COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFT

FOLLOW-UP WORK ON BEPS ACTION 6: PREVENT TREATY ABUSE

12 January 2015
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VNO-NCW 751
9 January 2015

By email to: taxtreaties@oecd.org

Marlies de Ruiter
Head, Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA

Dear Marlies,

**BEPS action 6 Discussion draft on preventing the granting of treaty benefits in inappropriate circumstances**

AFME\(^1\) and the BBA\(^2\) welcome the opportunity to respond to the OECD’s discussion draft entitled: “Follow up work on BEPS action 6: preventing treaty abuse” published on the 21 November 2014 (the discussion draft). We wish to make clear that while AFME and the BBA have separate and distinct memberships, for the purposes of the OECD discussion draft, both organisations have decided to submit a single, combined response since our respective members share the same concerns with respect to the proposals in the discussion draft.

Given the relatively short time available to respond to the discussion draft it has been difficult to consider all aspects of the proposals and we are therefore providing our initial comments on the most important issues of concern to us. We may decide to write to you again with further observations once we have had a chance to consider the proposals in greater detail.

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\(^1\) The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

\(^2\) The BBA is the leading trade association for the UK banking sector with more than 230 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Our associate membership includes over 80 of the world’s leading financial and professional services organisations.
Executive Summary

We support the OECD’s consultative approach on the development of these proposals. We believe that this will benefit both policymakers and business, by helping to reduce any unintended consequences arising from the OECD’s proposals. We also believe that it is essential for the OECD to take account of the views of business on the practical aspects of operating the intended policy.

As noted in our response dated 9 April 2014 to the 14 March 2014 OECD discussion draft entitled “Preventing the granting of treaty benefits in inappropriate circumstances” we are concerned that, when considered as a whole, the OECD’s proposals represent a disproportionate response to any potential abuse of the tax treaty system. The broad scope of these proposals means that activity which we would consider low risk in relation to treaty abuse could be inadvertently affected by the anti-abuse provisions. We therefore believe that the OECD’s policy objectives would be better served by targeting the proposals in a manner which addresses specific areas of concern identified by tax administrations. We have previously highlighted areas where we believe the anti-abuse provisions may inadvertently apply. The main body of this provides additional detail in this respect for the OECD’s consideration.

If the broad scope of the proposals is not clarified, this could introduce uncertainty into whether treaty relief is available in ordinary commercial circumstances. This uncertainty risks undermining the usefulness of tax treaty networks that states have spent decades putting in place in order to facilitate international trade and promote economic growth. Whilst we recognise that tax administrations require assurance that treaty benefits are only being granted in appropriate circumstances, this should be applied in a proportionate manner to ensure tax treaties are able to achieve their objective which is to encourage cross border investment.

The latest discussion draft states that the proposals do not represent the consensus view of the Committee on Fiscal Affairs (CFA). Whilst we recognise that there may be a need to accommodate different anti-abuse instruments within a framework, we are concerned that these instruments may be subject to more than one interpretation by tax administrations. For banks facilitating cross border investment on behalf of their clients this will likely result in inconsistent and unpredictable data requests from tax administrations to support treaty benefit claims. We would strongly encourage the OECD to provide additional clarification to each of the different anti-abuse provisions, particularly with respect to the evidential requirements. This will help to ensure consistent and predictable interpretation by both tax administrations and business.

In addition to the uncertainty which may arise from the proposals in the discussion draft, we would also highlight the need for the OECD to consider the interaction of the proposals with existing domestic anti-avoidance provisions and other areas currently being addressed under separate BEPS actions. Whilst it is welcome that the discussion draft recognises the interaction of these proposals with other BEPS action points under discussion (specifically actions 2, 3, 4, 8, 9 and 10), we would encourage the OECD to also ensure that any final proposals to combat potential treaty abuse make reference to the need for tax administrations to align any domestic measures already in place to tackle perceived abuse. This will help ensure a proportionate approach to the potential abuse of tax treaties whilst preventing the benefits of tax treaties from being undermined.
General Comments

Application of the Principal Purpose Test (PPT) and Limitation on Benefit (LOB) rules

We are concerned that the current proposals are too ambiguous and open to inconsistent interpretations by Tax Authorities. This will lead to uncertainty for business in how tax authorities will apply the PPT and LOB rules and is likely to disrupt the relief at source process administered by banks. For example the customers of banks make financial investments – such as owning shares and debt securities. Such investments are often held in custody by the bank, on behalf of customers. In such cases, it is the customer’s eligibility for treaty relief that the bank may have to administer, which could include relief at source from withholding tax on the income arising on the shares or securities.

The current proposals will present additional complications for both tax administrations and banks and we would foresee the following consequences unless greater certainty is provided:

- Source tax authorities may experience additional demands on their resources to process increased volume of reclaims;
- Increased cross border investor uncertainty especially for pension fund investors/sovereign wealth funds and cross border investors where the potential for tax treaty abuse is low;
- Increased cost to business arising from inconsistencies in each source tax authority’s method of testing eligibility and associated documentation requirements;
- Additional complexity and cost will reduce the attractiveness for cross border investors, as they factor in the risk and cost to achieving the level of income return they believe that they are entitled to;
- Uncertainty on the accruing of relief in markets which currently operate a relief at source model;
- Uncertainty for Collective Investment Vehicles (CIVs) on time taken to actually achieve repayment of tax deducted at source which will impact the Net Asset Value of the fund (calculable on a daily basis);
- Investors may forego claiming relief due to the complexity.

We therefore urge the OECD to provide additional clarification within the commentary to reduce areas of subjectivity and provide business with greater certainty regarding the application of the PPT and LOB rules.

Impact of PPT and LOB rules on Non-CIVs

We are concerned that non-CIVs such as pension funds and sovereign wealth funds will be negatively impacted by the provisions of action 6. Currently, these types of entity are able to receive either a lower withholding tax rate or exemption under double tax treaties. We would also highlight that these types of entities are intended to provide pension and long term savings vehicles for individuals or a return for a particular state which may assist the provision of public goods and services. Therefore it is important that these benefits are not negatively impacted by any changes to the PPT and LOB rules.

We also believe that non-CIVs should be treated as “look at” rather than “look through” entities for the purposes of determining eligibility for treaty benefits. This will be consistent with tax information exchange requirements under FATCA and the Common Reporting Standard (CRS) where there is no requirement to look through these entities. These entities are seen to
represent a low risk of tax evasion and we therefore feel it would be appropriate for them to only be required to evidence their status.

Information requests to determine eligibility for treaty benefits

We believe that there should be greater standardisation of how tax authorities request information from business to establish eligibility for treaty benefits. This is a significant concern for banks that make investments via a custody arrangement on behalf of their customers. Tax administrations are increasingly requesting information from banks making investments on behalf of their customers in a custody arrangement which requires the collation and provision of data which was not previously understood to have been necessary to support the granting of treaty benefits. Introducing retrospective requirements in this manner creates significant practical challenges for banks from a number of perspectives:

- The information, or level of detail required, may not be held as there were no requirements at the time to record this data for tax or regulatory purposes;
- The request may require firms to collate data across multiple business lines and products where the original income was not received;
- If enquiries are of a historical nature, systems may have changed or evolved and data may be even harder to obtain;
- Depending on the nature of an enquiry, third parties, such as custodians or agents, used to support any business may have changed. It may therefore be harder to obtain support for any such enquiry where there is no longer a business relationship;
- There may also be practical issues such as obtaining certifications, notarisation from third parties when these are required within a specified time period.

In recent years banks have seen various examples of jurisdictions requesting additional layers of non-standard documentation to establish whether the claimant was the true beneficial owner, for example in relation to the dividend income for all cross border investors wishing to file reclaims (with limited exceptions). We would also note that in some jurisdictions treaty relief at source procedures are also inconsistently applied across regional tax offices within a jurisdiction which creates further complexity for banks.

We would highlight how the level of detail and supporting documentation requested by tax administrations is often disproportionate in comparison to the risk of potential treaty abuse, as well as the volume and costs of the claims. Examples of this include requirements to provide P&L information with respect to specific equity trades or on a per instrument basis. Where the cost of meeting these additional information requests outweighs the benefits, this may result in entitled cross border investors choosing to waive their rights under the double tax treaty.

Whilst we recognise that tax administrations need to be satisfied that treaty benefits are not being unduly granted, we believe that there needs to be greater standardisation over what information is required to evidence treaty eligibility. Information requests should also be proportionate to the risk of tax treaty abuse and value of claims to ensure that investors are not unduly prevented from receiving the benefits to which they are entitled.

We would urge the OECD to consult further with business on how the relevant facts and circumstances can be established at the time of a claim for treaty relief as we believe that greater dialogue in this respect will deliver significant cost savings for both industry and tax administrations.
Reduction in the ability of investors to receive treaty relief at source

In addition to greater uncertainty with respect to ordinary commercial transactions, we are concerned that the proposals may exacerbate a tendency in the approach of tax authorities globally towards the application of more onerous information and evidential requirements at the time of the claim for treaty relief. One consequence is that this may result in a significant decrease in the ability of investors to receive treaty relief at source as the only way in which banks acting on the customer’s behalf would be able to satisfy the information requested is via a reclaim process.

Proposals leading to a reduced relief at source system contradict the objectives of the Treaty Relief and Compliance Enhancement (TRACE) system, another tax-related project undertaken by the OECD which is aimed at moving towards a “relief at source” system. A transparent and predictable relief at source mechanism is in the interests of tax authorities, cross border investors and business as it provides greater certainty around the granting of treaty benefits and reduces the operational costs associated with reclaim processes for all parties.

Whilst the TRACE and BEPS projects have different objectives, we are disappointed that there has not been greater consideration of how TRACE might allow tax authorities to mitigate some of the concerns around potential treaty abuse whilst providing business with increased certainty in relation to cross border investment.

Issues on which comments are invited

Given the relatively short time available consider the discussion draft it has been impractical for us to comment all aspects of the paper. We are therefore providing specific comments on some of the most important issues of concern identified by our members.

Collective investment vehicles: application of the LOB and treaty entitlement

Comments are invited as to whether the recommendations of the 2010 CIV Report continue to be adequate for widely-held CIVs and whether any improvements should be made to the conclusions included in that Report. Comments are invited, for example, on whether it would be advisable to provide for a preferred approach with respect to issues related to the tax treaty entitlement of the income of CIVs and the application of the LOB to CIVs, and if yes, on what that approach should be.

We believe that the recommendations of the 2010 CIV report remain broadly appropriate and would also encourage tax administrations to adopt the TRACE implementation package which has been designed to provide the additional assurances to tax administrations about the validity of tax treaty claims.

Commentary on the discretionary relief provision of the LOB rule

Suggestions are invited as to possible factors or examples that could be included in the Commentary on the discretionary relief provision of paragraph 5 of the LOB rule in order to clarify the circumstances in which that provision is intended to apply.

A discretionary relief rule has potential value as a means to ensure that treaty benefits are available where appropriate but should not be seen as a substitute for well thought through and appropriate double tax treaties and administrative processes to support their application.
Alternative LOB provisions for EU countries

Paragraph 13 of the Report acknowledges that the LOB rule (paragraph 16 of the Report) needs to be adapted to reflect certain EU law requirements. There is therefore a need to draft alternative provisions that would accommodate the concerns of EU member states.

In addition to accommodating the concerns of EU member states we would also encourage the OECD to consider how the LOB provisions might be adapted to accommodate other mutual fund recognition programmes.

Requirement that each intermediate owner be a resident of either Contracting State

Further work is required in order to determine whether and how the requirement could be relaxed without creating opportunities for treaty-shopping; that work will be carried on in relation with the work on issues related to the derivative benefit provision and the definition of equivalent beneficiary which are described in section 6 below.

Whilst we understand the desire to prevent treaty shopping, we would make the general comment that the residency of the ultimate beneficial owner should be a more relevant consideration than the residency of an intermediate owner. Many multinational companies establish intermediate holding companies in third countries for commercial reasons e.g. establishment of a holding company with a management board for regional subsidiaries. It is not clear why the existence of such an intermediate holding company in a third country is in itself an indicator of treaty shopping and sufficient to deny an operating subsidiary “qualified person” status. This requirement could create competitive distortions for multi-national enterprises based on holding company structures even in circumstances where there is no evidence of treaty shopping. Furthermore it may not be possible to exit existing holding company structures easily or without incurring substantial costs.

The existence of a “derivatives benefit” clause may mitigate the issue in part but not entirely. Holding companies established in third party States may not satisfy the definition of “equivalent beneficiary” even in circumstances where treaty rate differentials are minimal. Furthermore, holding companies could cease to be considered equivalent beneficiaries in future years if treaties are subsequently renegotiated (e.g. source state and state of residence renegotiate a treaty resulting in improved terms compared to the treaty between the source state and the state of residence of the holding company).

Financial transactions at arm’s length can take place between different members of multi-national banking groups. In such cases, as more generally, the residence of intermediate holding companies should not be relevant to determining the entitlement of the parties to treaty benefits.

Clarification of the “active business” provision

Comments are invited as to possible clarifications that could be made concerning the interpretation and application of the “active business” provision found in paragraph 3 of the LOB rule (paragraph 16 of the Report).

We would suggest that the ‘active business’ provision in paragraph 3 of the LOB rule should be clarified to confirm that when a company meets any equivalent active business tests in the context of domestic legislation, it will be considered to be carrying on an active business in the context of tax treaties. For example in the UK, a company which is treated as a trading company
In the UK for the purposes of the substantial shareholdings exemption, or a company which complies with the business profit gateway safe harbour in the CFC rules.

We would also suggest that a company which is regulated in its country of incorporation and meets the requirements of the local regulator (e.g. in terms of capital, staff, business activities) should be regarded as carrying on an active business.

We believe that both the above points should be made clear in the relevant provision or the associated commentary.

*Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level*

In a number of countries, the application of the general anti-abuse rule found in domestic law is subject to approval by a committee composed of senior officials. In some cases, that committee includes academics and/or tax experts from the private sector. The Commentary on the PPT could include the suggestion that countries consider establishing a similar form of administrative process that would ensure that the PPT is only applied after approval at a senior level.

We agree that there should be an appropriate administrative process to support the application of PPT. This should be made publicly available by tax authorities to ensure that the process is transparent, consistent and predictable.

*The design and drafting of the rule applicable to permanent establishments located in third States*

The anti-abuse rule included in paragraph 42 of the Report is currently restricted to cases where the profits of the PE are exempt in the State of the enterprise to which the PE belongs. Are there other situations where the rule should apply?

Are the exceptions included in subparagraphs e) and f) of the anti-abuse rule sufficient to address cases where the rule would otherwise affect arrangements that are not tax-motivated?

Do these exceptions raise potential BEPS concerns?

It is essential for bank branches to be able to use their parent company’s tax treaties and we welcome that this is recognised within the rules by the exemption for banking, insurance and securities dealing. There are, however, some aspects of the rules which could also be interpreted in a manner which has an impact on banking activity. We do not believe that these are areas of concern that the OECD proposals are seeking to counter and would ask that consideration is given to ensuring that these scenarios are not perceived as treaty abuse.

It is our understanding that where the exemption for banking, insurance and securities dealing doesn’t apply, the use of treaties to avoid taxation at source will be denied where:

- The home country exempts income from the source country; and
- The local tax charge on the branch’s income is less than 60% of what the charge would have been if the income had been earned in the home country H.

The commentary also states that:
“Where the State of residence exempts the investment income of such permanent establishments situated in third States, the State of source should not be expected to grant treaty benefits with respect to such income.”

This may lead to the conclusion that taxation at source should be seen as the default position and impact the way global banks split their business between head office and foreign branches. By way of illustration, where a fully taxable UK branch of a foreign company pays less than 60% of its home country tax, it will still pay the same tax as UK banks. We do not believe this can be considered abusive and would not expect the source country to impose withholding tax on that bank. The current wording, however, may lead to the danger of different interpretations of the tax benefits that would otherwise apply and the (hypothetical) liability in the home country that opens up the risk of double taxation. Therefore we feel the commentary should be revised to focus on the targeted abuse where a treaty exemption provides double non-taxation, or something close to it, for a branch of a resident of a contracting state.

In addition to this concern we would also query the use of the term ‘effective rate of tax’ which could imply that a running test will be made between the branch’s actual tax charge and the benchmark home country tax rate. Treaty claims are generally made just after an investment is made and utilising the current tax charge as a benchmark is of limited usefulness. In scenarios where a branch is making losses at that time (even if the branch would pay tax the following year) the branch could lose treaty benefits under this provision. We believe the commentary should provide for the expected (nominal) rate of tax, or the total tax including deferred tax, to be used as a benchmark rather than the current tax charge.

Furthermore, we would suggest that the position should be settled for an agreed substantial period so that the parties have certainty. Normally, a lender is indemnified by the borrower against suffering an unexpected withholding tax, so the cost (of grossing-up) would be borne by the resident of the source country. Any requirement to monitor or track this on an ongoing basis would present a considerable operational challenge for banks. This would also affect borrowers who would now be exposed to a risk that they could not hedge and a refinancing risk, without any benefit to the source country as the loans would be replaced before any tax flowed from them.

We would also ask the OECD to give further consideration to the use of the percentage test. We believe that the current percentage test may give rise to unfair outcomes in some instances where there is no abuse of tax treaties. By way of illustration, branches in countries like Hong Kong (16.5%), Singapore (17%), and Ireland (12.5%/25%) would be treated as abusive and treaty benefits would be lost by French and Spanish banks (assuming the branch is exempt from home country tax but not caught by tax haven legislation) but not by UK and Swiss banks. If the UK tax rate goes up 1% or Irish tax goes down 0.5%, transactions in Irish branches of UK banks would then become tainted. This difference in the treatment of competing banks does not seem to meet the policy objective and may suggest that a benchmark at the 60% level may need to be revisited. We would suggest that a level of 25% may prevent inadvertent outcomes whilst still meeting the policy objectives of the proposals.

Yours sincerely,
9 January 2015

Dear Sirs

OECD discussion draft 21 November 2014
BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

The Alternative Investment Management Association\(^1\) responded on 3 April 2014 to the initial OECD discussion draft on BEPS Action 6 which preceded the Report and now wishes to comment on the proposals for follow-up work set out in the 21 November 2014 discussion draft.

In our 3 April 2014 letter we stated:

*AIMA is concerned that the measures proposed to be introduced into the OECD Model Tax Convention concerning entitlement to benefits will, if adopted in their present form, have significant effects on the ability of collective investment schemes in general (and not limited to those in the alternative investment sector which AIMA represents) to obtain the benefit of double tax treaties. The part of the new Article proposed in the discussion draft which is concerned with limitation of benefits broadly requires a fund that wishes to claim treaty benefits to have a significant connection with the country in which it is resident for tax purposes, be it an effective listing or a majority of investors there. Many funds are not listed and pool capital from investors across a number of countries and so will not pass such a limitation of benefits threshold. The “derivative benefits” provision considered in the discussion draft is too narrowly drawn to be of assistance.*

We, like other respondents to the initial discussion draft, requested the OECD to consider further the application of the measures to collective investment schemes. We welcome the decision to carry out more work on this aspect. However, we are concerned that the issues identified in the 21 November 2014 discussion draft for further work focus only on the details of the limitation on benefits (LOB) rule and the principal purposes test (PPT) whereas the difficulties caused for collective investment schemes are more fundamental and arise from the formulation of the LOB and PPT which the 21 November 2014 discussion draft does not address.

The 21 November 2014 discussion draft also does not address the question of the ability of collective investment schemes to access double tax treaties at all. This was considered in the OECD’s 2010 CIV Report whose recommendations remain valid. We therefore do not consider this issue further.

Collective investment schemes generally exist to receive investment monies from a range of investors and to deploy that capital in order to generate investment returns. They are not designed or promoted as vehicles for tax avoidance. Many investors are not liable to tax, being pension funds, sovereign wealth entities, not for profit organisations, charities and other entities that would be entitled to treaty benefits in their own right if they invested directly in the underlying investments. Accordingly, “double non-taxation” is not an aim of such collective investment schemes but rather to achieve tax neutrality as far as possible for a diverse investor base.

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\(^1\) AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector - including hedge fund managers, funds of hedge fund managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.
In summary, AIMA considers:

- For very many collective investment schemes there will be practical difficulties for the manager in showing that the LOB is satisfied at any relevant time. In addition to the inequality that will exist where one collective investment scheme can demonstrate that it is entitled to treaty benefits but an otherwise identical collective investment scheme cannot, the necessary uncertainty that the LOB will at any relevant time in fact be met will give rise to inequalities between investors in the same collective investment scheme which is undesirable.

- While the PPT, as directed to the principal purposes of the transaction, would more readily afford continuing certainty of treatment, it is too widely aimed and should be focussed on the matters within (or which should be within) the knowledge of the manager.

- We suggest that there should be an alternative test (“genuine diversity of ownership” or “GDO”), as described in the annex to this letter. This test would examine whether the proposed basis for marketing and distribution of the interests in a collective investment scheme is intended to result in it being widely held (and therefore unlikely to have been established for a tax avoidance purpose). The advantage of a test of this type is that it does not require verification of the identity and residence status of investors and therefore offers administrative advantages to both the manager of the collective investment scheme and relevant tax authorities. The test is based on one adopted for a similar purpose in UK taxation legislation, initially in relation to certain types of collective investment scheme and extended more widely as it proved a practical solution.

- If these concerns are not addressed, the range of collective investment schemes available to investors is likely to be affected.

We explain these concerns in more detail in the annex to this letter and then comment further on some of the issues identified in the 21 November 2014 discussion draft.

One of the policy objectives of the OECD - for instance, as stated in its 2006 publication the Policy Framework for Investment - is to mobilise private investment that supports economic growth and sustainable development. The fund management industry is an important provider of international private investment, both as a primary investor and as a provider of liquidity in the secondary markets. The Model Convention should, as a uniform approach of internationally agreed rules that can provide certainty and coherence, recognise the role of collective investment schemes, consistent with the objective of the BEPS project to facilitate cross border investment as well as addressing double taxation and double non-taxation. The OECD should ensure that it does not, through inappropriate application of measures such as the LOB and PPT, stifle private investment or increase the costs of its provision.

Yours faithfully,

Paul Hale
Director, Head of Tax Affairs
Annex

OECD discussion draft 21 November 2014
BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

AIMA’s concerns

1. The nature of collective investment schemes as open-ended funds gives rise to two issues which must be taken into account:

   a. As subscriptions and redemptions at net asset value must generally be freely permitted on stated dealing days, such funds have a body of investors that may continually change. The attributes of investors, including their tax residence status and other information required for the LOB, will be subject to frequent change. Even with the evolving requirements of anti-money laundering legislation and tax reporting regimes, not all such information may be available. For instance, where an investor is a “fund of funds”, the investee collective investment scheme may not have or be entitled to obtain information on the persons investing in the fund of funds. Similarly, where a financial institution invests in a collective investment scheme on behalf of its own clients (i.e. nominee accounts) or for the purposes of structured investments which it sells to its own clients, or where interests in the collective investment scheme are sold through a fund platform, the collective investment scheme may have no knowledge of the ultimate investors.

   b. The value of their assets and the extent of their liabilities (including potential tax liabilities) must be capable of being ascertained for each dealing day, which may be anything from any business day to monthly or less frequently, in order that the net asset value attributable to interests in the collective investment scheme can be accurately calculated and subscription and redemption prices set accordingly. If this is not done, an investor may pay too little or too much on subscribing interests in the collective investment scheme or receive too little or too much in redeeming interests in the collective investment scheme. Any uncertainty over the availability of treaty benefits, so that these are not taken into account when available or are taken into account when not available, will result in some categories of investors being disadvantaged, through redemption and subscription prices proving inaccurate. There is no ready mechanism to permit retrospective adjustment.

Consistent and certain treatment is required which the LOB cannot provide.

This will become a concern also for closed-ended collective investment schemes (such as private equity and infrastructure funds) as secondary markets develop for interests in such schemes and their investor base no longer remains constant.

2. A PPT would be easier for collective investment schemes to operate than a LOB but the model proposed permits there to be too much emphasis on the motives, intentions and other attributes of investors which, for the reasons given above, may not be known nor reasonably should be known to the collective investment scheme or its manager. This would have the consequence that a new investor that is acting on a tax avoidance motive would adversely affect the position of existing investors. An investor may select a collective investment scheme for reasons such as its track record or that of its manager or the investment strategy which it adopts, but it may be required to demonstrate that any advantageous tax treatment it receives (contrasted with direct investment) is a secondary consideration.

3. The Report and the 21 November discussion draft draw a distinction between CIVs, as defined for the purposes of the OECD 2010 Report on collective investment vehicles, and other collective investment schemes (non-CIVs). We consider that the distinction is unnecessary and unhelpful as it relies on the absence of factors which relate more appropriately to publicly marketed funds. Other collective investment schemes are unlikely to be subject to investor-protection regulation in the country in which they are established and will invest in
asset classes other than “securities”. Consequently, the distinction attributes to institutional funds a presumption of potential tax avoidance where that is in practice unlikely to exist.\(^2\)

4. The one factor which in our view both serves as an indicator of potential tax avoidance but can be monitored and demonstrated satisfactorily by the collective investment scheme and its manager is whether, by the way in which it is established and marketed, it is designed to be or in practice is intended to be held by only a limited number of investors or investors who are connected with each other. This test ("genuine diversity of ownership", "GDO") has been adopted in UK tax legislation in a number of situations and has proved a useful filter which is practical to operate for the tax authority as well as other parties.\(^3\)

5. Consistency and certainty of treatment is necessary also in the way in which tax authorities in all relevant jurisdictions assess entitlement to treaty benefits. An advantage of a test such as the GDO is that it can be used as a kite mark such that certification of a collective investment scheme by the tax authorities of the jurisdiction(s) in which it (or alternatively its manager) is tax resident as meeting the GDO would satisfy tax authorities of other treaty jurisdictions. This would provide administrative savings and facilitate also the operation of financial intermediary-linked withholding tax systems (including TRACE).

6. We consider that the LOB should more clearly recognise collective investment schemes as qualifying persons in order to remove the disadvantages we have described. It would be preferable for Contracting States to identify categories of collective investment schemes that are qualifying persons as of right. However, if a jurisdiction considers that this would be inadequate and that some means of eliminating collective investment schemes that may be being used for tax avoidance purposes is desirable, we propose that a GDO should be used as a filter for this purpose. Indeed, some Contracting State may conclude that the LOB is inappropriate for collective investment schemes and that a PPT or GDO-style rule is to be preferred. Any multilateral agreement (and commentary) should permit the possibility of adopting these approaches.

7. We consider that, if these concerns are not addressed, investors (including pension funds and other significant institutions) will suffer through diminishment of the range of collective investment schemes on offer:

   a. Sponsors may be forced to establish geographically concentrated collective investment schemes where the collective investment scheme, its assets and/or investor base are in one jurisdiction alone, in order to limit reliance on treaty provisions and avoid inappropriate tax inefficiencies. Collective investment schemes with investments across a number of jurisdictions could become less common and concentration of risk in each collective investment scheme would increase.

   b. Prospective investors may be denied access to particular collective investment schemes if they are not resident within specified jurisdictions.

   c. Overall numbers of collective investment schemes may decrease as collective investment becomes penalised due to the difficulties in managing the tax qualities of the investor base and the risk that collective investment reduces post-tax returns in comparison to direct investment.

**Issues on which comments are invited**

1. Comments are invited as to whether the recommendations of the 2010 CIV Report continue to be adequate for widely-held CIVs and whether any improvements should be made to the conclusions included in that Report. Comments are invited, for example, on whether it would be advisable to provide for a preferred approach with respect to issues related to the tax treaty entitlement of the income of CIVs and the application of the LOB to CIVs, and if yes, on what that approach should be.

\(^2\)For this reason, we do not regard the distinction between CIVs and non-CIVs as meaningful and use instead the term "collective investment scheme".

\(^3\)The GDO is not a test of whether a fund is actually widely held or has sufficient unconnected investors and therefore avoids the verification issues which arise for the LOB and PPT.
For the purposes of the 2010 Report, “collective investment vehicles” are defined 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”. Alternative funds / private equity funds generally do not meet these conditions because they typically have a limited number of institutional investors, may not hold a diverse portfolio and are not subject to the same investor-protection regulation.

We have addressed these above.

2. Comments are invited as to whether the preceding paragraphs accurately describe the treaty entitlement issues of sovereign wealth funds, pension funds and alternative funds / private equity funds. Comments are also invited as to how to address these issues without creating opportunities for treaty shopping.

We have addressed this above.

3. Suggestions are invited as to possible factors or examples that could be included in the Commentary on the discretionary relief provision of paragraph 5 of the LOB rule in order to clarify the circumstances in which that provision is intended to apply.

While a GDO rule could be addressed in this context or could expressly operate as a filter within the LOB (comparable to the publicly-listed entity provision), we consider that the GDO also offers a practical alternative to the LOB itself.

4. Suggestions are invited on possible changes that could be made to the derivative benefit provision (paragraph 4 of the LOB rule), the definition of equivalent beneficiary (paragraph 6 of the LOB rule) or other provisions of the Model Tax Convention in order to assist in the work on other parts of the Action Plan and ensure that the inclusion of a derivative benefit provision would not raise BEPS concerns whilst providing that cases where intermediate companies are used for valid commercial reasons are not excluded from treaty benefits.

We believe that these provisions raise significant problems in an EU context, with regard to issues such as freedom of establishment and free movement of capital.

5. Comments are invited on the rules concerning the temporal aspects of the various provisions of the LOB rule (paragraph 16 of the Report). One particular issue on which comments are invited is whether it would be possible for an entity to become, or cease to be, publicly-listed without such event triggering a new taxable period and, if yes, whether this could create a problem for the application of the LOB.

As we have set out above, the temporal aspects of the LOB rule render it impractical to be met for very many collective investment schemes.

The particular issue on listing is an example of how the discussion draft proposes to focus on details (on which there will be diverging laws and practices in Contracting States) rather than address bigger issues on the LOB and PPT.

6. Comments are invited as to whether and how subparagraph 2 c) of the LOB rule (the “publicly-listed entity” provision) could be modified to take account of the concerns of small countries that do not have important stock exchanges whilst ensuring that a publicly-listed entity has a sufficient nexus with a country to warrant the application of the provision.

We do not propose to comment on this detail.

7. Comments are invited as to possible clarifications that could be made concerning the interpretation and application of the “active business” provision found in paragraph 3 of the LOB rule (paragraph 16 of the Report).

We do not propose to comment on this detail which is unlikely to be relevant to many collective investment schemes.
8. Comments are invited as to possible inconsistencies between the Commentary on how the phrase “did not have as one of its principal purposes the obtaining of benefits under this Convention” should be applied in the context of the discretionary relief provision of the LOB rule (paragraph 16 of the Report) and how the phrase “obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit” should be interpreted in the context of the PPT rule (paragraph 17 of the Report).

It is undesirable that a treaty should contain two provisions concerned with tax avoidance between which inconsistencies may exist.

9. Commentators are invited to suggest examples where some form of discretionary relief would be justified following the application of the PPT rule.

Any exercise of discretionary relief would depend upon all the circumstances of each case and may be affected by the domestic practices of the Contracting State. We doubt that any example would have practical value.

10. Comments are invited on the various features of the “anti-conduit rule” in paragraph 15 of the Commentary on the PPT rule (paragraph 17 of the Report). Comments are also invited on possible examples that could be included in the Commentary in order to illustrate the application of this “anti-conduit rule”.

We have no comment on this issue.

11. Commentators are invited to suggest additional examples that could be included in paragraph 14 of the Commentary on the PPT rule (paragraph 17 of the Report). For example, representatives of investment funds are invited to suggest an additional example that would deal with the non-tax motivated use of a special purpose vehicle in order to pool the investment of various institutional investors from different countries.

We do not understand the context in which such a “special purpose vehicle” is contemplated. It would itself be a collective investment scheme (or a feeder into a collective investment scheme) to which our remarks above apply.

Special purpose vehicles may, however, be used in various circumstances for the purposes of holding particular assets or portfolios of investments. The question of whether such a special purpose vehicle should be entitled to treaty benefits should be determined by reference to the status and attributes of the collective investment scheme, and not be considered in isolation.

12. The anti-abuse rule included in paragraph 42 of the Report is currently restricted to cases where the profits of the PE are exempt in the State of the enterprise to which the PE belongs. Are there other situations where the rule should apply? Are the exceptions included in subparagraphs e) and f) of the anti-abuse rule sufficient to address cases where the rule would otherwise affect arrangements that are not tax-motivated? Do these exceptions raise potential BEPS concerns?

We have no comment on this issue.

13. Apart from the changes described above, are there other clarifications/additions that should be made to the Commentary changes in paragraph 49 of the Report?

We have no comment on this issue.
Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Organisation for Economic Cooperation and Development
2 rue André-Pascal
75 775, Paris
France

submitted by email: taxtreaties@oecd.org

Amsterdam, 23 December 2014

Re: Comments and suggestions for BEPS Action 6, the Follow Up Report

Dear Madam,

The American Chamber of Commerce in the Netherlands (AmCham) is a non-profit, non-governmental, non-political, voluntary organization of companies and individuals engaged in investment and trade between the United States of America and the Netherlands. AmCham promotes continued US investment in the Netherlands by emphasizing its well-known features. These include the Dutch Gateway to Europe with Schiphol Airport and the Ports of Rotterdam and Amsterdam, a quality workforce, an environment that stimulates and supports entrepreneurship and innovation, and a stable and safe political, economic, legal and tax infrastructure.

The Netherlands is one of the most open economies in the world. Dutch businesses are traditionally in the top 10 of direct investors abroad. The Netherlands receives proportionally more direct investments from abroad than almost any other country. These in and outbound investments are important for the open Dutch economy – they are a stable source of funding, contribute to increased productivity and innovation, and create jobs. Indeed, as an important destination for US direct investment, about 225,000 people are employed by American companies in the Netherlands.
BEPS Action 6

Action 6 of the BEPS Action Plan calls for work to be carried on in order to develop model treaty provisions and recommendations regarding the design of rules to prevent the granting of treaty benefits in inappropriate circumstances. The Tax Committee of AmCham is acutely aware that differences in legal tradition and cultural background cause deviating views on matters including the eligibility for treaty benefits. Unsatisfactory resolve of this matter results in unilateral action by local states, creating further uncertainty and limiting international investment opportunities.

The Tax Committee of AmCham therefore supports the design of rules that clarify the granting of treaty benefits. The Tax Committee prefers the use of a limitation on benefits clause (“LoB”) that includes a suitable derivative benefits provision over a Principle Purposes Test (“PPT”). In proposed form, the latter instrument casts a net that is wider than the goals set for Action 6 warrant: its application will impede on intermediary entities that have a valid commercial reason without being instances of treaty shopping. This problem could in theory be mitigated by establishing objective criteria to determine whether the presence of an intermediary is driven principally for the purpose of obtaining access to treaty benefits or not. However, the Tax Committee anticipates that interpretation issues will be resilient and prefers the legal certainty of the LoB approach.

The Tax Committee of AmCham believes that the LoB clause must contain a derivative benefits provision that does not impede on legal structures with intermediaries that exist for valid commercial reasons (which may include local tax considerations, other than obtaining treaty benefits). After careful review of the current working draft of the derivative benefits test as described in the September 2014 report “BEPS Action 6: “Preventing the granting of treaty benefits in inappropriate circumstances” (the “Report”), the Tax Committee concludes that the draft provision is too restrictive. If adopted in current form, this provision causes that existing and legitimate commercial structures will no longer be able to enjoy treaty benefits. The current scope of this draft provision is not merely limited to circumstances where the granting of treaty benefits would be inappropriate.

In this context the Tax Committee of AmCham is grateful for the opportunity to provide comments and suggestions on issue 6 outlined in the November 21 public discussion draft “Follow up work on BEPS Action 6: Preventing Treaty Abuse” (the “Follow Up Report”). As a remedy for our concerns in regard of issue 6, we conclude this letter with the suggestion to apply the discretionary relief provision of the limitation on benefits provision affirmatively. We provide this suggestion under issue 3 of the Follow Up Report.
1. Issues relating to the derivative benefits provision (issue #6)

1.1 Framing the issue: intermediary owners

The premise of the proposed LoB clause is that a tax resident of a treaty state must also be a qualified person to be eligible for the benefits of the treaty. In the context of subsidiaries of a multinational company, such subsidiaries are only considered as qualified persons if they are either (i) publicly listed on a recognized stock exchange, (ii) an (in)direct subsidiary of such a publicly listed company that is also a tax resident of one of the two treaty states, or (iii) (in)directly held for at least 50% by other qualified persons that are also tax resident of one of the two treaty states.

By consequence, subsidiaries in intermediary jurisdictions will in all but exceptional circumstances not be considered as qualified persons – for their (ultimate) shareholders will not be tax residents of that intermediary jurisdiction or the other treaty state (the source state) and hence, by definition cannot be qualified persons. This follows from the premise of the LoB to limit treaty benefits in principle to tax residents with sufficient legal nexus with one or both of the treaty states (but not with third states). Such non qualified person intermediate subsidiaries can claim treaty benefits, however, if they qualify for the requirements of, inter alia, the derivative benefits test. The derivative benefits test entitles a tax resident to treaty benefits if its ultimate beneficial owner would have been entitled to the same benefit had the income in question flowed directly to that ultimate beneficial owner. The rationale to allow treaty benefits in these situations is clear: there is no instance of treaty shopping if the ultimate beneficial owner of the income is entitled to equivalent treaty benefits as the intermediary.

The working draft of the derivative benefits test in the Report annuls this rationale, however. This because the working draft of the derivative benefits test requires that in case of intermediate ownership of the entity seeking treaty benefits, “each intermediate owner is itself an equivalent beneficiary”. Because in the context of corporate multinationals, only a publicly listed company can be an equivalent beneficiary, the derivative benefits test as currently proposed in the Report will in all but exceptional circumstance not be available – regardless whether the ultimate beneficial owner that is publicly listed is entitled to derivative benefits. The working draft of the derivative benefits test in general and the definition of an equivalent beneficiary in particular is therefore too restrictive.

It disallows access to the derivative benefits test in (nearly) all situations with intermediary owners – which typically are interposed for valid commercial reasons.
To clarify, please consider example 1 below.

US MNC is a conglomerate publicly traded on the New York Stock Exchange and as such, subject to being entitled to equivalent benefits, in principle meets the definition of an equivalent beneficiary. US MNC has organized its diverse businesses in separate divisions, with every division in a separate legal chain. Division A is organized through a headquarter company in EU Member State A.

Where the Division A operating subsidiary in EU Member State B receives a dividend from a lower tier operating company in Country X (that is sourced from non-complementary income), the former is not entitled to a reduced rate of withholding tax normally available under the applicable tax treaty when applying the derivative benefits test, because not all its intermediary owners qualify as “equivalent beneficiaries”.

This because Division A headquarter company in EU Member State A is itself not publicly listed and as such, cannot be an equivalent beneficiary for purposes of the tax treaty between Country X and Country B.

Examples 2 and 3 provide further illustration of this issue applied to common corporate structures.
US MNC is publicly traded on the New York Stock Exchange and as such, subject to being entitled to equivalent benefits, in principle meets the definition of an **equivalent beneficiary**.

US MNC previously acquired all shares Target Co, a resident of EU Member State A. For the purpose of the acquisition, with a view to off-setting the acquisition and interest expense with the operating profits of the Target group as well as legal considerations, US MNC organized AcquisitionCo in EU Member State A to acquire the shares in TargetCo. If the operating subsidiary in Country X pays a dividend to Target Co, the latter is not entitled to a reduced rate of withholding tax normally available under the applicable tax treaty, because not all its intermediary owners qualify as "equivalent beneficiaries".

This because Target Co is no longer publicly listed and as such, cannot be an equivalent beneficiary for purposes of the tax treaty between Country X and Country A.

HoldCo in EU Member State A holds all shares in two OpCos, one in EU Member State A and one in Country X. The OpCo in EU Member State A has made a loan to the OpCo in Country X in order to fund the latter’s working capital requirements. Any interest paid by the borrower to the creditor is not eligible for a reduced rate of interest withholding tax, because not all its intermediary owners qualify as “equivalent beneficiaries”.

This because the HoldCo in EU Member State A is itself not publicly listed and as such, cannot be an equivalent beneficiary for purposes of the tax treaty between Country X and Country A.
1.2 Our suggestions for intermediary holders

The Follow Up Report solicits suggestions for changes to the derivative benefits provision and the definition of equivalent beneficiary, without raising further BEPS concerns, to ensure that the use of intermediate companies that are used for valid commercial reasons are not excluded from treaty benefits.

The Tax Committee of AmCham considers that the principal aim of the derivative benefits test is to disallow treaty shopping on the basis of the ownership attributes of the entities involved. These attributes can be objectively established. This test does not consider whether the entities are interposed for “valid commercial reasons”. The Tax Committee of the AmCham reiterates its view that none of the recommendations under BEPS Action 6 ought to impede on intermediary entities that have a valid commercial reason. Where such reasons exist, no treaty shopping occurs, and therefore no inappropriate use of a treaty arises. Such instances should be limited by LoB nor PPT.

Nonetheless, to mitigate the concerns illustrated on the derivative benefits test in regard of intermediary owners, which arise under the current working draft of the test proposed in the Report, rendering this provision de facto useless for multinationals, the Tax Committee of AmCham suggests the following balanced multi pronged approach:

1. Delete the requirement that “each intermediate owner is itself an equivalent beneficiary”. Rather, in the context of multinational companies, it is sufficient that at least 95 per cent of the aggregate voting power and value of the shares of the company claiming the treaty benefits is owned, directly or indirectly, by seven or fewer persons that are publicly listed companies which are entitled to equivalent benefits (i.e., are equivalent beneficiaries). This is in line with the U.S. version of the derivative benefits test, as included in various tax treaties concluded by the United States, including its treaties with the United Kingdom and the Netherlands.

2. The Tax Committee of AmCham considers that any BEPS concerns which may arise as a result of the change suggested sub (1) above, can and should be addressed principally under Actions 2 (Hybrids) and 3 (CFC). Where the treaty claimant qualifies for the LoB requirements and successfully claims the benefits of a tax treaty, the subsequent use of the proceeds paid to the treaty claimant are no longer a concern to the source state of the original payment (assuming, of course, that the treaty claimant was also the beneficial owner of the income stream from the source state).
3. If, notwithstanding the above, the drafting committee is of the view that a back-up mechanism should be agreed in the event BEPS Actions 2 and/or 3 are not effective in ensuring that the intermediary owner of the item of income (that originated in the source state and that was distributed by the treaty claimant to the intermediary owner) is subject to a sufficient level of taxation on its worldwide income, the Tax Committee proposes to specify requirements to be imposed on such intermediaries. As a result, only if these requirements are met would a treaty claimant that is indirectly held by an equivalent beneficiary be eligible for the benefits of the treaty.

Various modalities exist to determine whether such intermediary owners are qualified intermediaries. The Tax Committee of AmCham considers the following alternatives as sufficiently practical to be not overly burdensome on taxpayers from an administrative point of view, without raising further BEPS concerns:

a) Intermediary shareholders that are tax resident in one of the treaty countries or a Member State of the European Union, or in a state that participates in the North American Free Trade Agreement, are considered to be qualified intermediaries. By allowing all EU Member State tax resident taxpayers as intermediaries, European Law constraints in regard of the current proposal are alleviated. This alternative will be restrictive however on investors from Asia Pacific, who often need to use subsidiaries in Singapore or Hong Kong for outbound investments in order to comply with local fx restrictions. Latin American investors may have similar concerns.

b) Intermediary shareholders that are tax resident in one of the treaty countries or an OECD member country, or state that is associated with the OECD, that has committed to implement the BEPS Actions in local law are considered as qualified intermediaries. Where these OECD member or associated countries have implemented the BEPS Action recommendations, the source state can be assured that the level of taxation at the level of the intermediaries, or otherwise at the level of the equivalent beneficiary by application of CFC provisions, is sufficient.

c) Intermediary shareholders that are tax residents in jurisdictions that do not appear on black list prepared and updated by the OECD’s Committee on Fiscal Affairs are deemed to be qualified intermediaries.
The Tax Committee of AmCham believes that a solution along the above lines does not take away from the sought outcome of BEPS Action 6, whilst ensuring that intermediaries within a multinational group can continue to have treaty access (by application of the derivative benefits test).

1.3 Framing the issue: the base erosion test

The working draft of the derivative benefits test in the Report contains a further limitation. A treaty claimant that qualifies under the ownership prong of the test, also must meet the so-called base erosion test. Under this test, the treaty benefits are available only if less than 50 percent of the treaty claimant’s gross income for the taxable period that includes the time when the benefit would be accorded is paid or accrued, directly or indirectly, to a person or persons who are not equivalent beneficiaries in the form of payments deductible for tax purposes in the company’s State of residence.

Because in the context of a multinational company only the publicly listed holding company will generally be able to meet the definition of an equivalent beneficiary, the base erosion test can be a real constraint on common group treasury management practices, such as cash pooling.

Multinational groups use cash pools to make cash balances available to members within the group. This reduces the need for external funding and therefore reduces funding costs. The cash pool operates through a pool header, in example 4 above that is the HoldCo in EU Member State A. As the header of the cash pool, HoldCo matches excess cash balances with cash requirements. In example 4, an OpCo in Country X made a drawing from the pool, for which it pays interest to HoldCo. HoldCo in turn pays interest to OpCo in Country Y, which made a deposit to the pool of its temporary excess cash balances.
Applying the working draft of the derivative benefits test to example 4, we find that HoldCo meets the ownership prong of the test. All of its shares are held, without intermediaries, by an equivalent beneficiary: MNC, which is publicly listed company on the New York Stock Exchange. However, HoldCo would not meet the base erosion test where it paid more than 50% of its gross income to the OpCo in Country Y as interest due on the cash pool. This because the OpCo in Country Y by definition cannot be an equivalent beneficiary: it is not publicly listed.

Because a cash pool leader will commonly have tens or hundreds of participants in the cash pool, with all of these participants either borrowing from or depositing to the pool, the cash pool leader would commonly pay more than 50% of its interest income received (from the cash pool borrowers) onward to non equivalent beneficiaries (the cash pool depositors). Treaty benefits would not be available, notwithstanding that cash pools are a common treasury management tool and not driven by treaty shopping considerations.

1.4 **Our suggestions for the base erosion test**

Clearly, no treaty shopping occurs where the treaty claimant (e.g. the cash pool leader in our example 4) pays more than 50% of its gross revenue onward to subsidiaries within the same corporate group that would, had they received the income directly from the source state, be eligible for equivalent benefits.

Thus, in the view of the Tax Commitee of AmCham, there’s no obvious reason why for purpose of the anti base erosion prong, qualified recipients must be limited to the only corporate form of an equivalent beneficiary that is currently available for multinationals: the publicly listed company.

Rather, it would be sufficient to provide that if the gross revenue of the treaty claimant is for more than 50% paid onward through tax deductible payments, treaty benefits are available only if the recipients of that income would have been entitled to similar treaty benefits (as treaty claimant), had they received the income directly from the source state (or that otherwise qualify as equivalent beneficiaries).

However, for cash pool arrangements with tens or hundreds of participants in the cash pool, such an approach causes significant practical issues. Money is fungible and in practice it will not be possible to determine whether payments of debet interest on a cash pool drawing were used by the pool header to settle credit interest to a depositor and if so, whether that depositor was entitled to equivalent benefits.
Considering that a cash pool arrangement is a common treasury tool that is not driven by a desire to shop treaty benefits, but rather by effective allocation of working capital available within the group, the Tax Committee of AmCham suggests to provide an exception to the base erosion test for cash pool headers that lead international cash pool arrangements.

To alleviate any BEPS concerns, the Tax Committee suggests to include provisions that e.g. require that at least 80% of the cash pool participants are tax residents of OECD member countries and/or to exclude participants that are resident in countries appearing on a (black) list.

2. Suggestion for the discretionary relief rule (issue #3)

As explained in the above paragraph, it is imperative that the working draft of the derivative benefits test is revised to ensure that the presence of an intermediary owner does not annul the test, and that payments to a qualified intermediary that is indirectly held by an equivalent beneficiary do not automatically cause a flunk of the base erosion component of the test.

Even if these revisions are made, it cannot be excluded that treaty benefits will no longer be available in structures that are currently common place and not currently subject to challenge by local authorities as being cases of treaty shopping.

In the view of the Tax Committee of AmCham, it is reasonable to allow a sunset period for such legal structures to be aligned with the goals and outcome of the BEPS project. In regard of Action 6 in general and the derivative benefits test in particular, during this sunset period, a treaty claimant whose ultimate beneficial owner would not have been entitled to the same benefit had the income in question flowed directly to that ultimate beneficial owner should be eligible for the treaty rate provided for in the tax treaty concluded by the source state and the state of the ultimate beneficial owner (if existent).

The Tax Committee of AmCham suggests that an amendment of the discretionary relief rule to effect the above on an affirmative basis, i.e. automatically and without the need for authorities to approve, neutralizes any immediate treaty shopping concerns whilst allowing the tax payer sufficient time to align legal structures with the outcome of the BEPS project without undue administrative complexity.

* * *
The Tax Committee of AmCham appreciates the opportunity to provide comments to the Follow Up Report. We reiterate our support for rules that clarify the granting of treaty benefits that do not unreasonably interfere with past, present or future legitimate commercial business decisions.

Should you desires, we are available to discuss our comments and suggestions at your convenience in more detail at a location of your choice.

Yours Sincerely,

<signed>     <signed>

Patrick Mikkelsen     Arjan van der Linde
Executive Director    Chairman Tax Committee
Marlies de Ruiter, Head,
Tax Treaties, Transfer Pricing
and Financial Transactions Division,
OECD/CTPA.

9 January 2015

Submitted by email: taxtreaties@oecd.org

Dear Marlies

Public Discussion Draft on Follow up Work on BEPS Action 6: Preventing Treaty Abuse

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK’s total net worth and contributing £11.8 billion in taxes to the Government. Employing over 315,000 people in the UK alone, the insurance industry is also one of this country’s major exporters, with 28% of its net premium income coming from overseas business. Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to protect themselves, their families, their homes and assets, provide for a financially secure future and manage the risks faced in their businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed.

The ABI

The Association of British Insurers (ABI) is the voice of the UK insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI’s role is to:
• Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
• Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
• Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
• Promote the benefits of insurance to the government, regulators, policy makers and the public.

We have seen the response to the consultation by the Investment Association. The issues raised apply equally to some insurance business models. We fully agree with and support the comments made by the Investment Association in their response.
If you have any questions or require further information, please do not hesitate to contact me.

Yours faithfully

Stephen Pautard
Assistant Director, Head of Taxation
Association of British Insurers
THE ASSOCIATION OF GLOBAL CUSTODIANS

BNY MELLON
Brown Brothers Harriman
CITIBANK N.A.
Deutsche Bank
HSBC Securities Services
J.P. MORGAN
NORTHERN TRUST
RBC Investor & Treasury Services
Skandinaviska Enskilda Banken
Standard Chartered Bank
State Street Bank and Trust Company

COUNSEL AND SECRETARIAT TO THE ASSOCIATION:
Baker & McKenzie LLP

EUROPE
ATT’Y ABDUL SAADA KL
100 NEW ERIDAN STREET
LONDON EC4V 6JA, ENGLAND
INTL. TEL: 44 20 7919 1000

GLOBAL
ATT’Y ROBIN TRUEBLOOD
615 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20006
TEL: 202 482 7000
FAX: 202 482 7974

WWW.THEAGC.COM

9 January 2015

VIA E-MAIL

Ms. Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy & Administration
Organisation for Economic Co-operation and Development
2, rue André-Pascal
75016 Paris
France
taxtreaties@oecd.org

Re: Comments on Discussion Draft on BEPS Action 6: Preventing Treaty Abuse

Dear Ms. de Ruiter:

This letter is submitted on behalf of the members of the Association of Global Custodians ("AGC" or "Association") to provide you with comments in respect of the OECD Discussion Draft: Preventing Treaty Abuse, issued on 21 November 2014 (the “Discussion Draft”) pursuant to Action 6 of the BEPS Action Plan.

