Are private equity and other collective investors entitled to tax treaty benefits?

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In November 2015, Prime Minister Justin Trudeau and the other G20 leaders endorsed the OECD's base erosion and profit shifting (BEPS) measures. The BEPS project is an ambitious plan undertaken jointly by the OECD and G20 to overhaul the global international tax system, culminating in a 2015 "Final Report" with hundreds of pages of recommendations. (A summary of the 2015 BEPS Report can be found here).

2015 BEPS Report – Action 6 minimum standards

Action 6 of the 2015 BEPS Report (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), included an agreed "minimum standard" for countries to prevent tax treaty abuse by:

1. including in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements; and
2. implementing such common intention through (a) a general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purpose test or "PPT" rule), (b) a limitation on benefits (LOB) rule that is supplemented by an "anti-conduit" mechanism, or (c) a combination of a LOB and PPT rule.

The 2015 BEPS report concluded that treaty benefits should be provided to collective investment vehicles (CIV), being widely held funds that hold a diversified investment portfolio and are subject to investor protection in the country in which they are established, in the circumstances set out in the OECD's 2010 Report (The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles) [PDF]. That 2010 Report provided for a variety of alternative methods that countries could choose from.

The 2015 BEPS Report also recognized the economic importance of cross-border investments by non-CIV funds such as private equity and hedge funds, and the need to ensure that treaty benefits are granted where appropriate. Without concluding on the appropriate treatment for non-CIV funds, the OECD indicated that further work would be done in the "first part of 2016" to ensure that new treaty provisions adequately address the treaty entitlement of various non-CIV funds.

2016 discussion draft

In March 2016, the OECD released a discussion draft (Treaty Entitlement of Non-CIV Funds [PDF]), and undertook public consultations. Osler and many others responded to the discussion draft with suggestions on how the OECD could clarify when private equity and other collective investors should be entitled to treaty benefits [PDF].

2016 multilateral instrument (MLI)

In November 2016, the OECD released a multilateral instrument or MLI [PDF] together with a detailed Explanatory Statement [PDF] arising from negotiations involving more than 100 jurisdictions, including Canada. The MLI is intended to allow swift implementation of a series of tax treaty measures that were contained in the 2015 BEPS Report, including the Action 6 treaty abuse “minimum standards.” Unfortunately, neither the MLI nor the Explanatory Statement included any changes in response to the March 2016 discussion draft, nor any further guidance on when treaty benefits should be provided to private equity and other collective investors. (A summary of the MLI and the resulting process to amend existing bilateral tax treaties is here). While it is not yet clear whether Canada intends to sign the MLI, the OECD has planned a general signing ceremony for June 2017.

2017 discussion draft – examples

On January 6, 2017 the OECD released its latest discussion draft entitled “BEPS Action 6 Discussion Draft on non-CIV examples.” [PDF] This discussion draft includes three examples that are intended to illustrate the application of the OECD’s proposed treaty shopping minimum standards for private equity and other non-CIV investors. In each example, the OECD concludes that (absent additional adverse facts) the PPT ought not to apply to deny treaty benefits despite the fact that such benefits were taken into account in structuring the relevant investment.

- **Example 1** – ***Regional Investment Platform***: This example involves a resident of State R, RCo, that is a subsidiary of a regulated institutional fund investor (Investor) resident in State T. RCo makes investments in countries in a regional grouping that includes State R and State S, and earns dividends from State S. Although the regional grouping factor may limit the direct relevance of this example outside of the EU context, Example 1 may be the most helpful of the three examples since RCo is entitled to a lower rate of State S dividend withholding tax than the Investor would have been entitled to if it had invested in a State S issuer directly (5% for RCo vs 10% for the Investor). However, the conclusion that the PPT does not apply in Example 1 is based in part on certain assumed non-tax factors for choosing to set up RCo in State R and on there being material investment functions and other activities carried out in State R. Also, Example 1 is only applicable by analogy to multi-investor funds, as it deals with the special purpose vehicle of a single institutional investor.

- **Example 2 – *Securitization Vehicle***: RCo, a corporate securitization vehicle resident in State R, was established by a State T bank which sold to RCo a portfolio of receivables from debtors in a number of countries. RCo is funded through the issuance of widely-held notes that are listed and traded on a stock exchange. For regulatory reasons, the bank holds a small percentage of the RCo notes. RCo claims a treaty-reduced rate of interest withholding tax imposed by State S, where 60% of the RCo receivables payments arise. The bank would have been entitled to equivalent benefits on interest payments under a treaty between the country in which the bank is resident and State S. The example is silent on whether the other noteholders would be entitled to equivalent treaty benefits if they held the receivables directly but concludes, based on the bank’s taking into account legitimate non-tax factors for choosing State R as the jurisdiction for RCo, that the PPT would generally not apply.

