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OECD Considers Availability of Tax Treaty Benefits for Investment Funds, Pension Funds and Private Equity Funds

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Related Expertise

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On November 21, 2014, as part of its Action Plan on Base Erosion and Profit Shifting (BEPS), the OECD released a discussion draft on "Follow-up work on BEPS Action 6: Preventing Treaty Abuse" (the Discussion Draft) for comments. The Discussion Draft deals with a number of issues relating to tax treaty abuse, including notably issues relating to treaty entitlements for collective investment vehicles (CIVs) such as widely held mutual funds, and non-CIV funds such as private equity funds, pension funds and sovereign wealth funds.

Background

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 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). The Report provided model LOB and PPT rules and draft commentary on the rules, noting that there was 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 standalone LOB rule being supplemented by an "anti-conduit" mechanism. However, the Report was released in draft rather than final form, as the OECD noted that further work was required in certain areas. In particular, the Report noted that further consideration was needed regarding potential exceptions from an LOB or PPT rule for certain CIV and non-CIV funds.

The Discussion Draft follows up on the principal outstanding items identified in the Report, including the application of treaty benefits CIVs and non-CIV funds. The Discussion Draft defers discussion of the actual implementation of the minimum standard described in the Report to 2015.

Canada's 2014 Federal Budget had proposed a domestic anti-treaty shopping rule that would have denied treaty benefits in certain circumstances. That rule did not contain specific exceptions for CIV and non-CIV funds. However, after engaging in consultations on the proposed domestic rule, on August 29, 2014 Canada announced that it will instead await further work from the OECD/G20 on the BEPS Project. Canada, together with other G20 countries, has committed to completing work on the BEPS project in 2015.

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. A public consultation on the Discussion Draft is to be held by the

OECD in Paris on January 22, 2015.

The Discussion Draft

CIV Funds

CIVs are 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. In 2010, the OECD released a detailed report on "Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles" (the CIV Report). The CIV Report recommended that, as a general rule, source countries should grant treaty benefits to foreign CIVs notwithstanding that CIVs themselves may not pay much if any tax in their home jurisdictions. It also recognized, however, that countries may be reluctant to grant treaty benefits to a CIV resident in a treaty partner country to the extent that the CIV has third country investors. The CIV Report acknowledged moreover that it would often be difficult (if not impossible) for a CIV, whose investors often hold their interests in the CIV through financial intermediaries, to accurately determine the treaty residence of its investors. In light of these competing policies and logistical challenges, the CIV Report had recommended an assortment of alternative model treaty provisions (which were incorporated into the commentary to the 2010 OECD model tax convention) that countries could choose from in addressing CIVs in their bilateral tax treaties. Among the options were: (a) a rule that would treat CIVs in both countries as residents generally entitled to treaty benefits without further inquiry as to the residence or treaty eligibility of a CIV's investors; (b) a rule that would treat CIVs in both countries as residents generally entitled to treaty benefits, but only to the extent that its investors wherever resident were entitled to equivalent treaty benefits (equivalent beneficiaries); (c) a rule that would treat CIVs in both countries as residents generally entitled to treaty benefits, but only to the extent that its investors were resident in the same country as the CIV. Alternative versions of rules (b) and (c) were provided with "safe harbour" percentage thresholds, which if satisfied would entitle 100% of the CIV's income to treaty benefits.

In the Report's recommendations for an LOB rule, the OECD took up the same issues as were addressed in the CIV Report. It recommended that if a treaty did not have a rule specifically addressing treaty residence of CIVs or had one that took the form described in clause (a) above, it would be appropriate to require that CIVs be "qualifying persons" for LOB purposes by meeting different possible alternative tests that looked much like the tests in clauses (b) or (c) above. The Report added that if a particular treaty already contains a test like the ones in clauses (b) or (c), then CIVs generally would not need to be separately addressed in an LOB rule. Perhaps recognizing the lack of consensus inherent in multiple alternatives and that greater clarity could be provided with respect to CIVs than that set out in the 2010 CIV Report and 2014 Action 6 Report, the Discussion Draft noted that further work needs to be done. Comments are invited on the question of 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.

The Discussion Draft notes that the further work on treaty entitlement of CIVs will also take into account the work on the Treaty Relief and Compliance Enhancement (TRACE) project. The OECD's TRACE project was launched in 2006 to address the obstacles under countries' withholding tax collection and relief procedures that taxpayers generally (not just CIVs) face when seeking treaty relief from withholding taxes on payments (dividends and interest) made on publicly traded securities, which are typically held through a complex network of domestic and foreign intermediaries (e.g., depositary/clearing agencies, custodians and brokers). A TRACE report, released in 2013, recommended that countries develop systems for claiming treaty benefits that allow authorised intermediaries to make claims on behalf of investors on a "pooled" basis and require such intermediaries to report beneficial owner

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information directly to source countries. This intersects with the work done by the OECD on treaty entitlements for CIVs, which (depending on their legal form and the applicable treaty provisions) can in some ways be considered to be claiming treaty benefits in respect of, if not usually on behalf of, their investors as treaty residents.

Pension Funds, Private Equity Funds and Sovereign Wealth Funds

The Discussion Draft canvasses – in a non-conclusive manner – special treaty benefit entitlement issues faced by pension funds, sovereign wealth funds and alternative funds (including private equity funds), which had been mentioned but not addressed in any detail in the Report.