As you know AGC members have been keenly following (and in some cases actively participating in) the work of the Organisation for Economic Co-Operation and Development ("OECD") for many years on various key tax developments and welcome the opportunity to provide comments to you on the second Discussion Draft.

The Association is an informal group of 11 member banks that provide securities safekeeping and asset serving functions to cross-border institutional investors worldwide including investment funds, pension funds, and insurance companies.

In providing global custody services, AGC members routinely seek appropriate tax treaty withholding tax relief on behalf of custody clients. The members typically collectively process millions of such relief claims each year, affecting substantial amounts of cross-border portfolio investment flows in and out of countries worldwide. A significant portion of the income for which the members process treaty relief claims is income received by institutional investors. As such, the AGC members experience on a daily basis the costs, inefficiencies, and excessive withholding that arises when the procedures for claiming lawful relief are unduly burdensome or complicated for the investors involved, or when the
standards for entitlement to treaty relief are too unclear or complicated to effectively accommodate treaty relief claims, whether at source or by refund.

For these reasons, the AGC wishes to share with the OECD certain observations relating to the Action 6 proposals for introducing anti-abuse provisions into treaties. The attached Annex sets forth the Association’s general comments on the proposals as well as more specific comments in response to the various issues raised in the Discussion Draft. These comments are primarily focused on the operational implications of the proposals for the process of obtaining legitimate treaty relief on high volume portfolio income flows. The AGC would be pleased to provide follow-up information on any of the points raised if desired by the OECD.

Sincerely yours on behalf of the Association,

Mary C. Bennett
Baker & McKenzie LLP
Counsel to the Association

Annex
AGC Comments on the 21 November 2014 Discussion Draft on BEPS Action 6
(Preventing Treaty Abuse)
9 January 2015

The Association of Global Custodians (“AGC”) is an informal group of 11 member banks that provide securities safekeeping and asset serving functions to cross-border institutional investors worldwide including investment funds, pension funds, and insurance companies.

In providing global custody services, we routinely seek appropriate tax treaty withholding tax relief on behalf of custody clients. The members typically collectively process millions of such relief claims each year, affecting substantial amounts of cross-border portfolio investment flows in and out of countries worldwide. A significant portion of the income for which our members process treaty relief claims is income received by institutional investors. As such, we experience on a daily basis the costs, inefficiencies, and excessive withholding that arises when the procedures for claiming lawful relief are unduly burdensome or complicated for the investors involved, or when the standards for entitlement to treaty relief are too unclear or complicated to effectively accommodate treaty relief claims, whether at source or by refund.

Based upon our perspective as custodians responsible for processing a high volume of treaty claims on behalf of our primarily institutional investor clients, we set forth below some general comments on the introduction of treaty anti-abuse provisions contemplated by the BEPS Action 6 Discussion Draft released on 21 November 2014 (the Discussion Draft), as well as specific views on certain of the individual issues on which the Discussion Draft seeks comments.

General Comments on Discussion Draft

As previously underlined in our comments submitted on 9 April 2014, due to the nature of the industry we operate in, members of the AGC have a direct interest in the lawful and warranted application of tax treaty benefits for our clients worldwide. While we fully understand and support the need to prevent abusive practices and the unintended use of double tax treaties, we are nevertheless concerned about the potential undesirable effects certain proposals put forward under Action 6 might have on governments and institutional investors alike.

We are particularly concerned that the introduction of specific measures such as the recommended Limitation on Benefits (“LOB”) provision and the principal purpose test (“PPT”) will result in disproportionate outcomes, investor uncertainty, and a shift from the current trend of granting treaty benefits at source to the more burdensome, non standard, costly reclaim method of relief.

PPT

A tightening in treaty relief procedures through the introduction of a PPT will likely result in the widespread use of the reclaim mechanism. Combined with the uncertainties associated with broadly-defined avoidance provisions, these measures represent a backward step in the OECD’s prior work in the area of treaty entitlement for collective investment vehicles (“CIVs”) and the Treaty Relief and Compliance Enhancement (“TRACE”) project. With the
backdrop of the introduction of automatic exchange of information initiatives, including US FATCA and the Common Reporting Standard (CRS), a reclaim procedure appears unnecessary when a tax authority will have sufficient information available, in particular, for an ordinary commercial transaction that CIVs and non-CIV funds undertake.

The PPT implies more onerous documentation requirements and the need for a greater level of resources (in many cases including external tax counsel), implying an increase in not only the associated operational costs but also in the opportunity costs suffered by investors that cannot immediately obtain due entitlements.

Where the costs incurred in collating, certifying, and submitting the data required outweigh the related treaty benefits, investors are likely to choose not to engage in an onerous treaty relief procedure and may therefore waive their legitimate rights to treaty benefits.

Such an outcome would be particularly detrimental for institutional investors because withholding taxes suffered abroad generally cannot be credited against tax liabilities in the state of residence (for example in the case of tax exempt entities such as pension funds and sovereign wealth funds), and the withholding taxes levied therefore represent a final cost. The outcome may also be detrimental for certain residence countries where institutional investors can credit/deduct their foreign withholding taxes against their domestic tax liabilities. Indeed, if there is a significant increase in foreign withholding tax expenses for the residence country this may severely impact their tax revenue, particularly if they cannot offset the increase through their own PPT/LOB provision.

The outcome of this could lead to:

- the residence country’s tax authorities being called on to intervene where taxpayers are not receiving their due treaty relief;
- changes in domestic policy to overcome revenue gaps caused by the denial of treaty relief; and
- use of the PPT as a means to compensate for tax revenue lost to source states.

Whilst individually foregone treaty benefits may not always be significant, in the aggregate these will have a substantial negative impact on investment markets. Such a result conflicts with the purpose of double tax treaties and is surely not desirable where the majority of investors are engaged in genuine investment activities and as such have a valid claim to treaty benefits.

LOB

The introduction of an LOB provision into treaties is somewhat counterintuitive in light of the general trend in past years towards encouraging institutional investors to expand their operations cross-border (e.g. efforts within the European Union to implement a cross-border registration process for UCITS funds and similar schemes that are being considered across Asian markets).
Indeed, an LOB provision may act as a disincentive for funds to widely distribute, unless, a workable “equivalent beneficiary” and “derivative benefits” provision is introduced, which would not entail an onerous compliance burden on the fund.

We would therefore strongly urge the introduction of a waiver from any LOB, PPT or other anti-abuse provisions for institutional investors where the risk of treaty abuse is low, such as widely-held CIVs, life insurance companies, regulated pension funds, and sovereign wealth funds. Without such a waiver and in the event of the introduction of an LOB and/or PPT through a multi-lateral agreement (Action 15), treaty access for such institutional investors could be thrown into uncertainty on a global basis causing widespread disruption to the effectiveness of such investors in the context of cross-border investment. We furthermore keenly support the introduction of the TRACE Implementation Package (IP) and encourage the OECD to consider how the TRACE IP in coordination with US FATCA and the CRS can be used to overcome treaty abuse concerns before introducing anti-avoidance measures. We also urge the OECD to opt for a coordinated and focused approach to anti-abuse provisions that leaves little room for interpretation and therefore ensures a consistent application across jurisdictions and the smooth functioning of international tax treaty networks.

Specific Comments on Discussion Draft

Issue #1 -- Collective investment vehicles: application of the LOB and treaty entitlement

We commend the OECD for the work it did in producing the 2010 CIV Report. It properly took into account the fact that CIVs take a variety of different forms and have different investor populations. It therefore provided different approaches to determining the substantive and procedural bases on which treaty benefits could be provided to CIVs, each tailored to the particular attributes of different types of CIVs. Therefore, while we understand the temptation to want to have a single preferred approach, we believe the OECD was right in 2010 in acknowledging that there was no “one size fits all” approach and we recommend retaining the flexibility to apply different approaches to different cases.

We further commend the OECD for the work done in the TRACE project, particularly in developing the TRACE Implementation Package. The CIV and TRACE work was a serious effort to analyze the real practicalities of applying LOB-like criteria to the high volume, heavily intermediated reality of cross-border portfolio investment by widely held, regulated investment funds. The solutions ultimately reflected a careful weighing and balancing of multiple interests: source State interests in ensuring treaty relief was available only to properly identified residents of treaty partners, residence State interests in ensuring that bargained for source State treaty relief was granted without the need for costly residence State involvement in documentation requirements or for excessive foreign tax credit claims, and investor interests in obtaining legitimate treaty relief at the withholding stage through the application of certain, non-overly burdensome procedural requirements.

Our experience as custodians has shown us how critical it is for consideration to be given to the practicalities of applying particular substantive requirements that may derive from the application of anti-treaty shopping principles to CIVs. The CIV Report and TRACE Implementation Package take into account the need to provide clear and administrable procedural approaches to establishing entitlement to benefits where that entitlement
depends upon the status of the investors in the CIV. They recognized the prohibitive cost of CIV documentation requirements that are excessively demanding in light of the risk of abuse, the extent of intermediation in investment channels, and the high numbers of investors involved. They acknowledged the need for substantive rules (including derivative benefits provisions) that adequately take into account the non-abusive, multinational character of many CIVs and also the needs for streamlined, harmonized procedural approaches for claiming benefits.

Regrettably, countries for the most part have not moved to adopt the CIV Report and TRACE IP recommendations, and the procedures for claiming treaty benefits have become much more burdensome in recent years, particularly as some countries have sought to impose incredibly onerous documentation requirements to prove CIVs’ satisfaction of LOB-like standards. This has led to widespread inability to obtain treaty relief legitimately due, with excessive withholdings now totaling in the billions of dollars.

We therefore urge the OECD not to abandon the approaches laid out in the CIV Report, and we encourage both OECD and non-OECD member countries, as a matter of urgency, to move forward as soon as possible with actual implementation of the recommendations of the CIV Report and TRACE Implementation Package.

Issue #2 -- Non-CIV funds: application of the LOB and treaty entitlement

The Discussion Draft notes that sovereign wealth funds, pension funds, and alternative funds/private equity funds are not covered by the CIV Report and have expressed concerns about the potential effects on them of introduction of LOB requirements. We share those concerns. In particular, we have begun to see widespread denial of access to treaty benefits for pension funds as some countries have started to impose requirements demanding extensive documentation with respect to every underlying participant in the fund. The practical inability of pension funds to meet these kinds of procedural documentation demands, notwithstanding the fact that the funds’ satisfaction of the substantive treaty requirements is typically a virtual certainty, is operating in a great many cases to make legitimate treaty relief unattainable or prohibitively expensive. It is therefore very wrong to assume that reasonable-sounding LOB standards pose no threat to treaty entitlement in most cases without taking into account the practical manner in which satisfaction of those standards will be established. It is interesting to note that for purposes of FATCA and the CRS, broad exemptions have been provided to pension funds (and other entities included in Annex II of a FATCA Intergovernmental Agreement), thereby relieving them of onerous documentation and reporting requirements with respect to their participants, and those precedents may be useful to analyze in this context.

We urge the OECD as a matter of priority to study the situation of non-CIV funds, especially pension funds (including pension funds pooling their investments through regulated tax transparent funds), in much the same way as it studied CIVs, working jointly with the fund industry, in order to get a better understanding of the limited extent of the treaty shopping risk these funds pose and of the feasibility of particular practical approaches for a fund to establish its entitlement to claim benefits. Thought should be given to the types of information that could help to demonstrate the likelihood that pension funds are primarily benefitting individuals from treaty partner jurisdictions, so that little to no treaty shopping
risk exists, without demanding exhaustive documentation from each individual participant. Factors such as the tax disadvantages of individuals’ participation in foreign pension plans and the primary operating locations of employers sponsoring the plans should help to assure governments that pension funds established in a treaty partner are primarily benefitting the right group of individuals, without the need for extensive documentation.\(^1\) We would also mention that when the CRS analysis was undertaken it was recognized that the tracing of underlying investors in pension funds was unwarranted, and that it is widely acknowledged that pension funds are not considered flow through entities and are the beneficial owners of income in their own right.

We fully support the treaty policy that provides a mutual exemption for the investment income of specified types of qualifying pension funds in each Contracting State, and we recommend, again as a matter of urgency, that the OECD work with governments and the pension fund industry to determine the types of criteria and also the procedural approaches that should be used for determining qualification for that treatment.

**Issue #6 -- Issues related to the derivative benefit provision**

The CIV Report properly acknowledged the derivative benefits concept as one that was potentially relevant to determining CIVs’ entitlement to treaty relief. We believe the same concept should be considered relevant for other collective funds as well, including pension funds. In other words, the existence of third country participants in a treaty country pension fund should not serve to endanger the fund’s entitlement to treaty benefits where the third country individuals are resident in treaty partners of the source State and are entitled to benefits comparable to those provided to individuals resident in the treaty country.

**Issue #8 -- Timing issues related to the various provisions of the LOB rule**

We understand the objective of ensuring that entities claiming treaty benefits are entitled to the benefits as of the time they are being claimed. In the context, however, of high volume portfolio investment flows where treaty relief is effectively administered by withholding agents at the time of payment, some accommodation needs to be considered for purposes of practicality to base the claims on information available as of a prior date. For example, paragraph 6.31 of the Commentary on Article 1, which grew out of the CIV Report, recommends that CIVs be entitled to claim benefits based on information allowing them to make determinations annually (or not more frequently than quarterly) of the status of their investors as of a date preceding the period for which benefits are to be claimed.\(^2\) Similar approaches should be considered for other types of collective investment funds.

\(^1\) See paragraph 6.30 of the Commentary on Article 1 of the OECD Model Convention, which referenced comparable assumptions for CIVs as a result of the CIV Report.

\(^2\) The proposed Memoranda of Understanding relating to CIV claims included in the TRACE Implementation Package give an example of this approach: “For example, a determination made on December 31, 2008, would be based on the equivalent beneficiary ownership percentages from November 1, 2008 and would apply with respect to the whole of 2009.”
Issue #12 -- Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level

As indicated in our general comments above, we are concerned that widespread introduction of PPT provisions into treaties could lead to a proliferation of non-harmonized procedural and documentation requirements which could serve to exacerbate the already serious difficulties being faced by CIVs, pension funds, and other institutional investors in obtaining the treaty relief to which they are legitimately entitled. In the case of the PPT, that concern is potentially more serious than under the LOB provision, because neither the funds nor, importantly, their withholding agents can be certain of the precise criteria source States will view as relevant to the application of the PPT without detailed guidance on that point from the source States themselves.

The proposed Commentary on the PPT gives an example of a CIV that qualifies for benefits under the PPT based on a number of factors included in the example, but a CIV (or its withholding agent) could legitimately wonder whether the conclusion would be different if the facts were different (e.g., if the CIV was not majority-owned by residents of its own country) or if there were procedural difficulties that precluded the CIV from proving the existence of the facts.

For this reason, we think it will be extremely important to the smooth operation of treaty claims in a world of widespread PPT provisions for the countries having such provisions in their treaties to offer some procedural mechanisms to provide certainty to all cross-border portfolio investors and withholding agents about whether the income of the investors will enjoy the reduced rates outlined in the treaty. An absolute minimum for providing such certainty would be the kind of high level panel mentioned in the Discussion Draft. A timely ruling process should also be part of the minimum standard of procedural safeguard to be associated with a PPT provision.

Issue #15 -- Whether some form of discretionary relief should be provided under the PPT rule

We support the suggestion in the Discussion Draft that “fallback” treaty relief should be available when the PPT rule is applied to deny treaty benefits on a theory that the substance of a transaction should be treated as different from its form, where the recharacterized transaction would itself be eligible for treaty relief.

Issue #17 -- List of examples in the Commentary on the PPT rule

As indicated above, we have some concern that the investment fund example in the proposed PPT Commentary may not provide adequate guidance to collective fund structures that present different facts. While we will leave it to the fund industry to provide its own suggested example(s) of qualifying situations under the PPT, we would emphasize the importance of accommodating cases where funds have investors from multiple countries (albeit without posing significant treaty shopping concerns) and of scoping out reasonable procedural approaches for claiming benefits in such cases.
The Association of the Luxembourg Fund Industry (ALFI) has taken note of the OECD Public Discussion Draft “Follow-up Work on BEPS Action 6: Preventing Treaty Abuse” dated 21 November 2014 (the “Follow-up Discussion Draft”). This Follow-up Discussion Draft was issued further to the release of the report “BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances” in September 2014 (hereafter referred to as the “September Report”).

ALFI is pleased to provide its comments on the Follow-up Discussion Draft. These comments only address (i) the situation of collective investment vehicles (“CIV”) being widely-held, diversified, and subject to investor-protection regulation in the country of establishment of the CIV, as previously defined by the 2010 OECD report on treaty eligibility for investors in CIVs1 (the “2010 Report”) and (ii) section A of the Follow-up Discussion Draft relating to the LOB provision and treaty entitlement.

I Importance and functioning of the European investment fund industry

Before entering into a technical discussion on the issues relating to treaty eligibility of CIVs as addressed by the Follow-up Discussion Draft (see section 2 below), ALFI would like to recall the importance of the European fund industry and its functioning. It is indeed important to clearly set out the economic and legal framework of the investment fund industry within the EU as its characteristics explain and justify, to a large extent, the proposed tax treatment with respect to treaty benefit of CIVs, as outlined in section 2 below.

The investment fund industry is a vital part of the EU financial sector

As recently recalled by the EU Commission2, the investment fund industry is a vital part of the EU financial sector. UCITS (i.e., Undertakings for Collective Investment in Transferable Securities) are investment funds regulated at European Union level by Directive 2009/65/EC as modified by Directive 2014/91/EU (the “UCITS Directive”). They account for around 75% of all collective investments by retail investors in Europe.

The success of UCITS as a cross-border vehicle for investments can be best evidenced by the rapid growth of assets managed in UCITS funds. Total assets under management (AuM) grew from €3,403bn at the end of 2001 to €5,889bn by 2010. In September 2011 AuM stood at €5,515bn. This development is in part due to the UCITS Directive’s harmonized rules on collective investment schemes that establish a European passport for the distribution of investment fund products that comply with the UCITS standard. The evolution of the UCITS rules is therefore important for the development of an integrated market that allows the cross-border sale of UCITS3.

By the end of 2014, about 80% of UCITS assets are invested by funds domiciled in four jurisdictions: Luxembourg (32.8%), Ireland (15.8%), France (14.8%), and the United Kingdom (12.5%)4.

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1 See OECD report on “The granting of treaty benefits with respect to the income of collective investment vehicles”, 23 April 2010.
3 See footnote 2, section 3.1.
Most EU investors are – directly or indirectly – retail investors

According to 2010 data gathered by the EU Commission⁵, EU investors held €6,900bn in mutual funds⁶, of which about 75% was invested in EU-domiciled funds and 25% in funds that are not domiciled in the EU. Non-EU investors invested further €3,300bn into EU-domiciled mutual funds. The investor profile of an EU mutual fund is shown in the graph above.

As more than 85% of EU mutual fund investments are directed towards UCITS vehicles to (€5,889bn out of €6,900bn in 2010), the graph is representative for the UCITS investor profile as well. The graph shows that retail investors are the principal investors in mutual funds. 28% of fund holdings are made up of direct retail investments while another 61% are intermediated either through insurance policies, pension funds and other financial corporations. Intermediaries, for example pension funds that provide retirement benefits to individual investors, invest monies they collect from retail investors into mutual funds.

Essentially this means that around 90% of mutual fund investments are directly or indirectly attributable to retail investors.

Importance of the EU Single Market

The EU has been promoting for many years the Single Market as a key factor in the global competitiveness of the EU. Its role is to provide an environment that is conducive to developing, buying,
selling and investing freely throughout Europe and beyond. In this respect, European policies also aim at ensuring the greater convergence of rules and standards at international level.\(^7\)

As far as investment funds are concerned, the goal of the European Commission is to facilitate the development of an internal market for asset management within the EU. Asset management comprises collective investment funds but also a wide variety of individually managed investment products. Asset management therefore plays a crucial role in facilitating the accumulation of personal savings, be it for major investments or for retirement. Asset management is also an important vehicle in channeling institutional and personal savings to companies and projects that will be crucial in bringing about Europe’s economic recovery.\(^8\)

**An increasing number of CIVs are distributed on a cross-border basis**

CIVs may have hundreds of thousands of investors, which change very rapidly and which are resident in numerous different jurisdictions. This is typically the case of jurisdictions like Luxembourg. The number of cross-border funds has grown steadily over the last 10 years.

Luxembourg, as one of the most popular markets for cross-border fund distribution, with a 67% global market share, is a location where the top 100 management groups distributing cross-border funds represent 92% of the market and the most popular markets from cross-border funds from Luxembourg are Germany, Switzerland, Austria, France and the Netherlands, the UK and Italy.

**CIVs are mainly set up for commercial reasons**

In practice, CIVs are usually put in place in order to achieve various investment objectives of portfolio investors in an efficient and cost-effective manner. Indeed the pooling of assets through regulated vehicles usually implies greater economies of scales, and better risk-spreading, compared to a direct investment.

In the EU more specifically, and as mentioned above, the introduction and further enhancement of the UCITS legal framework in the EU legislation aimed at two objectives:

- To facilitate the cross-border offer of investment funds for the retail investor, and
- To protect retail investors by limiting fund risks through strict diversification rules on the investment policy of funds.\(^9\)

The European Commission recognized that the diversity of EU Member State’s tax regimes was considered as one important barrier to the cross-border sale of funds. Barriers are sometimes the result of historical developments (and cultural preferences) or the desire to privilege the use of a particular investment vehicle (e.g. pension funds). Tax constraints generate often additional administrative requirements and are powerful financial disincentives. Concrete examples of such requirements are the need to appoint a tax representative or to make a complex tax computation. A clear illustration of a financial disincentive could be the fact that dividends distributed by foreign funds are subject to a

\(^8\) http://ec.europa.eu/finance/investment/index_en.htm.
\(^9\) Commission staff working paper, annex to the “Green paper on the enhancement of the EU framework for investment funds”, COM(2005)314 final.
withholding tax\textsuperscript{10}. It is also worth noting at this juncture that the European Court of Justice has consistently ruled\textsuperscript{11} that tax rules of EU jurisdictions applying withholding tax on dividends paid to foreign funds where an exemption exists for dividends paid to comparable domestic funds are discriminatory and therefore contrary to the fundamental freedoms enshrined in the EU treaty.

This is the reason why most EU and OECD countries (including Luxembourg) have implemented a tax system that provides for a quasi-tax neutrality between direct investments and investments through a CIV, so that taxation should arise only at the level of the investors.

For cross-border CIVs, double tax treaties play an important role, as they help achieving neutrality between a direct investment and an investment through a CIV in the international context, just as the goal of most domestic provisions addressing the treatment of CIVs is to achieve such neutrality in the wholly domestic context.

\textbf{2 Issues surrounding the treaty entitlement for CIVs}

The September Report stated that policy considerations had to be addressed to make sure that the BEPS proposals do not unduly impact CIVs in cases where countries do not intend to deprive them of treaty benefits.

\textit{The BEPS recommendations must not unduly impact CIVs}

The September Report expressly stated why the situation of CIVs is specific and why their situation becomes problematic when it comes to applying the proposed LOB tests to them. The main reasons are as follows:

- the interests in the CIV are not publicly-traded (even though these interests are widely distributed);
- these interests are held by residents of third States;
- the distributions made by the CIV are deductible payments, and
- the CIV is used for investment purposes rather than for the “active conduct of a business”\textsuperscript{12}.

ALFI shares this observation and would like to recall that, although it is perfectly legitimate to find a compromise solution that may allow contracting states to avoid treaty shopping, in many cases, denying the right for CIVs to claim for treaty benefits, will undermine one of the primary goals of the tax treaty, i.e. to eliminate barriers to cross-border investment\textsuperscript{13}.

On the contrary, and as mentioned in the 2010 Report, granting treaty benefits to CIVs will allow to:

- Serve the goals of neutrality as between direct investments and investments through a CIV.
- Decrease the risk of double taxation between the source State and the State of residence of the investor, to the extent that there is a tax treaty between them.

\textsuperscript{10} See footnote 9.
\textsuperscript{11} Case C \textsuperscript{–}190/12, Emerging Markets Series of DFA Investment Trust Company, is the most recent in a consistent line of cases on this point.
\textsuperscript{12} See § 31
\textsuperscript{13} See 2010 Report, § 50.
Benefit investors, particularly those from small countries, who will consequently enjoy a greater choice of investment vehicles.

Increase economies of scale, which are a primary economic benefit of investing through CIVs.

It is therefore of the utmost importance to ensure that CIVs will effectively be granted treaty benefits. Furthermore, as CIVs are principally set up for genuine commercial reasons and given their economic characteristics it is reasonable to conclude that CIVs cannot, in principle, be effectively used for treaty shopping. This is the reason why the main focus of the BEPS action plan is – and should remain – multinationals and not CIVs.

**The September Report suggested several alternatives provisions based on the 2010 Report**

The September Report suggested several alternative provisions that may be used to deal adequately with the CIVs that are found in each Contracting State. In this respect, the Report suggested that Contracting States wishing to address the issue of CIVs’ entitlement to treaty benefits may want to consider the economic characteristics, including the potential for treaty shopping, of the different types of CIVs that are used in each Contracting State and may conclude that the tax treatment of CIVs established in the two States does not give rise to treaty-shopping concerns and decide to include in their bilateral treaty a provision which would expressly provide for the treaty entitlement of CIVs established in each State.

The September Report specifically referred to Paragraphs 6.8 to 6.34 of the Commentary on Article 1 (deriving from the 2010 Report) that discuss various factors that should be considered for the purpose of determining the treaty entitlement of CIVs and acknowledge that these paragraphs are therefore relevant when determining whether a provision on CIVs should be included in the LOB clause and how it should be drafted.

The September Report thus does not exclude that the solutions agreed in the 2010 Report are still valid and could be sufficient in order to address the issues surrounding treaty eligibility of CIVs.

**The conclusions of the 2010 Report remain valid**

As mentioned in the Follow-up Discussion Draft, it is now intended to review the above mentioned 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.

In this respect, the OECD is seeking input as to whether the recommendations of the 2010 Report continue to be adequate for widely-held CIVs.

ALFI considers that the recommendations of the 2010 Report continue to be adequate for CIVs (for the reasons outlined above), although this conclusion should not prevent from also considering these recommendations as being only the minimum level of protective provisions for CIVs.

**But improvements to the conclusions of the 2010 Report are required**

ALFI believes that improvements could be made to the conclusions included in that Report.

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14 See § 34
Indeed, in our view, these alternative provisions leave too much flexibility to Contracting States, as the situation and potential for treaty shopping of each CIV has to be analyzed on a case by case basis and then to be clarified bilaterally. This means that CIVs of a country may qualify as treaty resident for the purpose of certain treaties concluded by that country, but not for others, which does not appear to be appropriate in practice and will bring inevitably some legal uncertainty for CIVs. And, in the worst case scenario, sometimes, treaty negotiators (deliberately or not) may not even address the situation of CIVs, in which case determining treaty eligibility will prove difficult, if not impossible, in practice.

ALFI therefore suggests identifying and defining the CIVs which will always qualify as resident within the meaning of the LOB clause and with respect to the more general question of treaty entitlement.

Both the 2010 Report and the September Report state that “Contracting States wishing to address the issue of CIVs’ entitlement to treaty benefits may want to consider the economic characteristics, including the potential for treaty shopping, of the different types of CIVs that are used in each Contracting State”. This means that CIVs having the same economic characteristics should be able to benefit from the same tax treatment with respect to treaty entitlement. Based on this, ALFI believes that there are good grounds to consider that all CIVs set up as UCITS should always be considered as residents for treaty purposes.

Similarly, ALFI is of the opinion that this principle must be extended to all other widely-distributed non-CIVs which have characteristics that are comparable to UCITS.

The UCITS Directive indeed provides for common basic rules for the authorization, supervision, structure and activities of UCITS established in EU Member States.

ALFI also considers that the proposed rule should apply without regard to the residence of the UCITS' investors. Indeed, UCITS being by definition widely-held, we do not see any reason why the alternative approach proposed in the 2010 Report for publicly-traded CIVs, could not be expanded to all UCITS. Based on this alternative approach, it was indeed proposed that all publicly-traded CIVs be granted treaty benefit on the basis that they cannot be used effectively for treaty shopping because the shareholders or unit holders of such a CIV cannot individually exercise control over it.

Granting treaty benefit to all UCITS would thus bring two benefits:

- First, to reduce the obstacles to the establishment of cross-border CIVs, which the UCITS Directive has been promoting for many years;
- Second, to avoid or solve a number of practical issues deriving from most of the other alternative solutions suggested by the 2010 Report, these alternative provisions implying that the CIVs are able to determine who their investors are. Indeed, because ownership of interests in CIVs changes regularly, and such interests frequently are held through intermediaries, the CIVs and their managers often do not themselves know the names and treaty status of the beneficial owners of interests. Obtaining treaty entitlement may thus impose substantial administrative burdens for CIVs or become practically impossible. Developing practical solutions for establishing the treaty entitlement of CIVs (or their investors) is therefore a key aspect.

3 ALFI’s recommendations

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15 See § 35 of the September Report (referring to § 6.19 and 6.20 of the Commentary on Article 1 of the OECD Model Convention).
16 See 2010 Report, § 57.
Consequently, ALFI believes that the final report on Action 6 should foresee that all CIVs set up as UCITS as well as all other widely-distributed non-CIVs whose characteristics are similar to those of UCITS will automatically qualify as resident for the purpose of article 1 of the OECD Model Convention and that they will also be considered as qualified residents for the purpose of the LOB clause.

As a result, the wording of Article 1 of the OECD Model should be amended in order to include the provision currently proposed in paragraph 6.17 of the Commentary on Article 1, which would only have to be slightly amended in order to expressly provide for the treaty entitlement of CIVs established as UCITS and comparable non-CIVs (because such CIVs would then be treated as an individual that is a resident of the Contracting State in which they are established).

Accordingly, subparagraph f) of paragraph 2 of the LOB clause would have to be drafted to ensure that CIVs set up as UCITS and comparable non-CIVs always constitute qualified persons.

Finally, ALFI also suggests to include a statement that Contracting States are encouraged to consider that UCITS and comparable non-CIVs will not be considered as creating opportunities for treaty shopping.
AZTEC FINANCIAL SERVICES (LUXEMBOURG) S.A.

PRIVATE EQUITY PARTNERSHIPS
THE AIFMD MISTAKE

May 2014
“That is the tragedy of Europe: the European Union is now endangered by too much respect for the rule of law. We think of the rule of law as something that we all aspire to, but laws are fallible, like all human constructs. And when laws are based on faulty economic doctrines, the rule of law can do a lot of harm, especially if applied too literally, as it is at present.”

George Soros
The Tragedy of the European Union, 2014
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INTRODUCTION

Purpose

On 2 December 2013, Luxembourg’s new coalition government released a political program stating its commitment to sustaining the long-term development of its financial centre and, in particular, to strengthening the attractiveness of Luxembourg as a centre for the largest private equity funds. This announcement was timely because the competitiveness of the private equity industry has been recently undermined by a series of policy decisions: restricting the recovery of input-VAT; interpreting transfer pricing rules too broadly; minimum taxation; and the missed opportunity of the new foundations’ law. The impact of these decisions, however, is eclipsed by the misapplication of the Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD) in relation to private equity partnerships. This mistake guarantees the failure of the new government’s programme. The purpose of this paper, therefore, is to explain, as clearly as we can, when misapplication occurs and why misapplication of the law of 12 July on alternative investment fund managers (or the AIFM Law) is so fundamental and poses such a serious issue to the Luxembourg industry (whether participants recognise this or not). This is the sole purpose of this paper.

This paper follows-on from a paper prepared in July 2010 that was entitled ‘Recasting the Luxembourg private equity industry’ (referred to as Paper I). Paper I was intended: (a) to challenge certain commonly held assumptions about the nature of the private equity industry in Luxembourg; and (b) to look at ways of improving efficiency through the use of foreign partnerships. Paper I was supplemented by a second paper in July 2011 that was entitled ‘Shifting Perspectives’ (referred to as Paper II) that was a response to an initiative by the Haut Comité de la Place Financière to introduce a new partnership regime into law. Paper II gave a snapshot of the reasons why the use of partnership structures could often achieve greater tax efficiency internationally than the use of pooled savings vehicles (referred to as UCI).

Note about Aztec Group

Aztec Group is a specialist fund administrator and depositary in the private equity sector that currently operates around 130 private equity, real estate and infrastructure industry funds worth in excess of US$90 billion. The Group enjoys a 100% client retention rate and has an unrivalled track record for service delivery that has been recognised with various industry awards. The Group operates off a common platform and remains jurisdiction agnostic in relation to the establishment of investment platforms. It aims to supply the same product from each of its offices and believes that increased competition in the sector will drive higher standards, create greater choice and have a positive impact on the cost of capital and broader European objectives.

Aztec Group employs approximately 220 staff in Guernsey, Jersey, Luxembourg, Sweden and the United Kingdom. The Luxembourg office opened in November 2007 and now employs around 40 people. The Group is committed to the local delivery of services by the creation of expert teams in each jurisdiction.
ALL ABOUT PRIVATE EQUITY

An industry and not a type of fund

It is impossible to appreciate the difficulties attached to the AIFMD in a private equity context without a clear understanding of the nature of the private equity industry. As we explained in Paper I, private equity is not an expression capable of easy definition. It is best understood in Europe as a commercial (as opposed to a legal) term representing the buy-out industry. This industry is a segment of the M&A sector rather than traditional asset management. While the asset management industry plays a role within private equity (often repackaging partnership interests for retail investors), private equity firms focus less on strategies for managing ‘wealth’ (i.e. portfolio and risk management) and more on strategies for developing portfolio companies (i.e. the underlying businesses). The focus is different.

The private equity industry is better understood as a derivative of management consultancy. The industry comprises a number of sector specialists that look to acquire relevant businesses and help management teams implement various value-adding strategies (such as the provision of working capital to a target business to nurture expansion, new product development, or restructuring of the business’ operations, management, or ownership) through shareholder participation and sometimes board representation. Rather than taking a fee for their services, private equity firms share in any increase in value. By adding value to European businesses, the private equity industry contributes significantly to the broader economy.

The role of partnerships in the private equity industry is easily confused. Partnerships serve an entirely functional role to facilitate investment and are non-controlling.

Private equity partnerships

Private equity partnerships (often referred to as ‘funds’ in a loose, commercial sense) are simple conduit-structures that are used to channel capital from a known investor universe into buy-out transactions. The growth in number of these partnerships in Europe since the 1970’s has been driven by the success of the buy-out industry (and not the other way round).

Partnerships should not be seen as corporate conglomerates or actively-managed UCI controlling sections of industry even if this is how they may appear legally. This is because portfolio businesses (as a matter of basic corporate governance) are managed exclusively by their respective management teams (with the consent of the particular funding banks), and each business acquired forms part of a different corporate group. Private equity partnerships are better understood as an equity ownership model for different corporate groups.

Private equity partnerships do not come about by accident and securing the right investment partners for a specific strategy can take years of preliminary negotiation. A private equity partnership should be seen as a joint undertaking that is typically originated by a sponsor in tandem with a selection of familiar financial institutions. The scope for further partners to be admitted to a partnership (i.e. a business arrangement) after initial closing is restricted as additional partners must fit the partnership profile (and be acceptable to existing partners). This very direct and immediate relationship between equal participants is the quintessential nature of a société de personnes or co-ownership arrangement.

As a co-ownership scheme, private equity partnerships do not trade and are largely inactive on a day-to-day basis. The operation of a general partner is limited to a number of periodic meetings each year at which partner reports and administrative matters are reviewed. Investment decisions are taken by the board of a general partner on an infrequent and irregular basis (perhaps only once per year) and there are very few money movements within a partnership (that is largely cashless). Reference by a general partner to any investment adviser (that may or may not be the same as the partnership sponsor(s)) generally only occurs where additional investment, divestment or restructuring advice is required.

Understanding the operational profile of a private equity partnership is key to understanding why the imposition of an AIF-template is problematic, even if applied on a proportional basis.
START WITH UCITS

Introduction

Private equity partnerships are now understood as alternative investment funds (AIF’s), which are UCI’s investing in alternative assets. The term ‘UCI’ has established meaning.

UCITS and other UCI

UCITS Directive

Fund regulation in the EU starts with undertakings for collective investments in transferable securities (UCITS) and the UCITS Directive 85/611/EEC (the UCITS Directive). Unlike the umbrella term ‘AIF’, UCITS’ are a specific product that encompasses undertakings that:

- have the sole object of collective investment in transferable securities or in other liquid financial assets, raise capital from the public and that operate on the principle of risk-spreading; and
- are open ended for investors; namely, the units or shares of which may generally be repurchased or redeemed out of the undertakings’ assets.

UCI’s may be constituted under contract, trust or company laws in each Member State. UCITS’ authorised in one Member State may be sold in other Member States without further authorisation.

The UCITS Directive was amended in 2002 by the so called ‘UCITS III’ package consisting of 2 new Directives. Directive 2001/108/EC widened the investment possibilities of UCITS to include new instruments, and eased investment restrictions for index tracker funds. Directive 2001/107/EC detailed minimum standards that a UCITS management company should comply with in terms of capital and risk control, rules of conduct and conditions relating to technical and human resources. The UCITS Directive was amended again by Directive 2009/65/EC. Amongst other things, ‘UCITS IV’ introduced a passport allowing a UCITS to be managed by a management company, authorised and supervised in a Member State other than its home Member State and simplified the notification procedure for the marketing of fund units or shares in other Member States by introducing a regulator-to-regulator notification framework.

The European Parliament voted to adopt the UCITS V Directive on 15 April 2014, in advance of Parliamentary elections next month. UCITS V is aimed at improving the protections afforded to UCITS investors, preventing a repeat of the abuses seen at the time of the Madoff scandal and brings the UCITS framework into alignment with some of the innovations of the AIFMD. Michel Barnier, Internal Market and Services Commissioner of the European Commission, has emphasised the need to maintain the UCITS framework as a ‘gold standard for fund regulation globally’.

The key provisions of UCITS V are:

- UCITS management companies will be required to establish remuneration policies that are consistent with sound and effective risk management.
- New rules relating to depositaries concerning liability, delegation and entities eligible to act as depositaries.
- Harmonisation of administrative sanctions.

Product summary

UCITS’ are actively-managed savings schemes in which retail investors pool money through the physical creation of a common fund (i.e. a pool of undivided capital), that is divided into equal units or shares depending on whether the particular UCI is contractual (an FCP) or corporate in nature (a SICAV).

FCPs and SICAVs are two of the most important types of UCI. An FCP or Fonds Commun de Placement is a common investment fund. Like a unit trust in the UK, an FCP is set up in the form of an instrument between the management-company and investors, in a similar way to a unit trust, and is not a separate legal entity in its own right. Instead, the legal entity is the management company setting up the fund. Investors hold units in an FCP. A SICAV or Société d’investissement à Capital Variable is an investment company with variable capital, whose ownership is in the form of shares. With SICAV’s, the UCI is a company and therefore a separate legal person. The company’s capital depends on the amounts paid-in by investors. As with an FCP, shares in a SICAV are bought and sold on the basis of the value of the UCI’s assets. In accordance with applicable law and regulations, a SICAV can either appoint a separate management company or can be self-managed. Operationally, it makes little difference in practice whether a UCI is an FCP or a SICAV.
The price of a unit or a share in all UCI’s is determined by the net asset value (NAV) of the common fund. The NAV is calculated as the market value of the UCI’s assets, minus any liabilities such as expenses or other debt. This figure is then divided by the number of units or shares in issue to get a unit or share price, colloquially referred to as the ‘NAV’. A NAV is the hallmark of a UCI and central to defining the obligations of the depository and the central administrator. This is because the proper pricing of units or shares is key to safeguarding the interests of investors.

Units or shares in UCI’s are subscribed to on the basis of a pre-approved prospectus (and summary document) that sets out a clearly defined investment policy and states how any capital raised will be spent. In particular, the prospectus will explain how often units or shares can be subscribed to or redeemed. Most UCITS’ offer daily subscription and redemption, although some restrict this to once a week or twice a month. Units or shares in UCITS’ are typically distributed to investors through banks, independent financial advisors and life assurance companies. They can also be distributed directly by a manager. There are clear guidelines for the marketing of UCITS’ and all fund documentation must comply with applicable regulations.

UCITS’ invest in liquid securities which must be actively managed as a consequence. Managers, therefore, are regulated and must comply with the organisational requirements set out in the UCITS Directive which require sufficient substance in these entities to ensure that they carry-out portfolio management within set parameters. The primary role of UCI managers is to construct a portfolio of qualifying securities that best achieves a UCI’s particular investment policy. The role of the portfolio manager is balanced by a risk management process. Risk management is a term that encompasses the processes employed by the manager to monitor and measure the risk of its positions and ensure that the UCI stays within investment and diversification limits in the context of a relatively broad range of liquid investments that are continually fluctuating in value.

In contrast to the AIFMD, the administration of the common fund is the responsibility of the manager; however, this is commonly delegated to a separately authorised central administration, registrar and transfer agent. This administrator is broadly responsible for all the processing that is done in the ‘back office’. Its functions include calculation of the NAV, preparation of reports, settlement of securities, measurement of the UCI’s performance, and the administration of client accounts. UCITS’ must also appoint a local credit institution to act as the depository. A depositary bank is responsible for safeguarding financial instruments (custody), monitoring cash flows and ensuring that UCI’s operate in accordance with applicable rules on an ongoing basis. As the UCITS regime is a retail one, the depositary bank also constitutes an important form of investor protection which has been central to investor confidence in the UCITS brand.

In practice, the depositary industry exercises considerable influence over the management of UCITS’ and will look to source distribution, banking, management, central administration, registrar and transfer agency services from affiliated entities and also sometimes even tax and legal services. While the obvious conflicts of interests with this approach may look problematic, the nature of the UCITS’ product (i.e. low risk, lower value and highly automated) means that significant operational synergies can be achieved through the bundling of support services that has not resulted in many instances of abuse.
Success

Luxembourg has become a leading global centre for establishing and distributing the UCITS’ product. It enjoys almost a third of all European UCITS assets. This success is based on a number of convergent factors: a carefully constructed brand, a pragmatic regulatory environment for many years, a broad support industry, political stability, easily achieved tax neutrality, accessibility (in terms of languages and location) and the success of UCITS itself as a product. Over the last 25 years, UCITS has become a benchmark product internationally that means UCITS’ can be distributed relatively easily to all types of investors – both retail and institutional – in most key markets outside Europe; Luxembourg-based UCITS’ represent approximately three quarters of this international market.
UCITS AS A TEMPLATE

Introduction

In Luxembourg, the importance of the UCITS Directive cannot be understated. It has set the parameters for industry’s understanding of funds and has become a generic model for fund regulation. It is difficult to discuss funds in Luxembourg without association being made to the UCITS Directive and UCITS’ concepts.

A template for funds’ regulation

If UCITS’ are UCI’s that invest in transferable securities, then fund legislation also needed to provide for UCI’s investing in other assets and that were closed-ended. When the UCITS Directive was transposed therefore by Part I of the law of 30 March 1988 relating to undertakings for collective investment as restated in 2002 and 2010 (the UCI Law), other UCI’s were captured by Part II of the UCI Law. This framework for the regulation of UCI’s was further supplemented by the law of 13 February 2007 relating to specialised investment funds (the SIF Law) that concerned UCI’s restricted to well-informed investors.

Consequently, there are currently 3 types of UCI under Luxembourg law: Part I UCI’s, Part II UCI’s and SIF’s, which can be summarised as follows.

<table>
<thead>
<tr>
<th>Features</th>
<th>Regimes</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Part I UCI’s</td>
</tr>
<tr>
<td>Regulation</td>
<td>Regulated</td>
</tr>
<tr>
<td>Authorisation</td>
<td>Pre-establishment</td>
</tr>
<tr>
<td>Historic structures</td>
<td>FCP or SICAV/F</td>
</tr>
<tr>
<td>Open or closed</td>
<td>Open ended</td>
</tr>
<tr>
<td>Compartments</td>
<td>Yes</td>
</tr>
<tr>
<td>Eligible investors</td>
<td>Retail</td>
</tr>
<tr>
<td>Information</td>
<td>Prospectus and Key</td>
</tr>
<tr>
<td></td>
<td>Investor Information Document</td>
</tr>
<tr>
<td>Number of investors</td>
<td>No limits</td>
</tr>
<tr>
<td>Product passport</td>
<td>Yes</td>
</tr>
<tr>
<td>Management</td>
<td>Internal or external</td>
</tr>
<tr>
<td>Eligible assets</td>
<td>Transferable securities</td>
</tr>
<tr>
<td>Investment rules</td>
<td>Detailed restrictions</td>
</tr>
<tr>
<td>Borrowing</td>
<td>Very limited</td>
</tr>
<tr>
<td>Fees and expenses</td>
<td>Disclosure</td>
</tr>
<tr>
<td>NAV calculation frequency</td>
<td>Minimum bi-monthly</td>
</tr>
<tr>
<td>Transferability</td>
<td>Freely transferable</td>
</tr>
<tr>
<td>Listing possible</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax</td>
<td>Subscription tax</td>
</tr>
<tr>
<td>Services providers</td>
<td>Management entity</td>
</tr>
<tr>
<td></td>
<td>Depositary</td>
</tr>
<tr>
<td></td>
<td>Administrator, registrar</td>
</tr>
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<td></td>
<td>and transfer agent</td>
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<td></td>
<td>Auditor</td>
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</tbody>
</table>

Each type of UCI follows the same legal and operational template with appropriate adjustments relating to its specific risk profile, and is treated as a UCI for Luxembourg legal purposes because the following criteria exist:
there is collective investment through the existence of a common fund;
an offering of common units or shares is made to the public or to a restricted circle of investors; and
direct or indirect risk-spreading occurs.

**Private equity UCI's**

As discussed in Paper I, private equity industry funds, as opposed to structured products, were never commonly established as UCI's because the legal and operational complexities involved with these add significantly to running costs.

**SIF's**

The SIF Law was intended to address this problem by creating a very flexible regime for specialist UCI's. It was recognised by industry that structuring some private equity funds as UCI's could achieve certain tax, regulatory, and accounting advantages over traditional partnerships and it was hoped that the SIF Law would therefore be a success.

Like other UCI's, SIF's could be established as FCP's or SICAV's that offered units or shares to investors on the basis of a common NAV. SIF's operated on the same basis as Part I or II UCI's with a manager, custody bank, central administrator, transfer agent and registrar but with much simpler and more efficient rules.

In contrast to the UCITS Directive, however, the flexibility of the SIF Law meant that it was possible to structure closed-ended UCI's on a 'private equity-basis'. This essentially meant that the direct and immediate subscription of units or shares by investors could be replaced by a contractual commitment to subscribe for units or shares when cash was actually required by a UCI. This was necessary in a private equity context because, unlike other asset classes, it could take up to 18 months to identify and negotiate the terms of each transaction. By staging the subscription of units or shares in this way, therefore, it enabled a manager to deploy cash only when an investment had been negotiated and the UCI was capable of generating a return on that investment.

This staging of subscription monies is important to the private equity industry because, by recognising the time-cost of capital, it enables managers to maximise the internal rate of return (IRR) on monies deployed by a fund. Without this, funds would never achieve the IRR required by institutions which, in turn, have their own liabilities to meet; the commercial profile of private equity industry funds ultimately being driven by investor needs.

Investors have a dual interest in a UCI when it is structured on a private equity basis:

- their commitment to subscribe for units or shares; and
- the units or shares themselves that are issued pursuant to the commitment.

As these UCI's are closed-ended without any possibility of redemptions at the initiative of the investor, investors are only interested in the monies ultimately returned by the UCI and not in the theoretical NAV of the units or shares subscribed from time-to-time. Insofar as unit or share NAV's are calculated periodically, they simply provide a mathematical basis for determining the pro-rata rights of investors. This is an entirely functional purpose that should be distinguished conceptually from the position with open ended UCI's where investors subscribe or redeem interests on the basis of a published NAV (which, therefore, has to be correct).
Like UCITS, SIF’s have proved popular. The flexibility of the SIF Law had advantage over Part II UCI and a considerable number of UCI’s targeting well informed investors made use of this new regime. As discussed in Paper I, however, relatively few SIF’s are used in a private equity context. The reasons for this remain the relative legal and operational complexity of UCI’s (that is increasing again rapidly) and limited demand from institutional investors (that are focused more on tax transparency).

**SICAR’s**

The SIF Law can be understood as an extension of the risk capital investment company or société d’investissement en capital à risque, established by the law of 15 June 2004 (the SICAR Act) as amended on 15 October 2008. The SICAR was originally intended to be a tailored-made vehicle for private equity and venture capital investment that would attract private equity ‘funds’ to Luxembourg.

The SICAR is best understood as a form of regulated holding company that benefits from special tax exemption insofar as it is used to invest in securities representing risk capital. The SICAR Act is very similar to the SIF Law in effect. A SICAR may have a variable or fixed capital and may create multiple investment compartments. Investment in a SICAR is limited to well-informed investors that must be invited to purchase shares or partnership interests on the basis of a pre-approved offering document. A SICAR, like a SIF, can be structured on a private equity basis with immediate investor subscriptions being replaced by commitments to subscribe for shares or interests. The SICAR Act, however, does not require risk spreading and, therefore, is not a UCI for Luxembourg legal purposes which can affect its treatment in certain circumstances. It also means that a SICAR cannot be established in the form of an FCP.

As considered in Paper I, the use of SICAR by the private equity industry has been quite limited. Most SICAR’s are used for structured purposes where specific need justifies the added complexities involved.

**Private equity funds**

Unfortunately, promotional literature published by industry organisation obscured the differences between the ‘private equity funds’ seen locally and the real private equity industry funds seen internationally. This meant that industry had limited awareness of the broader issues leading into the publication of the AIFMD.
THE AIFMD FRAMEWORK

Background
The background of the AIFMD is particularly unsatisfactory.

The AIFMD originated at the G20 summit in November 2008 at which representatives concluded that a secure and stable financial system required all significant financial market participants to be subject to ‘appropriate’ regulation and supervision for the protection of investors as well as for financial stability reasons. This resulted in a proposal by the European Commission in April 2009 for a new Directive covering alternative investment fund managers (or the AIFMD). The proposal, originally intended to regulate hedge funds, was extended to cover all alternative ‘funds’ (without any clear analysis being undertaken of the different types of fund across the EU). This political nature of the subject, strong vested interests (in the custody-banking sector) and the EU’s tri-partite decision-taking process all contributed to an unhelpful (and often confused) negotiation which ended under the stewardship of the Belgium presidency in October 2010 (based on certain discrete assurances relating to the application of threshold tests to third country managers that were subsequently ignored). The final draft of the AIFMD was published on 21 July 2011 and the transposition deadline for Member States was 22 July 2013.

The AIFMD (Level 1) was supplemented by a delegated regulation on 19 December 2012 (that was controversially re-written by the Commission) setting out detailed implementing measures and technical rules in relation to the Directive (the AIFM Regulation). The AIFM Regulation (or Level 2) is binding and directly applicable in all Member States.

ESMA has sought – in the face of continued contradiction by the Commission – to promote a common and consistent interpretation of the AIFMD through the publication of regulatory technical standards (RTS) and guidelines (Level 3) on certain aspects of the new law. While only the RTS are binding, the guidelines are intended to ensure a common, uniform and consistent approach between regulators.

Summary
The AIFMD draws heavily from the UCITS Directive and the Markets in Financial Instruments Directive 2004/39/EC (MiFID) in its approach and both the text of the Directive and the framework described by it are familiar. Indeed, the AIFM licence requirements are remarkably similar to those that apply to the authorisation of UCITS management companies. Authorisation must be sought by:

- the AIF itself, if it is internally-managed (and thus qualifies as an AIFM); or
- an externally appointed AIFM, which may also provide management functions to UCITS’ and other services described below.

