefits as CIVs, is that such a provision would be drafted too narrowly. Depending on how an LOB is drafted, alternative funds and their holding companies might be denied treaty benefits even if a large proportion of the ultimate investors are resident in treaty jurisdictions. As noted by the Discussion Draft, denial of treaty benefits in these circumstances can also adversely affect pension funds and sovereign wealth funds invested in alternative fund structures. The Discussion Draft recognizes these challenges and how further work is required to meet them, but it is unclear yet what approach may be adopted.

Conclusion

The OECD is confronted with seeking to balance its goal of ensuring the granting of treaty benefits to CIVs in appropriate circumstances with the BEPS initiative related to the prevention of granting treaty benefits in inappropriate circumstances. Ultimately, CIV eligibility for treaty benefits will be determined by the specific terms negotiated and adopted in bilateral negotiations between contracting states, but the OECD is engaged in the important task of seeking to provide a framework to facilitate this process. Whether the OECD can do more by identifying a preferred approach remains to be seen.

The area in which there is no sign of an immediate solution is with respect to private equity funds and other alternative funds. There are no specific guidelines for ensuring the granting of treaty benefits to ensure neutrality between direct investment and indirect investment through these funds, and the BEPS initiative has the potential to foreclose access to treaty benefits. Addressing treaty benefit for alternative funds will be a major challenge for the OECD — and for stakeholders seeking to influence the outcome of Action 6 — as the remaining BEPS work on treaty abuse is carried out in 2015.

A final note is that the world of Funds is not divided into watertight compartments, with all CIVs clearly demarcated from all alternative funds. Arguably, favourable rules clarifying when CIVs should be entitled to treaty benefits should apply not only to widely held Funds subject to investor-protection regulation (i.e., one of the components of how the OECD defines a CIV) but should equally apply to other types of Funds, like, for example, a Canadian "pooled fund" trust not subject to National Instrument 81-102 and whose units are held by institutional investors (such as pension plans) that are resident in Canada. In such circumstances, the fact that investor-protection regulation does not apply seems irrelevant to such a fund's entitlement to treaty benefits. In seeking to provide relief for CIVs in the context of implementing a general LOB rule, the OECD and member states will need to be careful they do not make it more difficult to claim treaty benefits for non-CIV Funds with investors who would on direct investment be entitled to treaty relief.

Notes:

[1] CIV Report at para 4. The OECD notes, at para 4, that CIVs, as defined, include master funds that hold a diversified portfolio on behalf of widely held feeder funds as part of a "funds of funds".

[2] CIV Report at paras 7 – 9.

[3] 2014 Investment Company Fact Book, 54 ed.

[4] CIV Report at para 16.

5 CIV Report, Section III.

6 CIV Report at para 50.

7 CIV Report at para 51.

8 Paragraph 6.17 of the Commentary to Article 1.

9 Paragraph 6.32 of the Commentary to Article 1.

10 Paragraph 6.26 of the Commentary to Article 1.

11 Paragraph 6.21 of the Commentary to Article 1.

12 Paragraph 6.27 of the Commentary to Article 1.

13 Paragraphs 6.29 and 6.31 of the Commentary to Article 1.

14 The only exception being limited references to pension funds.

15 2014 Report at 45.

16 Discussion Draft at para 3.

17 CIV Report at para 62.

18 Association of British Insurers, "ABI Response: OECD Public Discussion Draft – BEPS Action Point 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" (9 April 2014). A similar comment was made by the UK's Investment Management Association, in its 8 April 2014 letter commenting on the March 2014 draft Action 6 report: "... where a LOB applies to a treaty, neutrality of treatment for investors in CIVs can only be achieved through a comprehensive derivative benefits provision. ... [A] derivative benefits clause could be ... administrable for CIVs only if a framework for identification of investors is developed pursuant to existing work on the CRS [common reporting standard] and TRACE. This would involve the passing of aggregate data on investor residence (compiled for CRS purposes) back through a distribution chain to the CIV or custodian making treaty claims on its behalf". Public comments on the March 2014 draft are available on the OECD website.