The proposed LOB rule contains specific provisions that allow pension funds and their wholly owned investment vehicles to qualify for treaty benefits, provided certain conditions are met. However, pension funds and such investment vehicles could face potential loss of treaty benefits under the LOB rule when investing through an entity that is a resident of a third country (such as where a Canadian pension plan uses a holding company in a third country to make an investment outside Canada or makes an investment in a private equity fund that makes use of such holding companies). The Discussion Draft also notes some other specific issues that stakeholders have raised regarding the entitlement to benefits of pension funds (relating to qualification of pension funds as treaty “residents,” the application of the LOB rule to multi-nation pension plans, and the possible adoption into treaties of a sample provision already found in the OECD commentary that provides a broad-based exemption from source country taxation to pension funds).

The Discussion Draft notes that sovereign wealth funds may qualify for an exemption from source country taxation under the sovereign immunity doctrine (or a domestically enacted statutory version thereof), or failing that, they may need to claim treaty benefits. The Discussion Draft acknowledges that the LOB rule recommended in Action 6 creates a potential issue for sovereign wealth funds investing through an entity that is a resident of a third country.

The Discussion Draft also touches on treaty issues faced by alternative funds, such as private equity funds, noting that treaty benefits for alternative funds will often affect sovereign wealth funds, pension funds and other institutional investors in an alternative fund. Alternative funds face some of the same issues as CIVs. Depending on their legal form, they may well not qualify as residents under existing rules and more generally they may not qualify for treaty benefits under the recommendations of Action 6 since their investor base is often not restricted to a single country. Moreover, any treaty provisions dealing expressly with CIVs may not otherwise apply to them.

The OECD requests comments as to whether the Discussion Draft accurately describes the treaty entitlement issues of sovereign wealth funds, pension funds and private equity funds/alternative funds. It also invites comments as to how to address these issues without creating opportunities for treaty shopping. As well, the Discussion Draft requests comments on a detailed list of specific topics related to pension fund treaty benefit entitlements.

Other LOB Rule Issues

The Discussion Draft also considers a variety of other outstanding issues related to the LOB Rule recommended in the Report, such as the following:

- The circumstances in which discretionary treaty relief should be provided when LOB

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requirements are not otherwise met, including the process for granting discretionary relief;

- Alternate LOB rules for EU countries to accommodate certain concerns raised by EU member states;
- Whether it is unduly restrictive for LOB rules to require all intermediate owners to be resident in a contracting state;
- Potential changes to the derivative benefit and equivalent beneficiary provisions of the LOB rules that do not raise BEPS concerns while recognizing the circumstances in which intermediate companies may be used for valid commercial reasons;
- Various temporal issues associated with LOB rules, including when an entity becomes, or ceases to be, publicly listed;
- Whether special rules are needed for publicly listed companies that are resident in small countries that do not have an important stock exchange; and
- Possible clarification of the "active business" exception for LOB rules, including with respect to headquarters operations.

PPT Rule

While much of the Discussion Draft is focused on potential exceptions to the LOB rule proposed in the Report, various issues with the PPT rule recommended in the Report were also considered. For example, the Discussion Draft considered:

- Clarifying that a person may have a "principal purpose" to obtain benefits under a particular tax treaty regardless of whether benefits are also obtained under another tax treaty or under domestic law;
- Consideration of countries establishing an administrative process for applying a PPT rule (such as the approach used in Canada with a GAAR Committee that considers the circumstances in which the Canada Revenue Agency should apply the Canadian general anti-avoidance rule);
- Whether the application of the PPT rule should be excluded from treaty arbitration clauses;
- Providing greater consistency between the explanations of the purpose test used in the LOB discretionary relief rule and the PPT rule;
- Whether there should be a PPT discretionary relief rule;
- Design features for an anti-conduit rule to backstop an LOB rule, including examples on when such a rule should apply; and
- Suggestions for additional examples to clarify when a PPT rule should apply, including with respect to non-tax motivated uses of special purpose vehicles to pool investments of

institutional investors from different countries.

Other Tax Treaty Rules

Finally, the Discussion Draft considers certain other tax treaty issues, such as the following:

- Clarification of the application of the treaty tie-breaker rule (such as to confirm that a person may still be a "resident" of a country for certain tax treaty purposes (such as for determining whether salaries are paid by a treaty resident) even if tax treaty benefits may otherwise be denied (such as where the competent authorities cannot agree on treaty residence);
- The design and drafting of a new rule recommended by the Report to deny treaty benefits in certain circumstances where a person has a permanent establishment in a third country; and
- Clarification with respect to the interaction of tax treaties with domestic anti-abuse rules, including any new rules that may be enacted to take into account recommendations in BEPS Action 2 (hybrid mismatch arrangements), Action 3 (CFC rules), Action 4 (interest deductions and other financial payments), and Actions 8, 9 and 10 (transfer pricing).

Conclusion

The availability of tax treaty benefits for CIVs, pension funds, sovereign wealth funds and private equity funds is extremely important, as a denial of such benefits may have a significant impact on applicable investment returns. The OECD has recognized that certain exceptions are necessary to prevent their recommendations in the Report (in particular the LOB/PPT rules) from denying treaty benefits to many CIV and non-CIV funds. The views and proposals included in the Discussion Draft do not represent the consensus views of the OECD or its subsidiary bodies, but are intended to provide stakeholders with substantive proposals for analysis and comment. CIV and non-CIV funds and their investors should consider responding to the questions and issues raised in the Discussion Draft to ensure that their concerns are taken into account in the final report on treaty abuse. While the recommendations in the final report are not binding on Canada or any other country, they will likely be taken into account by Canada and other countries when negotiating tax treaties.

For further information on the material covered in the Discussion Draft, please contact any member of our Tax Department.