The logic of the AIFMD is that all AIF’s must have a single AIFM that is a company whose ‘regular business’ is managing AIF’s. Authorised AIFM’s must perform one of the defined management functions (portfolio and risk management) and (if such a manager it) may also perform certain ancillary tasks such as administration (i.e. legal and accounting services, customer inquiries, valuation and pricing, maintenance of a unit holders'/shareholders’ register, distribution of income, unit/share issues and redemptions, contract settlements; record keeping and preparing tax returns), marketing (the offer or placing of units or shares) and administrative tasks related to the assets of the AIF (such as facilities management). AIFM’s are restricted in carrying on business unrelated to the management of AIF’s.

MiFID-like requirements must be met by AIFM’s to become and remain authorised. These include: minimum regulatory capital and additional capital requirements; professional indemnity insurance or additional own funds obligations; organisational requirements; functional segregation; an approved persons regime; remuneration policies and practices; delegation controls to avoid letter box entities; and reporting obligations. The AIFMD while only regulating AIFM’s also contains rules in relation to how AIF’s must be supervised and operated; including specific provisions in relation to the use of leverage and the acquisition of controlling participations in relevant companies.
AIF’s are a form of UCI that may be constituted by contract, trust or company law or take any other legal form and may be open-ended or closed-ended. The valuation rules specify that the unit or share price of an AIF must be determined by reference to the net asset value of the common fund. The NAV is calculated as the market value of the UCI’s assets calculated by an appropriate methodology, which is then divided by the number of units or shares in issue to get unit or share price. This process is very similar to that required for UCITS and other existing forms of UCI and, because the proper pricing of units or shares is seen as key to safeguarding the interests of investors, the AIFM Regulation subjects it to the supervision of the depositary.

AIF
**Definition**

The AIFMD establishes that there are 2 types of UCI; UCIs investing in transferable securities (UCITS) and UCI’s investing in anything else (AIF). This reasoning is reflected in Article 4.1(a) of the AIFMD that defines an AIF as follows:

- an undertaking for collective investment (not requiring authorisation under the UCITS Directive), that additionally,
- raises capital;
- from a number of investors;
- with a view to investing that capital in accordance with a defined investment policy;
- for the benefit of those investors.

This definition has always been problematic and the Swedish presidency commented in a note published on 2 September 2009:

“The general view of delegations seems to be that the current wording does not make it sufficiently clear what entities will be under the scope.”

Similar concerns were raised by the Financial Markets Law Committee (FMLC) in the UK in January 2010 in relation to the use of the term ‘UCI’:

“… the term ‘collective investment undertaking’ is itself not defined in the Commission’s Proposal and, although it is not new to European law, it has no pre-existing settled meaning. The term appears in the plural ("collective investment undertakings") in Article 3 of Council Directive 2009/65/EC on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (the “UCITS Directive”) and has become familiar to the markets in that context but it is a concept which is neither explained nor defined therein. Instead, the scope of the UCITS Directive is further circumscribed by additional provisions which clarify, inter alia, that it applies to collective investment
undertakings which are “open-ended”. In contrast, it is clear by virtue of Article 2(1)(c) that the regulatory ambit of the Commission’s Proposal is not restricted in the same way. The breadth of this definition and, in theory, the scope of the Directive, is likely to give rise to very substantial uncertainty as commercial undertakings consider whether they are within the scope of a directive targeted at the investment management industry.”

The task of clarifying the definition, therefore, fell to ESMA which published guidelines on key concepts of the AIFMD in August 2013.

ESMA Guidance

According to ESMA, the following characteristics, if all of them are exhibited by an undertaking, demonstrate that it is a UCI:

- The undertaking does not have a general commercial or industrial purpose;
- The undertaking pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors; and
- The unit holders or shareholders of the undertaking – as a collective group – have no day-to-day discretion or control.

It is the second criterion that is most useful in identifying what is meant by the term UCI because it requires:

- The pooling together of the capital raised by an undertaking through the issue of common units or shares;
- For the purpose of generating a common return.

The concept of pooling is not specifically defined by the UCITS Directive or the AIFMD, but it is immediately recognisable from an ordinary reading of the UCITS Directive, the AIFMD and the AIFM Regulations. This is the common pool resulting from the issue of common units or shares at a NAV. The ‘commercial activity’ of raising a common pool for investment purposes is the concept of capital raising also identified by ESMA. The term ‘capital’ must be construed in its broadest possible sense as asset ownership (cash or otherwise). For a UCI to have capital, a common fund must exist independently of its investors.

It is interesting to note that the phrase ‘units or shares’ is used 70 times in the AIFMD and 40 times in the AIFM Regulation to describe all aspects of the operation of an AIF as well as approximately 140 times in the UCITS Directive. The term ‘partnership interest’ is never once referred to. This phraseology choice is not accidental, but rather highlights the established nature of UCI that is reflected in Luxembourg law.
The AIFMD challenge

An AIF should be immediately recognisable to anyone familiar with the Luxembourg funds industry as a UCI. An AIF can take the form of an unregulated company (or a SOPARFI), a SICAR, a SIF or a Part II UCI and fits easily within established operating platforms.

The challenge presented by the AIFMD over and above existing product laws, is ensuring that the local AIFM has sufficient substance to meet the various requirements of the Directive to avoid being classed a letter-box entity. This has resulted in:

- the regulator focussing on AIFM’s adopting UCITS-based best practice in relation to AIF’s (e.g. independent directors, risk management and valuation); and
- industry identifying workable solutions to ensure continued management locally (such as the widespread promotion of UCITS-style third party management companies referred to as ‘plug n’play manco’s’).

The mistake has been to assume that all AIF are essentially the same. It would be much better if the regulator and industry focussed on the specific features of general partner companies and private equity partnerships. This should inevitably result in very different solutions being put forward which would be consistent with ‘industry’ best practice as reflected in EVCA’s professional standards.
Luxembourg partnerships

Introduction

The Luxembourg government used the transposition of the AIFMD to introduce changes to its partnership regime. This reform was intended to bring limited partnership laws in line with international norms and make them more attractive for fund manager (in particular, private equity managers); however, it is not always clear whether the reform fully achieves what was claimed.

Existing partnerships

Historically, the law on commercial companies of 10 August 1915 recognised 2 forms of limited partnership, each of which had separate legal personality:

- a corporate partnership limited by shares (or société en commandite par actions), which is similar to a public company with a corporate director bearing unlimited liability; and
- a common limited partnership (or société en commandite simple), which is a close company again managed by a corporate director that issues partnership interests as opposed to shares.

SCA’s and SCS’s have two types of partner:

- at least one unlimited partner (the associé commandité or in anglicised terms, the general partner), which has the right to have control over the management of the company and has joint and several liability for all the obligations of the partnership; and
- one or more limited partners (associés commanditaires), who are passive investors and whose liability is limited to their contribution,

and sometimes a separate manager (gérant).

The key difference between these partnerships is that the SCA is a company with a share capital represented by shares that are in principle freely transferable, whereas the SCS issues partnership interests that are not freely transferable (unless stated in the partnership agreement). In other words, the SCA is a joint stock company (société de capitaux) whereas the SCS is an intuitu personae partnership (société de personnes) where the identity and the relationship of trust between the partners are of decisive importance. It is worth noting that the nature of an SCS as a société de personnes can sometimes appear unclear where there is an associé commandité.

As with other civil law jurisdictions, these partnerships raise capital through issuing shares or partnership interests forming the patrimoine (or capital). This is reflected in both the 1915 law and the law of 2002 on the register of commerce and companies and the accounting and annual accounts of undertakings.
Diagram

**Special Limited Partnership**

The AIFM Law updated the SCS regime (including its tax treatment) and introduced a third form of limited partnership; the special limited partnership (or *société en commandite spéciale*) that was supposed to be modelled on the English limited partnership. Industry has placed great emphasis on the similarity of SCSp’s and English partnerships in general promotional literature, which should define how these partnerships are understood (if this literature is to be correct).

Like an SCS, the SCSp is established by a partnership agreement (through a notary deed or by private instrument), entered into between one or more general partners with joint and several liability for all the obligations of the partnership and one or more limited partners having their liability limited to their respective contributions. Unlike an SCA and the SCS, however, the SCSp is not a legal vehicle but rather a relationship that subsists between two or more partners. This relationship takes the form of a commercially negotiated contract between the partners without any separate legal form or identity.

Partnership agreements internationally typically provide that the assets of the partnership are co-owned by each partner directly (that has its own ‘partnership account’) and there is no common fund in which the partners have equal units, shares or other interests. The interest of each partner in the arrangement is determined by the partnership agreement and may be specific to that partner. A partnership interest is not one or more interests in an SCSp for example, but rather a singular interest in the assets that belong to all the partners in connection with the partnership.

An SCSp or limited partnership should be understood as an ordinary partnership save that the liability of the limited partners is limited to their contributions (at law) on the basis that such partners do not become actively involved in the management of the partnership. Management has specific meaning under the revised 1915 law and does not mean that limited partners are not involved in the partnership. Quite the contrary, limited partners may be very involved in the business of a partnership even if they do not technically ‘manage’ it. This involvement is the quintessential nature of *intuitu personae* undertaking.

In performing its role, it is best to understand the general partner as one of the partners that acts as a contractual agent on behalf of all the partners (itself included) in entering into contracts and holding assets on their behalf (i.e. it can only act within its scope of competence). This is not dissimilar to the position of a management company acting on behalf of an FCP. This arrangement is one of practical and legal convenience and should not obscure the nature of the partnership itself that should be seen as a flexible co-ownership arrangement.

The legal profile of an SCSp structured with capital accounts, therefore, looks very different to an existing civil law partnership.
Diagram

The key feature to note is that there is no pooling of interests and no common fund is formed. The interest of each partner in the partnership is specific and, as explored in Paper II, this creates scope for legitimate tax optimisation among the partners in much the same way that governments commonly rely upon tax incentives to influence behaviour (i.e. the respective tax status of different partners is a real commercial concern to be considered when freely negotiating the allocation of returns from a joint venture).

The absence of pooling also distinguishes the commercial profile of a typical limited partnership arrangement from an SCA or SCS. This difference is manifest in the following situations:

- a fee rebate awarded to a partner in a limited partnership is reflected in the application of the waterfall provisions to that individual partner (reducing the applicable hurdle before any carry becomes payable by it). By contrast, a fee rebate paid to a share or interest holder in a pooled arrangement impacts the waterfall provisions applicable to that class of share or interest holder as whole (and the fee rebate is largely gratuitous in the hands of the receiving partner); or
- the general partner of a limited partnership is typically financed by way of a priority profit share rather than a management fee. A typical limited partnership does not have capital and, therefore, the general partner receives advances on its profit rights rather than being paid a fee from the capital of a common fund.

Many more examples could be given, all of which impact the drafting of a limited partnership agreement and its operation.

**Losing concepts in translation**

The revised SCS and the SCSp are new products in Luxembourg and it is still unclear whether or not it is possible to replicate international limited partnerships. This is because industry is unfamiliar with the concept of co-ownership and it is possible to argue that all partnerships must have a *patrimoine*. This view is based on Article 22-2 of the 1915 law which states that registration and other formalities regarding the assets pooled within the SCSp shall be made in the name of the SCSp even though it does not separate legal personality. At least one commentator has argued that such lack of personality is

“misleading, as the SCSp appears to be an hybrid corporate vehicle which, despite the prima facie absence of legal personality, will be vested with the main attributes of companies with legal personality”.

We would argue however that such uncertainty should be avoided and that registration formalities should not undermine contractual freedom when negotiating a partnership arrangement. Moreover, this argument may well be overtaken by local industry practice. The rapid adoption of partnership agreements in an international format make it increasingly difficult to deny the possibility of establishing partnerships structured with capital accounts.
**Unitised partnerships**

The civil law approach is a rarity (if not precluded) in the UK because HM Revenue & Customs (HMRC) states that unitising a partnership may prejudice its tax transparency. This is because the partners would cease to co-own the partnership assets and would instead become interested in the common fund constituted by the partnership interests (i.e. the partnership would cease to be treated as a partnership and would be treated as an unregulated unit trust). This could result in the general partner being taxed on the profits of the partnership as a whole.

**Regulated partnerships**

**Basic position**

Partnerships are not subject to a specific regulatory regime and industry takes the view that SCA’s, SCS’s and SCSp’s may be established as regulated as well as unregulated vehicles. This is necessary because Luxembourg regulation becomes mandatory where a partnership: (i) is raising capital from more than a limited circle of investors in the case of an SCA or (a non-intuitu personae) SCS; and (ii) has as its objective to invest the monies raised on a collective basis. Regulated partnerships must comply with the SIF Law or the SICAR Act in addition to the 1915 law in order to benefit from approval and ongoing supervision by the Commission de surveillance du secteur financier (CSSF).

**SIF Law**

It has always been possible to establish SCA’s as SICAV or SICAF SIF’s; however, the position of SCS’s and SCSp’s is more unclear. This is because these partnerships do not logically fit into any of the 3 categories of SIF identified by the SIF Law:

- a common fund (or FCP) divided into units that is established under Chapter 2 and managed by a local management company;
- an investment company with variable capital (or SICAV) that is established under Chapter 3 and may be internally or externally managed; or
- a form other than an FCP or a SICAV that is established under Chapter 4. This chapter is generally understood to apply to fixed capital companies or Sociétés d’Investissement à Capital Fixe (SICAF’s) which are rarely used.

The AIFM Law took the view that partnership interests should be treated as the equivalent of share capital and, therefore, that SCS’s and SCSp’s should be treated as SICAV-SIF’s. This approach may have been driven by a desire to ensure that these partnerships befit from treaty recognition. To be a SICAV, however, these partnerships must have share capital, issue securities that are capable of redemption and it must publish a NAV at least once a year. This approach attempts to reconcile (or gloss over the differences) of 2 fundamentally different valuations approaches:

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<tr>
<th>UCI’s</th>
<th>Private equity partnerships</th>
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<td><img src="image1.png" alt="UCI's graph" /></td>
<td><img src="image2.png" alt="Private equity partnerships graph" /></td>
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</table>

With UCI’s capital in contributed and increases or decreases like a company. With partnerships, there are continual inflows and outflows.
As mentioned above, there is nothing in the 1915 law to stop SCS’s and SCSp’s being structured as civil law partnerships (akin to companies) and not as international limited partnerships, however, such unitisation gives rise to 4 very clear problems:

- it subtracts the operational efficiencies achieved through the use of capital accounts and changes the commercial relationship between the partners;
- the unitisation of a partnership may affect tax transparency internationally (i.e. in respect of UK managed funds) as it results in pooling. It is because of pooling that SICAV's sometimes benefit from treaty recognition internationally;
- it may effect regulatory identification more broadly; and
- it seems clear that an SCS or SCSp structured with capital accounts cannot be regulated under the SIF Law. Any partnership that did obtain authorisation by the CSSF would be in immediate breach of its obligations at law.

SICAR Act

The amended SICAR Act takes the same approach as the SIF Law and, in the case of the SCS and the SCSp, equates partnership interests with securities, the issue of which constitutes the capital of the SICAR (and needs to meet minimum thresholds). Indeed, capital can be divided between different compartments in a SICAR, like a SIF, to facilitate the ring-fencing of different liabilities.

The SICAR Act foresees capital raising through the issue of partnership interests on the basis of a published prospectus (that must consequently be kept up-to-date) because the term ‘partnership interests’ in the sense used are ‘transferable securities’ for the purposes of the Prospectus Directive. Transferable securities are, in turn, defined by reference to MiFID to include only those securities that are ‘negotiable on [a] capital market’. This connection is important because it highlights the difference between an SCS or SCSp structured as a civil law partnership and one structured with capital accounts. Partners in a partnership that does not pool capital do not have partnership interests but rather an individual participation that is in non-negotiable form (i.e. it is specific to that partner, non-assignable and consists of a bundle of specific rights and obligations). It is the non-negotiable nature of such partnership interests which is why the rules limiting the raising capital from more than a limited circle of investors may not have applied in the case of an (intuitu personae) SCS or an SCSp (noting that the current rules relating to private placement in Luxembourg are particularly unclear following recent CSSF FAQ’s).

Conclusion

In many respects, the concept of a regulated partnership seems inconsistent with the legal meaning of an intuitu personae relationship (e.g. it difficult to see how compartments are possible if the identity of all partners should be known). More specifically, the use of partnership accounts is inconsistent with the drafting of the SIF Law and the SICAR Act in numerous ways. This brings into question whether the law, if properly construed, permits an SCS or an SCSp with partnership accounts to be regulated at all.

Scope of the AIFM Law

Luxembourg

An AIF in Luxembourg is a UCI that raises capital from investors through the issue or units or shares with a view to investing that capital in accordance with a defined investment policy for the benefit of such investors. A UCI is any form of pooled investment vehicle that facilitates collective investment, whether or not there is any risk spreading now. Under Luxembourg law, this includes almost all legal vehicles whether regulated or unregulated.

The aberration is an SCS or SCSp structured with capital accounts rather than partnership interests because there is:

- no collective or mutual investment as each partner negotiates its own specific position in the partnership. These commercial negotiations may be protracted and formal, with both the general partner and the limited partners being separately represented;
- no issue of common units, shares or other negotiable interests with the consequence that there is no pooling of the proceeds. Pooling only occurs in the underlying assets;
- while a common undertaking does exist, an SCS or an SCSp is a parallel or co-ownership scheme. This type of arrangement would be better categorised as a joint venture; and
• all partners participate in partnership, even if they do not manage it. Simple legal generalisations should not obscure the commercial reality of partnerships that differs clearly from UCI’s (where investors do not have day-to-day discretion or control).

The AIFMD, and in particular the AIFM Regulation, specifies in much more detail than the SIF Law or the SICAR Act that AIF’s are NAV-based investment vehicles that issue units or shares by way of general offer or placement. Even if reference to ‘units’ or ‘shares’ is construed more broadly to refer to partnership interests (as in Germany) or even any transferable securities (not that there is any legal basis for this under the AIFM Law) then there is still no logical way in which the AIFM Law could be construed under ordinary principles of legal interpretation to include SCS’ or SCSp’s structured with capital accounts. Indeed, if an SCS or SCSp were treated as an AIF then the AIFM and the AIF’s depositary would be forced to breach those provisions of the AIFM Law and the AIFM Regulation relating the valuation, subscription and redemption of units or shares. Complying with the AIFM Law would be a legal impossibility.

England and Wales
This problem is not unique to Luxembourg and has already been considered in England. English law and practice, however, are very different from Luxembourg and UCI’s are not commonly used by the private equity industry in the UK. Indeed, the concept of a UCI is not widely understood at all.

Limited partnerships are broadly equivalent to SOPARFI’s and are not products under English law, however, they can be construed as funds or ‘collective investment schemes’ (CIS) for the purposes of section 235 of the Financial Services and Markets Act 2000 (FSMA) that imposes very strict limits on the ‘promotion’ of CIS. It is important to note that section 235(3) FSMA does not specifically require that CIS ‘pool’ investor interests; consolidated management is possible instead (see subsection (3)(b)). This is because section 235 was drafted as broadly as possible to provide the Financial Conduct Authority (FCA) with the widest possible powers to restrict the promotion of unregulated CIS (which was the purpose of the section). Reliance on the concept of a CIS as opposed to a UCI meant that the UK industry was unfamiliar with the concept of pooling and did not appreciate the much broader scope of UK funds’ regulation, which is generally defined by way of exception.

This confusion between the concept of a CIS and a UCI is also evident from:
• the application of MiFID exemptions, where the FCA allows private equity firms managing limited partnerships to rely on Article 2(1)(h) MiFID relating to UCI; and
• proposals in 2011 to introduce authorised contractual schemes (including authorised partnerships) to facilitate the establishment of master funds under the UCITS IV Directive.

The definitional shortcomings of the AIFMD were identified by both the CLLS and the Financial Markets Law Committee (FMLC), but the FCA did not appear to take note and clearly struggled to come up with their own definition of an AIF:

“In one sense the shareholders in a supermarket invest on a collective basis in the underlying business of the company. It invests its shareholder funds to buy goods and sell them at a profit. The supermarket may set out its policy for investing shareholder funds in a formal policy document. It may raise external capital to fund its business. On a broad reading of the AIF definition that would mean that the supermarket would be an AIF.”

The FCA took the decision in CP13/09 to start with the policy objectives of the AIFMD and work backwards. They stated that the purpose of the AIFMD, following-on from G20 commitments, was to regulate the management of all ‘funds’ that are not UCITS, including:
• hedge funds;
• commodity funds;
• private equity funds (including large buy-out funds, mid-cap investment funds and venture capital funds);
• infrastructure funds;
• real estate funds;
• conventional non-UCITS investment funds. These invest primarily in traditional asset classes (such as equities, bonds and derivatives) and pursue traditional investment strategies.

This was an unusual approach, because:
• the FCA did not consider the use of the term ‘fund’. The term ‘fund’ can be used in a commercial way as well as in a legal way to describe an arrangement (such as a company, trust or partnership), and it is important to appreciate the difference. Just because an arrangement describes itself as a fund, does not mean that it is a fund in a legal sense, which is essentially a regulatory term. Regulatory categorisation as a fund can be applied very broadly to control the marketing of ‘CIS’ or it can be applied much more narrowly, where status as a ‘UCI’ confers specific benefits;

• the types of fund listed do not have any legal meaning. These designations are simply commercial terms that have evolved. Taking ‘private equity’ for example, the term has no settled definition and means different things in different jurisdictions. Arguably, it is only in the UK that the term is synonymous with the buy-out industry; and

• the FCA and HM Treasury do not appear to have consulted HMRC at an earlier enough stage because they did not identify the clear distinction between ‘funds’ and ‘partnerships’ made by the Taxation (International and Other Provisions) Act 2010 and HMRC’s International Tax Manual.

The FCA justified its approach on policy as opposed to legal grounds:

“When defining what an AIF is the drafters of the AIFMD faced a dilemma. If it is defined in a precise and detailed way there is a risk that some funds would fall outside regulation, given the wide variety of legal forms they can take. However, by defining the term in a broad way there is a risk that the AIFMD is given a much wider scope than intended. The definition of AIF that was chosen is drafted at a high level of generality and uses words which have a wide meaning. So the FCA has approached PERG 16 by looking at what sorts of entities are clearly meant to be caught and then has used that as a guide to identify cases which are not fairly within the definition so as to avoid an interpretation that would give it an exorbitantly wide scope. PERG 16 should be read in the same way and so descriptions of what is excluded should not be read in a narrow way that would take cases out of scope that are fairly within it.”

The FCA then used the FUND Sourcebook to re-write the UK AIFM Regulations published by HM Treasury to expand the scope of the AIFMD to cover certain types of CIS that it felt should be in scope even though these CIS’ could not be UCI’s:

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<th>AIFMD</th>
<th>AIFM Regulation</th>
<th>FCA Guidance</th>
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<td>Article 19: Valuation</td>
<td>Article 72: Calculation of the net asset value per unit or share</td>
<td>The meaning of a unit or share of an AIF 8.37.7 G</td>
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<td>3. AIFMs shall also ensure that the net asset value per unit or share of AIFs is calculated and disclosed to the investors in accordance with this Article, the applicable national law and the AIF rules or instruments of incorporation.</td>
<td>1. An AIFM shall ensure that for each AIF it manages the net asset value per unit or share is calculated on the occasion of each issue or subscription or redemption or cancellation of units or shares, but at least once a year.</td>
<td>The terms ‘unit’ and ‘share’ as used in the AIFMD UK regulation are generic and can be interpreted as encompassing all forms of equity of an AIF. As such, the terms are not limited to AIFs which are structured as companies or unitised funds and may include other forms of collective investment undertakings, such as partnerships or non-unitised trusts.</td>
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<td>The valuation procedures used shall ensure that the assets are valued and the net asset value per unit or share is calculated at least once a year.</td>
<td>2. An AIFM shall ensure that the procedures and the methodology for calculating the net asset value per unit or share are fully documented. The calculation procedures and methodologies and their application shall be subject to regular verification by the AIFM, and the documentation shall be amended accordingly.</td>
<td>Question 2.8: Must the scheme be time-limited or designed to allow investors to exit from time to time or at a particular time?</td>
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<td>If the AIF is of the open-ended type, such valuations and calculations shall also be carried out at a frequency which is both appropriate to the assets held by the AIF and its issuance and redemption frequency.</td>
<td>3. An AIFM shall ensure that remedial procedures are in place in the event of an incorrect calculation of the net asset value.</td>
<td>A scheme may be an AIF even if there are no arrangements for units or shares to be repurchased, redeemed or cancelled...</td>
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This was a significant extension of the AIFMD and the Right Honourable Sajid Javid PC MP commented on 13 May 2013:

“Nevertheless, in transposing the definition of an AIF, the UK has proposed to follow a "copy out" approach. The definition in the proposed regulations follows the same terminology used at Article 4 of the Level 1 text. Therefore, if a person wishes to make an argument that a particular arrangement does not amount to an AIF that argument could be made equally in relation to the Directive and the proposed UK regulations. Enforcement of the UK regulations will be a matter for the Financial Conduct Authority.”

Following the Capital Alternatives case (2014) that reiterated the non-legally binding nature of FCA guidance, there may be a prima facie case under English law (based on ordinary rules of statutory interpretation) that the FCA’s approach is *ultra vires*. It certainly seems worth testing. Previously, if an English limited partnership was a CIS but a Delaware limited partnership was not (as a company), then it was simply a case of remembering to include the right rubric in the offering memorandum. The situation changes with AIFMD, however, and the scope of the law carries significant criminal, civil, regulatory, commercial and fiscal implications that should not be determined by the FCA’s Handbook.

There are a number of factors that could have shaped the approach of the FCA in relation to the AIFMD:

- commitments given at the G20 in 2008 even if these were given on mistaken premises (and discounting the fact that the FCA already regulated all private equity firms operating out of the UK);
- the nature of the co-ownership model may have become obscured in the UK as a result of structuring carried interests payments through a separate vehicle and not the general partner;
- all limited partnerships in the UK are structured with capital accounts and would fall outside scope of the AIFMD on a proper interpretation of the law;
- the risk of undermining the new regime for authorised contractual schemes that does not require pooling;
- that UK-based managers generally adopt a management as opposed to an advisory model for operating private equity partnerships, which obscures the different roles and processes within the manager (i.e. there is a big building with name outside that appears to be an AIFM) and consequently some of the difficulties with the AIFMD;
- the commercial opportunity presented by the AIFMD itself. It was quickly realised that the AIFMD would allow UK-based managers to distribute products throughout Europe for the first time. These managers were best placed to accommodate the additional costs of the AIFMD and would no longer have to establish third country platforms to raise commitments from Continental and other international investors. The broader the definition of an AIF, therefore, the greater the commercial opportunity presented by the AIFMD; and
- the proximity of offshore markets also facilitating international business.

The approach of the UK authorities was very thoroughly considered and as a consequence, is unlikely to change.
MISAPPLYING THE AIFMD

A real problem

The decision by the UK authorities to apply the AIFMD where there is neither an AIF nor an AIFM is illogical and can only be understood in the context of the UK. While the Luxembourg authorities may be tempted to follow the FCA’s policy-driven approach, they should first consider whether:

- they have fully appreciated the reasoning of the FCA and HM Treasury;
- a similar approach would in fact be correct as a matter of Luxembourg and/or EU law;
- extending the scope of the AIFMD to non AIF-like products would reinforce or weaken the integrity of the brand;
- there is any possible prejudice to other rules such as the EuVECA Regulations;
- the absence of international investors, locally-based private equity firms and limited access to non-EU financial centres places Luxembourg at a relative disadvantage; and
- the substance requirements are a disproportionate burden for a third country.

This is because mis-applying the AIFMD is not an academic question centring on whether or not a ‘fund’ pools capital, but a decision attaching real risk. It perverts the application of law in unforeseen ways and discourages the use of Luxembourg-based partnerships.

Private equity partnerships

The immediate consequence of such a decision is the need to establish an AIF and an AIFM matching the features prescribed by the AIFMD. This is problematic as industry locally commonly adopts an advisory (and not a management) model when structuring funds.

With such a model, a general partner was never an AIFM in the sense foreseen by the AIFMD, but rather a non-trading SPV established specifically for each partnership. This is because partnerships were not actively managed UCI’s. All this must change with the AIFMD as the Directive assumes that a general partner is a trading business (similar to a MiFID investment firm) and imposes what are considered sensible capital requirements and insurance arrangements in relation to it even though this is not the case. It requires that there should be segregation between different business units that do not exist and risk management should be undertaken in relation to illiquid assets over which management rights cannot be exercised. Additionally, the general partner should adopt remuneration rules even though it has no employees, or ensure that delegation rules are applied when there is no delegation (because there is no actual activity to delegate).

Similarly, partnerships are sociétés de personnes and no common fund exists that can be managed and supervised in the manner foreseen. Taking the restrictions in Section V as an example:

- A partnership structured with capital accounts does not have capital and cannot be leveraged at AIF-level. Partnership borrowing is limited recourse leverage at an investor level.
- Management restrictions attaching to private equity AIF to prevent the abuse of portfolio companies assume the existence of direct management even though direct management rights are not (and should not be) exercised.

The costs of transforming a largely passive conduit structure into a functional business should not be overlooked; especially, in third country domiciles where the added cost is a pure overhead. It should be recognised that substance has an inflexion point, after which discourages local activity. These additional costs of doing business will be further exacerbated by non-executive and other (risk) officer fees, advisory fees, depositary fees, enhanced audit fees and, in some jurisdictions, steeply increased regulatory costs. The AIFMD has generated a mini industry that quotes best practice from other asset classes to suggest the absurd in a private equity context.

As a general statement, complex regulation is only suitable for UCI’s with basic and symmetric processes. Private equity partnerships by contrast, operate on a more complex basis with asymmetric processes which are more difficult to identify and regulate correctly. Unfortunately, these issues were not identified and regulation has consequently become disconnected from reality, and private equity firms operating partnerships are presented with an unfortunate choice:

- pretending to undertake additional functions that are commercially unjustified (and contrary to established industry best practice) to be seen to comply; or
- operating out-of-scope and having to navigate around barriers of a largely political nature.

Neither is conducive for investment in European industry or enhances the reputation of Europe as a management centre for private equity industry funds.

Marketing

The ease of applying passive marketing rules in the context of partnership participation is not abusive, but belies more fundamental issues. Knowing these issues will be important as the ‘private placement’ of AIF’s will not be possible at all in some Member States (such as Croatia, Greece, Latvia and Poland) and will be strictly limited in others (such as Austria, Denmark, France, Germany and Italy).

Advantages

Those who are politically aligned with the AIFMD, argue that access to a marketing passport will place EU-based AIFM at a significant advantage. Non-EU managers (and sub-threshold EU AIFM falling outside other product laws) must navigate the complexities of restricted private placement regimes which may involve commercial risk (i.e. breach could result in partnership commitments being unenforceable).

Disadvantages

Putting aside the questionable ethics of such protectionism, this view may be incorrect in a private equity context where there is no AIF (in the sense originally intended by the law). After all, private equity partnerships do not raise capital by way of:

“a direct or indirect offering or placement at the initiative of the AIFM, or on behalf of the AIFM, of units or shares of an AIF it manages…”

on a private (as opposed to a public) basis. Rather, partners, their sponsors and advisers negotiate the terms of participation in a private equity partnership with each other directly, before:

- the AIFM is incorporated;
- the limited partnership is established; or
- an ‘offering document’ is drafted and issued.

All of this is pre-marketing and, typically, there never is any ‘capital raising’; ‘closing’ is simply when pre-agreed documents are signed-up. Participation after first closing is similarly undertaken on a negotiated basis that can be controlled in terms of location and in relation to whom takes the first initiative.

It is worth noting that the use of ‘PPM’s’ by private equity partnerships is misleading as these are not detailed contractual offering documents in the form commonly published by UCI’s. PPM’s are typically summary documents that focus on the key commercial features of a partnership rather than the detailed partnership terms. PPM’s are not even remotely capable of ‘acceptance’ on the basis of an attached subscription agreement for example.

The use of the term ‘private placement’ by Recitals 85, 88 and 90 of the AIFMD is important because it evidences the intention of the legislature in adopting marketing restrictions in the Directive itself. Private placement is not a harmonised term (i.e. it has no established meaning). In a call for evidence in April 2007, the European Commission characterised private placement as a set of exemptions from rules that would otherwise normally apply in the event of the public offer/sale of financial instruments. This characterisation was reiterated in the Commission’s final Impact Assessment Report on Private Placement in 2008. This characterisation is very important because it connects the term with an offering of ‘transferable securities’ under the Prospectus Directive (2003/71/EC), which must be in ‘negotiable form’:

“The concept of negotiability contains the notion that the instrument is tradable. If restrictions on transfer prevent an instrument from being tradable in such contexts, it is not a transferable security.”

Participation in an intuitu personae partnership or a société de personnes, however, as already identified, is in a non-negotiable form and therefore falls outside private placement rules (whatever they may have been or be now). The specific restrictions in the text of the Directive are expressed to apply directly to units or shares in AIF’s but, again, if these do not exist, it is unclear what additional marketing restrictions the AIFMD gives rise to in the context of private equity partnerships. Logically, as a matter of law, the regulatory status quo continues to apply across the EU unless additional restrictions have now been put in place at a national level.
Where the private placement of units or shares cannot be credibly avoided in the EU (perhaps as a result of the number of investors in a Member State), then the placement of interests in feeder structures may prove operationally easier than the placement of units or shares in a directly-investing private equity AIF. This is because a feeder structure would not invest directly in portfolio companies and depositary obligations will be more clear cut.

**Passporting and alternative access**

The non-negotiable nature of typical limited partnership interests undermines the entire logic of a marketing passport because a passport assumes that:

- it is possible to have a pre-approved (i.e. static) offering of units or shares in a negotiated context where the terms of participation are specific and dynamic; and
- there is an actual offering or placement of units or shares.

Neither is correct and, therefore, it would seem that a passport is of little real relevance in relation to private equity partnerships that are closely promoted. It is of greater relevance perhaps in a private equity fund of funds (FoF’s) context where UCI’s need to raise capital on a much wider basis through a general offering of (negotiable) units or shares and an EU passport facilitates access to new, previously closed markets. Henry Watkinson, at Headstart Advisers, commented recently:

> “The vast majority of good new … funds are coming out of the US, but are not going to bother with [the] AIFMD. Many of the best funds are also soft-closed or closed and can get by on reverse solicitation. This will cause European investors to be largely precluded from seeing any of these funds. We see this as a strong opportunity for the European fund of … funds industry to provide access to those managers.”

Similarly, Paul Berriman of Towers Watson Investment Management is quoted as saying:

> “Funds of … funds that can articulate the value proposition of providing access to noncompliant US managers and provide evidence of that working in practice, stand in good stead to benefit in the post-AIFMD world.”

Perhaps the AIFMD will indeed encourage more platform-type FoF’s for European investors; unfortunately however, the marketing passport (such as it exists) is expensive and limited to ‘professional investors’ defined under MiFID. This is unhelpful to AIFM marketing private equity FoF’s structured as AIF because, as a result of the tightening of private placement rules around Europe as a consequence of the AIFMD, managers may no longer approach High Net Worth Individuals (HNWI’s) that fall outside the MiFID definition. As a result, access to both EU and third country managed AIF could be complicated by the AIFMD, and European investors may be well advised to develop their own solutions to ensure continued access to the best funds (such as New York or other non EU-based investment conduits).

**Legal certainty**

Some Member States may be tempted to gold-plate Article 42 to protect local industry; however, this would create considerable legal uncertainty in relation to the use of local vehicles. In such a situation, promoters and international investors would be well advised to choose more certain jurisdictions in which to do business. In this regard, English law and regulation is likely to remain very clear (with the FCA already adopting a pragmatic approach to pre and passive marketing in its Perimeter Guidance).

**Systemic risk**

**General**

Systemic risk should be seen as a sudden shock (typically a liability) impacting the financial sector as a whole requiring government intervention (usually in the form of financial support). A shock can impact a financial system where liabilities attaching to a specific activity or product are borne by or transferred (through cross-liability) to one or more participants of the local financial sector, and this has knock-on effects for the public or the financial place. Financial centres in smaller jurisdictions need to be especially alert to systemic risk because of the disproportionate importance of financial services to GDP.

**Custody**

In Paper I, we examined how a basically good concept came to distort the market, create conflicts and increase systemic risk in the buy-out sector by underwriting ill-defined risks that more properly ‘belonged’ with investors. Investment platforms which should have been risk transparent from a local perspective actually trapped liabilities of systemic importance in Luxembourg and conducted those risks into the banking sector.
While the AIFMD arguably makes matters worse by imposing an additional depositary requirement, the effect of this is mitigated by better defining depositary obligations (in relation to custody and other assets) and opening-up the depositary market to competition from non-banks (reducing the possibility of investment risks being transferred into the banking system).

**AIFM**

**A new role**

Section 2 of Chapter V of the AIFMD applies to partnerships that acquire control of EU portfolio companies which are not ‘SME’s’ (i.e. companies with less than 250 employees and either has a turnover of up to €50 million or a balance sheet total of up to €43 million). In taking control, an AIFM must disclose its, “intentions with regard to the future business of the … company and the likely repercussions on employment, including any material change in the conditions of employment”.

make ongoing disclosures and refrain from ‘asset stripping’. These provisions, together with the provisions on risk management (and, in particular, those Articles of the AIFM Regulation relating to the limits applicable to, measurement and management of risks), suggest that private equity partnerships are holding companies that exercise decisive control over portfolio companies (i.e. real businesses attaching real liabilities). In adopting this approach, the AIFMD overlooked the role of the management teams and runs contrary to established principles of law and corporate governance that look to separate the ownership and control of companies. This extraordinary approach was seen as necessary, however, to ensure accountability if investment activities of private equity AIF’s were not carried out in a socially responsible manner.

Nicholas Neveling articulated the wider commercial difficulty of this in Real Deals,

“All these efforts to paint the industry as some kind of big social enterprise, however, seem misplaced. The strategy may have distracted private equity’s critics initially, but the asset class now finds itself in an ongoing struggle to try and be something that it is not. Let’s be honest, private equity has never been a crowd-pleaser, but it shouldn’t have to pretend that it is. Private equity firms are there to make as much money as they possibly can for their partners and investors. They are not there to boost employment or keep SMEs afloat. That might not sit well with everyone, but that is not the asset class’ concern.”

The critical point, however, legal and commercial issues aside, was in stopping general partners playing a passive role and encouraging them to become controlling AIFM’s, the AIFMD risks transforming passive conduit structures into actively managed holding companies that may, quite correctly, attach liability for the actions of their subsidiaries internationally. Given the breadth of industrial groups owned by private equity partnerships, this represents a significant volume of risk.

In a sense, the AIFMD is simply an extension of the approach foreseen by the SICAR Law where the SICAR is required to actively develop its target investments and the passive investor principle is denied. Luckily perhaps, the SICAR has never been widely adopted by the private equity industry.

**Avoiding holding company status**

**Management**

While a UCI may be construed as a holding vehicle, it is unclear how a société de personnes could be. The portfolio companies are partnership property and do not belong to the general partner (even it is named in the shareholders’ register). The concept of partnership property is defined by law ‘as the assets bought by one or more partners for all the partners’ (my words) and are held ‘exclusively for the purposes of the partnership and in accordance with the partnership agreement’ (again my words). There is not a specific trust; the partners have a claim to the assets in accordance with the partnership agreement. The words: ‘the general partner shall have full power and authority on behalf of the partnership and with the power to bind the partnership’ is shorthand for ‘the general partner shall have full power and authority on behalf of the [partners] and with the power to bind [all the partners] [in accordance with the partnership agreement].’

This point highlights a fundamental difference between a co-ownership arrangement and a UCI structured as an FCP or a unit trust. The partners’ interests are in the partnership property directly and not any partnership capital, which does not exist. Consequently, each of the partners should be construed as a % owner of the respective portfolio companies in line with the applicable tax analysis, with the general partner acting in a nominee capacity only. A portfolio company could only be construed as a subsidiary of the general partner.
then, as a minority shareholder, if the general partner exercised control of it in the sense intended by the relevant companies’ legislation. This is why any exercise of any control rights should be very carefully considered each time.

Where a general partner did exercise control rights, however, it is important to differentiate between:

- when it exercises control on behalf of all the partners (acting in unison in accordance with the partnership agreement); and
- when it does so on its own behalf (for its own purposes),

with grouping occurring only in the latter situation (which should never be relevant in practice).

The exercise of control rights can also give rise to shadow directorship concerns in many jurisdictions, which is why direct involvement by the general partner in portfolio companies is typically avoided; relying instead on the adviser to provide monitoring services.

**Accounting**

Investment funds do not count as group holding companies (under amended IFRS or US GAAP) as they are not engaged in a common activity with the groups that they acquire (and certain other criteria are also met). Therefore, if a general partner, save taking investment decisions, does not involve itself or its partners in the running of the portfolio companies, it should not be seen as a group holding company from an accounting perspective. This analysis is not so clear with in-scope AIF.

In summary, therefore, a private equity partnership should not be understood as a holding company from a management or accounting perspective. A private equity partnership may facilitate the co-ownership of corporate groups by a consortium of institutions, but should not be seen as giving rise to the creation of a super group.

**Passive investor principle**

The passive investor principle is fundamental to co-investment arrangements; however, it has not been given sufficient emphasis and 2 recent cases serve once again to underline the dangers.

- In the Sun Capital case (2013), a court in the US considered that a private equity partnership should not be jointly and severally liable for a portfolio company's pension deficit on the basis that such ‘funds’ were passive investors and not ‘trades or businesses’ that controlled the bankrupt company.
- In the Prysmian case (2014), the European Commission took the view that the fund manager, Goldman Sachs Capital Partners (GSCP), had exercised ‘decisive influence’ over a company and its decisions and, therefore, the fund could be responsible for a portfolio company's anticompetitive conduct during its period of ownership. GSCP is reported to be considering an appeal.

Private equity firms therefore face a fairly clear dilemma between: (i) relying on the passive investor principle to best manage risk; or (ii) exerting a responsible influence over the management of portfolio companies which could result in much broader accountability. Getting the right balance will require considerable awareness and judgment in relation to what is really important.

**Ring-fencing**

Given the liabilities that can attach to controlling participations, it is necessary to ring-fence liabilities within (i) private equity partnerships and (ii) across related partnerships to avoid cross-contamination (i.e. liabilities stemming from bad assets attaching to good assets). This is achieved internationally through the use of SPV-general partners for each partnership and applying the passive investor principle. In encouraging the use of third party management companies and denying the passive investor principle, the AIFMD gives rise to new systemic risks in a private equity context that were not anticipated.

Cross-contamination cannot be controlled in private equity partnerships through the use of compartments, even where this is enshrined by law. This is because compartments may not have any effect internationally as became clear in the Dominion Trust case (2011). In this case, the trustees found themselves potentially liable to a UK rating authority for the payment of the outstanding rates (as legal owners of a property) notwithstanding that the trust had no assets and the trustee ostensibly benefited from limited liability under Jersey law. Moreover, to the extent that the trustees had any other UK situs assets belonging to other trusts,
the court also considered that these could be subject to enforcement action without recourse to Jersey law (that ring-fences the assets of different trusts).

Additionally, in a Luxembourg context, it is arguable that any patrimoine of an SCS or SCSp should be available to all creditors in the event of insolvency. If correct, this would have the effect of overriding separate capital accounts (where certain limited partners may have been excused from certain investments) by pooling liabilities with a partnership. This is not how partnerships are supposed to operate.

**Systemic consequences**

Contrary to the claims of politicians and the Commission, the AIFMD gives rise to systemic risks where none previously existed. These risks are impossible to manage from Luxembourg.