- **Example 3 – *Real Estate Fund***: RE Fund is treated as fiscally transparent under the tax law of State C, where it has been organized to invest in a portfolio of real estate investments.

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RE Fund makes investments indirectly through its holding company, RCo, which enjoys treaty benefits with respect to its real estate investments. RE Fund's investors would have been entitled to equivalent treaty benefits, and the countries where the real estate investments are based can tax the directly earned income on those investments (e.g. rent). Based on those factors, and the fact that RCo's real property investments are made for commercial purposes, the PPT should generally not apply.

Although the OECD has acknowledged that it is important to provide treaty benefits to private equity and other collective investors in "appropriate" circumstances, the OECD has done very little to provide such investors with the certainty they need at the time investments are made. The above examples provide some guidance but little certainty. In each case, the OECD says that the PPT could apply if there are further 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 applicable treaty, which gives leeway for tax authorities seeking to distinguish the examples. Also, there is little indication about how to apply the PPT where most but not all of the investors are equivalent beneficiaries. Finally, the relevance of certain facts is left unexplained: in Example 2, for instance, would treaty benefits potentially be denied if the notes were (as is more often the case) not listed on a stock exchange? This lack of actionable guidance is particularly disappointing since the OECD, after considering the issue for several years, appears content to proceed with an MLI signing ceremony while offering private equity and other collective investors virtually no guidance on when treaty benefits may or may not be available, other than through the three limited examples in its latest discussion draft.

The PPT is vague and subjective, allowing tax authorities the potential ability to deny treaty benefits in respect of practically any cross-border investment. This has prompted significant criticism from the United States Treasury and many others. The general uncertainty under the PPT is compounded by the OECD's use of a "one of principal purposes" test, with very little guidance on how to determine whether or when a particular tax consideration may be elevated into a principal purpose, particularly when an investor may have multiple purposes.

The latest discussion draft examples provide little guidance on how to distinguish a "principal purpose" from a general consideration. If a tax benefit is significant, could a tax authority always view it as having been a principal purpose? Could treaty benefits be denied if any of the assumed facts in the examples are missing (such as where investments are not confined to a particular geographic region)? This opens the PPT to being potentially used as a form of "smell test" under which tax authorities could simply unilaterally decide whether treaty benefits ought to be allowed. Investors would unlikely proceed with an investment based upon the mere hope that tax authorities will subsequently agree that treaty benefits apply.

The OECD stated that it deliberately kept the number of examples in the discussion draft low and has avoided any "controversial" examples, perhaps with a view to maintaining the illusion of consensus among its members. However, controversial examples are precisely where clarity is most needed, especially in situations where countries may take differing views regarding particular fact patterns. It is important to bring differing views to light, rather than obscuring them.

The OECD has suggested that countries may address the granting of treaty benefits for private equity and other collective investors on a bilateral basis. While such an approach could work, it is unclear why the OECD would not include sample provisions into its model (and the MLI) for this purpose. For example, the MLI could include a presumption that the PPT would not apply if at least 75% of the ultimate investors in a fund would have been entitled to the same or similar treaty benefits had they not invested on a collective basis (the use of a 75% threshold would allow consistency between the PPT rule and the proposed derivative benefits rule under the MLI's simplified LOB approach). Countries would then be free to include such a rule or follow an alternative approach as desired. In addition, if

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countries were to address the issue on a bilateral basis they could provide further examples or other guidance on the intended application of the rule in particular circumstances. While such a bilateral approach would be helpful, it would nevertheless be preferable for the OECD to simply provide such guidance on a multilateral basis prior to the MLI changes coming into effect.

Finally, we note that the OECD could also link its Action 6 minimum standards with its recommendations on Action 14 (Making Dispute Resolution Mechanisms More Effective). This could be done, for example, through the use of a pre-ruling mechanism that would allow private equity or other collective investors to determine, on an expedited basis and in advance of an investment, whether treaty benefits will apply to a particular investment.

Comments on the discussion draft should be sent to the OECD by February 3, 2017. Osler intends to convey our concerns, including those noted above, to the OECD.

For further information on BEPS, treaty benefits, and Canada's international tax regime, please contact any member of our Tax Group.