**Diagram**

```
Financial Place

AIF

Investors

Risk dispersion instead of transparency

Management

Depositary

Business Risks
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**Direct taxation**

**Tax transparency**

Private equity partnerships are tax transparent. Transparency means that the existence of a partnership is ignored for tax purposes and each partner is taxed directly on its returns from the underlying assets. This is because each partner is co-investing in parallel. Consequently, each time an asset is sold, each partner realises a gain or a loss immediately as if each sold their respective part of the underlying asset.

Tax transparency is different from a tax neutral UCI because, in ESMA’s own words:

“Investors in AIFs are generally not the registered holders of the underlying assets and do not individually directly own the underlying assets, but rather their ownership of the assets is represented by shares/units in the AIF.”

With an FCP for example, each unit holder is deemed to have invested in a pro-rata share of the common fund and not the underlying assets. A UCI can sell assets and re-invest the proceeds without triggering any taxable events for unit holders. Unit holders are only subject to tax when they receive a distribution from the FCP or sell the units. Therefore, FCP’s may be tax neutral but they are tax opaque as a consequence of pooling.

**Private equity partnerships**

Achieving tax transparency is critical for international investors and this should now be possible in Luxembourg with an unregulated SCS or SCSp structured with capital accounts. If product laws or the AIFMD require SCS’ or SCSp’s to become UCI’s then this may also impact their tax treatment. HMRC, for example, has issued guidance setting out the factors that they look at when considering whether an international fund should be treated as tax transparent as opposed to tax neutral. In summary, to achieve tax transparency, an entity must not have separate legal personality and must not issue share capital or equivalent, the business of the entity must be carried on by the persons who have an interest in it, profits must be attributed to those with an interest as they arise, those same people must be responsible for any leverage, and the underlying assets
of the entity must belong directly to those persons who have an interest in it. This would be achieved by a partnership structured with capital accounts but not by one issuing partnership interests.

**Diagram**
The difference between UCI's and partnerships is fairly straightforward.

**Partnerships**

**Diagram**

The limited partners taxed as if they had directly made the investment:

<table>
<thead>
<tr>
<th></th>
<th>LP1</th>
<th>LP2</th>
<th>LP3</th>
<th>Example tax rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return of capital</td>
<td>10m</td>
<td>5m</td>
<td>5m</td>
<td>n/a</td>
</tr>
<tr>
<td>Capital gain</td>
<td>10m</td>
<td>5m</td>
<td>5m</td>
<td>c. 28%</td>
</tr>
<tr>
<td>Income</td>
<td>4m</td>
<td>2m</td>
<td>2m</td>
<td>c. 45%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>24m</td>
<td>12m</td>
<td>12m</td>
<td></td>
</tr>
</tbody>
</table>

**UCI**

**Diagram**

The use of UCI's limits accurate taxation:
and are suitable where it is impractical to breakdown the taxable nature of different events because of greater volume and lower values. This may become relevant in relation to the BEPS debate (see below).

**UK**

The AIFMD should not result in the unitisation of partnerships in the UK because UCI are no longer treated as pooled investment vehicles as a consequence of the government’s introduction of authorised contractual schemes and the FCA’s reinterpretation of the UK AIFM Regulations. There is nothing to stop the Luxembourg authorities taking this same approach although it would seem, *prima facie*, to run contrary to the AIFM Regulation (and therefore be unlawful under both national and European law).

**Accounting**

The accounting treatment of UCI’s and private equity partnerships is different reflecting the different commercial and legal relationship represented by both.

**UCI’s**

The financial statements from which the share or unit NAV’s are calculated are not so different to that of an ordinary company:

**Example**

![Accounting Diagram]

**Partnerships**

The key difference between a partnership and a UCI is that the limited partnership agreement (LPA) is ‘investor-facing’. This means that the LPA sets out the rights of each partner specifically which is facilitated through the creation of separate partnership accounts rather than through the creation a common unit or share NAV. This difference can become important where, for example, one or more partners are excused from a particular investment and the capital of the partnership is no longer distributed among the limited partners on a pro rata basis.

The creation of separate partnership accounts in the financial statements of a private equity partnership should be recognised as demonstrating an absence of pooling. This is clearer from an accounting perspective than a legal one.
Other regulatory and fiscal risks

EMIR and other regulatory risk
Defining private equity partnerships as something that they are not carries significant risk in the context of the single European rulebook.
Under the definitions of the Regulation on OTC derivatives, central counterparties and trade repositories (Regulation (EU) 648/2012) also known as the European Markets Infrastructure Regulation (EMIR), an AIF managed by an AIFM authorised or registered in accordance with the AIFMD (as well as UCITS’ and, where relevant, its management company, authorised in accordance with the UCITS Directive) are classified as financial counterparties and therefore subject to the full range of additional obligations imposed by EMIR. This includes the clearing, the OTC risk mitigation and the reporting obligations. EMIR is an important reminder that the AIFMD should not be viewed in isolation and other European regulatory initiatives (such as MiFID II and shadow banking rules) could have an impact on any private equity AIF’s established in the EU. AIFMD II, III, IV etc. should also be actively anticipated because, in submitting to arbitrary regulation (i.e. ownership is not usually a regulated activity) industry must accept that the rules will keep changing and any concessions agreed to may be revoked at any time. Such an environment creates inherent product uncertainty within the EU and seems incompatible with long term (i.e. 10 plus 2 years) and high value investment products. In this regard, AIF’s compare badly to traditional private equity partnerships which continue to offer elsewhere a long term framework for institutions to operate within.

Regulatory risk also exists at a national level. An example of this was the recent publication by the Federal Ministry of Finance (Bundesministerium der Finanzen) of a new draft regulation amending the investment ordinance in response to the German Capital Investment Act (Kapitalanlagegesetzbuch or ‘KAGB’). This proposed regulation could significantly restrict investment by German insurance companies and pension funds in AIF based on rather arbitrary criteria that do not seem properly considered.

Fiscal risks
The other risk of misconstruction is fiscal and could prejudice the private equity industry in 5 immediate ways.

**Subscription tax**
Regulated partnerships would become subject to subscription tax. It is unclear to us on what basis subscription taxes could be applied to a société de personnes without a patrimoine.

**FTT**
Many Member States need money and the financial sector has already been targeted by the EU Financial Transaction Tax (FTT). This tax, together with the costs of implementing it, could well be a significant cost for financial institutions that will be defined to include AIF. The FTT is likely to cover both investments made by AIF’s as well as transactions in interests in AIF’s themselves. The FTT may well be followed by other new taxes targeting AIF’s.

**BEPS**
The BEPS action plan focuses on hybrid mis-match arrangements that may require a precise understanding of the difference between tax neutral UCI’s (i.e. tax exempted) and tax transparent partnerships (i.e. tax irrelevant) in looking at situations where “deduction/no inclusion outcomes” could arise (i.e. a distortion in international tax rates). BEPS could also have relevance in relation to the use of (i) tax treaties by UCI (i.e. in contrast to partnerships) and (ii) intermediate vehicles as holding or financing companies. The breadth of the BEPS action plan and a lack of clarity in relation to investment structures, gives rise to a real risk that certain forms of investment will be construed as abusive in a European context without identifying whether there is any abuse (i.e. is the tax base of another jurisdiction actually being eroded or profit shifted).

**Carried interest**
Carried interest is an enhanced share of the profits arising on the disposal of any investments made by the partners of a private equity partnership. This profit right, however, is mis-defined by the AIFMD as:

“a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF and excluding any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF,”

which renders the inclusion of ‘carried interest’ at all in the remuneration provisions of the Directive (and ESMA guidance on these) unsound intellectually. Carried interest is neither remuneration nor a management fee.
Such misconstruction is likely to confuse the debate in relation to the proper taxation of carried interest and the danger of this was recently highlighted by the Nordic case (2013). In this case, the Swedish tax authorities argued that carried interest did not represent the capital gains of a partner (in a co-ownership arrangement), but rather, in reality, was performance-related remuneration paid to executives (by a UCI). Stockholm's administrative appeals court dismissed the tax authority's arguments recognising the nature of returns from private equity partnerships. Skatteverket is currently appealing.

**VAT**

It leaves the VAT position of general partners unclear. This is because general partners of partnerships structured with capital accounts receive a priority profit share from the other partners (for value generated) as opposed to a fee from the provision of (exempt) management services to what may or may not be classed as an AIF (even though an AIF does not actually exist). This advance profit share suffered by the other partners is eventually recaptured so is not a fee at all.

As discussed in Paper I, a broadly defined management exemption and low headline rate of VAT are largely irrelevant in determining the competitive position of Luxembourg. Competitiveness depends on the recovery of input VAT incurred locally, which represents a significant burden for managers. This is because the commercial activity of private equity managers differs significantly from the activities of those managing traditional funds or real estate structures, and results in much higher costs being incurred. To date, the difference between the asset classes has simply been overlooked with a one-size-fits-all approach being adopted.

By not differentiating between UCI and partnerships and the different services provided to different parties, arguably, VAT rules are being fundamentally misapplied (i.e. taxing fictitious service provision and denying input recovery on real economic activity) and this state of affairs urgently needs re-examining. Reference should be made to the Deutsche Bank case (2012).
THE AIFMD EQUATION

It is self-evident that something is not quite right with the AIFMD. After years of headlines and sometimes coercive commentary from those with vested interests in the AIFMD’s success, it came and went in 2013 with little shift in the market. Outside small and explicable niches, enthusiasm for AIF-like products has not materialised and there has been a steady flow of new private equity partnerships being set-up outside scope (either in geographical or threshold terms).

Amy Bensted, Preqin’s head of hedge fund products, recently summarised matters:

“Quite a large proportion of US-based fund managers have told us over the last year they would not market in the EU as a result of AIFMD so there could be a pull-out of some US funds from the region, or they just may rely on reverse solicitation. Anecdotally, the US guys do seem quite wary of AIFMD … [it] is not practicable to the vast majority of American-based managers. Many US … funds would have to change their business models to do this, which is why so many are sitting on the side-lines.”

The problem of AIF status can be easily summarised in diagrammatic form:

Diagram

- **Downsides**
  - Incorrect
  - Unnecessary and exaggerated costs
  - Commercial risk
  - Product risk
  - Systemic risks
  - Fiscal risks
  - Regulatory risks

- **Upside**
  - Misconceived passport

This equation is an inescapable consequence of the application of the AIFM Law to all private equity partnerships (without distinction), and it will not re-balance on its own. The UK has carefully accommodated this equation through structural differences and London’s international position; however, it poses a more complex challenge locally. This equation must be addressed in Luxembourg because the unfavourable environment created by the AIFMD all but precludes it from consideration as a domicile for the larger, direct-investing private equity partnerships on any rational basis. The new government’s stated policy objective, therefore, is bound to fail.

To reiterate Paper I, and contrary to common understanding locally, the use of Luxembourg fund vehicles offers no general advantage to the private equity industry or investors that could otherwise have the effect of re-balancing the AIFMD equation, and the high operating costs and inefficiencies of the domicile more generally undermine its competitive position. Consequently, to achieve a level playing field, the authorities must look to re-balance the equation through a more sophisticated (and correct) approach to law that avoids the AIFMD mistake altogether.
The title of this Paper, the ‘AIFMD mistake’ is slightly misleading because the mis-application of the AIFMD to private equity partnerships is anything but a mistake. At some point after the publication of the Directive, European and certain national authorities began to recognise that the drafting of the AIFMD did not clearly reference private equity partnerships and sought to adjust transposition:

- to accommodate ‘partnership interests’ alongside references to ‘units’ or ‘shares’; or
- in the case of the FCA, to deny the need for negotiable interests, units or shares altogether under (the UCITS Directive and) the AIFMD.

In doing so, there can be no doubt at all that the relevant authorities acted in good faith to accommodate (i) what they felt were the original policy objectives of the AIFMD and (ii) subsequent policy decisions taken on the back on them (e.g. EMIR). Unfortunately, and benefitting from hindsight, the original policy objectives of the AIFMD were mistaken.

In adjusting the transposition of the AIFMD, the relevant authorities failed to recognise the conceptual difference between (i) UCI and (ii) co-ownership arrangements or société de personnes and, as a result, the extent of the AIFMD mistake. As a consequence, the rather superficial (and arguably unlawful) adjustments have little effect in accommodating private equity partnerships and give rise to breath taking risks that can be summarised by the AIFMD equation. Arguably, as a matter of market conduct, industry is under a fiduciary duty to make investors aware of these risks that could be avoided entirely by the use of traditional private equity partnerships; outside the EU if necessary.

The AIFMD mistake is a challenge to the integrity of the European rulebook and how it is applied in different Member States. Its importance goes far beyond the AIFMD and, as has been seen in Sweden (carried interest) and the UK (taxation of LLP’s), touches directly on other commercial, legal, regulatory and fiscal principles that depend on a proper understanding of partnerships. This challenge, however, is also an opportunity for the Luxembourg authorities to look again at what is required to achieve a successful financial place that could safely accommodate larger, more international private equity partnerships; outside the EU if necessary.

James Bermingham  
General Counsel  
Aztec Group  

Disclaimer: Aztec Group makes no representations in relation to the contents or the accuracy of this paper, which has not been formally verified. The purpose of this paper is to further understanding of a complex topic and should not be relied upon. Aztec Group does not give professional advice.
“...it’s better to confront harsh reality than to passively submit to it... when the rules are wrong, they must be changed...”

George Soros
Dear Madam,

BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

The Aztec Group is a specialist private equity fund administrator currently looking after approximately 180 private equity funds in Guernsey, Jersey, Luxembourg, the Netherlands, Sweden and the United Kingdom with a total value in excess of US$110 billion (together with numerous investment vehicles). We see at first hand the direct benefits that private equity brings to the European economy in promoting industrial efficiency and growth.

Thank you for inviting responses to the Public Discussion Draft published on 21 November 2014. We would very much like to clarify 3 points relevant to private equity investment.

1. The nature of alternative funds / private equity funds

(a) In the context of defining collective investment vehicles (CIVs) and ‘non-CIV funds’, it may be helpful to note that most private equity funds are not ‘undertakings for collective investment’ (UCI) in the legal sense intended by UCITS Directive 85/611/EEC or the Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD). Please refer to the Annex that was prepared in relation to an ESMA consultation.

(b) To explain, most private equity funds are in fact simple partnership agreements that facilitate co-investment by different institutions (such as government agencies, banks, insurance companies and pension funds) in target businesses under whatever contractual terms may be specifically agreed (i.e. partnerships are société de personnes). Partnerships can be seen as a form of joint ownership and, therefore, are typically tax transparent / have no taxable base to erode. UCI, in contrast, are legal vehicles that raise capital through the issue of [transferable] securities for the purpose of collective investment. By raising separate legal capital, UCI, while they may remain tax neutral (by virtue of special tax exemption), cease to be tax transparent and could become relevant in determining the application of treaty rights (e.g. SICAV’s).

(c) Although in a broad sense the term ‘private equity’ could cover all equity investments into unlisted companies, it has come to represent the buy-out and venture capital industry in Europe and should not be seen as a type of fund or confused with the broader alternative asset management industry (like hedge funds etc.). The focus of this letter is very much on the buy-out industry.

(d) The difference between simple partnerships and UCI and the nature of ‘private equity’ were discussed extensively in the context of the transposition of the AIFMD and we enclose a technical paper that we prepared for the benefit of the Luxembourg industry addressing these 2 points:

http://www.aztecgroup.co.uk/james-bermingham-industry-comment/the-aifmd-mistake
(e) If the OECD is considering a specific carve out for private equity funds from BEPS then it will be important to have a clear conceptual understanding of the different legal relationships that are often referred to as ‘funds’ as well as the economic activities that comprise the ‘private equity industry’ as well as understanding why private equity is not abusive (whether or not channelled through a CIV or a non-CIV fund). The risk is that the use of loosely conceived terms could cloud understanding and encourage further artificiality / repackaging in the future. This could drive-up costs for industry.

2. The use of intermediate holding companies

(a) Institutional investment capital is often channelled through partnerships into target businesses by way of intermediate holding companies located in lower tax jurisdictions. This use of intermediate holding companies in one jurisdiction reduces risk (especially where it is very stable), minimises permanent establishment risks and achieves administrative efficiencies for the partners (in terms of enabling a generic approach, facilitating composite filings etc.). Many jurisdictions are used.

(b) In the EU, intermediate holding companies ordinarily have a dual purpose:

(i) holding activities – namely, holding participations in the relevant target businesses. Returns are usually tax exempt and should be ignored when considering treaty abuses;

(ii) financing activities – these typically take the form of back-to-back loans with a small profit margin being realised by the financing company. These loans are priced in the context of a negotiated transaction and, therefore, it is easy to determine an appropriate price for the back-to-back loan on a cost plus basis without need to make reference to artificial (and expensive to access) comparators.

At present this ‘financing cost’ is minimal. It would be unfortunate if OECD-inspired anti-abuse rules had the effect of exaggerating ‘transfer pricing’ through transferring taxable activity to the intermediate state by:

(1) requiring an increase in the taxable profits realised by financing companies through the use of ill-inspired transfer pricing methodologies; and

(2) increasing the scope of taxable activities by requiring unnecessary substance (i.e. the adoption of uncommercial arrangements).

Increasing the taxable activities of financing companies would be at the direct cost of investors and their home states insofar as this resulted in the loss of taxable profits.

(c) Withholding tax is not ordinarily an issue in our experience, because, the institutions participating in a private equity partnership typically make the majority of their returns through capital gains on the disposal of participations in the portfolio companies. Where it is an issue however (like in connection with the odd interest or dividend payment from a portfolio company) and investors cannot otherwise offset the cost, then the use of intermediate holding companies is just one way of mitigating this possible tax in line with applicable national rules / competencies.

(d) Intermediate holding companies sometimes issue debt / equity hybrid instruments to mitigate ‘dry income’ and other problems suffered by partners in their home states. The treatment of these hybrids, however, is totally within the competence of the affected states and should not concern the OECD.

(e) Finally, it is worth reiterating that companies are legal persons and not businesses per se (i.e. a person may or may not trade). The creation of legal persons for...
administrative and legal purposes (e.g. limited liability) should not be presumed abusive.

3. **Risk to long term investment**

(a) Co-investment by institutions in target businesses, whether or not an intermediate holding company is used, does not logically result in any base erosion or profit shifting. In this regard, private equity investment is remarkably transparent insofar as it is as if the relevant institutions had acquired the target business directly (and double or triple taxation is avoided). Private equity funds should not be confused with UCI (that are often opaque for tax matters) or multinational holding companies.

(b) The risk for the private equity industry, its investors and their stakeholders posed by the BEPS Action Plan, is that anti-abuse rules (targeting well-known problems relating to the taxation of multinationals) capture investment structures where there is no actual base erosion or profit shifting occurring (i.e. there is no artificial supply of services transferring profits). The application of such anti-abuse rules would increase direct and indirect expenses that, in turn, would unnecessarily drive-up the cost of capital. This would be economically counter-productive.

(c) National rivalries increase the risk that BEPS will be mis-applied. The BEPS Action Plan could well be hijacked by states to implement capital controls and restrict cross-border investment (as we saw with AIFMD transposition).

If the OECD is serious about tackling abuses then, in an ordinary private equity context, it should ignore tax transparent arrangements entirely and focus on what ‘taxable income’ really arises in intermediate holding companies. If there is little (taxable as opposed to exempt) activity within them, then, contrary to what is often argued, very little margin should be realised. In this way, taxing rights would remain with the states of the investing institutions and the portfolio companies and scope for any abuse in between would be limited; not that there appears much abuse at present.

We hope that this submission is helpful and should you like any further information, please do not hesitate to contact me on +352 24 616 006.

Yours faithfully,

James Bermingham
General Counsel

Aztec Financial Services (Luxembourg) S.A.
7, rue Lou Hemmer L-1748
Luxembourg – Findel
Grand-Duché de Luxembourg
Annex – Tax, regulatory and risk analysis of private equity partnerships and AIF

1) Traditional, passive co-investment model: tax transparent and risk remote

Features:
1) No securities or capital raising.
2) No mutual pool.
3) No management of a pool, just an arranger.
4) Not a controlling shareholder.

Regulation will target a management function that doesn’t exist.

(a) Pre-agreed contractual returns, including (a) a priority profit share; and (b) a carried interest share.
(b) Pre-agreed returns from the investee companies: investor by investor (no mutuality). Pre-agreement is necessary for tax transparency.
(c) No management fee is payable as no “management” (so exemption irrelevant / unhelpful).
(d) It is the tax efficiency of the GP which is important, not the fund.

Important: Tested risk architecture with no systemic risks attaching.

2) Actively managed alternate UCI (AIF): tax neutral and systemically significant

Features:
1) Units, shares or other interests represented by securities.
2) Subscription monies are pooled collectively (i.e. NAV-based product).
3) A limited liability ManCo with discretion to manage the pool (i.e. portfolio management) and control subsidiaries (i.e. risk management concept and Chapter V, Section 2).

An unsuitable framework legally, for investing in real businesses with real risks (as opposed to passive securities).

(a) Distributions of income / capital from the fund at the discretion of ManCo.
(b) Returns paid to fund, not investors. This is why the withholding tax analysis can differ.
(c) Various examples of catastrophic risk could be given: SANDOS (88), SEVESO (76), BHOPAL (84) etc.
(d) In contrast to ordinary group holding companies, AIF are risk conduits that are linked to the local financial system.
(e) Not tax efficient in a private equity context.

Important: Each fund could result in the transfer of business risks to the local financial system/state. This is the regulatory paradox that can only be addressed with a special regime for private equity.

AiFMD Note: Partnerships investing in self-managed assets need little other management. In contrast, UCI investing in passive securities need a management company. Once this differential becomes clear, the futility of introducing manager-based regulation in a private equity context can be understood.
This response is submitted by the BEPS Monitoring Group (BMG). The BMG is a group of specialists on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Tax Justice Network, Christian Aid, Action Aid, Oxfam, Tax Research UK. This response has not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This response has been prepared by Francis Weyzig, with input from Jeffery Kadet, Christiana HJI Panayi, Yansheng Zhu and Sol Picciotto, and with comments from other members of the Group.

We welcome the opportunity to comment on the Public Discussion Draft regarding Follow-up Work on BEPS Action 6: Preventing Treaty Abuse, published by the OECD on 21 November 2014. Our comments build on the BMG’s previous submission on 9 April 2014, in response to the first Public Discussion Draft on Action 6, and the BMG’s OECD BEPS Scorecard, which discussed the OECD’s Reports on Action 6 of 16 September 2014. In our view, the scorecard highlighted some issues that require continued attention.

We will begin with some general comments, and then address some (but not all) of the specific questions posed in the current Public Discussion Draft.

1. GENERAL COMMENTS

The current discussion draft asks for input on specific technical issues, including some rather detailed ones, to support decision making on the final text. This raises the question how the OECD will approach urgent political issues regarding the implementation of measures against treaty abuse. We acknowledge that these may be more difficult to include in a public consultation round, but we are concerned that the OECD has not presented a clear strategy so far for implementation of the proposals.

A strong mechanism is required to ensure implementation especially by key countries

It is important to face up squarely to the problem that the majority of existing treaties do not contain any anti-abuse provisions, and almost none have one in the form now proposed. Including these provisions into existing treaties will require the consent of all partners to existing treaties. Even if this process is speeded up through the proposed multilateral instrument, it would require all relevant states to accede to that instrument. This would need to include states which have developed extensive treaty networks, sometimes combined with domestic laws that make them suitable to use as conduits for investments. These include OECD and G20 countries (e.g. the Netherlands, Switzerland) as well as non-OECD/non-G20 countries (e.g. United Arab Emirates, Qatar and Mauritius). Many developing countries have few or even in some cases no tax treaties, and in some respects they may be considered fortunate. However, if they have even one treaty, it may be used as a conduit for investment, unless it contains an anti-abuse provision.
Hence, a key political issue is how to prevent any country from operating as regional or global treaty-shopping platform. If key countries with special tax treaty networks would not cooperate to implement Action 6, it would be severely undermined. Treaty abuse can only be effectively addressed if all relevant countries cooperate. Developing countries are not in a position to easily persuade treaty partners to amend their existing treaties. The only effective measure would of course be for countries to threaten to cancel existing treaties, but this would be highly impractical for individual states and in some cases there might be repercussions. OECD members and G-20 countries should therefore use their political power to bring in all key non-OECD/non-G20 countries, agreeing on a strong mechanism to enforce cooperation if necessary.

This issue should be addressed separately from the discussions on the content of the proposed multilateral instrument. Countries with special treaty networks may be reluctant to refuse openly the addition of the proposed anti-abuse provisions to existing treaties. However, they may attempt to barter their consent in order to ensure that other provisions of the multilateral instrument would be acceptable to them. This could put at risk many of the potential gains of the BEPS project.

We therefore suggest that a political commitment should be sought now through the G20 to support a Declaration Against Harmful Tax Practices. Such a Declaration should include a commitment to include in all tax treaties the minimum standard for anti-abuse provisions now proposed under Action 6. It should of course also encompass commitments to accept the proposals and standards to combat Harmful Tax Practices being developed under Action 5.

**Developing country preferences should have priority**

A second key issue is how to decide which type of anti-abuse provisions will be applied to each treaty. If a non-G20 developing country has a strong preference for a specific provision, we suggest that the choice of the developing country should be decisive in determining the type of provision in its treaties with OECD and G20 partners. Expecting developing countries to have to apply a range of different anti-abuse measures would unnecessarily strain their administrative capacity. Clearly, this issue has implications for Action 15 on the development of a multilateral instrument as well.

Developing countries explicitly requested at the BEPS engagement meeting on 11-12 December 2014 that outputs should be practical and easy to implement. A failure to deliver on this would not just hamper effective implementation of measures against treaty abuse, but could affect the whole range of BEPS Actions, especially if other Actions result in high administrative burdens too. In case OECD members cannot agree how to resolve this, the CTPA should point out clearly that they are putting the success of the whole BEPS project at risk. However, developing countries have a responsibility themselves too, because they also have treaties among themselves. It is in the interest of all that implementation becomes not too burdensome.

It might be useful if the CTPA makes an inventory of all countries’ preferred type of anti-abuse measures. If it turns out that a large majority of capacity-constrained developing countries prefers a single type, this could be made the default option, including for the multilateral instrument.

**Limiting complexity should be a guiding principle**

The existing network of thousands of bilateral tax treaties, all of them different, inherently creates a lot of complexity. The various options for anti-abuse provisions in tax treaties will make the international tax system even more complex. Under the proposed minimum standard, some treaties may include a principal purposes test only, others a limitation-on-benefits rule plus an anti-conduit rule, and yet others a combination of limitation-on-benefits plus a full principal purposes test. This makes it challenging to achieve practical and easy implementation. Further technical decisions can
still make a substantial difference, though, and limiting complexity where possible should therefore be a guiding principle for finalising the model treaty provisions.

The following suggestions could limit complexity and therefore make it easier to implement the proposals for Action 6:

- Present a default option for anti-abuse provisions in the model text, reducing the use of alternative choices;
- Align the wording of the LOB and PPT clauses as much as possible and ensure that their commentary is clear and concise;
- Provide further clarifications and practical examples in the Commentary, for example on the difference between “associated enterprise” and “persons connected to a person” used in the proposed LOB rule, and between “primary place of management and control” used in the proposed LOB rule and “the place of effective management” used in other tax treaty provisions;
- Limit provisions designed for specific situations, recognising that limiting complexity is more important than designing treaty provisions that lead to the desired outcome in all conceivable situations;
- Limit the scope for discretionary exemptions;
- Adjust existing treaties with LOB or PPT clauses to the new standard.

In the long term, a more fundamental reform of the international corporate tax system may be required to overcome the ever-increasing complexity of the current system of bilateral tax treaties.

**Technical assistance to developing countries should be fully integrated into the BEPS project**

A related technical issue is how to effectively implement the proposed LOB rule in developing countries. As mentioned in paragraph 16 of Action 6, the proposed LOB rule is based on the experiences of the US, Japan and India. Thus, the rule might be not easily understandable for competent authorities in developing countries that have not concluded tax treaties with one of these three countries. Some developing countries also have domestic legal systems that differ substantially from those on which the proposed LOB rule is based, therefore a mismatch resulting from the underlying domestic legal system might occur, which would undermine the effect of anti-abuse measures. Furthermore, for countries in which English is not an official language, it is a major challenge how to precisely translate the proposed LOB rule into their own languages in order to have it properly implemented by their competent authorities. In view of all factors mentioned above, it would be essential that developing countries receive sufficient technical assistance and capacity building to implement the anti-abuse provisions proposed under the Action 6. Unfortunately, the current set of proposed Actions for the BEPS project does not include an explicit commitment to ensure sufficient technical assistance and capacity building for the implementation of each Action in all developing countries. The necessary support should therefore be fully integrated into the BEPS project, for example as part of the final plans for Action 6 and each of the other actions.

**Effective implementation requires exchange of information**

Tax authorities of residence states often have access to information that is relevant to source states for the application of anti-abuse provisions. In fact, without such information, effective implementation of anti-abuse measures becomes very difficult. Tax authorities of source countries might face a large
administrative burden if they would have to assess or verify the financing and activities of foreign investors themselves. Effective implementation therefore requires spontaneous exchange of information by residence states. The OECD model treaty should therefore include an obligation, or at least a strong recommendation, that treaty partners exchange information that is foreseeably relevant for the application of anti-abuse provisions.

2. SPECIFIC QUESTIONS

Question A3: Discretionary relief provision of the LOB rule

Maximum transparency is required

Generally, the ability to give discretionary relief could generate many problems and perpetuate base erosion and profit shifting arrangements. Large firms seeking discretionary advantages and lack of transparency about discretionary tax rulings are major problems, as illustrated by a range of Luxembourg leaks files. Therefore, the parameters for discretion ought to be clearly defined. It would be helpful if the OECD clarifies, in its Commentary, that discretionary relief is intended for exceptional situations only.

The possibility for discretionary relief could also give rise to undue pressures on tax officials and create an enabling environment for corruption. Exchange of information on positive discretionary relief decisions among competent authorities would not help to create the necessary domestic checks and balances. To discourage corrupt practices, and to create more clarity for tax payers, the OECD should strongly recommend that tax authorities publicly disclose their decisions regarding requests for discretionary relief, including explanations of the decision. These could if necessary be anonymised. Various OECD countries, including the US, already have such a system in place for tax rulings in general.

In addition, the OECD could require tax authorities to exchange information on such decisions. They should be included in the procedures proposed for compulsory spontaneous exchange of information under Action 5.

Application in the EU will be restricted

As for EU Member States, any power to give discretionary relief must be tested against the state aid prohibition (Art 107 TFEU). Aids given contrary to the Treaty provisions are incompatible with EU law and have to be recovered. There are five cumulative requirements for under the Treaty.

1. There has to be an aid in the sense of a benefit or advantage,
2. granted by a Member State or through Member State resources,
3. the aid must favour certain undertakings or the production of certain goods (the ‘selectivity’ principle),
4. distort or threaten to distort competition,
5. and must be capable of affecting trade between Member States.

The Commission’s draft Notice on the application of the State aid rules to measures relating to direct business taxation (OJ 98/C 384/3) reiterates that treating taxpayers on a discretionary basis may indicate selectivity where the exercise of the discretionary power goes beyond the simple management of tax revenue by reference to objective criteria. There have also been a number of legal cases on this point.
Furthermore, in the past few months, the Commission has issued several decisions against some Member States on the basis that their advance pricing agreements led to selective tax advantages contrary to the state aid prohibition. The multinationals and jurisdictions involved were Apple in Ireland, Starbucks in the Netherlands and Fiat in Luxembourg. The fact that the Commission started investigations in this area suggests that it is likely to continue scrutinising discretionary practices of tax authorities.

**Practical example illustrates complexity**

Drawing from practical experience, we can think of situations where discretionary relief would be appropriate. At the same time, it can be very difficult to distinguish such situations from undue tax avoidance. As a consequence, the possibility for discretionary relief can make the application of the LOB rule very complex, creating a large administrative burden for tax authorities. The following example, which the OECD might use in the commentary, illustrates our point.

Suppose a company from country A and a company from country B form a 50-50 joint venture. This joint venture assembles the two companies’ products into a single product that would be sold to customers. The joint venture would not be a controlled subsidiary of either joint venture partner. The two companies plan for the manufacturing facility to be in country C and for all products to be sold in C. The joint venture agreement provides that if the manufacturing and sales in C are a success, then they would want to form additional joint venture operations in other countries.

If the company to be formed in C were itself the joint venture vehicle, directly owned by the two joint venture partners, then the management of the joint venture company would likely want any future joint venture operations in other countries to be formed as subsidiaries of the joint venture company in country C. However, this might result in an additional layer of withholding taxes as dividends are distributed from subsidiaries in other countries to the joint venture’s headquarters in C, and then onwards from C to the joint venture partners in A and B.

In this case, one might consider it appropriate that the joint venture establishes its parent company in an intermediate country, and structures any future expansions as direct subsidiaries of this parent, with a view to reducing effective withholding taxes for profits from those future operations to the rates that would apply to direct distributions from the subsidiaries to the joint venture partners in countries A and B. In this case, discretionary relief could be granted by country C as well as the countries of future expansion if the LOB requirements in their tax treaties with the intermediate country are not otherwise met. However, it could be very difficult to distinguish such a situation from a conduit structure where there is no intention to meaningfully expand operations into other countries. In addition, it would be undesirable that in this situation discretionary relief were to result in effective withholding taxes that are lower than the withholding taxes on direct distributions to A and B. This raises the question whether partial discretionary relief could be an option too, which would create even more complexity.

**Questions A4-6: Equivalent beneficiary and derivative benefits provisions of the LOB rule**

**EU law allows application of LOB rules**

Strictly speaking, a derivative benefits clause is not yet required under EU law, because the Court of Justice in the famous D case has accepted the bilateralism of tax treaties and did not demand an most-favoured nation (MFN) clause (Case C-376/03 [2005] ECR I-5821). In other words, in this case the Court found that the tax treaty benefits given under a tax treaty were unique to that tax treaty so an EU national not benefiting under the treaty (as he was not tax resident in the treaty countries) could
not demand the extension of treaty benefits. This reasoning was followed in the *ACT Group Litigation* case (Case C-374/04 [2006] ECR I-11673) and extended to LOB rules, showing the Court’s reluctance to interfere with anti-treaty-shopping provisions. LOB rules were considered to be a natural corollary of the bilateralism enshrined in tax treaties. They were characterised by the Court of Justice as “an inherent consequence of bilateral double taxation conventions”, not precluded by Treaty provisions on freedom of establishment.

Therefore, although LOB rules contain mechanical tests, similar to those that the Court has found to be disproportional in its general tax abuse case law, the Court has specifically refrained from striking down LOB rules.

**Question B15: Discretionary relief under the PPT rule**

*Discretionary relief should be left out or least clearly restricted*

As far as we are aware, existing tax treaties with a main purpose test do not provide for the possibility of discretionary relief, so it is not immediately clear why such a possibility is necessary. It is difficult to think of a situation where discretionary relief would be essential. In our view, the example of a capital gain on shares mentioned in the discussion draft should not qualify for treaty benefits, because it is equivalent to a dividend distribution in economic terms.

If some OECD members insist on allowing discretionary relief under the PPT rule, the guidance in the Commentary should make clear that situations where discretionary relief is warranted will be rare. The parameters for discretion ought to be clearly defined and there should not be any encouragement in the Commentary or elsewhere to provide discretionary relief where a taxpayer has voluntarily entered into an avoidance arrangement. Furthermore, similar to the discretionary relief provision under the LOB rule, maximum transparency would be required on all discretionary decisions to prevent an enabling environment for corruption.
Dear Marlies,

Please find below BIAC’s comments on the OECD Discussion Draft on Follow Up Work on BEPS Action 6: Preventing Treaty Abuse, issued on 21 November 2014 (“Discussion Draft”).

Firstly, thank you and your team for remaining open and flexible in your contacts with stakeholders, despite the intense pressures that you are under. In turn, in order to be as helpful as possible BIAC has again sought to draft a consensus document that represents business views more generally, rather than simply passing on views from our members.

We would like to start by saying that we feel there have been some positive developments in relation to Action Item 6, such as recognising the need to address specific issues faced by various forms of funds, and continuing the dialogue around certain Limitation on Benefit clauses. However, there is an underlying concern among BIAC members that many aspects of the proposals continue to risk removing treaty benefits in what are genuine commercial situations. We have already made representations in relation to this, and we are somewhat disappointed that our concerns have not been addressed in this new Discussion Draft. We have highlighted some of these points again in our response, below, so that we do not lose sight of these important issues.

Purpose of Action Item 6

BIAC continues to support the broad aims of the BEPS initiatives, to tackle abusive tax avoidance by a minority of taxpayers. In relation to Action Item 6, however, this must be addressed in a balanced and efficient manner, allowing the clarity and certainty of Treaty benefits appropriate to the vast majority of taxpayers entering into genuine commercial transactions.

We reiterate our view that the primary route to tackling avoidance should be through local tax law. Treaties should remain focused on removing double taxation and promoting international trade. The only avoidance to be addressed in Treaties should be where benefits are obtained under the Treaty in an unintended manner; or where the Treaty would otherwise override the local law aimed at tackling the offending avoidance.
Complexity, Clarity and Predictability

BIAC supports the principle that Treaties should not create unintended opportunities for double non-taxation. BIAC also supports the removal of Treaty benefits, where a structure has been artificially established solely for the purpose of obtaining Treaty benefits. However, again, it is important that there is protection for bona fide commercial arrangements.

BIAC continues to have concerns over the layers of rules currently being proposed, which include a Limitation on Benefits Article, a Principal Purpose Test, and a series of Specific Anti-Avoidance Rules. These will be in addition to current rules, such as those relating to beneficial ownership of income. We believe these layers will add considerable complexity, cost, and uncertainty.

The Model Convention should provide that either a Limitation on Benefits, or a Principal Purpose Test approach should be adopted, but not both. Whichever approach is taken, this should be simple and not overly restrictive, whilst providing protection against “treaty shopping”.

In order to resolve conflicts effectively (and as already noted), a more streamlined dispute resolution process is required, with, ultimately, a mandatory binding arbitration mechanism.

The Purpose of Treaties

Tax Treaties are principally entered into to promote global growth by removing the barriers to cross-border trade and investment caused by double taxation. Facilitating the development of a broad network of Tax Treaties has been one of the most significant of the OECD’s contributions to the expansion in international trade and investment over the past fifty years, and significantly altering Treaty protection should, we suggest, be approached with considerable caution.

In this regard, as I pointed out in our original submission, the proposed preamble devotes one line to the prevention of double taxation and three lines to the prevention of abuse. It is certainly entirely appropriate to prevent abuse of Treaties, but it is not the purpose of a Treaty to prevent that abuse. If we view Tax Treaties primarily as an anti-abuse tool, then we risk seriously damaging one of the OECD’s most successful instruments.

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We hope that you find our comments useful. We look forward to participating in the public consultation on 22 January, and would also be happy to help in any other way that we can.

Sincerely,

Will Morris, Chair
BIAC Tax Committee
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High Level Observations

1. BIAC supports a common OECD framework to address Treaty Abuse issues. We would recommend, as a point of policy, that the OECD pause Treaty Abuse discussions, in order to continue to allow for alignment with other BEPS actions, such as via the Hybrids work, since many of the concerns arising in the Treaty Abuse Discussion Document may then fall away.

2. Treaties are principally designed to remove the barrier of double taxation, in order to promote cross border trade and investment. They are bilateral arrangements entered into by States in order to determine the agreed allocation of taxing rights. Unilateral discretions to deny benefits based on subjective criteria are therefore not only cause for concern for taxpayers, but also for governments, as taxing rights may be usurped. The value of Treaties is significantly reduced if the applicability is less certain.

3. The current PPT test ("one of the main purposes") is widely framed. Even with the examples in the Commentary, there is a risk of misinterpretation, or misapplication by tax authorities. We would recommend focusing on substance. We would also recommend that if the two tax authorities have differing views, that there should be prima facie assumption that it is not reasonable to conclude that obtaining treaty benefits was one of the principal purposes.

4. Application of Treaty benefits should not be considered to be abuse, and BIAC is concerned that anti-avoidance provisions not be used selectively to deny benefits that States have agreed under the Treaty to provide. If there is a problem with the Treaty, then the Treaty should be revised.

5. It is noted in the “Action Plan on Base Erosion and Profit Shifting, OECD, 19 July 2013” that “No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.” Companies should not be seen to be abusing Treaty benefits where a business or activity is set up for genuine purposes. This aligns with our comment in 3 above, that more focus should be given to substance, and ensuring treaty benefits are available to bona fide commercial arrangements.

6. Tax avoidance should be addressed through coordinated and consistent local tax laws, using approaches such as the work under Action 2 ("hybrids"). Treaties should in principle focus on tackling double taxation issues. However, BIAC supports the initiative that Treaties should not create unintended opportunities for double non-taxation. BIAC therefore supports removal of Treaty benefits, where a structure has been artificially set up solely for that purpose; or where the Treaty would otherwise override the local law aimed at tackling the offending avoidance.

7. We believe that the use of either a PPT or an LOB is appropriate, but a combination will be unnecessarily burdensome. The layers of rules that need to be assessed; the complexity of those rules; potential interpretations and different applications by States in practice, give rise to an increased administrative burden, and uncertainty. We do understand and support the idea that abuse of Treaty provisions should be prevented, in order to secure the benefit of Treaties more broadly. However, we feel that the Model Convention should provide that either a LOB, or a PPT approach should be adopted, and not both. If they are well constructed and appropriately targeted against artificial structures, then they should in

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*As previously noted*
principle address the same scenarios, whilst not denying treaty benefits for genuine commercial arrangements. Adopting both in the same Treaty would almost certainly add complexity and uncertainty whilst not providing any additional protection against "treaty shopping".

8. Tax incentives: where tax incentives are made available, and such incentives are not judged “harmful” on objective criteria (taking account of the OECD’s work on Action item 5), then taking advantage of such incentives should not be seen as abusive, and specifically in terms of Action 6, not as Treaty Abuse. Treatment of Tax sparing (which could be considered a form of double non-taxation), needs to be clarified specifically.

9. Where a State is seen to be entering into Harmful Tax Practices, that should also be addressed under appropriate domestic legislation; or by entering into a Protocol addressing the issue appropriately, rather than through one sided denial of Treaty benefits. Anti-avoidance clauses should not be used by one State to counter or address tax policy decisions made by the other State. We are concerned that simply denying Treaty benefits for existing structures in such cases, will lead to tax base effectively being moved from one Treaty partner to another with resulting double taxation (and adverse effects on investment).

10. States should assess Treaty risks before entering into an agreement; and have an obligation to exit treaties in a controlled and transparent manner that are seen to be consistently abused in order to retain predictability of treatment, rather than seeking to apply them selectively.

11. In order to address situations not anticipated by the Treaty, there should be provisions to request upfront Competent Authority confirmation that a structure is not abusive, and therefore the anti-Abuse provisions (whether Limitation on Benefits, or PPT Rule) do not apply. Failure to agree (upfront or at a later stage) should result in a mandatory binding arbitration procedure, with a clear and limited timeframe.

12. The Anti-Avoidance provisions should recognise that holding, financing and investment activities (including licensing) are normal and legitimate business activities that should not suffer blanket exclusions from Treaty protection. Any perceived avoidance should be addressed through local law, and not by removing Treaty benefits from genuine structures.

13. We note that there will be a significant increase on the resource requirement of Competent Authorities, and we have a concern over the responsiveness, clarity and certainty of treatment as a result. We recommend that increased reliance on Competent Authority procedures be backed by a corresponding increase in the availability of appropriately trained and experienced Tax Authority resources for such procedures. Enhanced dispute resolution mechanisms, including mandatory arbitration, should also be addressed in Action 14.
BIAC consensus responses to OECD Discussion Draft

A. Issues related to the LOB provision

1. Collective investment vehicles: application of the LOB and treaty entitlement

<table>
<thead>
<tr>
<th>Issues on which comments are invited</th>
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<tr>
<td>- Whether the recommendations of the 2010 CIV Report continue to be adequate for widely-held CIVs</td>
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<tr>
<td>- Whether any improvements should be made to the conclusions included in that Report</td>
</tr>
<tr>
<td>- Comments, for example, on whether to provide a single preferred approach for the application of the LOB to CIVs, and if so, what that should be</td>
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Overall

BIAC believes, based upon our leadership of the business delegation to the informal consultative group that developed the CIV Report, that the recommendations of the 2010 CIV Report are sound.

We also believe, based upon our ongoing discussions with representatives for the widely-held CIVs addressed in the Report, that the recommendations should not be modified.

While a single approach, on the surface, has the appeal of simplicity, the variables in the structures, investor base, and investment policies of CIVs make a single approach impractical and would deny treaty access to numerous CIVs that should have access to treaty benefits.

Background Discussion

The CIV Report was the result of a concerted effort to provide CIV investors, regardless of how their CIV was structured or sold, with the opportunity to enjoy the benefits and efficiencies of collective investment without being penalised by the loss of the treaty relief that they would have received if investing directly. The effort was undertaken because, in general, only those investors in CIVs that are treaty entitled in their own right (as persons, residents, and the beneficial owners of their income) were receiving treaty benefits. The other options provided by the Report, such as allowing a CIV to claim treaty relief on behalf of its eligible investors and allowing a fund to be treated as transparent, were designed to extend treaty relief to investors in fund structures that are pass-through in nature. This improvement could benefit CIVs that, for example, are distributed in multiple countries or, alternatively, only to pension funds.

Another important aspect of the CIV Report involves procedures for establishing the treaty eligibility of CIV investors. In some cases, the Report notes, it may be appropriate to treat the CIV as satisfying any applicable limitation on benefits provision because the CIV’s investors are predominantly resident in the CIV’s residence country; this situation could arise, for example, if the CIV were distributed only within its country of residence, particularly if the resident country’s CIV tax regime provided adverse tax treatment to non-resident investors. When interests in a CIV are distributed only within its own country of residence, we believe treaty benefits should be available without the administrative burdens and costs of collecting and verifying proof of investor eligibility. When “proof” of investor treaty eligibility is necessary, to alleviate the potential material administrative burdens, such proof generally should be required only annually and never more
frequently than quarterly. Moreover, the CIV Report notes, countries should accept “practical and reliable” approaches for identifying investors.

In discussing “eligible” investors, the CIV Report noted that many CIVs are distributed in multiple countries with which a source country has a treaty. Many CIVs, for example, are distributed widely in European countries that have broad treaty networks. In situations such as these, BIAC believes, it is appropriate to treat all CIV investors who are resident in countries with which the source country provides treaty relief as treaty-eligible; these investors would receive treaty relief had they invested directly, rather than through a CIV, in the source country. CIVs exist to provide efficient access to the capital markets for all investors and provide economies of scale; by their very nature, they never are formed for the purpose of attaining treaty benefits. Equivalent beneficiary treatment is essential to ensuring appropriate treaty relief for investors in CIVs that are marketed globally and that investors are not penalised by higher taxation by reason of choosing this efficient means of investment.

The CIV Report’s rationale for proposing various alternative approaches – rather than a single method – for allowing a CIV to establish treaty eligibility remains sound. CIVs are not the same – in structure, in operation, in investor base, or in distribution strategy. The Report provides mechanisms for all CIVs – regardless of their differences – to secure treaty relief for their eligible investors when the alternative standards are met. Were only a single method advanced, treaty relief for many investors (e.g., those in CIVs that are treaty entitled in their own right) would be denied and many CIVs would have to be restructured in costly and inefficient ways to avoid penalising their investors by the loss of treaty benefits to which they would otherwise be entitled.

CIVs also are not the same as other investment vehicles. The CIV Report was limited, expressly and purposefully, to “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.” The rationale for this limitation was the need to address the distinct burdens of establishing treaty eligibility for individuals – typically numbering in the tens or hundreds of thousands – who invest in CIVs through intermediaries such as banks or brokers that may choose to hold their clients’ investments in nominee (or “street name”) accounts.

Ensuring appropriate treaty eligibility for investors in other types of investment vehicles should be pursued actively by the OECD – perhaps by adopting the same approach that was used to develop the CIV Report. Because of differences between CIVs and other investment vehicle types, however, this work should not impact in any way the CIV Report or hinder the implementation of its conclusions.

The OECD also should continue its strong support for the Treaty Relief and Compliance Enhancement (TRACE) implementation package. TRACE’s investor documentation and reporting mechanisms will provide countries with additional assurances that the claims investors make for treaty relief are appropriate.
2. Non-CIV funds: application of the LOB and treaty entitlement

Issues on which comments are invited

- Whether the Discussion Document accurately describes the treaty entitlement issues of Sovereign Wealth funds, pension funds, and alternative funds/private equity funds

- As regards more specifically the situation of pension funds:
  - whether and how the issue of the treaty residence of pension funds should be addressed
  - whether changes should be made to paragraph 69 of the Commentary on Article 18
  - whether drafting changes should be made to the alternative provision included in paragraph 69 of the Commentary on Article 18 (e.g. restricting its application to portfolio investment income)
  - how the 50% ownership test could be modified in order to address cases where it may produce inappropriate results, without creating opportunities for treaty-shopping
  - how the description of pension funds found in subparagraph 2 d) of the LOB rule (“person that...was constituted and is operated exclusively to administer or provide pension or other similar benefits”) could be clarified

Overall

Focus on Pension Funds

Pension funds help individual wage-earners achieve long-term financial security. Society at large benefits from these funds because the resulting financial security of the elderly reduces the need to raise tax revenue from the public at large to support them.

In the typical arrangement, a relatively small portion of a worker’s total compensation is contributed to the plan by the employer and/or the employee. The contributed amounts, along with the plan’s earnings, grow over an extended time period.

Countries typically provide their local pension funds with favourable tax treatment, e.g., no current tax on a pension fund’s income. This favourable treatment is provided not only because it enhances the value of the fund and further promotes long-term financial security but also because pension funds are not viewed as “tax-abusive” vehicles. By treating such funds as deemed compliant for FATCA purposes, for example, the US government effectively concluded that such funds do not raise tax avoidance concerns.

Those pension funds that diversify their risk by investing globally, however, face potential negative withholding tax consequences. To address these concerns, and promote risk diversification, many treaties now exempt from withholding tax the income and gains of resident pension funds. As noted in the public discussion draft, however, difficult treaty entitlement issues may arise if the pension fund invests through a third-country vehicle or has beneficiaries resident in third countries.

Given the valuable role performed by pension funds and the limited prospect for tax avoidance, BIAC questions the need for such funds to be subjected to LOB or principal purpose tests. Any time that two countries have agreed to exempt each other’s pension funds from tax, they have acknowledged the social good that such funds provide.
In the “typical” situation – in which the pension fund participants and beneficiaries reside in the same country as the business that established the plan – the BEPS 6 recommendations should have no impact. In this typical situation, the pension fund’s residence is the same without regard to whether residence is determined based upon the country in which the business operates or the country in which the plan is established. The only caveat on this “no impact” assessment is that any procedures for establishing treaty eligibility must be applied reasonably.

For businesses operating globally, however, the BEPS 6 recommendations may create some issues. Such funds, for example, are more likely to include workers resident in multiple countries. Even if separate plans are created for workers in each country, employees from one country working in another may return home to retire and become “non-resident beneficiaries” of the plan.

Furthermore, as cross-border investments are made to diversify the fund’s investment risk and enhance their value, LOB and principle purpose test rules should be applied sparingly, if at all. LOB rules in particular seem inappropriate in this situation.

Finally, we recommend that examples be provided of the types of situations in which the principle purpose test might be applicable.

Focus on non-CIV Investment Funds

Guidance should be provided to ensure that treaty-entitled investors in non-CIV investment funds, making commonplace cross-border investments, receive the relief negotiated by their relevant States. This guidance will provide better certainty, encouraging continued cross-border investment growth, and more effective capital allocation.

3. Commentary on the Discretionary Relief provision of the LOB rule

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<th>Issues on which comments are invited</th>
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<tbody>
<tr>
<td>Suggestions are invited as to possible factors or examples that could be included in the Commentary on the discretionary relief provision of paragraph 5 of the LOB rule in order to clarify the circumstances in which that provision is intended to apply</td>
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</table>

General Comments

We welcome the Discretionary Relief rule as a fall-back provision to reverse denial of treaty benefits where they should be available.

However, this route should not be seen as a solution for every situation, since it creates uncertainty, causes delay, increases costs, and places pressure on resources of tax authorities. Such an outcome will reduce the value of treaties, and detract from their aim to remove the barrier of double taxation, in order to promote cross-border trade and investment. Targeting anti-avoidance accurately, is paramount.

An advanced ruling process should be made available, with an appropriate timescale [e.g., 2 months] for agreed outcomes, in order to provide business the predictability that is needed in order to ensure double taxation does not arise, in advance of making investment decisions.

We would also welcome guidance and examples of how Joint Ventures (“JV”) should be able to retain intended Treaty benefits, particularly in situations where a JV holding company may be set up in a third State, with little substance, but for purely commercial reasons with no tax motive.
Specific Comments

Paragraphs 62 and 63 of the Commentary highlight that an entity should not have as one of its principal purposes the obtaining of benefits under the Convention; and that there should be clear reasons, other than obtaining treaty benefits for its formation, acquisition and maintenance.

It is proposed in the Discussion Document, that the fact that such an entity may not have the availability of lower withholding rates than would have applied to its parent, does not satisfy these criteria. Unless there are other treaty benefits of which the entity makes use, it is difficult to see how obtaining treaty benefits could be a principal purpose for its existence, when those rates are not lower than could have been achieved directly by the parent. We would welcome some clarification as to the avoidance which the OECD has in mind when making this proposal in the Discussion Document.

We would propose that there be a rebuttable assumption of non-abuse, in situations where the treaty with the ultimate parent provides for a rate of WHT which is not higher that then one with the direct beneficiary of the income.

4. Alternative LOB provision for EU countries

We agree with the observation that the LOB provisions need to allow compliance with EU law. The recommendations in this paper, if implemented, should not cause for further changes in order to address EU law requirements.

5. Requirement that each intermediate owner be a resident of either Contracting State; and

6. Issues related to the derivative benefit provision

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<td>suggestions are invited on possible changes that could be made to the derivative benefit provision (paragraph 4 of the LOB rule), the definition of equivalent beneficiary (paragraph 6 of the LOB rule) or other provisions of the Model Tax Convention in order to assist in the work on the other parts of the Action Plan and ensure that the inclusion of a derivative benefit provision would not raise BEPS concerns whilst providing that cases where intermediate companies are used for valid commercial reasons are not excluded from treaty benefits</td>
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Overall

The purpose of treaties is to remove double taxation in order to promote cross border trade and investment. The success of treaties in encouraging economic activity has been widely realised. This aim must remain fundamental to any treaty network.

We agree that Tax Treaties should not be abused, not should they be used to create double non-taxation. However, in order to retain the economic benefits realised by Treaties over the decades, we strongly recommend that Tax Treaties should not be used as a tool to tackle other avoidance. Such issues should be addressed by local domestic tax legislation, and where appropriate, it should be made clear in Tax Treaties which articles of domestic legislation override the Treaty, in order to ensure the Treaty is not used to circumvent specific domestic anti-avoidance laws.

Treaty networks should continue to eliminate or reduce double taxation as widely as possible, with the exception of circumstances where the Treaties themselves are being abused.
Specific Comments

As already noted, the fundamental purposes of double tax treaties are to facilitate cross border trade and eliminate double taxation. The new proposed OECD Model Treaty includes a limitation on benefits (“LOB”) provision that would deny treaty benefits where there is purported “treaty shopping”. However, the proposed Model Treaty will deny treaty benefits where there is no treaty abuse, including situations where intermediary companies are being tested in addition to the ultimate beneficial owners, e.g., publicly traded companies. In our view, the elimination of intermediary company testing would:

- Be consistent with the fundamental purpose of treaties to encourage cross border trade and eliminate double taxation;
- Alleviate situations where the testing of intermediary companies would deny treaty benefits even where there is no treaty shopping motive;
- Allow more flexibility to account for inherited structures from M&A transactions; and
- Reduce a significant compliance burden.

For this reason, we believe that it is important to reiterate what has previously been said: the Model Treaty should focus on the Contracting State of the ultimate beneficial owners (“UBO”), and not test intermediary companies. There are a number of areas where this is relevant. We highlight below some examples, to demonstrate commercial situations where the Model Convention would fail to meet the objectives of facilitating cross border trade and removing double taxation in the future.

Subsidiaries of publicly traded companies (“Sub test”)

The proposed Model Treaty requires a 50% owned subsidiary to be a resident of a Contracting State and for its publicly traded parent to be a qualified resident of a Contracting State. The Model Treaty also requires that each intermediary subsidiary be a resident of either Contracting State; however, the Commentary to the Model Treaty notes that this requirement may be considered too restrictive by some States. We also agree that testing intermediary companies is too restrictive, and would lead to denial of treaty benefits where there is no treaty shopping. This restriction should be removed.

Such an approach would be consistent with the “minimum” standard approach for the Model Treaty, and would allow more flexibility to account for inherited structures from M&A transactions, etc. It would also reduce the significant compliance burden, and focus on the ultimate beneficial owner (“UBO”), which is the key concern in treaty shopping.

Our recommendation would therefore be to look to the UBO. We would therefore propose to amend para 2 c) ii) to read:

“at least 50 per cent of the aggregate voting power and value of the shares (and at least 50 per cent of any disproportionate class of shares) in the company or entity is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subdivision i) of this subparagraph., [provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State]”
**Example:** This example shows a UK multinational that has taken over a Dutch resident and public listed company (Dutch sub) with various subsidiaries located outside the Netherlands by acquiring its shares via a public offer. **There are commercial reasons for the acquisition of the Dutch group by the UK plc group.** In addition, there are legitimate business reasons (managerial, legal, governance, commercial) for the acquiring company to be UK sub1. In that case, when looking at flows from US sub, the once Dutch public listed company becomes a subsidiary of the UK sub1 and fails the “Sub test” as it is not resident of one of the contracting states—which has a subsequent effect on the income received by UK sub2.

**Result:** payments from US sub to UK sub2 do not benefit from intended treaty rates.

**Ownership/base erosion test (“OBE test”)**

The proposed Model Treaty permits a resident entity of a Contracting State to qualify for treaty benefits under the OBE test where both an ownership test and base erosion test are met. Consistent with the Sub Test, the proposed Model Treaty requires that intermediate owners of an entity seeking treaty benefits must all be a resident of the Contracting State in which the parent company is listed. **For similar reasons as already set forth above—as well as the inclusion of an additional requirement (base erosion test) for companies to meet the OBE test—we believe that the testing of intermediary companies should be eliminated and only the UBO should be tested.**

**Example:** UK plc acquires German sub in a cross-border acquisition. Acquiring a company with existing foreign subsidiaries introduces an intermediate holding company that is not resident in the UK, which would cause German sub to fail the “OBE test”. (As noted above, UK sub 2 fails the Sub test because of the intermediary company).
**Result:** payments from US sub to UK sub 2 do not benefit from intended treaty rates. Denying treaty benefits to UK sub 2 with regard to interest and dividend payments by US sub is unwarranted and contrary to the fundamental purposes of encouraging trade and eliminating double taxation.

**Derivative benefits test (“DB” test)**

We strongly believe that the proposed Model Treaty should provide for a derivative benefits test (consistent with existing bilateral treaties), as taxpayers should be able to show objectively that there is no treaty shopping abuse where they do not get a better result than if amounts were paid directly to the parent.

We also believe that the benefit provided should be limited to the rates applicable to UBO under its relevant treaty, if such rates are higher than the rate applicable to the recipient of the income under its treaty. As such, this treatment would avoid the “cliff effect” of the current DB test, where benefits are denied completely if the test is failed rather than a comparable benefit that would be obtained if the income were directly received by the UBO.

Given the increasing commercial use of joint ventures, we believe the 95% ownership requirement will deny treaty benefits in many commercial situations. Lowering the ownership requirement to 75% should allow greater flexibility for such situations, without creating a significant risk to treaty abuse situations.

Finally, for the reasons set forth above and the fact that there is a base erosion test in the DB test, we believe that testing intermediary companies is unwarranted and should be eliminated consistent with Sub test and the OBE test.

7. Provisions dealing with “dual-listed company arrangements”

[No further comments]

8. Timing issues related to the various provisions of the LOB rule

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<td>comments are invited on the rules concerning the temporal aspects of the various provisions of the LOB rule (paragraph 16 of the Report). One particular issue on which comments are invited as whether it would be possible for an entity to become, or cease to be, publicly-listed without such event triggering a new taxable period and, if yes, whether this should create a problem for the application of the LOB.</td>
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**Overall**

We would recommend that for Treaty purposes, the time at which a company becomes listed should be treated from that time forward as meeting the criteria of article 2 c).

Likewise, if an entity were to cease to be listed, it would not meet the criteria of 2 c) from that point on. For discrete payments (such as dividends) this should be clear. However, there may be instances where a time apportionment on a just and reasonable basis may be required (for the year in which the entity becomes, or ceases to be, listed.

We would therefore recommend amending article 2 c) to read:

“c) a company or other entity, if, at the relevant time for seeking benefits...”
9. Conditions for the application of the provision on publicly-listed entities

**Issues on which comments are invited**

- Comments are invited as to whether and how subparagraph 2 c) of the LOB rule (the “publicly-listed entity” provision) could be modified to take account of the concerns of small countries that do not have important stock exchanges whilst ensuring that a publicly-listed entity has sufficient nexus with a country to warrant the application of the provision.

**Overall**

We would strongly encourage countries not to use the publicly-listed test to counter all undesired treaty applications, since a test which is too restrictive can have a significant detrimental impact on normal business operations and capital markets, and impede the purpose of Treaties, to encourage and enhance trade, investment, and economic cooperation.

Countries that want to pursue tax policy objectives beyond the scope of “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances”, should instead adopt domestic targeted anti-abuse provision to counter those specific concerns.

- An example may be the concerns in the US around inversions, which should instead be targeted using local legislation in the country of (former) residence, and made clear which local legislation will override Treaties, and in what circumstances.

- We would note that although discretionary relief may be cited as a fall-back, reliance should not be placed on this option, as there is inherent uncertainty, delays, and cost implications. In order for tax authorities to ensure the objectives and economic benefits of the Treaty network are retained, it is important to have certainty upfront as to whether a Treaty will apply.

**Specific Comments**

Access to capital markets is paramount for companies to fund their business operations and to create economic growth. Moreover some (large) institutional investors require listing at major international stock exchanges (e.g. New York, London) to be allowed to invest in a particular company; or for the shares to be included in certain tracker indices for example.

In our view the issue is two part:

- Is there sufficient nexus with the country of residence of the listed company; and

- what seems to be the underlying concern - is the structure set up artificially to obtain Treaty benefits – in effect Treaty shopping.

We believe the nexus question should already have been considered when looking at residency by virtue of central management and control.

We would also suggest that the question of Treaty shopping could be addressed by listing specific stock exchanges that qualify (or by identifying measurable criteria to apply to stock exchanges), in order to manage the perceived risk, whilst giving certainty to taxpayers, and allowing the vast majority of genuine commercial situations to continue to obtain the intended Treaty benefits.

In that way companies that are resident in smaller economies can be listed on a stock exchange outside their country of residence, whilst tax authorities still have sufficient control over which stock exchanges qualify.
We note that being listed on major stock exchanges subjects a company to stringent and extensive financial regulations which in itself warrant sufficiently that a company will not likely opt for secondary listing for the sole purpose of obtaining treaty benefits.

This practice is recognised in existing Treaties (including for example, US/Netherlands; US/Switzerland), and also in paragraph 16 of the Commentary to the proposed Model Treaty. Therefore, consistent with such existing treaties and the stated objective to be a minimum standard, we would recommend that the proposed Model Treaty provide a broader test, such that trading of shares should not be restricted to exchange(s) in the country of residence of the listed entity.

In addition, we believe that the primarily traded test ("principal class of shares... primarily traded") is too restrictive for larger MNEs listed on more than one exchange. In such circumstance, it may not be possible to meet this test since there may not be one single exchange on which shares are primarily traded. We recommend broadening this test to aggregate all trading of principal class of shares on all recognised stock exchanges at which a company’s shares are listed.

This practice is applied for instance in the US-UK Treaty and is commonly believed to serve well, for example in defining “regularly traded”. The Explanation to the Treaty mentions: “A class of shares will be "regularly traded" in a taxable period, (...) if the aggregate number of shares of that class traded on one or more recognised exchanges during the twelve months ending on the day before the beginning of that taxable period is at least six percent of the average number of shares outstanding in that class during that twelve-month period.”

As such, we recommend to amend the wording of Article X para 2 c) i) A) to read:

"its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or "

We would recommend that a standard list of “recognised stock exchanges” (para 6 a) i) ) be included (or qualifying criteria), and consistently applied when signing up to the proposed Model Treaty.

Finally, as a consequence, the wording of the Commentary (for example, in paragraph 16) should be amended to reflect that this is a recommended minimum standard, which has been applied in practice, and to clarify that all trading on recognised stock exchanges can be considered in aggregate.

By way of example:

The following example shows a German based multinational listed on multiple stock exchanges to have optimal access to global capital markets. The shares are primarily traded on the LSE and NYSE for commercial reasons. This is especially applicable for multinationals located in smaller economies, or with significant capital listed on various stock exchanges.

The principle class of shares in the example below is therefore not primarily traded on the German stock exchange, which would result in failing the “Publicly-listed test”. It may, in fact, not be primarily traded on any individual exchange.
10. Clarification of the “active business” provision

Issues on which comments are invited

- Comments are invited as to possible clarifications that could be made concerning the interpretation and application of the “active business” provision found in paragraph 3 of the LOB rule (paragraph 16 of the Report).

Overall

Currently a Headquarters company would be excluded from qualifying. We believe that the OECD should also recognise that regional headquarters companies are common in today’s business environment involving regional operations, where there can be benefits of understanding local market requirements in order to adjust and modify products and services offered. Notably, in the context of global M&A transactions, an acquired company may not qualify under the active conduct of a business test, and without a HQ test, this could become problematic for MNEs operating in genuine commercial circumstances. We would therefore recommend that, aligned with existing treaties, the proposed Model Treaty be amended to incorporate a HQ test.

The second comment seems to be based on the assumption that there is some type of conflict between the exclusion of financing activities in paragraph (a) and the affiliated activity provision in paragraph (c) in the event that both activities are present within the same affiliated group. We understand that the way it is supposed to work is that one looks at the entire affiliated group to determine whether there is a substantial active business. However, investment/financing activities conducted by various affiliates of the group are not counted in determining whether there is an active business or whether that business is substantial. If the group as a whole does have a substantial active business then all members of the group qualify regardless of their particular activities. The point is that if the group has a substantial active business, then neither the group nor individual entities are tainted because the group also has investment/financing activities.

Of course, the “in connection or incidental to” test must also be satisfied. This interpretation has been the consistent US interpretation of the US LOB provision as is made clear in the various US Technical Explanations.

Specific Comments

Headquarters companies

In addition to the overall observation above, in relation to a holding company, we would recommend removing the Commentary in para 48 which specifically excludes HQ companies from satisfying the active conduct of a business test, if its business is managing of investments. It is not
clear how this operates in conjunction with the attribution of business activities to a holding company where appropriate affiliation tests are met. It is also not aligned with some existing treaties which require the principles of an active conduct of business to apply before HQ status can be achieved.

Headquarters companies are commonplace, and removal of this test can cause issues.

By way of example:

Result: without a “HQ test”, UK Hold co is not able to apply treaty benefits to payments made to US parent (unless US parent meets other criteria, such as Public Co test), despite there being no treaty shopping intended either in the original acquisition, or the ongoing structure being maintained for purely commercial reasons, due to there being no other active business in the UK. Similarly, payments made from the manufacturing subsidiaries to UK Hold co would not benefit from treaty rates.

Other Holding Companies

We also have concerns where the recipient is a holding company, and will therefore fail the LOB test in its own right. In that case the recipient may still qualify under the connected entities provision (para 3 c) ), which states that activities conducted by entities connected (as defined) to the recipient shall be deemed to be conducted by the recipient itself.

The provisions in para 3 a) and para 3 c) together require that only connected activities in the state of the recipient can qualify. The next test in the main rule is whether the income received by the recipient is in connection with or incidental to the business conducted by the recipient. An item of income is derived in connection with a business if the business activity in one State forms a part of or is complementary to the business activity in the other State. The final part of the test (para 3 b) ), is that where the business activity carried on by the recipient is substantial in relation to the business activity carried on by the distributing company, the active business test will be considered to be met. This will be determined based on all facts and circumstances. The substantiality test is only applicable with regard to income from transactions with a branch or a related party. One compares the size of the activities in the first state to size of the activities in the other state not to the size of the income item. One also takes the size of the market and general economy of each country in determining substantiality.

By way of example, for an MNE, the following situation could arise:

A UK Holdco, with no active conduct of business. The below depicted structure can very well be the result of multiple genuine business transactions occurring in the course of years in which the
A company decided to buy and sell investments in various countries. In this case the “connected to test” does not work as the investments in the subsidiaries in the UK are less than 50%. UK Hold Co used to have 100% in the UK subsidiaries but for commercial reasons of risk management and capital allocation, decided to cooperate with a partner who acquired 60% of the UK subsidiaries. Lowering the ownership from 100% to 40% would have detrimental effect under the proposed Model Convention.

Under existing bilateral treaties, all payments benefit from applicable Treaties, as intended. However, applying para 3 c), activities conducted by entities connected (as defined) to the recipient shall be deemed to be conducted by the recipient itself.

- Note that Joint Ventures (which exist for purely commercial reasons) may not be brought into account if the holding structure does not meet the ownership threshold (i.e. 50%);
- Partnerships are not currently brought into account
- UK activities of connected entities are allocated to UK Holdco, which (before selling 60% to a partner), may have allowed it to qualify under para 3 a), depending on further facts and circumstances.

If UK Holdco receives income from its German subsidiary, then based on para 3 a), the income producing activity in Germany must be connected with or incidental to the business conducted by UK Holdco. The German subsidiary does not conduct a business as it is also a Holdco. However, the business activities of its German connected entities may allow it to qualify under Para 3 c).

Subsequently, based on para 3 b), business activity carried on by the recipient must be substantial in relation to the business activity carried on by the distributing company. This will be determined based on all facts and circumstances, as noted above. However, many legitimate business activities are carried out by partnerships. Para 3 c) is overly restrictive in that it excludes all activities carried out in partnerships. Thus, we would propose that as in some existing bilateral treaties, the wording of Para 3 c) be amended as set forth below to include the activities of partnerships of which the resident is a partner.
“c) For purposes of applying this paragraph, activities conducted by a partnership in which that person is a partner and activities conducted by persons connected to a person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) or another person possesses at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate voting power and value of the company’s shares or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.”

By way of example:

![Diagram showing control and connection between companies in different countries]

- Country 1 Parent has been engaged in Business A for a number of years. Some years back Country 1 Parent contribute all of its business into a partnership with an Unrelated Partner.
- Country 1 Parent wishes to expand Business A into Country 2, but Unrelated Partner does not wish to expand into Country 2.
- Country 1 Parent incorporates Country 2 Sub to carry out Business A in Country B on its own.
- Even though Country 1 Parent has a longstanding and active business in Country 1 it does qualify under the active conduct of business test because the business was contributed to the partnership in a prior unrelated transaction.

Finally, “substantial” is not defined in the proposed Model Treaty, although the examples are illustrative. We would recommend that the proposed Model Treaty contain a “safe harbour” based on objective metrics such as the one contained the NL-US treaty, where three ratios are examined: value of the assets, gross income, and payroll expense.
B. Issues related to the PPT rule

11. Application of the PPT rule where benefits are obtained under different treaties; and

12. Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level; and

13. Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable; and

14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

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<td>Comments are invited as to possible inconsistencies between the Commentary on how the phrase &quot;did not have as one of its principal purposes the obtaining of benefits under this Convention&quot; should be applied in the context of the discretionary relief provision of the LOB rule (paragraph 16 of the Report) and how the phrase &quot;obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit&quot; should be interpreted in the context of the PPT rule (paragraph 17 of the Report).</td>
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Overall

Application of the discretionary relief rule of the LOB, and the PPT rule should both be under mandatory arbitration.

In any case, if the Contracting States are unable to agree, then there should be an underlying assumption that it is therefore not reasonable to conclude that obtaining a benefit was a principal purpose, and therefore the PPT rule should not apply (and discretionary relief should be available).

Denial of treaty benefits should require alignment, and not allow unilateral action by one authority.

Tax will usually be one of many considerations to take into account when deciding on the economic viability of an investment. It would be instructive to include examples of how tax authorities will therefore interpret whether tax is one of the principle purposes, and in what circumstances.

Finally, treaty benefits should remain available unless tax authorities establish that the PPT rule applies, rather than there being an assumption of avoidance, and passing the burden of proof to the taxpayer.

Specific Comments

The examples in the Report are quite specific and as such have limited application in giving clarity to typical holding company structures and M&A activity.

Often, a MNE will have holding companies in various jurisdictions. Typically acquisitions will be made by existing regional or divisional holding companies, or specific acquisition vehicles will be established for individual acquisitions (for example to ring-fence financing relating to the acquisition; to ring fence legal risks related to investments; or to facilitate a post-acquisition integration of the acquired business).
In making an acquisition, a MNE typically has a degree of choice as to the location of the acquiring entity and this choice is often influenced to some extent by the tax treaty implications. As such, many holding structures will be exposed to the risk that tax authorities will argue that one of the principal purposes of the arrangement is to benefit from the relevant double tax treaty.

BIAC believes that for a commercial acquisition the main purpose of the transaction will by definition be to acquire the entity, and not to obtain treaty benefits, notwithstanding the fact that access to treaties will be taken into account in determining the appropriate acquisition structure. This is similar to Example C (at paragraph 17 of the Report) where a producer of electronic devices based in State R decides to establish a manufacturing plant in State S and where the tax convention between State R and State S is effectively the deciding factor.

However, Example D (at paragraph 17 of the Report) includes a number of caveats which make the position unclear. It specifies that residents of State S are minority investors and that investors’ decisions to invest in RCo are not driven by any particular investment made by RCo. Whilst again this example is quite specific, it could be used to support a position that casts doubt on the application of double tax treaties given the decision to use a particular acquisition entity will typically be driven in part by reference to access to an appropriate double tax treaty.

It is not clear how the above two examples reconcile and this could lead to a risk of misinterpretation or misapplication by tax authorities.

**By way of example**

A UK public parented group has worldwide operations. It is mainly structured with regional holding companies the majority of which are held by a Netherlands holding company.

The group acquires a subsidiary in Turkey (where the group does not have an existing presence) from a third party.

The non-treaty rate of divided withholding tax for Turkey is 15%. Turkey has a double tax convention with both the UK and the Netherlands under which the treaty rate of dividend withholding tax is 10%.

However, the double tax convention between Spain and Turkey provides for dividend withholding tax of 5%. The group has an existing trading subsidiary in Spain and uses this subsidiary to make the acquisition of the Turkish subsidiary.
We would recommend providing better clarity around this type of scenario. For example:

- assuming that the choice of using the existing Spanish trading subsidiary to make the acquisition was driven by access to the favourable treaty rate for dividend withholding tax, confirmation whether the PPT would be considered to apply to deny treaty benefits for dividends paid from Turkey to Spain;

- confirmation whether the PPT would be considered to apply to deny treaty benefits if instead a new Spanish company had been established to make the acquisition

- confirmation whether the PPT would be considered to apply to deny treaty benefits if instead a new Spanish company was established to make the acquisition and the group did not have any existing operations in Spain.

Whilst additional examples and guidance to provide more clarity would be welcome, with a purpose based test there will inevitably be disagreements as to whether treaty benefits should apply and accordingly denial of treaty benefits for certain situations. In such cases, we believe that treaty relief should not be denied per se, rather that the treaty benefit provided should be limited to the rate applicable to UBO under its relevant treaty which would avoid a cliff effect (similar to the observations in point 6 above).

15. Whether some form of discretionary relief should be provided under the PPT rule

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<td>Commentators are invited to suggest examples where some form of discretionary relief would be justified following the application of the PPT rule</td>
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Overall

The treatment of an item as income or capital should follow domestic legislation (in a similar way to the comments in paragraph 43 of the Report).

Where there are concerns that a treaty may be abused in order to override such provisions, we refer to our comments on question 20 below, so that domestic law should be allowed to override treaties in specified circumstances.

Once the treatment of the item in question is established, the treaty should be applied to that item. The fact that the domestic anti-avoidance rule may have overridden the treaty in order to characterise the income/capital as intended, should not prevent the treaty from being applied to that income/capital as normal. This then ensures that anti-avoidance concerns are addressed, and the treaty only serves to reduce/eliminate double taxation as intended when entering into the treaty.

We believe this should then address the question underlying the issue raised in question 15.

However, there should be protection against creation of double taxation (for example, if the recipient recharacterises the income, but the source State does not, and therefore different rates of WHT may result than anticipated by the recipient State, the recipient should not be restricted in crediting the source State WHT).
16. Drafting the alternative “conduit-PPT rule"

**Issues on which comments are invited**

- Comments are invited on the various features of the “anti-conduit rule” in paragraph 15 of the Commentary on the PPT rule (paragraph 17 of the Report).

- Commentators are also invited on possible examples that could be included in the Commentary in order to illustrate the application of this “anti-conduit rule”.

**Overall**

Since the proposed wording for the conduit arrangement includes a principal purpose test, this option is similar in concept to, although more targeted than, the PPT rule.

17. List of examples in the Commentary on the PPT rule

**Issues on which comments are invited**

- Commentators are invited to suggest additional examples that could be included in paragraph 14 of the Commentary on the PPT rule (paragraph 17 of the Report). For example, representatives of investment funds are invited to suggest an additional example that would deal with the non-tax motivated use of a special purpose vehicle in order to pool the investment of various institutional investors from different countries.

**Overall**

**CIV Funds**

CIV relief from the PPT rule appropriately is provided by Example D. This example’s relief is limited, however, to a CIV that (1) has, as a majority of its investors, persons resident in the CIV’s country of residence and (2) distributes its income annually to investors (paying tax on any retained amounts).

We believe that additional examples should be provided of CIVs that do not fall foul of the PPT rule.

One example would apply to a CIV that is owned more than 50% by investors resident in any State with which the source State has a tax treaty providing tax relief comparable to that provided to investors resident in the treaty partner. This example would apply the equivalent beneficiary standard to globally-distributed CIVs and is necessary to ensure appropriate treaty relief.

A second example would apply to a CIV that distributes, rather than retains, its income (as the retained income becomes taxable when the investor disposes of the CIV interests). This second example could be applied by any State that provides treaty relief from double taxation (rather than double current taxation).

These additional examples will provide appropriate relief to investors in globally-distributed CIVs. The individual investors in these CIVs typically are of moderate means and invest in CIVs to help meet their retirement savings needs.

**Non-CIV Funds**

We believe that an example should also be provided of an investment fund created for investors, such as pension funds, that would be treaty-entitled if investing directly. Treaty-entitled investors in a non-CIV investment fund, created for legitimate investing purposes (including professional
management and economies-of-scale benefits) should not be disadvantaged by seeking to benefit from those advantages.

C. Other issues

18. Application of the new treaty tie-breaker rule; and

19. The design and drafting of the rule applicable to permanent establishments located in third States

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<th>Issues on which comments are invited</th>
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<tr>
<td>- The anti-abuse rule included in paragraph 42 of the Report is currently restricted to cases where the profits of the PE are exempt in the State of the enterprise to which the PE belongs. Are there other situations where the rules should apply?</td>
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<tr>
<td>- Are the exceptions included in subparagraphs e) and f) of the anti-abuse rule sufficient to address cases where the rule would otherwise affect arrangements that are not tax-motivated?</td>
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<td>- Do these exceptions raise potential BEPS concerns?</td>
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Overall

Tie Breaker rule

As noted previously, dual residence may arise for purely commercial reasons if a legal incorporation in a country is preferred, which results in tax residency under local laws, whilst the Board meets in the country of its headquarters, for example. Any tie-breaker rule needs to provide a clear and predictable result in advance, and therefore we would recommend retaining the “effective management” test in Treaties.

Furthermore, using “endeavours” of Competent Authorities to determine single residency will result in no predictable result, and perhaps no result at all, as there is currently no proposed requirement on the Competent Authorities to agree the residency.

We consider the preferred solution for dual resident entities, is to retain “effective management”, but with a recourse to ascertain a single residency via Competent Authorities. Only in exceptional circumstances, where structures are set up for abusive purposes, should there be a possibility of failure to agree on a single residency between Competent Authorities. In such cases, the entity should be carved out of the treaty, which is essentially what the last sentence of the new Article 4(3) does, although it is not currently clear that this should be on an exceptional basis.

Where Competent Authorities are unable to agree the mode of application, the proposal is that there would be no entitlement to relief or exemption, except as agreed by the Competent Authorities. It would be preferable, instead, that companies would not be treated as a resident of either State for purposes of claiming any benefits provided by the treaty. The preferred route leaves open the possibility of benefits that are not based on residence being automatically available. This may be a small class of benefits, but since they do not depend on residence, it would seem appropriate not to exclude them due to dual residency concerns.

The above comments should be taken into account in the hybrid mismatch discussions (not considered in this paper), to ensure consistency.
Transparent entities

BIAC has a fundamental concern that there is an underlying assumption of a tax avoidance motive. If States enact incentives specifically aimed at attracting business, then when businesses structure themselves accordingly, this should not be considered to be tax avoidance. The existence of a low effective tax rate should not be a concern, provided the structure is a genuine commercial set up. This is as anticipated in “Action Plan on Base Erosion and Profit Shifting, OECD, 19 July 2013” where it is confirmed that “No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.” Therefore, the test should be whether the structure is artificial – or put another way, the focus should be on substance. Specifically:

a. The proposed wording in paragraph 42 is solely focused on an effective tax rate, which remains in stark contrast to the wording of the action plan referred to above, where no or low taxation is not the driving concern;

b. Genuine commercial activities can include holding, financing and investment activities; and

c. If the final structure gives rise to a tax result that is not considered desirable (note that this does not necessarily arise due to any form of avoidance), this should be addressed through local tax law, and not by removing Treaty benefits where a genuine commercial structure exists.

In the absence of “abuse” as defined, and provided beneficial ownership of the income is with a resident of one contracting State, the State of residence of the source should not deny Treaty relief. The source State’s view of the status of the recipient should not be relevant for Treaty purposes (although there may be considerations for Harmful Tax Practices, or to address in domestic anti-avoidance rules).

The current wording proposed (paragraph 42 of the Report) would appear to permit the source State to deny Treaty relief if the recipient State does not tax the income. We would assert that the rate of tax, or whether the recipient State chooses not to tax at all, the relevant income, should not be a matter for the Treaty, but should be dealt with under one or more of:

- local legislation;
- under Harmful Tax Practices; and
- taken into consideration when weighing up the risks before deciding to enter into a treaty.

Provided the beneficial owner of the income is resident in the contracting State, the source State should not deny the agreed relief, irrespective of the rate of tax applied to that income. This applies equally to transparent entities within the recipient State (which would not be considered the beneficial owner of the income by that State due to the transparent nature), or to other situations, such as (but not limited to) a branch or PE in a third State, where the income is earned.

20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

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<td>- Apart from the changes described above [sic], are there other clarifications/additions that should be made to the Commentary changes in paragraph 49 of the Report?</td>
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Overall

We agree with the comment in paragraph 44, that appropriate action should be largely through other Actions under the BEPS program. However, in order for that approach to work, Treaties cannot override specific sections of local law, as stated in paragraph 45.

We recommend that the Model convention include specific, clear pieces of local legislation that are not overridden by the Treaty, so as to avoid uncertainty and protracted discussions with tax authorities.

Furthermore, local law changes should not immediately impact the application of the Treaty, without a specific Protocol, ensuring both parties are aware of the impact on their tax revenues, and include in the Protocol specific references to the new local law that now also overrides the Treaty. This will ensure clarity and certainty of treatment, both for the taxpayer, and the tax authority. Specifically, this also includes new interpretations of existing law, and retroactive law changes, where the bilateral counterparty would not necessarily have expected the situation, any more than the taxpayer.

We also recommend that provision be made to ensure that in enforcing local laws, double taxation is not created, just as double non-taxation is to be avoided. Therefore, where one State denies a deduction (such as under thin capitalisation rules), there should be a mechanism for a compensating adjustment in the other State.

Specific comments

In order to retain as much clarity and certainty as possible, we would recommend that Treaties should specify clearly which domestic legislation is intended to override the Treaty. This protects both the taxpayer from later changes in views, and similarly tax authorities from entering into a Treaty which does not then apply to its residents in situations where they had expected it would.

In this vein, the proposed paragraph 9 to the Commentary suggests that the PPT could be used as a route to allow domestic rules to override the Treaty. We would strongly encourage the issue of tax avoidance (to be addressed under local legislation) to be separated from Treaty Abuse (which is a different question).

Domestic anti-avoidance rules should be allowed to override the Treaty, to ensure their proper application, but the circumstances for overriding the treaty must be clear and known upfront. The PPT rule should not be seen as a route to allow tax authorities to removed intended Treaty benefits, in circumstances unforeseen by either the taxpayer or the other Contracting tax authority, due to a change in their domestic interpretations. We therefore have concerns over the wording of paragraph 9 to the Commentary as drafted.

Finally, we note that paragraph 9 to the Commentary suggests that “...the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied under paragraph 7 of Article [X] (the PPT rule) or, in the case of a treaty that does not include that paragraph, to the guiding principle in paragraph 9.5 of the Commentary on Article 1.” Whilst we agree with guiding principle, the mechanics of how the tax authorities agree those principles should work, is set out in either the LOB and/or the PPT rules adopted. If the tax authorities have agreed not to include a PPT rule, then it should not be possible to invoke one under the guise of the guiding principles. Doing so would create confusion, reduce the value and certainty of the treaty network, and allow one tax authority to behave in a manner which was not intended or agreed when signing the
treaty. If it had been, it would have been easy to include a PPT clause. We would therefore recommend removing such suggestion from the Commentary.
January 9, 2014

To: Marlies de Ruiter  
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division  
OECD/CTPA

From: Harris M. Horowitz  
Managing Director, Global Head of Tax  
BlackRock, Inc.

Benjamin B. Lopata  
Managing Director, Head of Corporate Tax  
JPMorgan Chase & Co.

**Application of BEPS Treaty Recommendations to Alternative Funds**

Dear Ms. de Ruiter,

We are writing with respect to the report Follow Up Work on BEPS Action 6: Preventing Treaty Abuse (the “Follow-Up Report”), which was developed as part of the base erosion and profit shifting (“BEPS”) project by the G-20 and the Organisation for Economic Co-operation and Development (“OECD”).

The Follow-Up Report solicits further comments on specific issues raised in the report on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (the “Treaty Report”). The Follow-Up Report raises, among others, issues regarding the application of the recommendations in the Treaty Report to alternative funds. For purposes of this letter, we use the term “Alternative Funds” to refer to all investment funds that do not qualify as CIVs under the 2010 OECD report The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles. Alternative Funds comprise a broad range of asset classes, including real estate funds, venture capital funds, private equity funds, hedge funds, renewable energy funds, and infrastructure funds.

We understand and support many of the important policy goals that the BEPS project is intended to address. As suggested in the Follow-Up Report, however, the recommendations in the Treaty Report, if implemented as currently drafted, would adversely impact cross-border investors and investment. That is, the Treaty Report provides no meaningful recommendations to mitigate the unintended consequences, which will arise from member country adoption, to Alternative Funds and their investors.
The important and ever-increasing role played by Alternative Funds in the global economy is described in our letter of October 17, 2014 (copy attached), but there are two key points to highlight. The first point, as recognized in the Follow-Up Report, is that the primary investors in Alternative Funds are institutional investors, including pension funds and sovereign wealth funds. Thus, denial of treaty benefits, or pricing imperfections due to uncertainty regarding the source country tax consequences of cross-border investment, impacts primarily these generally tax-exempt investors. Second, Alternative Funds play a large and growing role in many jurisdictions in providing funding for important projects and businesses that face a more constrained bank lending environment. Erecting barriers to cross-border investment by denying treaty benefits to all Alternative Funds is thereby inconsistent with source countries’ broader economic policy goals and the needs of the global economy.

Nevertheless, we understand that governments have two main concerns about granting treaty benefits with respect to cross-border investments of some Alternative Funds. The first is that governments want to ensure that Alternative Funds are not used to provide treaty benefits to investors that are not themselves entitled to treaty benefits. The second is that some governments are concerned that investors in Alternative Funds may defer recognition of income on which treaty benefits have been granted.

We therefore detail in this letter and its annexes a number of suggestions which aim to reconcile the treaty concerns of governments with the concerns of Alternative Funds and their investors. First, the commentary to the Model Tax Convention should set forth a presumption that the PPT (as defined in the Treaty Report) does not apply to deny treaty benefits to an Investment Entity as defined in the OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters (commonly referred to as the “CRS”) in the absence of abuse, fraud, or sham. The principal purpose of Alternative Funds, like collective investment vehicles, is to allow investors to pool capital and gain efficient access to professional management and diverse assets. Access to treaty benefits is not per se a principal purpose of Alternative Funds, although treaty benefits may be necessary to prevent investors from suffering an additional layer of tax due to their investment through an Alternative Fund.

Second, a number of conceptual frameworks for treaty eligibility could be used to address concerns about both the LOB rule and the PPT, namely: (i) the “Ultimate Beneficial Owners Approach”; (ii) the “Look-Through Approach”; and (iii) the “Substance Approach”. These frameworks, described in greater detail below, would be intended to be options to governments, are not mutually exclusive and could apply regardless of whether a treaty incorporates an LOB provision, a PPT, or both.

As recognized in the Follow-Up Report, the policy considerations regarding the entitlement of Alternative Funds to treaty benefits raise difficult issues that require further consideration. We think the proposed approaches we outline in this letter provide a good starting point, but further work is clearly needed. We would like to discuss the approaches and suggestions in this letter further with governments and the OECD at both a policy level and a technical level.

Other concerns regarding the use of Alternative Funds can be addressed through the BEPS actions on hybrid mismatch arrangements, controlled foreign company rules, and limitations on
the deductibility of interest expense, and we would like to work with governments to address those concerns as well.

Sincerely,

cc: Pascal Saint-Amans
    Raffaele Russo
    Jacques Sasseville
Detailed Discussion

The Follow-Up Report

The Follow-Up Report notes that the limitation on benefits (“LOB”) rule as drafted in the Treaty Report generally would deny treaty benefits to Alternative Funds on their cross-border investments because: (i) the investor base of Alternative Funds is not restricted to a single country; and (ii) Alternative Funds generally cannot avail themselves of the active business test in the LOB. The Follow-Up Report then solicits comments as to how to address these issues without creating opportunities for treaty shopping.

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<tr>
<td>Comments are invited as to whether the preceding paragraphs accurately describe the treaty entitlement issues of sovereign wealth funds, pension funds and alternative funds / private equity funds. Comments are also invited as to how to address these issues without creating opportunities for treaty shopping.</td>
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The Follow-Up Report also notes general concerns about the impact of the Principal Purposes Test (“PPT”) on Alternative Funds and solicits examples that could clarify the application of the PPT to Alternative Funds.

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Proposed Approaches to Alternative Funds Treaty Entitlement

Broadly speaking, we believe the Follow-Up Report identifies the issues raised for Alternative Funds by the LOB and the PPT – namely, that the LOB would deny treaty benefits to cross-border investments of Alternative Funds, and that the PPT would, at best, create considerable uncertainty regarding treaty entitlement. Government concerns about treaty abuse can and should be addressed without creating such negative consequences for Alternative Funds, investors, source countries, and the global economy.

We understand that there are at least two general concerns that governments have about granting treaty benefits with respect to cross-border investments of some Alternative Funds. The first is
that governments want to ensure that Alternative Funds are not used to provide treaty benefits to investors that are not themselves entitled to treaty benefits, absent a sufficient connection of the Alternative Fund to its state of residence. While this is sensible as a policy concern, governments also should recognize that the efficient pooling of capital, local law, regulation, market practices, and administrative burdens do not allow Alternative Funds to create fund vehicles that would perfectly segregate different types of investors and different types of investments in different jurisdictions. Some thresholds or proportionate benefits are therefore suggested in order to balance such concerns.

Second, we understand that some governments are concerned about the possibility that investors in Alternative Funds may defer recognition of income on which treaty benefits have been granted. However, for many Alternative Funds, the compensation of the manager is based on the internal rate of return realized by investors on the cash flow they receive. The manager thus has a compelling interest in distributing cash as quickly as possible. In addition, many investors in Alternative Funds are either tax-exempt (so deferral does not benefit them) or recognize the income and gains currently due to the transparency of the fund vehicles or due to anti-deferral regimes such as controlled foreign company, passive foreign investment company, or foreign accrual property income rules (collectively, “Anti-Deferral Regimes”). Nonetheless, the proposed approaches, as described below, attempt to take these concerns into account.

With respect to the PPT, the principal purpose of Alternative Funds, like collective investment vehicles, is to allow investors to pool capital and gain efficient access to professional management and diverse assets. Access to treaty benefits is not per se a principal purpose of Alternative Funds, although treaty benefits may be necessary to prevent investors from suffering an additional layer of tax due to their investment through an Alternative Fund. Therefore, the commentary to the Model Tax Convention should set forth a presumption that the PPT does not apply to deny treaty benefits to an Investment Entity as defined in the OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters (commonly referred to as the “CRS”) in the absence of abuse, fraud, or sham. Proposed language for the presumption is set forth in Annex I.

In addition, we suggest that there are at least three conceptual frameworks that can be used to reconcile the treaty concerns of governments with the concerns of Alternative Funds and their investors. These proposed frameworks can be used to address concerns about both the LOB rule and the PPT. Each of these frameworks also incorporates a number of elements that can be adjusted to strike the right balance among the various policy concerns.

These three frameworks are: (i) the “Ultimate Beneficial Owners Approach”; (ii) the “Look-Through Approach”; and (iii) the “Substance Approach”. These frameworks are intended to be options to governments and are not mutually exclusive. In general, the Ultimate Beneficial Owners Approach would grant treaty benefits to an Alternative Fund based on whether the Alternative Fund is owned by certain qualified investors entitled to equivalent benefits. Under the Look-Through Approach, an Alternative Fund treated as fiscally transparent would claim treaty benefits on behalf of its ultimate investors. The Substance Approach would base an Alternative Fund’s eligibility for treaty benefits on the connection that entity has to, and the
substance it has in, the treaty jurisdiction. These frameworks for determining treaty eligibility could apply regardless of whether a treaty incorporates an LOB provision, a PPT, or both.

The three frameworks are described below, and specific proposed examples and draft changes to the relevant provisions are set forth in Annexes I and II.

**Ultimate Beneficial Owners Approach**

The Ultimate Beneficial Owners Approach would look to the benefits to which the ultimate beneficial owners of the Alternative Fund are entitled, but in practice would grant benefits to the Alternative Fund entity itself. The investors in Alternative Funds are primarily institutional investors, and are often entitled to benefits that are at least as good as the benefits that might be claimed by the Alternative Fund. The fact that Alternative Funds pool capital from investors in and make investments in different jurisdictions should not cause such investors to forfeit the treaty benefits to which they would be entitled if they invested directly.

To address government concerns, the Ultimate Beneficial Owners Approach could be limited to Alternative Funds that meet certain criteria. Specifically, the Ultimate Beneficial Owners Approach could be limited to entities (“Investment Vehicles”) that:

(i) are institutional investors or wholly owned by institutional investors;

(ii) (A) are subject to customer due diligence requirements under anti-money laundering legislation and are subject to reporting requirements under an exchange of information regime like the OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters (commonly referred to as the “CRS”) or the U.S. rules commonly known as FATCA; (B) have a bona fide investment objective; and (C) are marketed to a diverse investor base; or

(iii) are wholly owned by one or more persons described in (i) or (ii), provided that substantially all the income and gain of that entity is derived from investments made for the benefit of such persons.

In addition, specific anti-abuse rules could be provided to minimize the creation of abusive Investment Vehicles.

An Ultimate Beneficial Owners Approach could then apply only to Investment Vehicles that are more than, for example, 80% owned, directly or indirectly, by owners that are entitled to treaty benefits (or benefits under the domestic law of the source country) that are at least as good as the benefits to which the Investment Vehicle is entitled and that either: (i) are tax-exempt entities described in paragraph 2(b) and (d) of the LOB provisions (generally government entities including sovereign wealth funds, pension funds, and charitable organizations); or (ii) include their proportionate share of the Investment Vehicle’s income and gains on a current basis (including pursuant to an Anti-Deferral Regime). This type of ownership test should address OECD member states’ concerns about deferral of income or stateless income, as a significant percentage of the Investment Vehicles’ owners either are tax-exempt (and therefore do not benefit from deferral) or include the income and gains on a current basis.
Application to PPT

The Ultimate Beneficial Owners Approach could be implemented in the PPT through examples incorporating the criteria described above, plus commentary providing applicable definitions. Draft examples are set forth in Annex I.

Application to LOB

The Ultimate Beneficial Owners Approach could be implemented in the LOB through the addition of a derivative benefits provision that incorporates the criteria described above. Suggested language is set forth in Annex II.

Look-Through Approach

Under the Look-Through Approach, treaty benefits would be granted on the basis of the treaty benefits to which the ultimate investors are themselves entitled. The treaty recommendations made in connection with Action 2 on Neutralising the Effects of Hybrid Mismatch Arrangements include a provision that takes a step in this direction. Specifically, that recommendation is to include a new paragraph 2 of Article 1 that would treat income (including gains) derived by or through a fiscally transparent entity as income of a resident of a Contracting State to the extent that the Contracting State taxes the income and gains as income of a resident of that Contracting State. This provision recognizes that, where the residence country taxes the income and gains, the resident owner should be entitled to treaty benefits from the source country. In this regard, the inclusion of the “saving clause” provision in new paragraph 3 of Article 1 would be helpful in clarifying the resident country’s primary rights to tax under bilateral treaties.

Broad adoption of new Article 1(2) would help address the treaty issues faced by Alternative Funds that are fiscally transparent; however, there are at least three issues that would need to be resolved in order for the provision to provide a viable means of resolving the treaty issues for Alternative Funds. The first is ensuring the broad and uniform adoption by member governments of new Article 1(2). The second issue is providing administrable procedures to identify the investors in Alternative Funds and the treaty benefits to which they are entitled. The third issue is providing a mechanism that allows (or requires) investors to treat the Alternative Fund entities as effectively fiscally transparent for purposes of their residence jurisdiction taxation, including due to Anti-Deferral Regimes, and new Article 1(2) would need to be modified to treat inclusion under an Anti-Deferral Regime as equivalent to fiscal transparency.

The OECD has previously recommended a provision similar to new Article 1(2); however, since the release of the 1999 report The Application of the OECD Model Tax Convention to Partnerships, few countries have adopted the provision in their bilateral tax treaties. If countries adopt a PPT and/or LOB through a multilateral instrument or on the basis of unilateral domestic law changes, simultaneous adoption of the recommendation regarding fiscally transparent entities is critical to ensuring that treaty benefits are not inappropriately denied. The most efficient means of ensuring simultaneous adoption of new Article 1(2) would be through including the provision in a multilateral instrument.
The second issue is that practical and uniform procedures must be provided for identifying Alternative Fund investors and making treaty claims on their behalf. The investor identification procedures of FATCA, CRS and the OECD’s Treaty Relief and Compliance Enhancement (“TRACE”) project could be used to ensure that the Look-Through Approach works as intended.

To make the Look-Through Approach even more attractive on a long-term basis, it must also address the fact that different countries treat Alternative Fund entities differently – some tax authorities will treat an entity as fiscally transparent, while others will treat the same entity as fiscally opaque. In some cases, an Alternative Fund may need to use a specific entity type that one or more countries treat as fiscally opaque for non-tax reasons such as to address commercial liabilities, including debt, or regulatory requirements. For purposes of claiming treaty benefits, the legal form of the investment entity should not matter as long as the investor is including the relevant income and gains on a current basis (including pursuant to the application of Anti-Deferral Regimes). To ensure a complete Look-Through Approach, jurisdictions thus would need to provide a mechanism that would allow (or require) its resident investors to treat, for tax purposes only, the Alternative Fund entities as fiscally transparent and to include the relevant income and gains on a current basis. We recognize that such a mechanism will take time to develop and to implement, but it could be pursued as part of ongoing work to address the issues raised by Alternative Funds.

The Look-Through Approach would require clarification that the LOB applies at the level of the investor claiming benefits, but otherwise the Look-Through Approach may not require amendments to the LOB or PPT, so long as new Article 1(2) is universally adopted and residence countries provide for Alternative Fund entities to be treated as fiscally transparent for tax purposes or impose Anti-Deferral Regimes (and treat inclusion under an Anti-Deferral Regime as equivalent to fiscal transparency for purposes of Article 1(2)).

An example in the Commentary would be helpful in clarifying the application of the Look-Through Approach in the case of Alternative Funds. A draft example is set forth in Annex I.

Substance Approach

Both the LOB and the commentary to the PPT acknowledge that treaty benefits may appropriately be granted on the basis of a substantial connection of an entity to the treaty jurisdiction. For example, the LOB may grant treaty benefits to an entity because it has an active trade or business – effectively meaning the entity has sufficient substance – in the jurisdiction. The challenge with such an approach for Alternative Funds is that the economic activities necessary for investing are very different than the activities required for non-investment businesses. A standard for what constitutes sufficient substance for an Alternative Fund can and should be developed as part of the work on treaty entitlements, and if an Alternative Fund meets that standard it should not be denied treaty benefits because the ultimate investors are resident in another jurisdiction.
Regarding the scope of the Substance Approach, we believe that such an approach should apply to Investment Vehicles, as defined above, and may appropriately be limited, for example, to investment entities that are more than 50% owned by institutional investors.

Regarding the substance threshold for Alternative Funds, it is important to take into account that substance is different in the context of an Investment Vehicle than it is in the context of, for example, a manufacturing business. Because Alternative Funds generally do not have their own employees and oftentimes are managed and/or administered by separate persons, the activities of such persons in the relevant jurisdiction should be taken into account in determining the Investment Vehicle’s substance in the jurisdiction.

The criteria for substance in Alternative Funds should look to the types of activities and factors that are critical to investing, namely portfolio management, investment committee activities, or the location and expertise of the board. The criteria for whether an Alternative Fund has sufficient substance in the treaty jurisdiction could look, for example, to: (i) whether the board members of the fund (or manager/administrator) are resident in the jurisdiction; (ii) whether the board members resident in the jurisdiction have the relevant expertise to direct the business of the fund; (iii) whether the fund (or manager/administrator) has qualified personnel in the jurisdiction that can fulfil and administer the transactions undertaken by the fund; (iv) whether decisions of the board are taken in the jurisdiction; or (v) whether the bookkeeping of the fund is performed in the jurisdiction.  

The Substance Approach is based on the view that if an Investment Vehicle has a sufficiently substantial connection to the jurisdiction in which it is resident, it should be entitled to the benefits of the treaties negotiated by its residence country. In the context of Alternative Funds, we understand that some governments may be concerned about the potential for abuse; we believe that these concerns can be addressed through work on the BEPS actions regarding hybrids, controlled foreign company rules, and interest deductibility, and we would like to work with governments to address any concerns.

Application to PPT

The Substance Approach could be incorporated into the PPT through examples that incorporate the criteria described above and commentary that provides relevant definitions. Suggested language is set forth in Annex I.

Application to LOB

The Substance Approach could be incorporated into the LOB through a modification of the active trade or business test to provide that an Investment Vehicle that meets the criteria described above is treated as engaged in an active trade or business, solely for purposes of

1 See, as a reference point, the Dutch Decree of 18 December 2013, Stb. 569, 2013. Published on 30 December 2013.
determining whether the Investment Vehicle is a qualified person. Suggested language is set forth in Annex II.
Annex I – Proposed Commentary and Examples for PPT

PPT Presumption for Investment Entities

XX. Investment Entities, as defined in the OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters (commonly referred to as the “CRS”), raise particular policy considerations in the context of this paragraph. In general, the purpose of an Investment Entity is to allow investors to pool capital and gain efficient access to professional management and diverse assets. Thus, governments ordinarily should presume, subject to rebuttal that the paragraph does not apply to deny benefits to an Investment Entity in the absence of abuse, fraud, or sham. In addition, the following examples illustrate some specific circumstances in which it would not be reasonable to conclude that a principal purpose of the arrangement is to obtain a benefit under the treaty.

Example 1 – Ultimate Beneficial Owners Approach

LP is a limited partnership organized under the laws of State Q. LP is an Investment Entity as defined in the CRS, and is subject to reporting requirements under State Q law based on
the CRS. LP was created to invest in, for example, companies in the life sciences industry and thereby has a bona fide investment objective and is marketed to a diverse investor base. Pension Fund C, an entity that is described in paragraph 2(d) and that is resident in State C, owns 33% of the equity interests in LP. SWF D, an entity that is described in paragraph 2(b) and that is resident in State D, also owns 33% of the equity interests in LP. Individual B, a resident of State B, owns 20% of LP. SWF E, an entity that is described in paragraph 2(b) and that is resident in State E, owns 14% of LP. LP is treated as fiscally transparent in States B, C, D, E, and Q.

LP wholly owns RCo, a company resident in State R. RCo was established to prevent liabilities of one investee company from impacting other investee companies and to prevent creditors of investee companies from making claims against investors in LP. RCo is subject to corporate income tax in State R, and is treated as fiscally opaque by States C, D, Q, and R. State B treats RCo as fiscally transparent, and Individual B includes his share of RCo’s income and gain on a current basis in State B.

RCo owns all of the outstanding equity in Subsidiary, a State S corporation that is a tax resident of State S. RCo has also lent money to Subsidiary. RCo sells shares of Subsidiary, and the gain is subject to tax under the domestic law of State S, but the gain would not be subject to tax under the State R – State S tax treaty.

State S has concluded treaties that are identical to the Model Tax Convention with States B, C, D, and R, but not with State E. RCo’s formation, operation and investment decisions take into account the existence of tax benefits provided under State R’s extensive tax convention network. In making its decision to invest in shares of Subsidiary, RCo considered the existence of a benefit under the State R-State S tax treaty, 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, RCo is an Investment Vehicle [as defined above] and more than 80% of the interests in RCo are owned indirectly by investors that are entitled to treaty benefits and that either are tax-exempt or include their share of RCo’s income and gains on a current basis (including under Anti-Deferral Regimes). Therefore, it would not be reasonable to conclude that a principal purpose of the arrangement was to obtain a benefit under the State-R – State S tax treaty, unless RCo’s investment is part of an abusive arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the treaty.
Example 2 – Ultimate Beneficial Owners Approach

RCo is a company resident in State R. RCo is liable to tax in State R, but can pay out most of its earnings to its owners in the form of deductible payments on profit participating loans. Such profit participating loans allow, for example, RCo to distribute available cash in a manner unrestricted by local accounting constraints which are not relevant to its business success. RCo owns a 40% interest in the equity of SCo, a company resident in State S. SCo pays a dividend to RCo that is subject to withholding tax under the domestic laws of State S.

RCo is wholly owned by LP, a limited partnership organized under the laws of State L. LP is an alternative fund with a mandate, for example, to invest in infrastructure assets in a defined geographic region. RCo was established to prevent liabilities related to one infrastructure project from impacting other infrastructure investments. RCo’s existence also facilitates the raising of debt that is structurally subordinate to the third-party debt at the level of SCo.

LP and RCo are Investment Vehicles [as described above]. The interests in LP are owned 60% directly by investors that are eligible for the benefits of a tax convention identical to the Model Tax Convention between their states of residence and State S, and that include their
proportionate share of RCo’s income and gains pursuant to an Anti-Deferral Regime. The other 40% of LP is owned by LCo, a company resident in State L. LCo is wholly owned by tax-exempt investors in State A, which also has a tax convention with State S that is identical to the Model Tax Convention. State L does not have a tax convention with State S. LCo serves as a pooling vehicle for the tax-exempt investors in State A and to prevent, e.g., debt at the LP level from affecting the tax-exempt status of their investment income.

RCo’s formation, operation and investment decisions take into account the existence of tax benefits provided under State R’s extensive tax convention network. In making its decision to invest in shares of SCo, RCo considered 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. In this example, RCo is an Investment Vehicle [as described above] and more than 80% of the interests in RCo are owned indirectly by investors that are entitled to benefits and that either are tax-exempt or include their share of RCo’s income and gains on a current basis (including pursuant to Anti-Deferral Regimes). Therefore, it would not be reasonable to conclude that a principal purpose of the arrangement was to obtain a benefit under the State R – State S tax treaty, unless RCo’s investment is part of an abusive arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the treaty. The existence of LCo is irrelevant to this analysis because the investors in State A are exempt from income tax on their investment income.
Example 3 – Ultimate Beneficial Owners Approach

RCo is a company resident in State R. RCo is liable to tax in State R, but can pay out most of its earnings to its owners in the form of deductible payments on, for example, profit participating loans. RCo thus serves as a tax-neutral and efficient cash flow vehicle (see Example 2). RCo owns a portfolio of debt securities issued by companies’ resident in, among others, State S. RCo receives interest subject to withholding tax under the domestic law of State S.

LP, a limited partnership organized under the laws of State L, owns 67% of the shares of RCo. LP is an alternative fund with a mandate, for example, to invest in distressed debt securities. LP and RCo are Investment Vehicles [as described above]. The other 33% of shares of RCo are owned by Pension Fund C, a pension fund resident in State C. Due to regulatory requirements in State C, Pension Fund C can only invest in limited types of securities, and therefore cannot own an interest in LP, but may hold shares of RCo. Thus, RCo accommodates the regulatory rules applicable to Pension Fund C.
The interests in LP are owned 20% by Individual B, an individual resident in State B, 40% by SWF D, a sovereign wealth fund resident in State D, and 40% by SWF E, a sovereign wealth fund resident in State E.

State S has concluded treaties identical to the Model Tax Convention with States R, C, D, and E, but has no treaty with State B or State L. RCo’s formation, operation and investment decisions take into account the existence of tax benefits provided under State R’s extensive tax convention network. In making its decision to invest in debt issued by residents of State S, 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, RCo is an Investment Vehicle [as described above] and more than 80% of the interests in RCo are owned directly and indirectly by investors that are entitled to benefits and that either are tax-exempt or include their share of RCo’s income and gains on a current basis (or pursuant to an Anti-Deferral Regime). Therefore, it would not be reasonable to conclude that a principal purpose of the arrangement is to obtain a benefit under the State R – State S tax treaty unless RCo’s investment is part of an abusive arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the treaty.
Example 4 – Look-Through Approach (Example illustrating new Article 1(2))

LP is a limited partnership organized under the laws of State L. Pension Fund C, an entity that is described in paragraph 2(d) and that is resident in State C, owns 50% of the equity interests in LP. SWF D, an entity that is described in paragraph 2(b) and that is resident in State D, owns 25% of the equity interests in LP. Individual B, a resident of State B, owns 25% of LP. LP is treated as fiscally transparent in States B, C, D, and L.

LP wholly owns RCo, a resident of State R. RCo is subject to corporate income tax in State R, and is treated as fiscally opaque by States R, D, and L. States B and C treat RCo as fiscally transparent, and Individual B and Pension Fund C include their proportionate share of RCo’s income and gains (or Individual B and Pension Fund C include their proportionate share of RCo’s income and gains under an Anti-Deferral Regime).

RCo owns all of the outstanding equity in Subsidiary, a State S corporation that is a tax resident of State S. State S has concluded treaties that are identical to the Model Tax Convention with States B, C, D, and R. Subsidiary pays a dividend to RCo that is subject
to State S domestic withholding tax. The paragraph (which has been modified applying the suggested Look-Through Approach here) provides that in such a case, 25% of the dividend shall be considered, for purposes of Article 10, to be income of a resident of State B, and 50% shall be considered to be income of a resident of State C. Because RCo is not treated as fiscally transparent under the laws of State D and SWF D does not include its proportionate share of RCo’s income and gains under an Anti-Deferral Regime, its share of income is not treated as income of a resident of State D; however, because RCo is resident in State R, the remaining 25% of the dividend is treated as income of a resident of State R.
XX. Investment Vehicles raise particular policy considerations in the context of this paragraph. For this purpose, an Investment Vehicle is a person that: (i) is a person described in paragraph 2(b) or 2(d); (ii) (A) is an Investment Entity as defined under the OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters (the “CRS”) and is subject to reporting requirements under an exchange of information regime like the CRS or the U.S. reporting provisions commonly known as FATCA; (B) has a bona fide investment objective; and (C) is offered to all investors in a defined class of investors to invest on a collective basis; or (iii) is wholly owned by one or more persons described in (i) or (ii), provided that substantially all the income and gains of that entity is derived from investments made for the benefit of such persons. Because many Investment Vehicles typically pool capital from multiple jurisdictions, and because they are not engaged in a non-investing business, their economic connection to a jurisdiction is different than entities in non-investing businesses. 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 connection of the Investment Vehicle to its jurisdiction of residence.

XX. The following example illustrates the application of the paragraph to Investment Vehicles:

Example: Fund is an investment fund, with a mandate, for example, to invest in real property assets in a specified geographic region that includes State R. Fund is organized as a limited partnership under the law of State R, is an Investment Entity as defined in the CRS, and is subject to reporting requirements under State R law based on the CRS. Fund is marketed to a diverse investor base.

An individual Investor A, owns 20% of the equity interests in Fund and is resident in State X. SWF B, an entity described in paragraph 2(b) that is also a resident in State X, owns 35% of the equity interests in Fund. Pension Fund C, an entity that is described in paragraph 2(d) and that is resident in State C, owns 15% of the equity interests in Fund. SWF D, an entity that is described in paragraph 2(b) and that is resident in State D, owns 30% of the equity interests in Fund. Fund is treated as fiscally transparent in States C, D, and R and fiscally opaque in State X. Fund serves as a pooling vehicle for diverse investors and was formed in State R, for example, to be sited within and to gain access to regional real property expertise. This includes engaging service providers such as investment managers, real property managers, joint venture partners, and administrators and appointing directors with regional investment expertise, knowledge of regional business practices and the regulatory environment and legal framework. Fund has qualified service providers in State R that provide administrative services like transfer agent and recordkeeping for Fund.

Fund wholly owns RCo, a company that is also resident in State R. RCo is subject to corporate income tax in State R, and is treated as fiscally opaque by States C, D, R and X. RCo was formed for a number of commercial reasons, including the ability to raise third-party debt at the level of RCo rather than at the Fund level, thereby protecting investors from liabilities, including real estate-related risks. RCo’s establishment also facilitates the later sale of real property assets in a more efficient form through the sale of some or all of its shares in its real property companies. Half of the board members of RCo (or its investment manager/administrator) are resident in State R, and each has the relevant expertise to direct the business of RCo. The decisions of the board are taken in State R.

RCo owns all of the outstanding equity in Subsidiary, a State S corporation that is a tax resident of State S and that owns real property assets in State S. Subsidiary pays a dividend to RCo that is subject to State S domestic withholding tax.

State S has concluded a treaty that is identical to the Model Tax Convention with State R but not States C, D, or X. RCo’s creation, operations and investment decisions take into account the existence of tax benefits provided under State R’s extensive tax convention network. In making its decision to invest in shares of Subsidiary, RCo considered 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. In this example, because Fund and RCo are Investment Vehicles [as defined above], were formed in State R for commercial reasons, and RCo’s activities are substantial such that it satisfies the requirements of this paragraph, unless RCo’s investment is part of an abusive arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to conclude that a principal purpose of RCo is to obtain a benefit of the State R – State S tax treaty.
Annex II – Draft Language for LOB

Application of Ultimate Beneficial Owners Approach to LOB

Paragraph X – Derivative benefits for Investment Vehicles

X. An Investment Vehicle that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if, at the time when that benefit would be accorded:

a) more than 80 per cent of the aggregate voting power or value of its shares or equity interests (and at least 80 percent of any disproportionate class of shares or equity interests) is owned, directly or indirectly, by persons that are equivalent beneficiaries that are described in paragraph 2(b) or 2(d) or that include their proportionate share of the Investment Vehicle’s income and gains on a current basis (including pursuant to an Anti-Deferral Regime), and

b) less than 50 per cent of the Investment Vehicle’s gross income, as determined in the Investment Vehicle’s state of residence, for the taxable period that includes that time, is paid or accrued, directly or indirectly, to persons who are not (i) Investment Vehicles described in clause (a), or (ii) residents of either Contracting State or equivalent beneficiaries, in the form of payments (but not including arm’s length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the Investment Vehicle’s state of residence.

Paragraph 6(j)

j) An Investment Vehicle is an entity that: (i) is a person described in paragraph 2(b) or 2(d); (ii) (A) is an Investment Entity as defined under the OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters (the “CRS”) and is subject to reporting requirements under an exchange of information regime like the CRS or the U.S. reporting provisions commonly known as FATCA; (B) has a bona fide investment objective; and (C) is offered to all investors from a defined class of investors to invest on a collective basis; or (iii) is wholly owned by one or more persons described in (i) or (ii), provided that substantially all the income or gains of that entity is derived from investments made for the benefit of such persons.

Application of Substance Approach to LOB

3. a) A resident of a Contracting State will be entitled to the benefits of this Convention with respect to an item of income or gains derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in the first mentioned Contracting State (other than the business of making or managing investments for the resident’s own account, unless these activities are banking, insurance or securities activities carried on by a bank or [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer or
Investment Vehicle, respectively), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that business.

* * *

d) Solely for purposes of applying this paragraph, an “Investment Vehicle” will be treated as engaged in the active conduct of a trade or business in a Contracting State only if (i) at least half of the board members of the Investment Vehicle (or investment manager/administrator) are resident in the jurisdiction; (ii) the board members resident in the jurisdiction have the relevant expertise to direct the business of the Investment Vehicle; and (iii) the Investment Vehicle (or investment manager/administrator) has qualified personnel in the jurisdiction that can fulfil and administer the transactions undertaken by the Investment Vehicle. For this purpose, an Investment Vehicle is a person that: (i) is a person described in paragraph 2(b) or 2(d); (ii) (A) is an Investment Entity as defined under the OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters (the “CRS”) and is subject to reporting requirements under an exchange of information regime like the CRS or the U.S. reporting provisions commonly known as FATCA; (B) has a bona fide investment objective; and (C) is offered to all investors in a defined class of investors to invest on a collective basis; or (iii) is wholly owned by one or more persons described in (i) or (ii), provided that substantially all the income of that entity is derived from investments made for the benefit of such persons.
Dear Ms de Ruiter

Follow up work on BEPS Action 6: Preventing treaty abuse – a BPF response

Introduction

The British Property Federation (BPF) is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses comprising commercial property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry.

We welcome the opportunity to comment on the OECD’s Public Discussion Draft. The issues and proposals raised therein are of great relevance to the real estate industry.

Executive summary

Investment into commercial real estate is critical for any economy. Such investment provides high quality accommodation in which businesses – from retailers to manufacturers, leisure centres to hospitals – can carry out their activities and allows them the flexibility to adapt and relocate as business economic conditions change.

We are keen to ensure that any proposals aimed at tackling perceived tax abuse do not inadvertently stem the flows of capital into real estate. That would ultimately harm the quality and availability of business infrastructure in the countries in which real estate funds choose to invest.

Given its bulky and illiquid nature, it is common for investors to gain exposure through collective investment vehicles and joint venture arrangements. Such arrangements spread commercial risk among participants and give investors access to opportunities and expertise they would not have on their own.

Investors in commercial real estate funds are a diverse group, ranging from major institutional investors such as pension and sovereign wealth funds to individual retail investors. Ultimately, however, the majority of investment into commercial real estate in the UK (and in most mature economies) provides pensions and savings for ordinary households around the world.

Real estate funds are designed to ensure that investors pay no more tax than if they had invested in property assets directly, while affording them the above noted benefits of collective investment. Typically, tax will be paid on rental profits, property gains, transfer taxes etc in the jurisdiction in which the property is located. As a result, real estate funds are generally structured in a tax transparent manner and the ability to reclaim any withholding tax suffered via double tax treaties is crucial to ensure that double or even triple taxation does not arise as the post-tax profits are repatriated to the ultimate investors.

We are concerned that by restricting access to treaty benefits the OECD’s current proposals could jeopardise the commercial viability of real estate investment structures and the
valuable contribution they make to both the real economy and to savers. Our principal concern is that the definition of “CIV” for the purposes of the proposed LOB provision is too narrow. We are also concerned that the proposed “derivative benefits” clause does not work in practice for “Non CIVs” that are currently unable to access treaties via the LOB provision. Please see Appendix 1 for more detail.

Key recommendations

- **Extend the definition of “CIV” to more adequately cover ‘alternative’ funds.** This could be achieved by removing the requirement for CIVs to be subject to investor protection regulation and hold a diversified portfolio of securities. The widely-held condition should remain, as this provides the best safeguard against abuse.

- **Update the derivative benefit provision to better apply to ‘alternative’ funds.** We do not see a justification for the requirement for an entity to be owned by seven or fewer beneficiaries and this condition should be relaxed or removed altogether. The requirement for 95% of the voting power to be held by equivalent beneficiaries could also be reduced (say, to 80%) if other anti-avoidance measures are adopted.

- **Amend the ‘equivalent beneficiary’ rules** so that intermediary holding entities in an investment structure that is ultimately more than 80% owned by equivalent beneficiaries are also treated as equivalent beneficiaries and are therefore able to benefit from treaty access. In addition, the type of entities that constitute ‘equivalent beneficiaries’ should be more consistent with entities that would qualify under the LOB rule.

- **Protect against the abuse of more relaxed CIV and derivative benefit provisions.** This could be done by denying treaty access to funds which are ultimately more than 10% owned by a single non-equivalent beneficiary and their connected parties.

Structure of this response

- Appendix 1: Application of LOB and derivative benefit provisions for CIV and Non-CIV funds

- Appendix 2: Issues related to the PPT rule

- Appendix 3: Examples of real estate investment structures

We would welcome the opportunity to discuss the contents of this letter in more detail. We remain at your disposal should you have any questions or require further details.

Yours sincerely

Ion Fletcher
Director of Policy (Finance), BPF
ionfletcher@bpf.org.uk
+44 (0)20 7802 0105
Appendix 1: Application of LOB and derivative benefit provisions to CIVs and non-CIVs

1. CIV funds: Application of the LOB rule and treaty entitlement

We are pleased that the current discussion paper acknowledges the need to reassess the policy considerations relevant to the treaty entitlement of collective investment vehicles. We are also pleased that the discussion draft identifies that many ‘alternative’ funds (including real estate) would not meet the conditions of the proposed CIV definition and may therefore be denied relief under the LOB rule, even if no tax avoidance is taking place.

In our view such an outcome would severely affect the viability of collective real estate investment and that in turn would result in less investment going into our built environment. Ultimately, that would hurt the real economy by depriving businesses of the space they need to thrive.

The proposed CIV definition includes “funds that are widely-held hold a diversified portfolio of securities and are subject to investor regulation in the country in which they are established”. Of those three conditions, we consider that the requirement for a fund to be “widely held” provides the greatest degree of protection against treaty abuse. Where a fund is genuinely widely held, the risk that any individual investor (or small group of them) could influence the structure or investments of the fund to facilitate their own tax advantage is significantly mitigated.

We would therefore encourage the OECD to make the “widely held” condition the most important factor in determining whether a fund should be entitled to treaty access. It will be important to consider what “widely held” should mean in this context and for these purposes it is worth considering where OECD member states have already implemented similar tests.

For instance, the UK’s Genuine Diversity of Ownership (or GDO) test looks to how widely a fund is marketed while the ‘close company’ rules consider cases where five or fewer participators have control over a company. Whatever test or criteria are ultimately adopted in assessing where a fund is “widely held”, it is important that it reflects the fact that a single institutional investor (e.g. a pension fund, or a life insurance company) is ultimately widely held.

We would question the relevance of investor protection regulation in determining whether a fund should be entitled to treaty access. We can see that it might be an indicator of probity, demonstrating that the fund is subject to outside scrutiny, but ultimately we do not think it should be necessary. Ultimately, requiring a fund to be “widely held” constitutes a far more effective mitigation of tax avoidance.

Indeed, retention of the investor protection regulation requirement would discriminate against funds with professional investors, which do not ordinarily require such protection. It seems unreasonable for funds which attract institutional investors to not meet the CIV definition, simply because they are not subject to investor regulation. Furthermore, investor regulation varies significantly across jurisdictions, rendering this condition somewhat inconsistent.

We also consider that the requirement for a CIV to hold a diversified portfolio of securities is irrelevant in considering whether it should be entitled to treaty access. As noted above, requiring a fund to be widely held should considerably curtail the ability of individual investors to determine both the structure of the investments as well as the investments made by the fund. The diversified portfolio of securities requirement also provides favourable treatment to funds which invest in securities over other asset classes, introducing an
unwanted element of discrimination. Accordingly, the portfolio of a fund should have no bearing on whether or not it is entitled to treaty benefits.

To conclude, the widely-held criteria should be the most relevant factor in determining whether a fund should be eligible for treaty benefits and the CIV definition should therefore be amended to reflect this by removing the investor protection regulation and diversified portfolio conditions. In order for this provision to work effectively for real estate investment structures, all intermediate holding companies and special purpose vehicles that are owned by a qualifying CIV should also be eligible for treaty benefits under the LOB rule.

2. Non CIV funds: Application of the derivative benefit provision and treaty entitlement

As noted above, the current CIV definition does not provide adequate double tax relief to ‘alternative’ funds and our strong recommendation is for it to be expanded to include all widely held funds.

However, if this is not felt to be feasible, it is essential that the derivative benefit provision works effectively for non-CIVs in order that treaty access can be obtained where a fund’s ultimate investors would be entitled to them.

Such funds often make use of intermediate holding companies for a variety of commercial purposes, such as isolating commercial risk, raising finance, achieving administrative efficiencies or facilitating joint venture arrangements. The latter is particularly common for real estate and infrastructure investment and it is therefore essential that the derivative benefit provision works for these types of structures (see Appendix 3 for illustrations and explanations in a real estate investment context). The use of such entities should not automatically be assumed to constitute tax avoidance.

Accordingly, the derivative benefit provision should recognise that intermediary holding entities in a structure can qualify as equivalent beneficiaries, as long as the clear majority (say, 80%) of the fund’s ultimate investors are themselves equivalent beneficiaries. We appreciate that our suggested 80% threshold is lower than the existing 95%, however we can foresee significant problems for funds and their managers in keeping track of the ‘equivalent beneficiary’ status of investors where units in the fund are widely held or regularly traded.

In order to avoid the “cliff edge” situation where a fund falls below a certain threshold of eligible investors, we agree with the approach outlined in the OECD’s 2010 report on CIV’s. That is, where a fund falls below a certain threshold of eligible investors, they would still be able to access treaty benefits on the income received based on the proportion of “good” investors (equivalent beneficiaries) in the fund.

In addition, it is not clear why an entity must be owned by seven or fewer equivalent beneficiaries in order to be considered an equivalent beneficiary in its own right and therefore benefit from treaty access. Many funds – even those that could not be described as ‘widely held’ – are likely to have more than seven investors. Furthermore, given that the more widely held a fund is, the more difficult it is for treaty abuse to take place; it is not clear what the policy intention is to place any restriction on the number of owners.

Finally, we would suggest that the type of entities that constitute ‘equivalent beneficiaries’ should be more consistent with entities that would meet the LOB rule. Furthermore, unquoted companies do not currently constitute an ‘equivalent beneficiary’ which is particularly problematic for holding companies within real estate investment structures.
While the suggested changes to the derivative benefits clause will improve the ability of some non-CIV funds to make use of treaty benefits, it is by no means an ideal solution for real estate funds. We would therefore reiterate the importance of developing a CIV definition that allows all widely held funds access to double tax treaties under the LOB rule.

3. **Avoidance/abuse considerations**

As noted above, where a fund is truly widely held this will significantly reduce the risk of treaty abuse as no single investor will have sufficient influence to determine the investment structure or the individual investments made by the fund. Therefore, we would encourage the OECD to make this the primary consideration in determining whether a fund qualifies as a CIV and does not therefore have its treaty benefits restricted by the LOB rule.

In respect of the derivative benefits clause, we have suggested that the minimum threshold of ownership by equivalent beneficiaries is reduced to 80%. This is particularly important if the definition of “CIV” remains as restrictive as currently proposed.

We acknowledge that lowering the threshold from 95% to 80% potentially opens up the scope for treaty benefits to be accessed by investors that would not otherwise be eligible for them. In order to limit the risk of these structures being used for avoidance, the OECD could consider introducing provisions that deny treaty benefits to any fund which is more than say, 10%, owned by a single non-equivalent beneficiary and their connected parties.
Appendix 2: Application of the PPT rule

The PPT rule does not provide the same level of categorical certainty as the LOB provision regarding eligibility for treaty benefits. However, it provides non-CIVs that would otherwise fall foul of the LOB and derivative benefits provisions with an opportunity to access treaties where there are clear non-tax motivated reasons for using particular structures. It is therefore important that the PPT rule is relatively straightforward to interpret across different jurisdictions.

In order to address the uncertainty inherent in a PPT rule, we recommend that it should be a test of the principal purpose of an arrangement, rather than one of the main purposes of the arrangement. We consider that modifying the PPT rule in this way will minimise the level of subjectivity from different tax authorities and increase certainty for investment funds.

We set out below our comments on specific issues raised by relevant paragraphs in the discussion draft.

**Paragraph 31**
The suggestions to clarify to wording of paragraph 13 of the Commentary of the PPT rule to clarify the application of the PPT rules where benefits are obtained under different treaties seems reasonable.

**Paragraph 32**
Real estate investors require certainly regarding their eligibility for treaty access in order to determine the viability of investments and in order to price their fund units. Therefore, we would recommend that countries are given the option to implement this suggestion, but only to the extent they have the necessary resources.

**Paragraph 34**
There is a significant difference between the discretionary relief provisions under the LOB rule and the PPT rule. The PPT rule only denies tax relief if it is reasonable to conclude that tax avoidance is in point while the LOB discretionary relief provisions put the onus on the taxpayer to show that the obtaining of benefits under the treaty was not a principal purpose of the arrangement.

We would recommend that a consistent approach should be adopted for both the PPT and discretionary benefit provision. We consider that the approach under the PPT rule is more appropriate therefore it should be expressly stated that the PPT guidance is also relevant to the discretionary benefit rule.

**Paragraph 37**
We strongly support the suggestion to include examples of non-tax motivated uses of special purpose vehicles (SPVs) in order to pool the investment of various institutional investors from different countries. We would also encourage the commentary of the PPT rule to include examples of non-tax motivated reasons for using intermediary vehicles in widely held investment structures more generally. Some typical commercial reasons for using intermediary vehicles are outlined over the next few paragraphs.

Due to its bulky and illiquid nature, it is very common for investors to enter into joint venture arrangements to invest in real estate. One of the main benefits of such arrangements is to enable investors to benefit from the capital or expertise (such as construction, development or property management skills) of their joint venture partners. Joint ventures rely on the use of SPVs to hold property assets and to aggregate the capital of its partners. See Appendix 3b for an illustration of a joint venture real estate investment structure.
More generally, one of the main aims of real estate investment structures is to ensure that investors suffer no more tax on their interest in the fund than they would have incurred had they invested in the underlying assets directly. Investment fund structures are often transparent for tax purposes to allow profits to be distributed to investors, who will pay tax based on their individual tax attributes. Property rental profits and gains are generally taxable in the country in which the asset is located (which is where the economic activity relating to property investment occurs). Any further tax suffered by investors would effectively represent double taxation.

The commercial operation of these arrangements relies on the use of SPVs in various different non-tax related ways:

i) SPVs are often used to hold individual real estate assets directly – they are often based in the same country as the real estate asset but not always. The benefits of using an SPV at this level include:
   a. Facilitate co-investment e.g. joint venture arrangements
   b. Enable the fund to sell a proportion of the asset rather than the entire asset;
   c. Allow specific borrowing secured against the property asset;
   d. Contain losses from a particular asset in a single entity, preventing them from affecting other assets;
   e. The SPV will also typically engage property managers and other local contractors.

ii) Intermediary holding companies typically perform fund administrative functions and accounts consolidation for the underlying property portfolio. They may also borrow money that is on-lent to property owning SPVs.

iii) The use of intermediary holding companies also enables investors to invest in specific assets or portfolios held by a fund without having to be exposed to all of the fund’s assets (as shown in Appendix 3b).

See Appendices 3a and 3b for an illustration of a typical real estate investment structure and joint venture arrangement.
Appendix 3a: Illustrative example of a widely held real estate investment structure

**Investors**
Investors invest via a fund to pool resources and achieve economies of scale, to spread risk and to access professional investment and portfolio management services.

**Master Feeder Fund**
This vehicle is usually a transparent entity. Investors like to invest in a transparent vehicle to ensure that they are taxed according to their individual tax attributes.

**Holding Company**
A holding company is required in order to consolidate all of the underlying real estate investments. The administration and financing of the property portfolio may also be carried out by the holding company.

Any double tax treaty claims applied for in respect of WHT suffered on the distributions received from the underlying investments are claimed by the holding company. This is an important function of the holding company as it is administratively simpler for one company to reclaim the WHT suffered, rather than each individual investor making a treaty claim. Individual investors may not have expertise to submit a treaty claim and it may not even be economically viable to do so on their portion of profits.

It is not uncommon for a local holding company to be used in the same jurisdiction as the investment, as illustrated with the investment in Country A.

**SPVs and investments**
Individual real estate assets are often directly owned by a special purpose vehicle or holding company, often (but not always) in the same country that the asset is located. This allows flexibility when selling the asset e.g. the ability to sell a proportion of the asset rather than the whole asset. It also allows for specific borrowing at the level of the asset if required.
Appendix 3b: Illustrative example of a joint venture real estate investment structure

The above is a relatively simple structure; JV arrangements can be far more structurally complicated. For example, investors may decide that further capital or expertise is required in respect of each of their investments. As a result, they may decide to invite a further JV partner to invest in that particular asset; as illustrated with the asset located in Country B. For every tier where further investors enter the structure, an additional holding company is typically introduced which adds further layers and complexity to the structure.

As with all real estate investment, rental income and gains made on the property are generally taxable in the location of the property. Hence, any further tax suffered by entities in the investment structure would constitute double or triple taxation on the same profits or earnings that are being repatriated to the ultimate investors.

**Investors**

Investors choose to invest together to benefit from the resources or skill set that the other joint venture partner brings to the arrangement. In this typical example, a pension fund or other professional institutional investor will bring the majority of the capital while the Property Company brings specific real estate industry expertise such as construction or development.

**JV investment vehicle**

JVs can either be structured through partnerships (typically transparent) or corporate (opaque) or regulated fund vehicles (transparent) that just happen to have a small number of participants, albeit the institutional investors will ultimately be widely held.

**Holding Company**

A holding company is required in order to consolidate all of the underlying real estate investments. The administration and financing of the property portfolio may also be carried out by the holding company.

Where a second tier JV investor is introduced further down the structure, it is not uncommon for a local holding company to be used, as illustrated with the investment in Country B.

**SPVs and investments**

Individual real estate assets are often directly owned by a special purpose vehicle or holding company, often (but not always) in the same country that the asset is located. This allows flexibility when selling the asset e.g. the ability to sell a proportion of the asset rather than the whole asset. It also allows specific borrowing to be done at the level of the asset if required.
8 January 2015

Submitted by email: taxtreaties@oecd.org


Through its members, BUSINESSEUROPE represents 20 million European small, medium and large companies. BUSINESSEUROPE’s members are 41 leading industrial and employers’ federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled “Follow up Work on BEPS Action 6: Preventing Treaty Abuse” 21 November 2014 – 9 January 2015 (hereinafter referred to as the Draft).

General Comments

BUSINESSEUROPE supports the OECD’s work to prevent abuse of tax treaties. It is however important to make any new provision sufficiently targeted toward abuse in order not to negatively impact bona fide businesses. The initial and prime objective with tax treaties is and should continue to be to facilitate cross-border trade through the allocation of taxing rights between countries and to provide for mechanisms to eliminate double-taxation. By doing so, tax treaties provide certainty and eliminate major obstacles to cross border trade.

BUSINESSEUROPE acknowledges the time pressure in the BEPS project. However, we fear that the proposed amendments to the Model Treaty will have a major impact not only on abusive cases but also have negative effects on genuine business activities. Considering the added complexity and unpredictability that will follow, should these proposals be implemented, we are surprised and concerned about the lack of new guidance in the Draft.
Although the prevention of tax evasion and avoidance may be important purposes of a tax treaty, they do not constitute a prime objective, equal to the prevention of double taxation, and should not be a main objective for entering into a tax treaty.

Before entering into treaty negotiations States should carefully analyse and study relevant provisions etc. in the other country, in order to identify potential areas that could open up for treaty abuse. If countries applied this in a consistent manner as indicated in the report on the work on Action 6 (the Report), there would be fewer loopholes to exploit and thus less need for anti-abuse rules. This approach would minimize the impact on genuine business activities. In case of abuse treaties should be renegotiated or as a last resort terminated.

It is of utmost importance that anti-abuse rules are designed so that they have a minimum impact on genuine business operations. Consequently, we believe that perceived inappropriate behaviour is best addressed with specific and targeted anti-abuse provisions. In our view, both the proposed LOB provision and the PPT fail in this respect, since they are too general in nature and not limited to abusive situations.

In particular, anti-abuse provisions should recognize that holding, financing and investment activities are normal and legitimate business activities that should not suffer blanket exclusions from treaty protection, which seems to be the outcome with the proposed LOB provision. Despite numerous comments from public commentators, we feel that these issues still have not been addressed properly.

The Principal Purpose Test (PPT), previously called the Main Purpose Test (MPT), is still very wide and vague. We still have difficulty in understanding how there could be more than one principal purpose. If a PPT should be used, the test should focus on the principal purpose of the arrangement or transaction.

Although we find both the LOB and the PPT rule to be too far-reaching we are positive to the fact that the OECD at least has dropped the requirement to have them both in a treaty and settled for a minimum standard of either a PPT or a LOB supplemented by a restricted PPT for conduit financing arrangements.

Apart from the fact that the LOB seems overly restrictive, a number of paragraphs in the proposed LOB could also be in violation with EU law. In addition, certain provisions such as subdivision 2 c) i) B seems to relate to specific US issues and should consequently be dealt with on a bilateral basis and not be inserted into the Model Treaty.

We have limited our comments to some of the issues in the Draft.
A. Issues related to the LOB provision

1. Collective investment vehicles: application of the LOB and treaty entitlement

An indirect investment through a CIV should not be treated worse than if the investment had been made directly. Consequently, we believe it is important to provide treaty benefits for CIVs and are positive to an inclusion of a specific paragraph in the LOB that would grant CIVs treaty benefits.

With the exception of para 42, the approaches in the report on action 6 require a test to establish that a certain amount of the investors in a CIV would have been entitled to treaty benefits had they invested directly. Such an approach would impose a high compliance burden on the CIV. Para 42 suggest that a CIV could be a qualified person if the principal class of shares in the CIV is listed and regularly traded on a recognised stock exchange. Even though this latter condition would be fairly easy to comply with, the problem is that it would only be applicable to a small portion of CIVs. Many CIVs are not traded on a stock exchange and would thus be excluded from treaty benefits.

In our opinion, a CIV should be entitled to treaty benefits if it is registered in one of the contracting states.

3. Commentary on the discretionary relief provision of the LOB rule

BUSINESSEUROPE would welcome a statement in the discretionary relief provision to ensure a prompt response from the competent authorities. A set time period would be preferable.

4. Alternative LOB provisions for EU countries

BUSINESSEUROPE agrees that the LOB rule needs to be adapted to reflect EU law requirements.

In particular, our concern is with the prohibition of non-resident intermediaries in the ownership tests, the local stock exchange requirement in the publicly traded test and the PPT rule.

Non-resident intermediaries in the ownership tests in subdivision 2 c) (ii) and 2 e) (i) of the LOB rule:

Apart from the fact that we believe the conditions regarding intermediate owners to be too restrictive, we also are concerned that they are in violation of EU law since both provisions disqualify companies from treaty protection if they are owned by companies in the EU/EEA. In our view, the LOB should focus on testing the ultimate beneficial owner and not intermediary companies. BUSINESSEUROPE proposes to delete the
reference to intermediate companies in both provisions. Under any circumstances, the provisions should at least be amended to provide for intermediate ownership within the EU/EEA.

**The local stock exchange requirement in subdivision 2 c) i) a) in the LOB rule:**

The choice of a stock exchange is no longer (if it ever was) an indication of a "home" jurisdiction but instead is driven by the desire to raise capital most efficiently. For example, mining companies often list on Toronto, technology companies list on NASDAQ etc.

In addition, the local stock exchange requirement is likely to be in violation with EU law since only the stock exchange in the Contracting State of which the company is a resident is accepted, thus preventing companies to list their share on other stock exchanges in the EU. Some treaties with the US contain a list of accepted stock exchanges as suggested in para 6 of the proposed LOB. Consequently, BUSINESSEUROPE proposes that the list in para 6 a) should at least include every stock exchange in the EU and any other State in the EEA.

**The PPT rule**

In addition to the fact that we find the PPT to be vague and not sufficiently targeted on abusive cases we are also concerned that the PPT could be in violation with EU law. The Cadbury Schweppes case (C-196/04) concludes that anti-abuse legislation should only target “wholly artificial arrangements”. As currently drafted, the PPT does not seem to provide such certainty.

In our opinion, these aspects, and possibly others, definitely require analysis in light of EU law. Should the conclusion be that the provisions are in violation with EU law; a significant number of OECD members would not be able to adopt the LOB provision as it stands.

5. **Requirement that each intermediate owner be a resident of either Contracting State**

As indicated above, we believe that the LOB rule should focus on the ultimate beneficial owner and not intermediate companies. We fully support the comments and examples made by BIAC on this issue.

6. **Issues related to the derivative benefit provision**

We strongly support a derivative benefit provision in the LOB. The derivate benefit provision would extend the granting of treaty benefits to entities that are controlled by
entities that are resident of a third country and that would enjoy the same treaty benefits with the contracting state in question. In such situations, there is no incentive for treaty shopping.

9. Conditions for the application of the provision on publicly-listed entities

We refer to our comments made under item 4 above.

10. Clarification of the “active business” provision

We fully support the comments and examples made by BIAC on this point.

B. Issues related to the PPT rule

12. Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level

BUSINESSEUROPE is in favour of such a requirement in order to prevent excessive use of the PPT.

13. Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable

Introducing a substantive provision such as the PPT without the possibility of mutual agreement procedures or arbitration is not acceptable. Furthermore, it is not unlikely that the Competent Authorities in many cases will be unable to reach an agreement on the application of the PPT with double taxation as the end result. Consequently, BUSINESSEUROPE strongly recommends that the application of the PPT should be under mandatory arbitration.

15. Whether some form of discretionary relief should be provided under the PPT rule

BUSINESSEUROPE is supportive of having a discretionary relief provision under the PPT rule.

16. Drafting of the alternative “conduit-PPT rule”

The provision needs clarification. The wording “all or substantially all of that income (at any time or in any form)” is unclear and could be interpreted too widely. At some
point in time, every company will pay all or substantially all of its income to its shareholders.

We support the inclusion of examples to illustrate that the rule is not intended to apply to a company merely because that company’s policy is to distribute most of its profits in the form of dividends.

C. Other issues

19. The design and drafting of the rule applicable to permanent establishments located in third States

BUSINESSEUROPE questions the necessity of a provision like this in the Model Treaty. This topic may be of interest in relation to some countries and should naturally be carefully considered before entering into a treaty with such a country. At any rate, those situations could be solved bilaterally. In addition, we fully support the comments made by BIAC.

20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

BUSINESSEUROPE supports the comments made by BIAC.

Concluding Remarks

Introducing provisions like the proposed LOB and PPT will undoubtedly induce further uncertainty into the Model Treaty and make treaty application even more difficult. Although, a number of countries have a LOB in their treaty with the United States, similar to the one proposed in The Draft, it is an entirely different matter to insert such a provision into the OECD Model, to be used on a global basis. As proposed, the LOB, apart from being very complex, seems overly restrictive and runs the risk of having a very negative impact on genuine business operations. Furthermore, some provisions seems to relate to specific US issues and it is questionable why such provisions should be included in the Model Treaty and not be dealt with on a bilateral basis.

Whereas the LOB provision is technically complex, it leaves less room for subjective and arbitrary assessments and provides for some certainty. The PPT on the other hand takes the opposite approach. It does not provide much guidance with respect to when the treaty benefits will be granted. Instead, it opens a door for tax administrations to disqualify taxpayers from treaty benefits where that tax administration finds it appropriate. The problem with the PPT is not its complexity. Rather, our concern lies with the fact that it is very subjective and leaves significant room for arbitrary assessments.
Considering the fact that a large number of OECD countries are also members of the EU, we are pleased that the OECD has acknowledged the fact that the LOB needs to be compliant with EU law. As indicated in our comments, we believe that the same is also relevant in relation to the PPT rule. We are, however, very disappointed that a proper analysis ensuring EU law compliance has still not been undertaken.

In view of the implications of introducing these new provisions in the Model Treaty we had expected the Draft to provide more guidance in relation to the issues still to be resolved. As currently drafted, the provisions could seriously undermine the certainty and predictability needed for investment decisions and also lead to an increase of double taxation cases. The effect would be very negative on investments, jobs and growth.

Consequently, we urge the OECD to carefully consider these aspects in the process ahead.

BUSINESSEUROPE would be willing to engage in a constructive dialogue with the OECD on treaty abuse.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

James Watson
Director
Economics Department
Dear Sirs

Re: Follow up work on BEPS Action 6: Preventing treaty abuse

1. Introduction

I am writing to you on behalf of the British Private Equity and Venture Capital Association (the "BVCA"), which represents the interests of members of the private equity and venture capital industry. The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 250 private equity, mid-market, venture capital firms and angel investors, together with over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

2. The role of private equity funds as part of the global economy

2.1. Private equity is one of the options which a company may consider in order to meet a need for capital. It fulfils a different role to say stock market capital or bank lending, because private equity investors will tend to take a more active role in the investee business via a position on the board. Private equity is a source of genuine long term investment without which the real economy would be worse off. Private equity funds are held by a diverse range of investors and are not vehicles formed for a purpose of tax avoidance (or indeed any other nefarious purpose) by any investor or group of investors. These factors are essential to a proper understanding of private equity, and each is addressed in greater detail below.

2.1.1 Private equity is a substantial source of genuine long term investment

BVCA research reveals that private equity funds managed in the UK currently back around 3,050 companies, employing around 1.2m people on a full-time equivalent basis (FTEs) across the world. Of these, around 790,000 FTEs are employed in the UK. Of the companies invested in during 2013 in the UK, around 65% were small companies, with around a further 22% being medium-sized companies.
Private equity funds managed in the UK currently have around £147bn assets under management, including around £48bn yet to be invested, of which around £20bn is destined for the UK.

The EVCA has conducted similar research\(^1\) concluding that:

- €307bn was invested by private equity in European companies from 2007 to 2013 in the 12 largest private equity markets in Europe.
- 25,000 companies are backed by private equity in Europe (of which 83% are SMEs).
- €305bn is the economic value of patents granted to private equity backed companies in Europe between 2006 and 2011.
- 12% of all industrial innovation in Europe is attributable to private equity backed companies.
- Private equity backed companies are up to 50% less likely to fail than non-private-equity backed companies with similar characteristics.

It is clear that private equity plays a meaningful role in providing capital to real businesses.

As well as the benefits to the investee companies and those directly or indirectly employed by them, investment by private equity also has wider benefits to communities. Many private equity firms have signed up to the UN’s Principles for Responsible Investment\(^2\). The private equity work stream was launched in 2008 and now has over 130 GPs and Funds of Funds as members. The UN have noted that "Private equity is highly conducive to responsible investment because of its relatively long-term horizon; the typical holding period for a portfolio company is 3-7 years. In principal, private equity firms have influence over company management and are therefore able to promote ESG initiatives at the company level".

It is clear that any action which reduces private equity investment will have an adverse impact on the real economy.

2.1.2 Investments into private equity funds come from a range of jurisdictions and investor types

Private equity funds managed in the UK raised around £11.2bn of funds in 2013\(^3\). The vast majority (around £9bn) of this fundraising came from overseas investors. The biggest sources of fundraising in 2013 were pension funds (£2.9bn); sovereign wealth funds (£1.9bn); funds of funds (£1.4bn); and insurance companies (£1.1bn). These investments were made from a diverse range of locations including the United States (£4.3bn); United Kingdom (£2.2bn); Germany and Canada (£0.5bn each), the Netherlands, Switzerland, China, and Middle East (£0.4bn each).

\(^2\) [http://www.unpri.org/areas-of-work/implementation-support/private-equity/](http://www.unpri.org/areas-of-work/implementation-support/private-equity/)
\(^3\) [http://www.bvca.co.uk/Portals/0/library/documents/RIA%20Guides/IAR%20Autumn14-fin.pdf](http://www.bvca.co.uk/Portals/0/library/documents/RIA%20Guides/IAR%20Autumn14-fin.pdf)
Separate EVCA research⁴ yields a similar picture: investment into private equity is international, and the vast majority of the capital deployed by private equity is sourced from investing entities which would be expected to qualify for treaty benefits.

Any action which restricts the international flow of capital will reduce the capital available for investment into real companies.

2.2. Having established that private funds provide a vital link between sources and users of capital, it is relevant to consider some of the other common features of a private equity fund.

Typically a private equity fund will be closed ended with a life of ten years. It will invest in a range of businesses, might make in the order of ten to twenty investments over the life of a single fund, and often operate with certain provisions included in the fund documentation to protect investors from excessive risk arising from lack of diversification (whether looked at on a jurisdiction, sector, investment size or similar basis).

Fund performance and executive incentives are driven by the quantum and timing of cash returns: investors will often measure funds on an IRR basis when considering whether to make commitments to subsequent funds, and executive incentive plans are typically subject to a performance hurdle calculated as an IRR on cash returned to investors. There is an important point which follows from this, which goes to answer a misconception which some may hold: private equity funds are simply not vehicles for rolling up or deferring investment returns, not least because private equity fund managers are motivated to return cash to investors.

Private equity fund managers are often comparatively small businesses. Their resources are directed to sourcing opportunities for investment and divestment, and to engaging with and developing the investment portfolio. They do not have capacity to actively manage the tax positions of investors.

The sources of investment into private equity were discussed above and include a diverse range of source locations and entity types. However, it is common amongst them that investors will often require knowledge of how investments will be held before making an investment. Fund managers may respond to this demand by selecting a holding structure for the fund. Important features of this structure will include:

- Clarity that an appropriate “corporate veil” exists to insulate investors from other legal liability risks.

- Familiarity, consistency and reasonable administrative cost. This is significant, because costs impact returns to investors, and investor reporting is one of the primary communication channels between private equity funds and their

⁴ http://www.evca.eu/research/activity-data/annual-activity-statistics/
investors, so it is essential that quality and consistency is maintained.

- Clarity on the ability to extract cash quickly and efficiently when required (some jurisdictions have regimes which restrict the ability to do this).

- A legal system which is attractive to providers of finance, in terms of the ability to grant guarantees, provide security, certainty over enforceability and subordination, etc.

- An ability to accommodate joint venture and co-investment arrangements without undue cost and complexity.

Taxation will of course be a relevant factor in establishing an appropriate strategy for holding investments, as it is for establishing any other business. However, it does not follow that the use of holding companies by private equity funds represents treaty abuse, which seems to be a misconception held by some outside of the industry. It has been seen that investors into private equity are largely institutional investors which would usually be considered to be “good” residents under double taxation agreements. Therefore, for example, to the extent that any holding structure reduces source jurisdiction withholding tax by virtue of double taxation agreements, in the majority of cases it is likely that this simply has the effect of reducing administrative cost for both the source fiscal authority and the investor in obviating the need to reclaim withholding tax. This could hardly be considered to be abusive. In addition, fund documentation will typically prevent the manager from favouring one group of investors over another, so it would be extremely unlikely that a holding structure would be formed, for example, to facilitate avoidance for any particular population of investors. Furthermore, the diverse nature of the investor base in a typical private equity fund means that it would be impractical for a fund to be used to facilitate avoidance, as a fund manager will not possess sufficient information with which to ascertain the consequences of a particular course of action on all of the investors.

Taking the above comments together, it can be seen that private equity funds are entirely commercially arrangements formed for the purpose of collective investment and risk diversification. They make a significant contribution to the real economy. They are not vehicles for tax avoidance.

3. The Public Discussion Draft dated 21 November 2014

3.1. Paragraphs 15 to 17 of the Public Discussion Draft deal with alternative and private equity funds.

Private equity, hedge, infrastructure, real estate, and other alternative investment strategies all have distinct features. It is unlikely that a single solution for granting appropriate treaty access to all of these fund types will be found. Each must be
considered separately if it is to be properly accommodated and investment capital for underlying businesses maintained.

3.2. Paragraph 15 highlights certain features of the definition of collective investment vehicle set out in the 2010 Report on The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles and concludes that “Alternative funds / private equity funds generally do not meet these conditions because they typically have a limited number of institutional investors, may not hold a diverse portfolio and are not subject to the same investor-protection regulation”.

The BVCA agrees that certain features of private equity are different to other funds which may fall within the definition of a CIV fund. However, taking the three broad areas highlighted in Paragraph 15 in turn:

- As discussed above, private equity funds typically do have a diverse investor base, both in terms of the source jurisdiction of invested capital and the organisational nature of the investors;

- As discussed above, private equity funds typically do hold a diverse portfolio; and

- Private equity funds are subject to significant regulation (as are CIV funds). Within the EU regulation in this area comes mainly from the Alternative Investment Fund Managers Directive. The fact that the Directive operates over the manager of the fund rather than the fund itself does not mean that investors are exposed to an environment which is entirely free of regulatory supervision. Similarly, in the United States private equity funds and their advisers are subject to extensive regulatory supervision, arising from a range of provisions including the U.S. Securities Act of 1933, the Foreign Corrupt Practices Act, and the U.S. Investment Advisers Act of 1940 as amended by the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, amongst others.

These observations are important as they underline that private equity funds simply do not exist to facilitate tax avoidance or evasion for any investor or set of investors, should that view persist; private equity is a genuine investment strategy chosen by a broad range of investors, it provides genuine investment into portfolio businesses, and is subject to extensive regulatory scrutiny. In this broad sense private equity funds are no different to CIV funds and have the same commercial validity.

Notwithstanding that private equity funds share certain broad commercial features with CIV funds, it is important to make clear that the solutions proposed for dealing with treaty challenges for CIV funds cannot readily be adopted by private equity funds. These solutions are largely based on the TRACE project, which developed proposals which were designed to apply to CIV funds, which explicitly excluded private equity. Having not been designed to apply to private equity, a TRACE solution cannot readily be adopted by private equity; private equity was not represented during the development of TRACE.
This highlights one of the differences between CIV funds and private equity funds: CIV funds operate in an environment where service providers offer fund platforms, paying agent services, and intermediary services (for example) to support the operations of the funds, but these roles largely aren’t required by private equity funds. As such, the manager would be required to operate TRACE.

Private equity fund documentation does not grant the manager of the fund the necessary power to obtain the information which would be necessary in order to operate TRACE in any form, and managers do not have the systems and processes in place to deal with such information if they could access it. As described above, private equity funds typically exist for periods of around ten years. Even if funds raised after the conclusion of the BEPS work on Action 6 began to include terms which could facilitate the operation of a system like TRACE it would be many years before such terms were observed in the majority of funds. For these reasons we consider that the proposals made in sections 4 and 5 below are preferable to any solution modelled on CIV funds.

3.3. Comments are invited on whether the Public Discussion Draft accurately describes the treaty entitlement issues for private equity funds and how to address these issues without creating opportunities for treaty shopping. We have provided these comments below.

3.4. Section 17 of the Discussion Draft invites examples which could be included in the Commentary on the PPT rule. These are provided in section 5 below.

4. Limitation on Benefits

For the reasons set out above, private equity funds will rarely if ever hold an investment directly – it will usually be held via an intermediate holding company which will ensure consistency of treatment amongst investors. Because of this, in what follows references to private equity funds include references to their controlled holding structures, which need to be accommodated as part of a solution which seeks to maintain treaty access for private equity and the viability of private equity as a source of international capital investment.

4.1. Treaty entitlement issues for private equity funds

Private equity funds would largely fail to qualify for treaty benefits under the draft LOB provisions because they:

- Would not usually be listed on a recognised stock exchange;
- Would not be carrying on an active trade or business as defined; and
- Could not avail themselves of the derivative benefits provisions because of the diversity of ownership outlined above.

The above points set out the technical issues which arise in considering how a private equity fund would be seen as measured by the draft LOB. However, of course, the
underlying and more meaningful issue is an economic one: if action on treaty abuse makes international investment into private equity less attractive then investment may fall, and the private equity fund industry and the support it provides for the real economy may contract as a result.

4.2. How treaty entitlement issues for private equity funds can be addressed without creating opportunities for avoidance

We believe that private equity/non-CIV funds should be explicitly excluded from the LOB work under Action Point 6 such that their ability to access treaty benefits is not compromised. However, in the event that the OECD are unable to accept this recommendation we set out below an alternative proposal. An additional category of qualified person would be required, to include the concept of a qualified fund. The four broad features of a qualified fund test would be:

A - Diversity of investors. The fund would be intended to be diversely held and would be marketed appropriately.

B - Appropriate regulation. The fund or manager, as appropriate, would be regulated by a recognised regulator.

C - Substance. Any holding structure would be subject to a minimum standard of investment in the local economy, measured perhaps in terms of locally incurred expenditure commensurate with investment activity.

D - Reporting. In order to be a qualifying fund, the fund would elect to participate in a reporting regime developed from existing mandatory reporting requirements. This reporting regime would be designed to deliver information about investors and underlying investments.

Of course, work would be required in order to refine this regime so that it could be included in the model LOB. However, in principle it is clear to see that such features would minimise the possibility of treaty abuse being facilitated by private equity funds. Taking the features in turn:

- The diversity of investors condition would ensure that a fund could not be used for purposes of treaty abuse by, say, a single dominant investor or indeed for any group of investors, bearing in mind the diversity of jurisdictions and entity types which contribute capital to private equity and the requirement to not favour any group of investors over another.

- Appropriate regulation will provide comfort that only genuine investment business qualify for the qualified fund definition. In this regard we would note that the administrative burden and financial cost of obtaining appropriate regulatory approval would act as a significant disincentive to abusing the
qualification.

- The substance condition should provide comfort that holding structures are not mere “shells” and that real business is being carried on – businesses cannot support unproductive costs.

- This reporting regime once developed should provide comfort to source jurisdiction fiscal authorities that no significant treaty abuse is occurring. If over time it became apparent that abuse was occurring then we accept that further action may be necessary – but we do not believe that this will be the case.

We would be pleased to work with the OECD to develop this proposal further.

As stated above, we do not consider that any solution based on the principles of the TRACE project could be a practical solution for private equity funds.

5. Principal Purposes Test

5.1. Treaty entitlement issues

While we support the approach of having a PPT (and not a LOB) as part of a minimum standard, the current proposals are not conducive to international business because they do not provide reasonable certainty for any party to an investment transaction. While of course the BVCA supports the aims of the work to prevent treaty abuse, the outcomes must also balance the need to support international investment, and we consider that, as currently drafted, an appropriate balance has not been reached.

As described above, private equity operates internationally, and all international funds will have experienced how different fiscal authorities view substantially identical fact patterns differently, leading to different treaty qualification outcomes. The current proposals will do nothing to alleviate this challenge and will indeed exacerbate the problem.

The main deficiency in the current proposals is that the PPT currently refers to “one of the principal purposes”. The commentary recognises that the test is subjective, but there is nothing which adequately explains the boundary between an acceptable activity of merely considering the tax consequences of a particular course of action on the one hand, and that consideration rising to become an unacceptable principal purpose on the other. It is inevitable that different tax authorities will interpret the test differently given the same set of facts. As a matter of principle all parties to the BEPS process should consider this to be an unacceptable outcome in designing an appropriate PPT.
Principle 1.4 of the G20/OECD High-level principle so long-term investment financing by institutional investors report\(^5\) concludes that “Investment frameworks should as far as possible be made consistent across counties to facilitate the cross-border flow of long-term financing”. As currently drafted the PPT will not ensure consistency across countries.

We consider that the PPT should be drafted so as to be a test of the principal purpose of an arrangement. We accept that this is a stricter standard which will require greater effort to apply. However, only by modifying the PPT in this way can the subjectivity which will be a barrier to international investment be minimised.

5.2. Example for inclusion in the Commentary

The following examples are provided on the assumption that the PPT remains in substantially the form as currently proposed.

The experience of our membership is that certain fiscal authorities will interpret the same facts aggressively whereas others will be satisfied that no treaty abuse is occurring. As noted above, it is vital that the commentary delivers a PPT which is not only workable but will be applied consistently across all BEPS participant jurisdictions. It is therefore necessary to include a range of examples in the commentary, in order to deliver this consistency.

*Example A: a fund structured as a limited partnership, which is not resident in any state, is marketed to a diverse range of potential investors and as part of this fundraising process indicates to potential investors that investments will be held via intermediate holding companies. In due course the fund is raised and it is necessary to form an intermediate holding company in anticipation of making a particular investment in a company in State S. The fund manager considers a range of potential jurisdictions for the intermediate holding company and as part of this process considers the treaty positions of companies in each potential jurisdiction as well as staff costs, property costs, regulatory costs, etc. The holding company is ultimately formed in State T.*

Taking into account the fact that the investors into the fund and therefore into the holding company are diverse in jurisdiction and in nature, the fact that treaty entitlement was considered as part of the decision to form a company in State T rather than any other state cannot not mean that treaty entitlement was a principal purpose of the arrangement; the holding company is not formed for the treaty abuse purposes of any investor or group of investors. The diversity of the investor group is a strong indication that obtaining treaty benefits was not a principle purpose of the arrangements.

*Example B: same facts as Example A, but the fund manager is aware that a significant majority of investors into the fund are of a type which would not be entitled to treaty benefits in respect of an investment into State S, and furthermore there is no identifiable

commercial purpose to establishing a holding company for this investment. Nevertheless the fund manager forms a holding company in State T in order to secure treaty relief for all investors.

The PPT applies but the holding company formed in State T may not avail itself of treaty benefits in respect of this arrangement.

Example C: same facts as Example A, but the fund manager decides to set up an intermediate holding company which will be used as a joint venture vehicle between the fund and one or several co-investors for the purposes of investing into one or several specific assets. An intermediary holding company or a chain of intermediate holding companies may also be set up to provide for structural subordination between different external financings (e.g. mezzanine loans).

In these circumstances, the set-up of the intermediate holding company or the chain of intermediary holding company is mostly driven by legal and commercial reasons.

Obtaining treaty benefits should thus not be considered as being one of the main purposes of the arrangements.

6. Conclusions

To reiterate our main comments above:

- Private equity funds represent an important source of capital for businesses and have a positive impact on the real economy.

- Private equity funds are diversely held. The majority of capital committed to private equity funds is sourced from pension funds and other institutions which would usually be considered to be “good” treaty beneficiaries. Private equity funds are not vehicles for treaty abuse or tax avoidance more generally; they are vehicles formed for genuine investment and risk diversification.

- The LOB test as currently drafted would have the effect of removing treaty benefits for holding companies owned by private equity funds. This would reduce returns to investors and potentially expose them to double taxation. Given that pension funds represent the largest grouping of investors into private equity funds, it is pensioners, largely in the United States and the United Kingdom, who will bear the cost of this double taxation. In the longer term there is a risk that investment into private equity funds and therefore into the real economy falls as a result.

- We have put forward a proposal to include a concept of a “qualified fund” as part of the LOB test. We appreciate that it would take time to develop the details of such an additional qualification. If the OECD feels that there is insufficient time to properly deal
with this then we would ask that private equity funds are carved-out of the current proposals and the status quo maintained until such time as treaty entitlement for private equity can be properly addressed.

- The PPT as currently drafted is excessively subjective and will result in fiscal authorities reaching a range of inconsistent views on similar sets of facts. The OECD have recognised that inconsistency is undesirable in itself. The solution to this issue is not further commentary and examples as this will just change the nature of the subjectivity. The PPT should be amended to be a test of the (single) principal purpose of a particular arrangement.

Thank you in anticipation for taking our comments into account as part of the consultation process. We would welcome an opportunity to engage more fully with the OECD in due course on this matter and would be pleased to discuss any of the comments made. The BVCA has registered to attend the consultation meeting on 22 January.

Yours faithfully,

David Nicolson

Chairman of the BVCA Taxation Committee
Dear Ms. de Ruiter,

We are writing in connection with the OECD’s invitation to comment on its Public Discussion Draft “Follow up Work on BEPS Action 6: Preventing Treaty Abuse”, released November 21, 2014 (the “Discussion Draft”), and specifically issues affecting pension funds and government-related funds with similar public policy objectives. We greatly appreciate the OECD’s interest in these matters and the opportunity to provide our comments thereon.

We recognize the important tax policy objectives of the BEPS project but we believe that, as currently drafted, the recommendations in the report on Action 6 “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances” may have unintended adverse consequences for other important public policy goals related to pension funds and similar government-related funds, as well as for markets in which these funds invest.

Pension funds as institutional investors play a crucial role in the global economy. In 2012, total assets held by pension funds amounted to USD 26.8 trillion. Pension funds support various sectors of the economy in OECD countries (e.g. infrastructure), act as a barrier against systemic risk and contribute to the economic development of OECD countries and to the deepening of their financial system and stability.

This letter and accompanying proposals describe those concerns, provide comment on certain of the specific issues raised in the Discussion Draft and make related suggestions to improve the tax treaty policy framework that the OECD seeks to update as part of the BEPS project.
Description of Organizations Concerned

As a group, the signatories to this letter have a commonality in that we have long-term obligations and commitments to our respective beneficiaries and constituents, such as, but not limited to, the funding and provision of pension benefits or social programs for current and future generations. Furthermore, we are exempt from income tax in our home jurisdiction, having been granted such benefits by our governments in order to allow them to fulfill their domestic public policy objectives. In addition, various foreign governments recognize that providing reciprocal tax treatment to similarly-situated investors can help them meet their own fiscal and economic policy objectives. There is a direct correlation between the after-tax return on our investments and the accumulation of assets available to meet our governments’ long-term public policy objectives (including supporting the retirement income of current and future generations).

While this signatory group is comprised of Canadian public-sector funds, we believe that both private and public pension funds residing in other countries would have an equal interest in improving the treaty policy framework that is being updated under Action 6.

Summary of Proposals

The Discussion Draft specifically invites comment on an exemption from taxation for income earned by pension funds and similar government-related funds under double tax treaties and related issues. As described in detail in the accompanying proposals, we support a broad exemption from source taxation for cross-border investment income earned by pension funds and similar government-related funds. This approach is appropriate for a number of reasons:

- An exemption from source taxation on investment income recognizes the socio-economic and public policy purpose of pension funds by enabling their ability to accumulate assets to fund growing future retirement obligations in the context of an aging population and longevity trends.

- It reflects and facilitates the growing level of cross-border investment made by pension funds globally in an increasingly diverse range of asset classes. This evolution in investment behaviour has been necessary both for (i) pension funds to earn the risk-adjusted returns required to fund rising future retirement obligations, and (ii) source countries to attract patient long-term institutional capital for a variety of national investment needs by fostering the neutrality of taxation of capital, a policy historically supported by the OECD. Pension fund capital is particularly sought after to fund critical infrastructure needs in a number of developed and developing countries.

- We understand the objective of the OECD initiative is to prevent profit-oriented multinational enterprises from earning untaxed, “stateless” income. An exemption for investment income of pension funds, however, should have no impact on the income tax paid on the operating income of the enterprises in which such pension plans have invested. In addition, since pension funds are generally taxable in their residence country but exempt under a specific tax rule established for domestic public policy purposes, the income they receive should not be seen as “stateless”. The taxation of that investment income is, in fact,
deferred until such time as it is distributed to individual pensioners. Generally, pensioners are taxable upon receipt of pension income.

- Source taxation of investment income inherently results in double taxation of income as pensioners generally cannot obtain tax relief for withholding taxes paid by pension funds. This is an inappropriate outcome from a tax policy perspective.

While a broad pension exemption is desirable and appropriate, the development of a consensus on its provisions among national governments and ultimate implementation through double tax treaties are long-term endeavours. In the near-term, Action 6 may deny treaty benefits to pension funds altogether in certain circumstances. Therefore, we also propose certain alleviating measures to reduce the adverse unintended consequences of Action 6. In particular, we request consideration for provisions to ensure that an investor is not penalized with an increased withholding tax burden for investing through an intermediary jurisdiction instead of directly from its country of origin.

Should you have any questions or comments regarding these matters, please do not hesitate to contact Marc Desrosiers of KPMG LLP (by telephone on +1 514 840 2358 and by electronic mail at marcdesrosiers@kpmg.ca). In addition, we would be interested in providing any further input that you would consider helpful in moving this important Action 6 initiative forward.

Sincerely,

[signed]                [signed]
Jacquelyn Colville     Serena Lefort
Chief Financial Officer Managing Director, Head of Tax
Alberta Investment Management OMERS Administration Corporation
Corporation

[signed]                [signed]
David Woodward     Hersh Joshi
Senior Vice President, Finance Vice President, Taxation
British Columbia Investment Management Ontario Teachers’ Pension Plan Board
Corporation

[signed]                [signed]
Steve Bossé     Jean-François Ratté
Senior Director, Tax Vice President, Taxation
Caisse de dépôt et placement du Québec Public Sector Pension Investment Board

[signed]
Kristina Fanjoy
Managing Director, Head of Tax
Canada Pension Plan Investment Board
PROPOSALS REGARDING THE OECD PUBLIC DISCUSSION DRAFT
“FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE”
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I. INTRODUCTION

Following the release of the Organisation for Economic Co-operation and Development’s (the “OECD”) (2014) report: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, OECD/G20 Base Erosion and Profit Shifting Project (the “Report”), a public discussion draft: Follow up Work on BEPS Action 6: Preventing Treaty Abuse (the “Discussion Draft”) was released on November 21, 2014 in which the OECD invited comments.

More specifically, the following items, among other matters, were identified in the Discussion Draft as being of interest for pension funds:

- Whether and how the issue of the treaty residence of pension funds should be addressed.
- Whether changes should be made to paragraph 69 of the Commentary on Article 18, which deals with the source taxation of income of foreign pension funds, in order to ensure that two countries that follow similar approaches with respect to the taxation of retirement savings consider more thoroughly the appropriateness of including in their bilateral treaty a provision exempting such investment income from source taxation in order to achieve greater neutrality with respect to the taxation of capital.
- Whether drafting changes should be made to the alternative provision included in paragraph 69 of the Commentary on Article 18 (e.g., restricting its application to portfolio investment income).
- How the description of pension funds found in subparagraph 2d) of the limitation on benefits rule (the “LOB rule”) (“person that ... was constituted and is operated exclusively to administer or provide pension or other similar benefits”) could be clarified.

We provide below our comments on the items listed above as well as on certain related issues dealing with treaty benefits for pension funds and similar government-related funds.

II. SUMMARY OF OUR PROPOSALS

1. The following is a summary of our proposals and related comments on certain specific matters raised in the Report and the Discussion Draft:

   - **Tax residence of pension funds** – The OECD Model Tax Convention (the “Model Tax Convention”) and related Commentary (the “Commentary”) should be strengthened to clarify that pension funds should be considered tax residents for purposes of tax treaties regardless of whether the fund benefits from a tax exemption in its country of residence.

   - **Reciprocal exemption for pension funds** – Source country taxation of pension funds’ investment income results in double taxation where a beneficiary of the fund is taxed on distributions and neither the fund nor the beneficiary can recover source country tax through a foreign tax credit or other mechanism. In addition, source country taxation on
investment income of pension funds and similar government-related funds impairs capital import and export neutrality. The most efficient and direct way to address these issues is through a reciprocal exemption from source country taxation on pension funds’ investment income from cross-border investments. Article 18 of the Model Tax Convention and the related Commentary should be modified to support a broad exemption from withholding tax on investment income (dividends, interest, royalties, capital gains and other non-business income) regardless of the ownership interest in the payer of the income. Potential concerns regarding inappropriate tax planning by tax-exempt investors in majority owned investments are not related to the question of treaty benefit entitlement, and would be more appropriately addressed through other BEPS actions.

- **Description of pension funds** – The definition of pension funds in the Model Tax Convention and the proposed LOB rule should be broadened to better take into account certain organizational variations among pension funds. As an alternative to the broadening of the pension definition, the Contracting States should provide for a proportionate exemption on the pension fund’s investment income based on the percentage of its assets to which the pension plan is economically entitled. That is, if an entity is not exclusively engaged in an activity referred to in the definition of pension fund in Article 4, it should obtain an exemption on its investment income determined on the basis of the proportion of its assets to which a pension fund (as narrowly defined) is economically entitled.

- **Discretionary relief under the LOB rule and the PPT** – Discretionary partial relief under both the LOB and the principal purpose test (the “PPT rule”) should be available, based on treaty benefits that would be applicable directly, so that investors are not penalized for investing indirectly through a third country (for example through a co-investment vehicle) rather than directly from their country of residence. This would be especially helpful in alleviating concerns that Action 6 could unduly increase the withholding tax burden of pension funds and similar government-related funds.

- **The “active business” exception to the LOB rule** – The “active business” exception should be made available, in certain circumstances, to institutional investors whose sole activity is the making of investments on their own account, as it is for certain other financial institutions or banks.

- **Non-tax motivated use of regional investment platforms and investment vehicles to pool capital of institutional investors** – The Commentary to the PPT rule should include one or more examples of the circumstances under which regional investment platforms and co-investment vehicles (which are used for a variety of non-tax reasons) should not be denied tax treaty benefits under the PPT rule.

This document does not specifically address the anti-conduit rule contained in the Report. Suggestions herein regarding the application of a “principal purpose” test would apply equally to
the principal purpose determination under the anti-conduit rule. While there are other aspects of
the Discussion Draft that are of interest to institutional investors such as pension funds and
similar government-related funds, given time constraints, we have chosen to focus this report on
those issues on which we are uniquely positioned to comment.

III. DETAILED COMMENTS

A. Tax Residence of Pension Funds

1. The Discussion Draft has invited comments on how the issue of tax residence of pension
funds for tax treaty purposes should be addressed (page 7, after paragraph 17). We
believe that the Model Tax Convention and related Commentary should be strengthened in
this regard and provide comments on the matter below.

2. Paragraph 8.7 of the existing Commentary on Article 4 indicates some States may not
consider pension funds as being “liable to tax” if they are exempt from tax under the
domestic tax law of the country in which they are constituted. By this reasoning, since
pension funds are not liable to tax, they cannot be said to be resident for tax treaty purposes
and would, therefore, be excluded from the ambit of the relevant tax treaty.

3. The above interpretation is too narrow and literal. It creates uncertainty and goes counter to
the concept of residency, as generally understood. Pension funds are generally liable to tax in
their country of residence but may benefit from certain exemptions to the extent relevant
conditions are met. As a consequence, a pension fund may not actually pay income tax in its
jurisdiction of residence but it is nonetheless clearly liable to tax under the domestic laws of
its country of residence.

4. A pension fund should be considered a resident of the country in which it is constituted
regardless of whether it benefits from a limited or complete income tax exemption in that
country. This is a fundamental principle explicitly recognized in numerous existing bilateral
tax treaties and by the Commentary on Article 4.

5. The public policy decision of the country in which the pension fund is constituted to provide
an income tax exemption should not (i) disqualify the pension fund from being considered a
resident in that country, (ii) prevent the pension fund from being entitled to treaty benefits, or
(iii) influence the source country’s decision to tax the pension fund. This tax exemption
should not be construed by a source country as a form of “stateless income” that would
warrant the denial of access to tax treaty benefit. Among other reasons, this is because
pensioners, the ultimate beneficiaries of the pension fund’s income, are generally taxable
upon receipt of their pension income. We suggest the OECD re-affirm the general eligibility
of pension funds and similar government-related funds as residents for purposes of tax
treaties.
6. In Section B.1 below, we provide a suggested common definition of “pension fund” for purposes of determining residence and eligibility for an exemption from source taxation for pension funds. This definition is also included in Appendix 1 as a suggested change to Article 4 of the Model Tax Convention.

B. Reciprocal Exemption for Pension Funds

7. The Discussion Draft has invited general comments on whether changes should be made to paragraph 69 of the Commentary on Article 18 and specific comments on whether its application should be restricted to portfolio investment income (page 7, after paragraph 17). We believe the Model Tax Convention and related Commentary should be updated to provide for a broader reciprocal pension exemption and provide our comments on the matter below. The matter of a broad reciprocal pension exemption raises a number of issues from a policy perspective, including:

- The scope of entities that should be eligible for such an exemption, including directly or indirectly wholly-owned investment subsidiaries resident in the same country as the pension fund;
- Whether a broad pension exemption from source taxation on investment income is generally appropriate from a policy perspective;
- Whether such exemption should apply only if both countries follow the same approach to the taxation of pension funds; and
- The type of investment income that should be eligible for such an exemption, including whether such exemption should be restricted if the investor holds an ownership interest above a certain threshold in the investee company that is the source of the particular income.

B.1 - Scope of eligible exempt entities

8. In order to properly assess which organizations and what types of income should appropriately benefit from a broad exemption from source taxation (i.e., on investment income), it is important to understand the history and evolution of investment behavior of pension funds and similar government-related funds. We set out below relevant background on the organizations that are signatories to the letter accompanying this report and the general trends in the sector to illustrate the particular issues relevant in determining appropriate access to this exemption.

B.1.1 – Background
9. While the organizations that are signatories to the cover letter accompanying this report are organized and operate in different ways, they have a number of characteristics in common:

- They own or manage assets predominately related to pension funds. Some organizations also own or manage assets in respect of government-related funds established for other public policy purposes. In all cases, the owner or manager of the funds is an organization created by government and governed by a transparent and robust statutory framework.

- Consistent with the overall tax policy framework in their home jurisdiction, all organizations benefit from an income tax exemption in their country of residence on their investment income. This benefit is granted to public-sector funds and the related governing legislation does not allow private individuals to inappropriately access the same benefits for personal gain.

- To fulfill their fiduciary duty to build a diverse investment portfolio that will support pension and other benefits to their beneficiaries over the long-term, all these organizations increasingly invest globally in a diverse range of investment asset classes. At the same time, this broad investment approach also serves to address investment capital gaps in the global economy. As described below, the OECD itself has recognized the critical role that the types of organizations represented in the cover letter accompanying this report play to fund global economic growth and development.

10. While this signatory group is comprised of Canadian public-sector funds, we believe that both private and public pension funds residing in OECD member countries would have an equal interest in improving the treaty policy framework that is being updated under Action 6.

B.1.2 - General Trends

11. In order to better frame the detailed technical comments that follow, it is important to be aware of some growing global trends in this sector.

B.1.2.1 - Growing Supply and Demand of Capital

12. Pension funds are large and increasingly important long-term institutional investors, both within Canada and around the world. Across the OECD, pension funds and public pension reserve funds (as defined by the OECD) held USD 26.8 trillion in assets in 2012.¹ Many developed and developing countries are actively seeking to attract this pool of long-term patient capital to fill capital needs and provide a stabilizing force on global capital markets.

B.1.2.2 - Investment Diversification

13. Over the past decade or so, the investment portfolios of many funds have undergone significant diversification across two dimensions:

¹ Annual Survey of Large Pension Funds and Public Pension Reserve Funds (OECD 2013).
Proposals Regarding OECD Discussion Draft
January 9, 2015

- First, they have increased their holdings of alternative assets (i.e., investments other than sovereign debt and minority positions in public securities), including real estate, infrastructure, and private equity investments. These asset classes are complementary to the already sizeable public market investments that the funds continue to hold.

- Second, they have increasingly invested internationally, to diversify their geographic risk and maximize their return on investments. For example, Canadian pension funds have invested 40% - 70% of their funds outside of Canada, and this proportion is growing. In many jurisdictions around the world, the economy is relatively small and does not provide the level of portfolio diversification necessary to sustain their local funds, forcing these funds to look abroad for investment opportunities.

14. Both of these changes, which are widely shared by pension funds around the world, are driven by the need of the funds to fulfill their fiduciary duty to their beneficiaries to build a diverse investment portfolio that will maximize risk-adjusted returns. These trends are likely to continue in the coming decades. In this context, the impact of source country taxation on the investment returns is of great – and increasing – importance to pension funds and similar government-related funds.

B.1.2.3 - In-House Professional Management and Combined Mandates

15. To better manage such large pools of diversified capital, particularly alternative assets, many public-sector pension funds, in particular, are developing in-house professional investment management expertise.

16. Furthermore, because of the increased complexity associated with the investment diversification, some governments have decided to collectively manage the assets of multiple public-sector pension plans and similar government-related funds, thereby realizing greater economies of scale and minimizing transaction costs.

B.1.3 - Implications for Tax Treaty Purposes

17. Given the commercial changes outlined above for the pension fund and government-related fund industry, we believe that the current wording in tax treaties should be updated to more accurately reflect these long-term structural changes in the sector. Hence, we respectfully propose the following definition of “pension fund”\(^2\) for tax treaty purposes:

\(^2\) The proposed definition of pension fund derives elements from the following sources: Article XXI (2) of the Convention Between Canada and U.S. With Respect to Taxes on Income and on Capital (1980) (“Canada-US DTT”), Articles 35 and 36 of the Convention Between the Kingdom of the Netherlands and the U.S. for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income (“Netherlands-US DTT”), and paragraph 2 of Article X of the proposed LOB rule in the Report.
For the purposes of this Convention, a pension fund means a trust, company, organization, plan, arrangement, agency, or other body of persons:\(^3\):

(a) that is constituted and operated:

i. exclusively to administer or provide pension, retirement, employee or other similar benefits\(^4\);

ii. principally for the purposes described in (i) and exclusively for public policy purposes;\(^5\)

iii. exclusively for public policy purposes; or

iv. for any combination of activities mentioned in i), ii) or iii) above; or

(b) that is constituted and operated exclusively to invest funds for the benefit of pension funds referred to in paragraph (a).\(^6\)

\(^3\) The phrase ‘trust, company, organization, plan, agency, arrangement or other body of persons’ is derived from precedents established in the Canada-US DTT and the Netherlands-US DTT. It is intended to allow for a wide variety of legal structures under which pension funds in many countries are organized, both in the private and public sectors.

\(^4\) The reference to ‘other similar benefits’ is consistent with the proposed LOB and the references to pension, retirement or employee benefits are in the Canada-US DTT and Netherlands-US DTT. Please note that we did not include the added condition of the proposed LOB that refers to a 50% beneficial interests test since it is not clear why this is desirable or required. Our objection to that extended condition is not based on a tax policy objection but because it is technically flawed. Generally, assets held in pension funds are not owned by individuals since the right to a pension is not subject to ordinary ownership rules governing property (e.g., ownership of chattels or real property). Rather, pension plans provide contingent entitlements governed by the plan terms and applicable laws. Assets of pension funds are used to fulfill these contingent entitlements. Pension entitlements are often established under trust or contract law, or provided under a statutory framework.

\(^5\) This clause is intended to accommodate public sector plans that are organized with mandates that include the management of assets dedicated both for pension and non-pension related benefits. The reference to “public purpose” is from the Netherlands–US DTT. Clauses (ii), (iii), and (iv) are intended to reflect different forms of organization of pension funds and to provide policy options to governments and the OECD regarding the scope of the definition. For this purpose, we propose that the Competent Authorities will mutually agree and apply this exemption.

\(^6\) This paragraph is derived from the definition in the proposed subparagraph 2(d) of the LOB rule in the Report and paragraph 3 of Article XXI of the Canada-US DTT. We omitted, however, the requirement that substantially all of the income of that person is derived from investments made for the benefit of pension funds described in (a), because that requirement seems redundant to the requirement that the person be constituted and operated “exclusively” to invest funds for the benefit of such pension funds. We understand that the reference to entities that “invest funds for the benefit of … “ it is intended to provide greater certainty that the pension fund definition should extend to those entities that are designed to ring-fence the management of the assets of the pension fund from the administration of those benefits (most often the government sponsor itself). This is an increasingly desirable governance framework for public sector pension funds (including social security schemes). Also, paragraph (b) is to provide greater certainty that the wholly-owned investment subsidiaries of a pension fund (whether owned directly or indirectly) should qualify as pension funds.
For greater certainty, for purposes of (b), investments made by a person that is, directly or indirectly, wholly-owned by a pension fund and that is resident in the same country as the pension fund shall be considered to be for the benefit of the pension fund.

The Competent Authorities of the States may by mutual agreement develop procedures for the purpose of implementing a(ii) and a(iii) for the purposes of this Convention.\(^7\)

18. The above definition would be relevant in affirmatively establishing that such a pension fund is a resident for tax treaty purposes under Articles 1 and 4 of the Model Tax Convention regardless of its tax status in its country of residence (as described in Section A above). In addition, it would also apply to establish those pension funds that are eligible for a reciprocal pension exemption from source taxation on investment income under Article 18 of the Model Tax Convention and for the proposed definition of “qualified persons” under subparagraph 2(d) of the LOB rule in the Report. Further, having the pension fund definition extended to entities with a public policy purpose is unlikely to be abused, as the proposed definition contemplates that the competent authorities of the Contracting States will mutually agree and apply this exemption. To the extent that a narrower version of the definition is selected for purposes of the exemption from source taxation under Article 18, the broader definition above should still be used for purposes of confirming residence under Article 4.

19. As described above, many pension funds manage or own assets for other public policy purposes in order to take advantage of economies of scale, among other reasons. For example, some of the funds that are signatories to the cover letter accompanying this report are appointed by a government body to manage assets for both pension and non-retirement related benefits provided to a broad population. limiting the definition of pension funds in paragraph 69 of the Commentary to Article 18 to entities “exclusively” operated to provide pension benefits is overly restrictive, as abuse can be prevented through the public policy and governance requirements. It is for this reason we have suggested broadening eligible activity in the proposed definition above.

20. Finally, as an alternative to the broadening of eligible activity, a proportionate exemption on investment income should, at the very least, be available based on the percentage of the entity’s assets to which a pension plan is economically entitled. To achieve this, the Contracting States should provide for a proportionate exemption on the pension fund’s investment income based on the percentage of its assets to which the pension plan is economically entitled. That is, if an entity is not exclusively engaged in an activity referred to in the definition of pension fund in Article 4, it should obtain an exemption on its investment income.

\(^7\) This sentence is an established precedent in Article 36 of the Netherlands-US DTT. This is only required if the recommended subparagraphs a(ii) or a(iii) are adopted. In that case, we anticipate that Contracting States may feel the need to introduce administrative procedures to further mitigate any risk of an inappropriate interpretation of a(ii) or (a)iii). The Competent Authorities may agree, for example, to include entities that are subject to governmental oversight by regulation or statute.
income determined on the basis of the proportion of its assets to which a pension fund (as narrowly defined) is economically entitled.

21. Pension funds often establish direct or indirect wholly-owned investment subsidiaries in the same country to hold investments for a variety of legal and business reasons. In most instances, the wholly-owned investment subsidiary is subject to the same statutory or regulatory oversight as the pension fund. Hence, we have suggested making it explicitly clear, for greater certainty, that the reciprocal exemption extends to such directly and indirectly wholly-owned investment subsidiaries of qualifying pension funds resident in the same country as the pension fund itself in the proposed definition above.

22. We recognize that there may be some concern by taxation authorities that the enhanced general reciprocal pension exemption described above could be inappropriately used by a small group of individuals for their private inurement. The suggested definition above would generally exclude access in these circumstances, if Competent Authorities mutually agree and apply the exemption accordingly.

B.2 - Appropriateness of a general tax exemption for direct investment in a source country

23. The Discussion Draft suggests that a reciprocal exemption in bilateral tax treaties for investment income of pension funds may be helpful in addressing the treaty access concerns raised by pension funds. We agree that such an exemption would be very helpful, as discussed below. We understand the objective of the BEPS initiative is to prevent profit-oriented multinational enterprises from earning untaxed, “stateless” income. Since pension funds are generally taxable in their residence country but exempt under a specific tax rule established for domestic public policy purposes, the income they receive should not be seen as “stateless” and therefore should be out of scope of the Report. Additionally, the stateless income result does not occur in the context of pensioners, who are generally taxable upon receipt of their pension income.

24. Many countries generally exempt the investment income (e.g., interest, royalties, dividends, rent, other non-business income and capital gains) of domestic pension funds. In general, this domestic exemption is provided to support the public policy goals that pension funds are established to promote (e.g., retirement security, workers compensation, and insurance funds for public service employees).

25. Source country taxation of the cross-border investment income of pension funds’ undermines these public policy goals by eroding the accumulation of assets available for these purposes. In addition, source country taxation is inconsistent with the principle of capital export neutrality – that is, source country taxation imposes a higher tax burden on a pension fund’s returns from an investment in that source country than would be imposed on returns from a similar investment in the pension fund’s country of residence, which may cause the pension fund to favour investment in its country of residence or in source countries that provide for exemption from tax. As countries are generally competing for investment funds, this is not in the interest of the source countries, because pension funds are a large and growing source of
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long-term capital. The OECD has undertaken substantial work on long-term investment by institutional investors, and has consistently found it appropriate to encourage policies that facilitate and promote long-term investment by institutional investors. In fact, a number of countries already explicitly recognize this by providing relevant exemptions under domestic law.

26. Source country taxation of the investment income of non-resident pension funds also conflicts with the principle of capital import neutrality in cases where a source country exempts its own resident pension funds, creating an unlevel playing field within the source country.

27. More specifically, with regard to income from pension fund assets, any source country tax incurred generally results in double taxation. Specifically, under many countries’ tax policy framework for pension plan arrangements, contributions to, and earnings of the fund, are generally exempt, while distributions are taxable (the so-called ‘EET system’). If pension funds are subject to source country taxation on their cross-border investment income, double taxation would result as neither the pension funds nor their beneficiaries receive a credit for taxes paid to the source country.

28. We believe that these concerns regarding double taxation and capital import and export neutrality justify a reciprocal exemption from source country taxation for pension funds’ investment income under bilateral tax treaty policy. Moreover, such an exemption would improve the ability of certain countries to attract a diverse investor pool that includes the long-term oriented patient capital of pension funds.

29. As suggested in the Discussion Draft regarding the Commentary on Article 18 (page 7, after paragraph 17), the most direct and efficient way to address these issues is for bilateral tax treaties generally to include a reciprocal exemption from source country taxation on pension funds’ investment income from their cross-border investments. We encourage the OECD to support such an exemption through its Model Tax Convention and related Commentary on Article 18 (Appendix 2 provides suggested wording in that regard) and through further work on BEPS Action 6.

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8 The main institutional investors in the OECD area – pension funds, insurance companies and mutual funds – held over USD 73 trillion at the end of 2011. See Celik, S. and M. Isaksson (2013), “Institutional Investors as Owners: Who Are They and What Do They Do?” OECD Corporate Governance Working Papers, No.11. According to data received from EVCA (2013), pension funds provided 25.2% of the money that went into private equity and venture capital funds in Europe between 2007 and 2012 [Ibid.] This figure appears to be exclusive of public pension reserve funds.


10 For example, section 118-500 of the Income Tax Assessment Act 1997 (Australia) and section 153 of the Mexican Income Tax Law.

11 Exempt-Exempt-Tax system of taxation. See also footnote 14 below.
B.3 - Relationship of reciprocal pension tax treaty exemption and domestic tax policy

30. The existing Commentary on Article 18 suggests that countries consider the inclusion of a reciprocal tax exemption to pension funds on investment income within bilateral tax treaties where both countries provide a domestic tax exemption for such income. This suggestion implicitly recognizes the public policy purpose of the domestic tax exemption, notably the enhanced accumulation of retirement assets in a context of generally an aging population, and fosters neutrality with respect to the geographic deployment of capital. This has been acted upon in a number of bilateral tax treaties. In addition, recent academic research strongly supports the economic benefits of adopting this approach.

31. With regard to those countries that observe the EET system of taxation of pension funds, a reciprocal exemption is justified for tax policy purposes in order to prevent double taxation, as described earlier.

32. In addition, a reciprocal exemption under bilateral tax treaties is appropriate as a general matter in order to encourage neutrality with respect to the cross-border deployment of capital, regardless of whether both countries follow the EET system of taxation. In our view, both countries do not necessarily have to follow the same approach to domestic taxation of pension funds in order for a reciprocal tax treaty exemption to be effective in achieving the capital neutrality objective. Furthermore, even in taxation systems other than the EET system, double taxation or unduly high levels of taxation can inherently result from source taxation of pension funds’ income. The limitation in current paragraph 69 of the Commentary to Article 18 that a reciprocal exemption should be considered where both countries follow the same approach in exempting pension funds’ investment income, thus appears to be too narrow, and should be modified.

B.4 - Income eligible for an exemption

B.4.1 - Types of eligible income

33. Some existing bilateral tax treaties provide for limited exemptions on pension funds’ interest and/or dividend income; most often solely in respect of public company investments of a portfolio nature. These exemptions were influenced by the historic investment behavior of pension funds of investing almost exclusively in sovereign debt and public markets. As previously described, this investment behavior has significantly changed over the years and

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tax treaty policy should evolve accordingly. The policy rationale for broadening these historic limited exemptions includes:

- the elimination of double taxation;
- the neutrality of taxation of capital as described earlier, which is equally applicable to the broader range of investments that global pension funds make today; and
- the need of source countries to attract long-term institutional capital offered by pension funds and similar government-related funds.

34. Hence, we believe that the reciprocal exemption should apply to all forms of investment income (dividends, interest, royalties, capital gains and other non-business income) from both public and private investments (i.e., alternative assets) in order to properly take into account the diverse range of investments made by pension funds in the current global investment environment.

B.4.2 - Ownership interest limitation

35. **The Discussion Draft invited comments on whether the reciprocal exemption should be restricted to portfolio investment income (page 7, after paragraph 17).** This appears to suggest that the exemption should be subject to some form of maximum ownership threshold with regard to the payer of the income. We do not believe it should be so limited.

36. As previously described, pension funds may take a variety of ownership interests in their investments, from a small minority interest to a 100% ownership interest. The policy objectives of achieving greater neutrality of deployment of capital and avoidance of double taxation are served at all levels of ownership interest.

37. As described earlier, pension fund investment has evolved from historical portfolio investment to larger ownership interests in a diverse range of asset classes. Tax policy should evolve to recognize this investment behavior. The change in investment behavior has resulted from the need for building sustainable, long-term oriented and diversified investment portfolios in order to support the retirement needs of an aging population. It has also been encouraged by countries seeking sources of long-term institutional capital for a variety of national investment requirements.

38. Given the necessity and, in fact, the desirability of pension funds to acquire ownership interests beyond mere portfolio investments, the limitation of the reciprocal exemption to a lower ownership threshold would result in double taxation on investments above that threshold as described earlier. This is an inappropriate result from a tax policy perspective.

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15 Certain types of investment income generated from alternative asset classes (such as an investment vehicle holding oil and gas properties) may be classified as royalties under relevant tax law and the applicable tax treaty.
39. We understand that some tax policy officials have concerns that a majority ownership interest in an investee company may permit tax planning opportunities for a tax-exempt investor that are unavailable to competing taxable bidders. We are of the view that such concerns are mitigated by the nature of pension funds and other proposed BEPS initiatives.

40. Firstly, even in situations of majority ownership, pension funds are investors and not direct operators or managers of the investee company’s business operations. Pension funds have fiduciary obligations to actively monitor their investments to maximize returns and will exert influence as shareholders to enhance long-term investment value. This is the case for many levels of ownership – whether minority interests in public companies or majority ownership of infrastructure investments.

41. Secondly, this concern appears to be related to the perceived potential use of shareholder debt by tax-exempt investors to erode the taxable income of an investee company. We note that this tax treatment of debt is true at any level of ownership, and suggest that these concerns are more appropriately addressed through other BEPS Actions (notably, on interest deductibility) and tax enforcement tools rather than through limitations on treaty benefits available to pension funds. If other BEPS Actions apply equally to tax-exempt and taxable investors, an investee company should be subject to the same amount of income tax on its earnings regardless of the tax status of the investee company’s owners. A pension exemption from withholding tax on investment income would therefore have no relative impact on the corporate income tax paid by the investee company and should not be denied on the basis of the particular level of ownership in the investee company.

B.5 - Proposed revised language for Article 18 and related Commentary

42. Revised language for Article 18 and the related scope of the suggested reciprocal exemption is set forth in Appendix 2. In summary, the following is accomplished by the revised language:

- The revised wording for Article 18 provides a reciprocal exemption for pension funds as defined earlier. These entities benefit generally from a full or partial exemption from taxation in their country of residence. Hence, providing an exemption from taxation in the source country eliminates the double taxation that would otherwise result.

- For a variety of legal and business reasons, pension funds often establish direct or indirect wholly-owned subsidiaries in the same country to hold investments. These wholly-owned investment entities should be accorded the same benefits.

- This exemption would only apply to pension funds’ investment income (i.e., interest, dividends, royalties, capital gains and other non-business income). To be clear, this is not an exemption from tax on operating profits earned by companies in which pension funds invest or from any business profits (Article 7).
As explained above, pension funds sometimes acquire an interest in an investment using assets that are both for the benefit of a pension plan and for other public policy purposes. If the definition of pension fund is not broadened as proposed above, the Contracting States should provide for a proportionate exemption on the pension fund’s investment income based on the percentage of its assets to which the pension plan is economically entitled. That is, if an entity is not exclusively engaged in an activity referred to in the definition of pension fund in Article 4, it should obtain an exemption on its investment income determined on the basis of the proportion of its assets to which a pension fund (as narrowly defined) is economically entitled.

We understand that, despite the arguments raised earlier in this report, governments may nonetheless have concerns about extending the reciprocal exemption to situations where an investor has a controlling interest in an investee company. Appendix 2 suggests proposed language to reflect this concern, generally modeled on Article XXI of the Canada-US DTT. However, rather than the use of a “related” test, which is subject to considerable subjectivity from jurisdiction to jurisdiction, we suggest instead an objective test, such as a percentage of the voting power or economic value through ownership of relevant share capital.

C. Description of Pension Funds for the LOB Rule

The Discussion Draft invites comments on the description of pension funds within the LOB rule (page 7, after paragraph 17). As suggested above in the context of the Commentary on Article 18, we believe that the use of the term “exclusively” in paragraph 2(d)(ii) of the proposed LOB rule is overly restrictive given the nature of non-pension public purpose activities of a number of pension funds. We suggest the same definition of pension fund as that set out above be employed for purposes of the LOB rule as it has been crafted in a manner to mitigate inappropriate access to treaty benefits.

D. Discretionary Relief under the LOB Rule and the PPT Rule

The Discussion Draft invites comments on the application of discretionary relief for purposes of the LOB rule (page 8, after paragraph 21) and the PPT rule (page 11, after paragraph 34). As previously described and also further discussed below under the section “F - Non-Tax Motivated Use of Investment Vehicles”, pension funds will often make investments through third-country entities. If the LOB rule or PPT rule were to apply to deny treaty benefits entirely to the third-country entity, a tax burden could arise that is greater than that if the pension fund had invested directly (i.e., maximum domestic withholding tax rates rather than the withholding tax rates under the applicable bilateral tax treaty with the pension fund’s country of residence). Some countries may lack a legal mechanism to apply treaty benefits on the basis of the direct tax treaty. This is inappropriate from a tax policy perspective.

In order to facilitate a country’s ability to ensure investors are not potentially worse off by investing indirectly, which may be influenced by a number of non-tax motivations, we
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strongly suggest that Commentary to the LOB rule and the PPT rule should indicate that
discretionary partial tax treaty benefits should be available in these circumstances to the
extent of the direct withholding tax rate otherwise applicable. In addition, specific examples
of this should be provided for both the LOB rule and the PPT rule. Providing clear examples
would alleviate current concerns about the potential application of the LOB rule and/or PPT
rule, particularly as it appears that the application of the PPT rule will be highly subjective. A
proposed example of discretionary partial relief for the LOB rule and PPT rule is set forth in
Appendix 3.

E. “Active Business” Exception to the LOB Rule

47. The Discussion Draft invites comments on the “active business” exception within the
LOB rule (page 10, after paragraph 30). The “active business” exception to the application
of the LOB rule has been designed with multinational corporations and their commercial
activities in mind. Pension funds and other institutional investors generally have as their sole
activity the making of investments on their own account. This would not qualify as an active
business for purposes of the LOB rule. We believe it would be appropriate to adapt the active
business exception for investment entities owned by pension funds where the entity meets
similarity and substantiality tests in the context of the entire institutional investor’s
organization. In this regard, we note that the nature of activities that are undertaken is similar
to the ones that would be accorded access under the active business exception for certain
financial institutions.

48. Specifically, the proposed commentary suggests extending access of the active business
exception to the business of making or managing investments for the resident’s own account
only when the relevant activities are part of banking, insurance or securities activities
conducted by a bank or financial institution that the Contracting States would consider to be
similar to a bank (such as a credit union or building society). The manner in which modern
pension funds operate includes many of the investment activities that are carried out by the
financial institutions referred to. Hence, there does not seem to be a compelling reason not to
extend the active business LOB rule exception to pension funds.

F. Non-Tax Motivated Use of Investment Vehicles

49. The Discussion Draft invites comments on examples to include in the Commentary on
the PPT rule (page 13, after paragraph 37). We set forth comments and proposals on this
matter below.

50. Like many institutional investors, pension funds often invest through joint ventures, pooling
vehicles such as alternative funds, and regional investment platforms. These vehicles are
established for a variety of commercial and tax reasons as described below.

51. Like many other global investors, pension funds are expanding their global office presence to
not only source foreign investment opportunities but also to establish stronger asset
management capabilities in regions in which they continually reinvest or hold assets over the long-term. When a certain critical mass of investment activity is reached or predicted, institutional investors may establish wholly-owned regional investment platforms to consolidate certain functions in a region and to reinvest capital. These investment platforms are staffed with full-time employees. The commercial advantages of operating through such wholly-owned investment vehicles include:

- access to directors with knowledge of a variety of regional business practices and regulations;
- access to a multilingual workforce that can more easily interact with investment partners in jurisdictions within relatively close proximity due to time zone efficiencies and cultural awareness;
- development of a locally engaged team to consistently apply best practices in stewardship and monitoring over assets in the region; and
- facility with use of the region’s common currency in certain instances.

52. We provide below examples of circumstances in which intermediary investment vehicles may be used for a variety of commercial and tax reasons and suggest that they be incorporated in the Commentary on the PPT rule as guidance for situations where the PPT rule should not be applied to deny treaty benefits. This is described more fully in Appendix 4.

53. In choosing the location of regional investment platforms, pension funds will seek a jurisdiction that will result in an overall investment return that is equal to or higher than the investment return the fund would otherwise realize if that portfolio of investments were held directly from their country of origin.

54. Similarly, commercial reasons for establishing joint ventures, co-investment vehicles, and pooling vehicles such as alternative funds include:

- access to a wider range of investment assets or classes;
- diversification of investment profiles and risks;
- allocation of governance rights with respect to the investment on the basis of a shareholders’ agreement and related contractual arrangements that are facilitated by the applicable law in the jurisdiction of the joint investment vehicle;
- ability to raise third-party debt at the level of the joint investment vehicle;
- ability to insulate the investor group from joint and several legal liability;
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- ability to introduce new shareholders at the level of the joint investment vehicle;
- ability to accommodate exits for investors; and
- joint monitoring of the underlying investment’s performance through appropriately skilled directors and/or officers of the joint investment vehicle.

55. The jurisdiction selected may also have tax advantages such as reduced withholding tax on dividends, interest and capital gains under an applicable tax treaty. These tax advantages would form part of the rationale for selecting the particular jurisdiction. Even if there were no incremental tax advantages, from the investors’ perspective the jurisdiction chosen would be selected to ensure it would not result in an increase in the withholding tax burden on the investment income earned. That is, it must at least be tax-neutral as no tax credits are available to the pension funds to offset any additional withholding tax cost. In our view, if pension funds and other institutional investors have decided to form a joint investment vehicle for non-tax reasons, the selection of a jurisdiction that is tax-efficient for those investors should not result in the PPT rule denying tax treaty benefits to the joint investment vehicle.

56. The current form of the PPT rule creates significant uncertainty for pension funds and similar government-related funds in anticipating the long-term financial impact of investing through intermediary entities. To alleviate this uncertainty, we ask the OECD to provide examples of when a wholly-owned investment vehicle that is formed for both non-tax and tax reasons could have access to tax treaty benefits under the PPT rule. This would reduce uncertainty to pension funds and allow for a more balanced approach to Action 6 in the context of pension funds and government-related funds. A proposed example is set forth in Appendix 4. Appendix 4 also contains a proposed example of a joint venture vehicle established by pension funds from different jurisdictions.

57. We suggest making it clear in the Commentary to the PPT rule that, in these circumstances, it could not reasonably be considered that one of the principal purposes of the investors with regard to this type of arrangement is to obtain tax treaty benefits. As a result, the PPT rule should not apply to deny tax treaty benefits.

IV. CONCLUSION

58. While we recognize the need for governments to prevent inappropriate access to tax treaty benefits, we believe that BEPS Action 6 would result in an unintended denial of tax treaty benefits for pension funds in certain circumstances.

59. We request that the OECD support a broad exemption for pension funds from source taxation on investment income and that it perform further work on Action 6 to alleviate potential inappropriate adverse impacts on pension funds. This is appropriate for a number of reasons:
• An exemption from source taxation on investment income recognizes the socio-economic and public policy purpose of pension funds by enabling their ability to accumulate assets to fund growing future retirement obligations in the context of an aging population and longevity trends.

• It reflects and facilitates the growing level of cross-border investment made by pension funds globally in an increasingly diverse range of asset classes. This evolution in investment behaviour has been necessary both for (i) pension funds to earn the risk-adjusted returns required to fund rising future retirement obligations, and (ii) source countries to attract patient long-term institutional capital for a variety of national investment needs by fostering the neutrality of taxation of capital, a policy historically supported by the OECD. Pension fund capital is particularly sought after to fund critical infrastructure needs in a number of developed and developing countries.

• We understand the objective of the OECD initiative is to prevent profit-oriented multinational enterprises from earning untaxed, “stateless” income. An exemption for investment income of pension funds, however, should have no impact on the income tax paid on the operating income of the enterprises in which such pension plans have invested. In addition, since pension funds are generally taxable in their residence country but exempt under a specific tax rule established for domestic public policy purposes, the income they receive should not be seen as “stateless”. The taxation of that investment income is, in fact, deferred until such time as it is distributed to individual pensioners. Generally, pensioners are taxable upon receipt of pension income.

• Source taxation of investment income inherently results in double taxation of income as pensioners generally cannot obtain tax relief for withholding taxes paid by pension funds. This is an inappropriate outcome from a tax policy perspective.

60. While a broad pension exemption on investment income is desirable and appropriate, the development of a consensus on its provisions among national governments and ultimate implementation through double tax treaties are long-term endeavors. In the near-term, Action 6 may deny treaty benefits to pension funds altogether in certain circumstances. Therefore, we also propose alleviating measures to reduce the adverse unintended consequences of Action 6. In particular, we request consideration for provisions to ensure that a pension fund investor is not penalized with an increased withholding tax burden for investing through an intermediary jurisdiction instead of directly from its country of origin.
Appendix 1

Suggested Article 1 and Article 4 Language and Proposed Changes to Commentaries

Recommended approaches to providing certainty in respect of pension funds’ residence for tax treaty purposes are illustrated below.

Article 1

Suggested additions underlined below to paragraph 6.37 of the Commentary on Article 1 should be incorporated:

6.37 In addition, many States include specific provisions in their bilateral conventions that grant an exemption to other States, and to some State-owned entities such as central banks, with respect to certain items of income such as interest (see paragraph 13.2 of the Commentary on Article 10 and paragraph 7.4 of the Commentary on Article 11). Treaty provisions that grant a tax exemption with respect to the income of pension funds (see paragraph 69 of the Commentary on Article 18) may similarly apply to pension funds that are wholly-owned by a State, depending on the wording of these provisions and the nature of the fund. For greater certainty, pension funds should be considered residents of the State in which they are constituted.

Article 4

Suggested changes underlined below to paragraph 8.6 of the Commentary on Article 4 should be incorporated:

8.6 Paragraph 1 refers to persons who are “liable to tax” in a Contracting State under its law by reason of various criteria. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organizations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. Most States would view such entities as residents for purposes of the Convention (see, for example, paragraph 1 of Article 10 and paragraph 5 of Article 11). States should view pension funds as residents for purposes of the Convention. The following suggested language for paragraph 1 of Article 4 could be included. This suggested language is for greater certainty only, as it is understood that those entities can only be considered residents of the state in which they are constituted.
Appendix 1 (Cont’d)

A suggested addition to Article 4 of the OECD Model Tax Convention is set out below:

*The term “resident” of a Contracting State is understood to include a “pension fund”. For this purpose, a pension fund means a trust, company, organization, plan, arrangement, agency, or other body of persons:*

(a) that is constituted and operated:

i. exclusively to administer or provide pension, retirement, employee or other similar benefits;

ii. principally for the purposes described in (i) and exclusively for public policy purposes;

iii. exclusively for public policy purposes; or

iv. for any combination of activities mentioned in i), ii) or iii) above; or

(b) that is constituted and operated exclusively to invest funds for the benefit of pension funds referred to in paragraph (a).

For greater certainty, for purposes of (b), investments made by a person that is, directly or indirectly, wholly-owned by a pension fund and that is resident in the same country as the pension fund shall be considered to be for the benefit of the pension fund.

The Competent Authorities of the States may by mutual agreement develop procedures for the purpose of implementing a)(ii) and a)(iii) for the purposes of this Convention.

Paragraph 8.7 of the Commentary below should be removed.

8.7 In some States, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws. These States may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention. Contracting States taking this view are free to address the issue in their bilateral negotiations.
Appendix 2

Existing OECD Commentary: Exemption of the income of a pension fund

The limited existing guidance on the taxation of pension funds’ income is reproduced below.

69. Where, under their domestic law, two States follow the same approach of generally exempting from tax the investment income of pension funds established in their territory, these States, in order to achieve greater neutrality with respect to the location of capital, may want to extend that exemption to the investment income that a pension fund established in one State derives from the other State. In order to do so, States sometimes include in their conventions a provision drafted along the following lines:

Notwithstanding any provision of this Convention, income arising in a Contracting State that is derived by a resident of the other Contracting State that was constituted and is operated exclusively to administer or provide pension benefits and has been accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognized as such for tax purposes by that State, shall be exempt from tax in that State.

Suggested Revised Article 18 Language

Pension, retirement, employee benefit and other public policy entities

1. Income referred to in Articles 10 (Dividends), 11 (Interest), 12 (Royalties), 13 (Capital gains) and 21 (Other income) derived by a pension fund, as defined in Article 4, shall be exempt from tax.
Appendix 2 (Cont’d)

Suggested Commentary on Revised Article 18

1. The revised wording for Article 18 provides a reciprocal exemption for pension funds. Pension funds are defined in Article 4 for this purpose.

2. For a variety of legal and business reasons, pension funds often establish directly or indirectly wholly-owned investment subsidiaries in the same country of residence as the pension fund itself. These entities should be accorded the same tax exemption benefits. This is accomplished by the definition of pension fund, which includes such entities.

3. Importantly, the exemption is limited to pension funds that are operated exclusively to provide certain pension, retirement, employee and similar benefits and for other public policy purposes, and applies only to such entities’ investment income – i.e., dividends, interest, royalties, other non-business income, and capital gains. It does not, for example, impact the source country taxation of the source country entity that is the payer of the income, nor does it apply to income described in Article 7 (business profits).

4. As explained above, pension funds sometimes acquire an interest in an investment using assets that are both for the benefit of a pension plan and for other public policy purposes. If the definition of pension fund is not broadened as proposed above, the Contracting States should provide for a proportionate exemption on the pension fund’s investment income based on the percentage of its assets to which the pension plan is economically entitled. That is, if an entity is not exclusively engaged in an activity referred to in the definition of pension fund in Article 4, it should obtain an exemption on its investment income determined on the basis of the proportion of its assets to which a pension fund (as narrowly defined) is economically entitled. In these situations, the Contracting States can add the following paragraph to Article 18:

Notwithstanding the foregoing, if an entity is not exclusively engaged in an activity referred to in [the definition of pension fund in Article 4], it shall obtain a partial exemption on its income referenced to in paragraph 1 on the basis of the proportion of the assets to which a pension fund is economically entitled.
Appendix 2 (Cont’d)

Alternative: Pension, retirement, employee benefit and other public policy entities

To the extent tax authorities remain concerned about extending a reciprocal exemption to situations where the payer of the income is controlled by the pension fund, an alternative (with adapted language in the related Commentary) could be considered by adding paragraph 3 below.

3. The provisions of paragraph 1 shall not apply with respect to the income of a pension fund derived from an entity in which it owns greater than [●%]\(^{16}\) of the voting power or economic value (other than a person referred to in paragraph 1).

\(^{16}\) In some bilateral tax treaties, this percentage is set at 50\%. See, e.g., the US – Canada DTT. In some other treaties, it is higher, such as in the Netherlands-US DTT, where it is 80%. See Treasury Department Technical Explanation of the Convention between the U.S. and Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income.
Appendix 3

Example of Discretionary Partial Relief for both the LOB Rule and the PPT Rule

Background

- RCo, a company resident in State R, is a wholly-owned subsidiary of an institutional investment organization (the “Fund”), established and subject to regulation in State S (for example, a pension organization or arrangement that was sponsored by the Government of State S or its political subdivisions).

- RCo operates exclusively to earn income for the benefit of the Fund.

- RCo owns a 40% interest in TCo, a company resident in State T, in respect of which it receives annual dividends.

- Under the treaty between State R and State T, the applicable withholding tax rate on dividends is reduced from 30% under State T domestic law to 5%.

- Under the treaty between State S and State T, the applicable withholding tax rate on dividends is 10%.

Discussion

Should the tax authorities in State T apply either the LOB Rule or the PPT Rule to deny the benefits of the State R-State T treaty, a withholding tax rate of 30% could result on the dividends paid by TCo to RCo. This is an overly harsh result since the alternative direct investment by the Fund in TCo would have attracted a 10% withholding tax rate under the State S-State T convention. Such 10% withholding tax rate would be the appropriate rate to apply.

Tax authorities are encouraged to use the discretionary relief provisions under the LOB rule and PPT rule to provide partial relief in these circumstances. This is consistent with administrative practice of some national tax administrations, such as Germany, in their enforcement of current anti-treaty shopping rules.
Appendix 4

Examples of Investment Vehicles and the PPT Rule

a) Regional Investment Platform Example

Background

RCo, a company resident in State R, is a wholly-owned subsidiary of an institutional investment organization (the “Fund”) established and subject to regulation in State S (for example, a pension organization or arrangement that was sponsored by the Government of State S or its political subdivisions).

RCo operates exclusively to earn income for the benefit of the Fund.

RCo’s organizational purpose is to acquire and manage a diversified portfolio of private market investments located in countries in the region that includes State R and to generate an investment return over the long term as the regional investment platform for the Fund.

The commercial reasons for the establishment of the regional investment platform in State R include:

- access to directors with knowledge of a variety of regional business practices and regulations;
- access to a multilingual workforce that can more easily interact with investment partners in jurisdictions within relatively close proximity due to time zone efficiencies and cultural awareness;
- development of a locally engaged team to consistently apply best practices in stewardship and monitoring over assets in the region; and
- facility with use of the region’s common currency in certain instances.

RCo employs a local management team in pursuit of its mandate. RCo’s management team is experienced, located in proximity of its investment territory and has responsibilities including the following:

- reviewing investment recommendations from the Fund’s investment teams;
- approving investments;
- monitoring investments’ performance;
- carrying on treasury functions;
Appendix 4 (Cont’d)

- in some cases, acting as directors on the boards of directors of some entities in which RCo has invested;
- maintaining RCo’s books and records; and
- ensuring compliance with regional regulatory requirements.

The board of directors of RCo is appointed by the Fund and is composed of a majority of State R resident directors with strong expertise in private investments and/or investment management, as well as members of the Fund’s global management team.

RCo’s investment decisions take into account the existence of tax benefits provided under State R’s extensive tax convention network.

RCo redeploy its capital in new investments in the region as opportunities arise.

RCo pays tax and files tax returns in State R.

TCo is fully subject to income tax in State T. Under the treaty between State R and State T, the withholding tax rate on dividends is reduced from 30% to 5%.

Under the treaty between State S and State T, the withholding tax rate on dividends is 10%.

Discussion

In making its decision to invest in shares of TCo, RCo considered the existence of a benefit under the State R-State T tax treaty with respect to dividends, but this alone would not be sufficient to trigger the application of paragraph 7. The intention of tax treaties includes providing 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 substantive investment functions exercised in State R. In this example, having regard to all facts and circumstances, it would not be reasonable to deny the benefit of the State R-State T tax treaty to RCo.
Appendix 4 (Cont’d)

b) Joint Venture Vehicle Example

Background

RCo is a company resident in State R.

RCo was formed by Pension Fund A, a pension fund resident in State A, and SWF B, a sovereign wealth fund resident in State B, to pool their capital to invest in infrastructure assets, possibly in multiple jurisdictions near State R.

Pension Fund A and SWF B each own 50% of RCo.

Pension Fund A and SWF B established RCo for, inter alia, the following reasons:

- Allocation of governance rights with respect to the investments on the basis of a shareholders’ agreement and related contractual arrangements that are facilitated by the applicable law in State R;
- Ability to raise third-party debt at the level of RCo;
- Ability to introduce new shareholders at the level of RCo;
- Ability to insulate the investor group from joint and several liability; and
- Joint monitoring of the underlying investments’ performance through appropriately skilled directors and/or officers of RCo.

RCo is subject to corporate income tax in State R.

RCo owns all of the outstanding equity in Subsidiary, a State S corporation that is a tax resident of State S and that owns and operates an infrastructure project in State S.

RCo has made a loan to Subsidiary and receives interest from Subsidiary that is subject to State S domestic withholding tax.

State S has concluded a tax treaty that is identical to the Model Tax Convention with States R and B.

State S has also concluded a tax treaty with State A, but the withholding rate on interest is higher under that treaty than under the treaty between State S and State R.
Appendix 4 (Cont’d)

Discussion

RCo’s formation, operation and investment decisions take into account the existence of tax benefits provided under State R’s extensive tax treaty network. In making its decision to invest in shares of Subsidiary, RCo considered the existence of a benefit under the State R-State S tax treaty 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, having regard to all the facts and circumstances, it would not be reasonable to deny the benefit of the State R-State S tax treaty to RCo.
CBI RESPONSE TO OECD PUBLIC DISCUSSION DRAFT ON FOLLOW-UP TO ACTION 6: PREVENTING TREATY ABUSE OF THE BEPS ACTION PLAN

1. The CBI is pleased to comment on the OECD’s Public Discussion Draft on the follow up work on Action 6: Preventing Treaty Abuse published on 21 November 2014. This document builds on the final recommendations issued on Action 6 on 16 September 2014 (“the September paper”)

2. As the UK’s leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

3. We have reviewed the response prepared by BIAC in respect of this paper and agree with the key points and conclusions submitted in that response. Our paper below highlights the key areas of concern for British business, and where possible, we have provided real commercial examples to highlight the impact of the proposals.

4. The CBI continues to support the BEPS programme to update international tax rules to reflect modern business practice, tackle abusive tax structures and target the incidence of double non-taxation. However, we are concerned that if complexity and uncertainty are not avoided, the outcome will be an increase of double taxation and resulting legal disputes, which could have a substantial and negative impact on cross border trade and investment, but also on tax administrations with limited resources.

Overview

5. The CBI recognises the potential risk with regard to treaty abuse and support a common OECD framework to address these issues. We recognise the need for the minimum standard approach adopted in the September paper to achieve consensus and believe that the use of either a Principle Purpose Test (“PPT”) or Limitation of Benefits (“LOB”) can be appropriate. However, we do not believe that a combination of both should be used as it would be unnecessarily burdensome.

6. Treaties are principally designed to remove the barrier of double taxation, in order to promote cross-border trade and investment. If a LOB or a PPT are well constructed and appropriately targeted against artificial structures, this can be achieved whilst not denying treaty benefits for genuine commercial arrangements. We are concerned that the provisions as drafted in the September paper go beyond the scope required to address abusive behaviours and could catch genuine commercial arrangements.

7. The approach adopted in the September paper was to outline a minimum standard to be incorporated into treaties. A minimum standard should be just that, the minimum required to achieve the basic level of protection against the abuse which is being targeted. Governments wishing to adopt a tighter approach can then do so under bilateral negotiations. If the minimum standard is drafted too tightly then governments who wish to recognise genuine local commercial arrangements may not have the flexibility to do so while still meeting the standard.

8. The LOB provisions outlined in the OECD paper released in September are closely modelled on the 2006 US model treaty. The LOB provision used in the 2006 US model treaty is tightly drafted, and therefore restricts treaty access to less taxpayers, than even a number of existing US treaties. Whilst it is accepted that at present it is only the US and Japan that frequently use LOB causes, it is of concern to
British businesses that the OECD should adopt a global standard based on the current needs of just one or two countries.

9. If the BEPS programme is to achieve its ultimate goal, its outputs should be relevant for a number of years in the future and applied on a consistent basis across the globe. It should be reasonable to assume that more countries will look to adopt a LOB clause in forthcoming years especially in developing countries where the existing treaty networks have significant room for expansion and objective tests are generally preferred. Therefore a minimum standard LOB must allow flexibility for governments to be able to reflect the way genuine local commercial arrangements are structured whilst also (given it is only a minimum standard) allowing other territories (like the US) to still impose tighter rules when negotiating its own bilateral negotiations.

10. In light of the above, we would recommend the following clauses are inserted or amended to ensure the minimum standard LOB can achieve this flexibility whilst remaining effective in targeting abusive tax planning:

- A derivative benefits clause should be included as standard
- The derivative benefit ownership test should be lowered to 75% with no restriction on the number of equivalent beneficiaries to exceed the ownership test
- The equivalent beneficiary test should not be a cliff edge to obtaining any treaty benefits at all. The test should just restrict the benefits to those that the person would be entitled to under the treaty with his home state
- There should be no requirement for intermediate companies to be a resident of either contracting state in both the derivative benefits and publically traded company tests
- The LOB should be amended to incorporate a Headquarters test
- The listed company test should be amended to aggregate all trading of a principal class of shares on all recognised stock exchanges to recognise that many shares are now traded on multiple exchanges.
- The LOB should clarify the treatment of shares in case of so called “Dual Listed Companies” to eliminate any uncertainty that they are a qualified person (we understand that detailed submissions have been made by our members which “DLC’s” concerned)
- Collective Investment Vehicles should be included as a standard in Para 2(f)
- A definition of a “qualify fund” should be developed with the non-CIV fund and private equity industry based on the principles applying to CIV’s and listed companies.

11. The PPT is widely framed and therefore there could be a risk of misinterpretation or misapplication by tax authorities. Therefore a significant number of examples must be provided in the commentary or some more objective criteria, for example looking at substance, should be adopted. If tax authorities have different views, we also recommend there should be a prima facie assumption that it is not reasonable to conclude that obtaining treaty benefits was one of the principle purposes.

12. There must be clear guidance regarding the interaction of domestic anti-abuse rules and tax treaties. Domestic rules should be allowed to override treaties to allow their proper application, but only in circumstances which are pre-defined and known up-front.

**Collective Investment Vehicles**

13. We have reviewed the response prepared by The Investment Association (“IA”) in respect of this paper which provides considerable background on this industry and the reasons why the conclusions in the 2010 OECD report on the Granting of Tax Treaty Benefits with Respect to the Income of Collective Investment Vehicles remain valid today. We therefore support the conclusions reached in the IA submission that the following provisions should be incorporated in respect of CIV’s:

- A CIV should be included in the standard list of “qualified persons” (as proposed under subparagraph 2(f) in the September paper)
- There should be no distinction between listed and non-listed funds.
- Funds which are corporates, or treated as corporates for tax purposes in their country of establishment should be regarded as persons under tax treaties.
- An exemption from tax for a fund should not in itself preclude a fund from being regarded as a resident for tax purposes.
Funds should be treated as the beneficial owners of income under double tax treaties when considering factors such as: the fund is widely held, its investors have no control over the assets of the funds, and the assets are managed by an external investment manager.

14. The application of the LOB to funds is one area where the current US standard would significantly favour the domestic US market compared to the international market. In general, US funds are retailed domestically and will frequently meet (and demonstrate) that 50% or more of the owners are resident in the US. However EU/Asian funds are marketed cross border and will commonly have multi-national investors. Therefore despite the function and the operation of the fund being broadly similar, a 50% local investors test does not work in non-US markets. It is important that the final proposals by the OECD accommodate global markets to provide flexibility in the case of more countries adopting the LOB provisions in future treaties.

Non-CIV Funds

15. We have reviewed the response prepared by the British Private Equity and Venture Capital Association (BVCA) in respect of this paper which provides considerable background on this industry.

16. As outlined in the BVCA paper, private equity funds would largely fail to qualify for treaty benefits under the draft LOB provisions because they:

- Would not usually be listed on a recognised stock exchange;
- Would not be carrying on an active trade or business as defined; and
- Could not avail themselves of the derivative benefits provisions because of the diversity of ownership outlined above.

17. The above points set out the technical issues which arise in considering how a private equity fund would be seen as measured by the draft LOB. The underlying and more meaningful issue is an economic one: if action on treaty abuse makes international investment into private equity less attractive then investment may fall, and the private equity fund industry and the support it provides for the real economy may contract as a result. Therefore provided a private equity funds can demonstrate similar key criteria as that which applies to collective investment vehicles, there appears to be no policy reason why such funds should not qualify for treaty benefits.

18. We support the BVCA recommendation that the issue of treaty entitlement for private equity funds can be addressed without creating opportunities for avoidance. This can be achieved through an additional category of a “qualified person” to include the concept of a qualify fund. The four broad features of a qualified fund test would be:

A - Diversity of investors. The fund would be intended to be diversely held and would be marketed appropriately.

B - Appropriate regulation. The fund or manager, as appropriate, would be regulated by a recognised regulator.

C - Substance. Any holding structure would be subject to a minimum standard of investment in the local economy, measured perhaps in terms of locally incurred expenditure commensurate with investment activity.

D - Enhanced reporting. The fund would enter into a new reporting regime designed to deliver:

- Identity and residence information for all investors, including the share of investment returns for all investors.
- Source jurisdiction information for all investment returns.
Automatic exchange provisions such that information reported to a fund’s “home” jurisdiction would be exchanged with investment source and investor recipient fiscal authorities.

19. Further work with the industry would be required in order to refine these principles into a form which could be included in the model LOB. However, in principle it is clear to see that such features would minimise the possibility of treaty abuse being facilitated by private equity funds.

**Sovereign Wealth Funds and Pension Funds**

20. We believe that many of the issues outlined in the paper (e.g. investments through 3rd countries) could be addressed if the recommendations outlined in paragraph 10 above were to be implemented (especially the derivative benefits test and the removal of the intermediate holding company tests).

**Discretionary Relief**

21. The CBI welcomes the discretionary relief rule to ensure that treaty benefits are available in genuine commercial situations which may otherwise fail a tightly worded objective test. It is important that this is not used as a solution for other subjective matters such as the active business test in areas of dispute.

22. We would recommend that an advanced ruling arrangement should be made available with an appropriate timescale for agreed outcomes to ensure that tax payers can achieve certainty for their transactions.

23. If there continues to be an absence of a derivative benefits test, it would be useful for the guidance supporting this test to cover areas where the ultimate shareholders are entitled to the equivalent treaty benefits.

**EU countries**

24. Paragraph 13 of the September paper acknowledges that the LOB needs to be adapted for certain EU law requirements. We recommend that these requirements are included in the basic minimum standard, and believe if the recommendations in this letter are adopted, they would generally be addressed.

25. We also recommend that other non-discrimination clauses in bilateral agreements between countries such as those in bilateral tax treaties are also taken into account when dealing with this issue as similar issues may arise with non-EU countries as well.

**Intermediate owners**

26. It is unclear, with the possible exception of dividends, how the location of an intermediate holding company would affect the ability of a company to undertake treaty shopping. In today's business environment, interest, royalties and other payment for group services are often undertaken between brother and sister companies or even entities which are in completely different chains of the group structure. In these situations the location of the immediate parent company is irrelevant and should therefore not be a factor in deciding whether treaty benefits should be applied.

27. There are many commercial reasons as to why you may have a holding company in a different jurisdiction to the subsidiary or the ultimate parent. This is particularly relevant in areas of historic M&A activity and where groups organise themselves on a regional basis.

28. Testing the intermediary company is too restrictive, and would lead to denial benefits were is no treaty shopping. This restriction should be removed. Such an approach would be consistent with the minimum standard approach for the model treaty. It would also reduce a significant compliance burden and focus on the ultimate beneficial owner which is the key concern on treaty shopping.

**Derivative benefits.**
29. A derivative benefits provision is an essential tool for a limitation of benefits test to ensure that the ultimate owners are entitled to the treaty benefits that they would have received if they had invested in, or undertaken transactions, directly with the company in question. The global market in which companies now operate often means that owners of private companies could be located in various states across the world. Larger companies will also generally operate on a regional basis and therefore for genuine operational reasons, payments of interest, royalties, dividends and other group payments may not go through companies which are in the jurisdiction of the ultimate parent company.

30. In situations where the ultimate owners are entitled to treaty benefits it is difficult to understand the policy behind not having a derivative benefits test. We also consider the situation where a derivatives benefits test will only apply where 95% of the owners are seven or fewer equivalent beneficiaries to be too restrictive.

31. For example, it should be easier for seven or fewer people to agree a common treaty abuse strategy compared to a situation where there are hundreds of investors. The more investors there are in a group, it should follow that it would be likely that treaty shopping could be arranged. We also consider the 95% threshold too high as it is unlikely that just 5% of investors would have significant influence to promote a tax treaty strategy. We believe that a more realistic threshold should be 75% which would be a sensible compromise between the requirement that a significant majority of investors should be entitled to the equivalent treaty benefits compared with the actual influence of a group of investors both practically and under company law.

32. We therefore recommend that the proposal is amended to a 75% threshold which can be met by as many investors as possible.

Example – Historic Acquisitions

33. We have a member group whose primary businesses originated in the US and which had over 30 years of US history before they were acquired by a UK group approximately 20 years ago. The group’s current operations are organised and managed regionally with management of the Americas region being in the US. The business is an active franchise and management business which results in fees, typically categorised by source jurisdictions as royalties but deriving from this active business, being received in the primary US regional companies. Because of the historical and regional management structure numerous shareholdings are also held under the US.

If the fees and dividends had been received directly in the UK, the listed company test would be in point and equivalent treaty benefits obtained. Therefore there is no treaty shopping, just a normal commercial operation created by historic activity which can be resolved by a derivative benefits test which does not require the intermediate company to be in the same jurisdiction as the ultimate parent.

Dual listed companies (DLC)

34. We welcome the introduction in the September paper of some provisions relating to dual listed company arrangements. However, we would note that a DLC arrangement is not necessarily static so language that only covers arrangements in place at time of forming the DLC would be too limiting. Our member’s which are DLC’s will be submitting a detailed response to address this point.

Public Listed Entities

35. In modern global markets, a number of multinational companies will be listed on more than one exchange. In such circumstances, it may not be possible to meet the test currently proposed as there may not be one exchange where the shares are primarily traded. We therefore recommend that the test is broadened to aggregate all trading of a principal class of shares on all recognised stock exchanges.
Active Business

36. The active business test is an important test to try and identify genuine business transactions between related activities of a group of companies where the objective ownership tests cannot be met.

37. We support the detailed text outlined in the BIAC response, but would particularly highlight our concerns in relation to the following issues:

   **Headquarter (HQ) Companies**

38. The proposed model treaty currently omits a HQ test. We believe that the OECD should recognise today’s business environment and not unduly penalise companies which operate on a regional basis. This is particularly relevant in the area of global M&A transactions where group structures may be inherited. We therefore recommend that, aligned with existing treaties, the proposed model treaty be incorporated to include a HQ test.

   **Investment/Financing Activities**

39. The proposed wording needs to be made clearer, so that the way the active business exemption works by looking at the entire affiliated group to determine whether there are substantial business activities. Financing and investment activities are then ignored in determining whether the activities in a territory are substantial. If the group as a whole in the territory does have substantial activity then all members should qualify regardless of their particular activities. Neither the group nor individual entities should be tainted because the group also has investment/financing activities (provided the “in connection or incidental to” test is satisfied).

**PPT**

40. The main concerns regarding the application of the PPT is the subjective nature of the words. It would be helpful if detailed examples were included in guidance to enable taxpayers to gain some certainty as to how the provisions should be interpreted. If tax authorities have different views, we also recommend there should be a prima facie assumption that it is not reasonable to conclude that obtaining treaty benefits was one of the principle purposes.

41. In relation to the issues raised in the OECD Discussion draft on the PPT, we make the following comments (paragraph numbers relate to the paragraph numbers in the OECD Discussion Draft):

   42. Paragraph 31 – We agree that the wording of the PPT should be clarified for the situation outlined.

   43. Paragraph 32 – Whilst having a safeguard of approval at senior level would be sensible, it is our concern that this could prove to be administratively burdensome, lengthy and too uncertain. The rules should be capable of applying on first principles, with an affirmatory process domestically if there is doubt.

   44. Paragraph 33 – It is our view that Article 25 paragraph 5 regarding arbitration should be capable of being applied to a PPT.

   45. Paragraph 34 – Given the purpose of both the LOB and PPT is to achieve the same goal, there should be no inconsistency on the dis-application of discretionary relief. Therefore we recommend that the aligning the words should be undertaken so they both read “did not have as one of its principal purposes being the obtaining of benefits under this Convention”.

   46. Paragraph 35 – We would recommend that discretionary relief is available under the PPT to provide consistency with the LOB and so they apply in a similar fashion.

   47. Paragraph 36 – If an anti-conduit rule is to be adopted (despite them being more restrictive than either LOB or PPT’s), then the OECD should consider how these rules can have preventative measures put in place so the effect to treaties can be given in a manner similar to treaty mechanisms involving LOB and PPT. We would recommend that the US/UK treaty examples are used to modify the application of such rules.
48. Paragraph 37 - Given the objective of applying a PPT or LOB is supposedly the same (namely to prevent abuse), we would recommend that in the guidance to the PPT, certainty could be provided relating to all of the situations to which the objective LOB should be in point. Therefore, specific examples should be included covering:

- Listed holding companies
- Companies held by shareholders all located in treaty jurisdictions (with at least the same level of treaty benefits)
- Pension funds set up for employees in the local territory
- Sovereign wealth funds
- Companies carrying out a related active trade and what the level of activity/substance required to qualify for treaty benefits should be

49. In addition, many of the contentious areas outlined in this paper relating to the LOB, should also be covered by guidance to the PPT. This should include:

- CIVs
- Alternative funds
- Private Equity
- Regional Holding Companies (outlining any differences from when a regional holding company is acquired compared to setting up a new structure).

50. We refer to the IA and BVCA papers for issues and examples to be addressed in guidance in relation to funds.

**Treaty Tie Breaker**

51. We welcome the relaxation in 24.2 to allow countries to adopt the effective management test to determine corporate residency in situations where a person other than an individual is resident in both contracting states under domestic law. A tie-breaker test should provide a clear and effective result that can be predicted in advance. Under the competent authority route it is currently required that each state undertake "endeavours" to reach an agreement and here is no require to actually reach an agreement which could deny taxpayers treaty benefits to which they are entitled. Under the current competent authority proposal, we recommend that a fixed time limit is imposed to achieve a result or the case should then be decided by arbitration.

We trust that you will find the above comments helpful in understanding the potential impact of the proposals outlined in your paper. We remain committed to ensuring that each BEPS Action achieves its stated goals whilst ensuring that genuine business arrangements are not unduly impacted. We remain at your disposal should you wish to discuss the issues we have raised in this paper in more detail. Please contact neil.anthony@cbi.org.uk for more information.
CFE Opinion Statement FC 2/2015 on the OECD Discussion Draft
“Follow-up work on BEPS Action 6: Preventing treaty abuse”

Prepared by the CFE Fiscal Committee and submitted to the OECD in January 2015
CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 26 professional organisations from 21 European countries (16 OECD members) with more than 100,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe. CFE is registered in the EU Transparency Register (No. 3543183647-05).

Introduction

The following comments relate to the OECD’s Public Discussion Draft “Follow-up work on BEPS Action 6: Preventing Treaty abuse” (hereinafter: Discussion Draft) of 21 November 2014. This Discussion Draft follows up on the OECD Discussion Draft of 14 March 2014 on the same topic on which the CFE has commented in its Opinion Statement FC 5/2014 of April 2014.

Please note that this version of our Opinion Statement is only preliminary. The final version will be published on the CFE website in the course of January 2015.

We will be pleased to answer any questions you may have concerning our comments. For further information, please contact Mr. Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Rudolf Reibel, Fiscal and Professional Affairs Officer of the CFE, at brusselsoffice@cfe-eutax.org.

CFE comments

The objective of BEPS Action 6 is the prevention of treaty benefits in inappropriate circumstances. It is felt however that the proposals put forward may be disproportionate to the objective intended and may create a situation of double taxation even if the primary intention had not been treaty abuse. More importantly, the subjective nature of certain proposals and the lack of certainty in the accompanying commentary creates scope for uncertainty in their application.

There are concerns that some of the changes proposed to date could have a disproportionate impact on businesses in smaller economies, with smaller capital markets, who are naturally more likely to seek capital and finance abroad.

Discretionary relief provisions

This suggestion is intended to provide treaty relief where a resident of a contracting state would otherwise be denied treaty benefits under the LOB rule. There are concerns that this may be difficult to apply in practice as experience has indicated that it can be very difficult to get agreement from tax authorities that discretionary relief should be afforded to a taxpayer even in circumstances where a company has very clear and substantial links with and operations in its company of residence.

In any case, a time limit should be imposed on the competent authority to process the request for the application of discretionary relief.

3 http://www.cfe-eutax.org/node/3668
Derivative benefit provisions

We welcome the suggestion of an inclusion of a derivative benefits test in the LOB (limitation of benefits) although we note that this is not supported by all the countries. The requirement that all entities in the chain of ownership should be “equivalent beneficiaries” is restrictive and the definition of equivalent beneficiaries excludes private companies. This should be changed so that the full range of persons including private companies are capable of being equivalent beneficiaries.

Timing issues related to the various provisions of the LOB rules

Listing is an onerous time consuming process that requires regulatory approval. A company that lists in the middle of a taxable year would have initiated the process way before that. The intention to list would have been there and consequently the requirement listed throughout the taxable period should be revised to “is listed during a taxable period”.

Active business test

The active business test provides an important opportunity for substantive businesses to pass the LOB.

The proposed LOB states that where income is derived from a related party, the active business test will only be considered to be satisfied if the business activity carried on in the small country is substantial in relation to the business activity carried on by the associated enterprise in the other state. Ideally, the substantiality requirement would be dropped because it will often be difficult for an entity in a small country to be able to meet this test.

The OECD commentary does helpfully note that due regard will be given to the relative sizes of the economies and markets in the two contracting states.

There also needs to provide clarification on what constitutes “active” business. It is quite possible that there is a substantial presence in the small country concerned which carries out substantial activity, but which is not “active” (as currently defined by US tax law). There should be clarification that business support activities (where the workforce in the small country concerned conduct substantial managerial and operational activities over those support services) can qualify as an active business even where those activities are provided for the benefit of related group parties.

It would also be useful to consider whether a “safe harbour” might be included similar to those contained in some US treaties currently – either a mathematical safe harbour or a purpose test.

Publicly Traded test

The definition of “another recognised stock exchange” should be extended to include major country exchanges (such as the US) and exchanges in regional groupings such as the EEA. There are valid and particular reasons why many non-US companies choose to list on NASDAQ as an example.

Principal Purpose test

There are concerns that the principal purpose test (PPT) will be much more difficult to pass for businesses in smaller economies. It is more likely that the benefits of being able to access a tax treaty to avoid double tax in relation to a cross border transaction or business arrangements will be more evident in the case of the taxpayer based in a smaller economy. This benefit could more easily be identified as one of the main
benefits that arise to that taxpayer from the cross border transaction. Smaller country businesses face considerable uncertainty as to whether they can ever pass the PPT test.

A business operating in a large economy will find it much easier to pass the PPT than a business operating in a smaller economy, simply by virtue of the size of the economy. This is a distortionary effect and creates an un-level playing field as well as very significant uncertainty and cost for businesses in smaller countries.

The PPT rule should be redrafted to provide that treaty benefits can arise except where the main purpose of the arrangement or transaction is to obtain the treaty benefit. This should achieve a balance between protection from treaty shopping and reflecting and preserving the benefits that treaties offer to taxpayers in smaller economies.

Submitted by email: taxtreaties@oecd.org
FAO Marlies de Ruiter, Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA

9 January 2015

Dear Ms de Ruiter

Public Discussion Draft: Follow-up Work on the Report on BEPS Action 6 (Prevent Treaty Abuse)

We are grateful for the opportunity to comment on this important aspect of the OECD’s work.

CREFC Europe is the voice of the commercial real estate (CRE) finance industry in Europe, representing banks, insurers, fund managers and others providing or intermediating the provision of debt to real estate businesses, as well as advisers, consultants and others with a stake in this sector. We seek to promote transparency and liquidity in CRE finance markets by developing and disseminating best practice and engaging with regulators and policymakers, so that our industry can flourish while playing its part in supporting the real estate sector and the wider economy and delivering returns to investors.

We set out below some high-level comments and state our support for the more detailed submissions of two other organisations whose membership and interests overlap in relevant ways with our own.

High-level comments

Past submissions. We would generally reiterate the points made in previous submissions regarding Action 6, independently on 9 April 2014 (referencing submissions by INREV1 and the BPF2), and jointly with a number of other European real estate industry associations on 23 May 2014.

Support for policy aims. We remain supportive of the OECD’s broad policy objectives in relation to preventing treaty abuse. We support efforts to develop internationally consistent solutions to address policymakers’ concerns in this area.

Concern about the treatment of investment funds... However, we are concerned that the evolving proposals continue to deal inadequately and inappropriately with the investment fund structures through which substantial international capital (both equity and debt) is channelled into investment in CRE and the built environment.

...and especially about the treatment of non-CIVs. We are especially concerned about the position of non-CIV funds, which are very widely used in the CRE sector for good (non-tax) commercial reasons flowing from the mostly institutional and international investor profile and the large-scale, long-term and illiquid nature of the underlying asset class invested in.

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1 INREV is the European Association for Investors in Non-listed Real Estate Vehicles.
2 The BPF is the British Property Federation.
No policy case for penalising investors in CRE debt funds. CRE debt funds typically attract capital from institutional investors including pension and insurance firms, which would qualify for treaty benefits if they invested directly, but choose to invest indirectly and collectively. Good (non-tax) reasons for that choice are a lack of the requisite resources or infrastructure to invest in CRE debt directly, or a preference for the risk diversification offered by collective investment. We see no policy justification for restricting treaty benefits in a way that disturbs such structures.

No policy case for penalising CRE debt funds’ use of subsidiaries. CRE debt funds typically use subsidiary companies to segregate the risks presented by different loans they invest in, and to facilitate joint venture investments or appropriate transaction-specific financing. In some cases, operational considerations (such as a desire to limit the number of subsidiaries used by a fund) lead to the use of cell/compartment and multi-issue vehicles by alternative investment funds. Given that the existence of such holding structures is not tax-driven, we do not consider that it should be regarded as objectionable for their location to be selected having regard to tax neutrality alongside other legal, practical and financial considerations. There is no particular reason for them to be located in the same jurisdiction as the fund, fund manager or underlying assets.

Risk of unintended consequences for financial stability. In the aftermath of the financial crisis, many countries, particularly in Europe, recognise the resilience that a more diversified financial system could offer. Given the feedback loops between property and credit cycles, CRE debt is one sector in which excessive reliance on the banking sector to provide finance seems very clear. Europe’s CRE debt market has experienced a strong, and very welcome, flowering of non-bank finance supply in the last few years, largely thanks to fund vehicles. These vehicles almost invariably fall within the regulatory scope of the Alternative Investment Fund Managers Directive (albeit the subsidiaries through which they invest usually won’t), but they typically fall outside the OECD’s CIV definition. Denying treaty benefits to such vehicles could have far-reaching adverse consequences for financial stability.

Risks to competition and to the flow and cost of credit for the real economy. Denying treaty benefits for (largely non-CIV) CRE debt funds would also have an adverse impact on the flow and cost of credit for borrowers and thus also for investment flows more generally in the built environment and the real economy. CRE loan documentation typically imposes a grossing up obligation on the borrower in the event of withholding taxes being imposed. The OECD’s current proposals risk both increasing the effective cost of borrowing for businesses under existing loans, and reducing effective competition in the debt market by placing market-based finance provision (through such funds) at an unjustifiable tax disadvantage relative to more traditional sources of finance.

Support for INREV and BPF submissions. As we did in our April 2014 submission, we would like to express our agreement with and support for the more detailed representations being made by INREV and the BPF, which identify the key issues arising from the current proposals for the flow of international capital into CRE, and make constructive suggestions for how those issues might be addressed.

Yours sincerely

Peter Cosmetatos
CEO, CREFC Europe
pcosmetatos@crefceurope.org
+44 20 3651 5696
Marlies de Ruiter  
Head Tax Treaties Transfer Pricing and  
Financial Transactions Division  
OECD Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris  
France  

Submitted by email: taxtreaties@oecd.org  


The Confederation of Swedish Enterprise is Sweden's largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.  

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled “Follow up Work on BEPS Action 6: Preventing Treaty Abuse” 21 November 2014 – 9 January 2015 (hereinafter referred to as the Draft).  

General Comments  

The Confederation of Swedish Enterprise supports the OECD's work to prevent abuse of tax treaties. It is however important to make any new provision sufficiently targeted toward abuse in order not to negatively impact bona fide businesses. The initial and prime objective with tax treaties is and should continue to be to facilitate cross-border trade through the allocation of taxing rights between countries and to provide for mechanisms to eliminate double-taxation. By doing so, tax treaties provide certainty and eliminate major obstacles to cross border trade.  

We acknowledge the time pressure in the BEPS project. However, we fear that the proposed amendments to the Model Treaty will have a major impact not only on abusive cases but also have negative effects on genuine business activities. We are seriously concerned about the lack of new guidance in the Draft, considering the added complexity and unpredictability that will follow, should these proposals be implemented.  

Although the prevention of tax evasion and avoidance may be important purposes of a tax treaty, they do not constitute a prime objective, equal to the prevention of double taxation, and should not be a main objective for entering into a tax treaty.  

Confederation of Swedish Enterprise  
Address: SE-114 82 Stockholm  
Visitors: Storgatan 19  
Phone: +46 (0)8 553 430 00  
www.swedishenterprise.se
Before entering into treaty negotiations States should carefully analyse and study relevant provisions etc. in the other country, in order to identify potential areas that could open up for treaty abuse. If countries applied this in a consistent manner as indicated in the report on the work on Action 6 (the Report), there would be fewer loopholes to exploit and thus less need for Anti-Abuse rules. This approach would minimize the impact on genuine business activities. In case of abuse treaties should be renegotiated or as a last resort terminated.

It is of utmost importance that anti-abuse rules are designed so that they have a minimum impact on genuine business operations. Consequently, we believe that perceived inappropriate behaviour is best addressed with specific and targeted anti-abuse provisions. We believe that both the proposed LOB provision and the PPT fail in this respect, since they are too general in nature and not limited to abusive situations.

In particular, anti-abuse provisions should recognize that holding, financing and investment activities are normal and legitimate business activities that should not suffer blanket exclusions from treaty protection, which seems to be the case in the proposed LOB provision. Despite numerous comments from public commentators we find, regrettably, that these issues still have not been properly addressed.

The Principal Purpose Test (PPT), previously called the Main Purpose Test (MPT), is still very wide and vague. We still have difficulty in understanding how there could be more than one principal purpose. The test should naturally focus on the principal purpose of the arrangement or transaction.

Although we find both the LOB and the PPT rule to be too far-reaching we are positive to the fact that the OECD at least has dropped the requirement to have them both in a treaty and settled for a minimum standard of either a PPT or a LOB supplemented by a restricted PPT for conduit financing arrangements.

Apart from the fact that the LOB seems overly restrictive, a number of paragraphs in the proposed LOB could also be in violation with EU law. In addition, certain provisions such as subdivision 2 c) i) B seems to relate to specific US issues and should consequently be dealt with on a bilateral basis and not be inserted into the Model Treaty.

We have limited our comments to some of the issues in the Draft.

A. Issues related to the LOB provision

1. Collective investment vehicles: application of the LOB and treaty entitlement

An indirect investment through a CIV should not be treated worse than if the investment had been made directly. Consequently, we believe it is important to provide treaty benefits for CIVs and are positive to an inclusion of a specific paragraph in the LOB that would grant CIVs treaty benefits.

With the exception of para 42, the approaches in the report on action 6 require a test to establish that a certain amount of the investors in a CIV would have been entitled to treaty benefits had they invested directly. Such an approach would impose a high
compliance burden on the CIV. Para 42 suggest that a CIV could be a qualified person if the principal class of shares in the CIV is listed and regularly traded on a recognised stock exchange. Even though this latter condition would be fairly easy to comply with, the problem is that it would only be applicable to a small portion of CIVs. Many CIVs are not traded on a stock exchange and would thus be excluded from treaty benefits.

In our opinion, a CIV should be entitled to treaty benefits if it is registered in one of the contracting states.

3. Commentary on the discretionary relief provision of the LOB rule

The Confederation of Swedish Enterprise would welcome a statement in the discretionary relief provision to ensure a prompt response from the competent authorities. A set time period of would be preferable.

4. Alternative LOB provisions for EU countries

The Confederation of Swedish Enterprise agrees that the LOB rule needs to be adapted to reflect EU law requirements.

In particular, our concern is with the prohibition of non-resident intermediaries in the ownership tests, the local stock exchange requirement in the publicly traded test and the PPT rule.

Non-resident intermediaries in the ownership tests in subdivision 2 c) (ii) and 2 e) (i) of the LOB rule:

Apart from the fact that we believe the conditions regarding intermediate owners to be too restrictive, we also are concerned that they are in violation of EU law since both provisions disqualify companies from treaty protection if they are owned by companies in the EU/EEA. In our view, the LOB should focus on testing the ultimate beneficial owner and not intermediary companies. The Confederation of Swedish Enterprise proposes to delete the reference to intermediate companies in both provisions. Under any circumstances, the provisions should at least be amended to provide for intermediate ownership within the EU/EEA.

The local stock exchange requirement in subdivision 2 c) i) a) in the LOB rule:

The local stock exchange requirement is likely to be in violation with EU law since only the stock exchange in the Contracting State of which the company is a resident is accepted, thus preventing companies to list their share on other stock exchanges in the EU. Some treaties including the one between Sweden and the US contain a list of accepted stock exchanges as suggested in para 6 of the proposed LOB. Consequently, the Confederation of Swedish Enterprise proposes that the list in para 6 a) should include every stock exchange in the EU and any other State in the EEA.
The PPT rule

In addition to the fact that we find the PPT to be vague and not sufficiently targeted on abusive cases we are also concerned that the PPT could be in violation with EU law. The Cadbury Schweppes case (C-196/04) concludes that anti-abuse legislation should only target “wholly artificial arrangements”. As currently drafted, the PPT does not seem to provide such certainty.

In our opinion, these aspects, and possibly others, definitely require analysis in light of EU law. Should the conclusion be that the provisions are in violation of EU law, a significant number of OECD members would not be able to adopt the LOB provision as it stands.

5. Requirement that each intermediate owner be a resident of either Contracting State

As indicated above, we believe that the LOB rule should focus on the ultimate beneficial owner and not intermediate companies. We fully support the comments and examples made by BIAC on this issue.

6. Issues related to the derivative benefit provision

We strongly support a derivative benefit provision in the LOB. The derivate benefit provision would extend the granting of treaty benefits to entities that are controlled by entities that are resident of a third country and that would enjoy the same treaty benefits with the contracting state in question. In such situations, there is no incentive for treaty shopping.

9. Conditions for the application of the provision on publicly-listed entities

We refer to our comments made under item 4 above.

10. Clarification of the “active business” provision

We fully support the comments and examples made by BIAC on this point.

B. Issues related to the PPT rule

12. Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level

The Confederation of Swedish Enterprise is in favour of such a requirement in order to prevent excessive use of the PPT.
13. Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable

Introducing a substantive provision such as the PPT without the possibility of mutual agreement procedures or arbitration is not acceptable. Furthermore, it is not unlikely that the Competent Authorities in many cases will be unable to reach an agreement on the application of the PPT with double taxation as the end result. Consequently, the Confederation of Swedish Enterprise strongly recommends that the application of the PPT should be under mandatory arbitration.

15. Whether some form of discretionary relief should be provided under the PPT rule

The Confederation of Swedish Enterprise is supportive of having a discretionary relief provision under the PPT rule.

16. Drafting of the alternative “conduit-PPT rule”

The provision needs clarification. The wording “all or substantially all of that income (at any time or in any form)” is unclear and could be interpreted too widely. At some point in time, every company will pay all or substantially all of its income to its shareholders.

We support the inclusion of examples to illustrate that the rule is not intended to apply to a company merely because that company’s policy is to distribute most of its profits in the form of dividends.

C. Other issues

19. The design and drafting of the rule applicable to permanent establishments located in third States

We question the necessity of a provision like this in the Model Treaty. This topic may be of interest in relation to some countries and should naturally be carefully considered before entering into a treaty with such a country. At any rate, those situations could be solved bilaterally. In addition, we fully support the comments made by BIAC.

20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

The Confederation of Swedish Enterprise supports the comments made by BIAC.

Concluding remarks

Introducing provisions like the proposed LOB and PPT will undoubtedly induce further uncertainty into the Model Treaty and make treaty application even more
difficult. Although, a number of countries have a LOB in their treaty with the United States, similar to the one proposed in The Draft, it is an entirely different matter to insert such a provision into the OECD Model, to be used on a global basis. As proposed, the LOB, apart from being very complex, seems overly restrictive and runs the risk of having a very negative impact on genuine business operations. Furthermore, some provisions seems to relate to specific US issues and it is questionable why such provisions should be included in the Model Treaty and not be dealt with on a bilateral basis.

Whereas the LOB provision is technically complex, it leaves less room for subjective and arbitrary assessments and provides for some certainty. The PPT on the other hand takes the opposite approach. It does not provide much guidance with respect to when the treaty benefits will be granted. Instead, it opens a door for tax administrations to disqualify taxpayers from treaty benefits where that tax administration finds it appropriate. The problem with the PPT is not its complexity. Rather, our concern lies with the fact that it is very subjective and leaves significant room for arbitrary assessments.

Considering the fact that a large number of OECD countries are also members of the EU, we are, however, pleased that the OECD has acknowledged the fact that the LOB needs to be compliant with EU law. As indicated in our comments, we believe that the same is also relevant in relation to the PPT rule. We are, however, very disappointed that a proper analysis ensuring EU law compliance has still not been undertaken.

In view of the implications of introducing these new provisions in the Model Treaty we had expected the Draft to provide more guidance in relation to the issues still to be resolved. As currently drafted, the provisions could seriously undermine the certainty and predictability needed for investment decisions and also lead to an increase of double taxation cases. The effect would be very negative on investments, jobs and growth.

Consequently, we urge the OECD to carefully consider these aspects in the process ahead.

On behalf of the Confederation of Swedish Enterprise

January 9, 2015

Krister Andersson
Head of the Tax Policy Department
Ms Marlies de Ruiter  
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA  
Organisation for Economic Cooperation and Development  
2 rue André-Pascal  
75775, Paris Cedex 16  
France  

by email to taxtreaties@oecd.org

8 January 2015

Dear Ms de Ruiter,

Re: PUBLIC DISCUSSION DRAFT: BEPS ACTION 6: Prevent the granting of treaty benefits in inappropriate circumstances

We welcome the opportunity to comment on the above document issued on 21 November 2014. We propose to limit our observations to certain of the questions raised in the discussion draft. As we understand it, the Limitation of Benefits (“LOB”) clause could limit or refuse access to treaty benefits where the taxpayer in question is owned or financed from abroad or where its shares are traded on a foreign stock exchange. As we have already signalled to you in previous correspondence, we feel that this approach is harmful to smaller countries which have more limited access to local capital markets and finance providers. Such countries therefore will be at a disadvantage as compared to taxpayers based in larger economies in meeting a LOB test which was designed for a larger country with large capital markets and broader access to local finance.
1. Collective investment vehicles: application of the LOB and treaty entitlement

We would support the recommendations of the 2010 CIV Report and would advocate their inclusion in the BEPS Deliverables. That report recommended that CIVs should obtain treaty protections if they qualify in their own right or if they are able to claim on behalf of investors who are eligible for treaty relief (as per the TRACE project which has already been endorsed by the OECD).

We feel it is important, particularly to smaller countries, that CIVs distributed cross border are not disadvantaged relative to funds that are distributed within their home jurisdiction.

3. Commentary on the discretionary relief provision of the Limitation on Benefits (LOB) rule

The approach to the management of LOB gives rise to 2 overarching problems.

The first of these is that it places very considerable discretion on the Revenue Authorities concerned who will be required to act as gatekeepers for access to treaty benefits. We make this point not by way of any criticism of the Revenue Authorities, but to emphasise that many jurisdictions are attempting to reduce the size of their Revenue Authorities. Both of the Revenue Authorities with which we in CCAB-I are most concerned, HM Revenue and Customs and the Irish Revenue Commissioners, have in recent years engaged in significant staff reduction programmes. A generally applicable LOB will increase the administrative role for Revenue Authorities against a backdrop of their reducing resources.

The second is that, while a principal concern of the OECD BEPS project has been to minimise uncertainty in international tax matters, a discretionary regime will in our view both slowdown the cross-border investment process and hamper the establishment of commercial projects by virtue of the uncertainty created by a discretionary LOB. At the very least, an efficient appeals mechanism against decisions taken by Revenue Authorities would have to be put in place.

4. Alternative LOB provisions for EU countries

This is a positive development. It would have been untenable to restructure the Treaty framework fundamentals without reference to the binding agreements entered into by the 28 EU Member States which guarantee freedom of establishment, along with free movement of capital, persons and services.
The Introduction to the Model Tax Convention states (at page 12, 8th edition 2010) that “it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries”. The possibility of alternative LOB provisions for EU countries offers reassurance that the concern to remove the obstacle of double taxation has not been lost.

8. Timing issues related to the various provisions of the LOB rule

There has to be recognition that with the growth of cross-border trade and commercial activity, multinational groups are not static, rarely changing entities. It may be necessary to introduce grandfathering provisions, whereby treaty benefits do not cease to be granted immediately following a change of ownership, or a change in the location of the public listing. We also suggest that there may have to be an accommodation for companies which are EU Member State resident, by reference to the operation of the Parent Subsidiary directive (2003/123/EC) and the Mergers directive (90/434/EEC).

10. Clarification of the “active business” provision

We suggest that it be made clear that business support activities can qualify as an active business. This would help mitigate the difficulties encountered by taxpayers in smaller markets whose workforce is engaged in substantial managerial and operational activities in connection with support services, but where there are limited sales of the group’s actual products and services by virtue of the small market size.

11. Application of the PPT rule where benefits are obtained under different treaties

We think it may be instructive to view a PPT rule through the lens of General Anti-Avoidance Provisions or Rules. Such Provisions tend to rely on the decisions taken by the Revenue Authority concerned, and thus we are back to the difficulties described above with Discretionary Relief provisions – an over reliance on the resources of the Revenue Authority coupled with greater uncertainty.

We are concerned that the PPT rule will also give rise to a greater incidence of cross-border treaty disputes. Currently treaty disputes are typically resolved in accordance with the domestic procedures applicable in the country seeking to apply the charge to tax. Resolution in these instances is not straightforward, and the complexity of the current Action 6 proposals will not help.

You may wish to note that this response is from a representative body. The Consultative Committee of Accountancy Bodies – Ireland is the representative committee for the main
accountancy bodies in Ireland. It comprises Chartered Accountants Ireland, the Association of Chartered Certified Accountants, the Institute of Certified Public Accountants in Ireland, and the Chartered Institute of Management Accountants, which represent a combined membership of some 40,000 accountants. Brian Keegan, Director of Taxation at Chartered Accountants Ireland (brian.keegan@charteredaccountants.ie, +353 1 6377 347) may be contacted if any further details in relation to this letter are required.

Yours sincerely

Paul Dillon, Chairman, CCAB-I Tax Committee
Marlies de Ruiter,
Head Tax Treaties, Transfer Pricing and Financial Transactions Division,
Centre for Tax Policy and Administration, OECD

By Email: taxtreaties@oecd.org

9 January 2015
Our ref: WJID/SJC/RF

Dear Marlies

Discussion Draft on BEPS Action 6:
We welcome the opportunity to comment on the Public Discussion Draft – ‘Follow up work on BEPS Action 6: Preventing Treaty Abuse’ released on 21 November 2014 (the ‘Discussion Draft’). Our comments are made from the perspective of the UK.

We set out in Appendix 1 our detailed comments on each section of the Discussion Draft, including our response to the specific questions raised.

As a general comment, we can envisage issues for Collective Investment Vehicles and Non-Collective Investment Vehicles should either a limitation on benefits test or principle purposes test be applied to them. We would therefore suggest that alternatives are also considered. An example could be along the lines of the UK Genuine Diversity of Ownership test, which is contained in the Authorised Investment Funds (Tax) Regulations (Statutory Instrument 2006/964). As modified and included in a treaty this could deny treaty access where there is only a small number of connected investors which would not otherwise be able to apply a treaty.

If you wish to discuss any of the points raised in this letter, please do not hesitate to contact either me (bdodwell@deloitte.co.uk) or Simon Cooper (sjcooper@deloitte.co.uk).

Yours sincerely

W J I Dodwell
Deloitte LLP

By Email: taxtreaties@oecd.org

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Yours sincerely

W J I Dodwell
Deloitte LLP
Appendix 1

1. Collective investment vehicles: application of the LOB and treaty entitlement

In order to access a double tax treaty with a limitation on benefits (LOB) rule the relevant person must first be a resident of one of the Contracting States. The 2010 Report could be helpful in this respect but we would suggest that further work needs to be undertaken. In particular:

- the meaning of Collective Investment Vehicles (CIVs) should be extended to reflect the fact that investor protection regulations may cover a region (for example, the European Union (EU)) and not be specific to the country, and
- the position of non-CIV vehicles should be further considered taking into account their possible investor base. We comment on this more fully in 2 below.

Although it would be helpful to have a preferred approach, this may not be possible due to the different forms that an investment vehicle may take. Instead we would suggest that in addition to the 2010 Report, countries should closely work together to determine which investment vehicles should have access to treaty benefits and make this information publicly available. To date there have been instances of countries taking different views on the eligibility of such vehicles to access treaties (for example, due to different views on whether the vehicle is tax transparent), which have resulted in tax uncertainty.

In addition, industry representatives have indicated their concern that ongoing monitoring of all investors’ treaty entitlements on a daily basis (ensuring that the correct rate of withholding was applied to each income receipt in the CIV) would have significant practical limitations. While FATCA and CRS are imposing upstream information provision requirements, there is not yet a TRACE like requirement to send the data to the CIV in order that it has certainty as to the treaty residence and status of all investors. This is of particular concern to widely distributed funds which may be using an intermediated distribution model with multiple third party nominee companies which may have local data protection restrictions on the provision of specific investor information.

2. Non-CIV funds: application of the LOB and treaty entitlement

As set out in the Discussion Draft alternative funds/ private equity funds1, and other funds that do not fall into the definition of a CIV, are likely to encounter many of the problems that an LOB rule creates for CIVs.

Investment vehicles (Funds) can take a variety of forms both within and across countries. The 2010 Report is helpful in providing a base which may allow certain of these vehicles to access treaty benefits but it is not, and cannot be comprehensive due to these differences. This said we believe that it is important that, as far as possible, investors should not be tax-disadvantaged by making an indirect rather than direct investment. An example of this could be a pension scheme investing in a private equity fund. This is common commercial practice and allows pension schemes to access more investment opportunities that could allow it to diversify its risks/ increase its returns. Pension schemes are generally treated as residents of a Contracting State and can meet LOB requirements. Private equity funds, on the other hand, are often unlikely to be able to benefit from double tax treaties and this could result in additional tax compared to a direct investment by the pension fund investor. In order to alleviate this taxation of tax exempt investors/ prevent double taxation, we would suggest that treaty benefits are available in respect of indirect investments. This could be achieved by:

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1 These types of fund would generally not be CIVs as defined in the 2010 Report as they are not widely held and/or regulated. Alternative funds are generally not within the scope of the 2010 Report due to the increased complexity of the investment strategies and certain classes of investments are targeted at sophisticated investors. Lighter regulation is therefore required to permit wider investment powers.
a. in the case of tax transparent Funds, where the income flows through to the investors, allowing the
investors in the Fund to apply any treaty entered into between their country of residence and the
country of residence of the underlying investment. An example of this is Article 1(8) of the UK-US
treaty, and
b. in the case of Funds which are not tax transparent:
   i. extending the derivative benefit test by increasing the number of equivalent beneficiaries and
      not requiring that all intermediate owners to be equivalent beneficiaries. We note this could
      extend treaty benefits beyond those that were originally contemplated, and/or
   ii. specifically referring to Funds in the Commentary relating to the discretionary relief provision
       of the LOB rule. The downside of this approach is that there would be uncertainty, which could
       be unacceptable to investors, whilst the Competent Authorities reach their decision.

In addition to the above a key consideration for Funds will often be the administration associated with making
a treaty claim. This will be a domestic matter but it would be helpful if countries were encouraged to adopt a
pragmatic approach which provides them with the comfort required without the need for excessive
paperwork.

3. Commentary on the discretionary relief provision of the LOB rule

We agree that it would be helpful to include possible factors and/or examples in the treaty or Commentary of
when discretionary relief will be available.

An example of this, which could be followed, is the Memorandum of Understanding regarding the Convention
between the Kingdom of the Netherlands and the United States of America regarding the 1992 convention2.
This includes the following:

“For purposes of paragraph 7 of Article 26 (Limitation on Benefits), in determining whether the
establishment, acquisition, or maintenance of a corporation resident of one of the States has or had as
one of its principal purposes the obtaining of benefits under this Convention, the competent authority of
the State in which the income in question arises may consider the following factors (among others):

(1) The date of incorporation of the corporation in relation to the date that this Convention entered
into force;
(2) the continuity of the historical business and ownership of the corporation;
(3) the business reasons for the corporation residing in its State of residence;
(4) the extent to which the corporation is claiming special tax benefits in its country of residence;
(5) the extent to which the corporation's business activity in the other State is dependent on the
capital, assets, or personnel of the corporation in its State of residence; and
(6) the extent to which the corporation would be entitled to treaty benefits comparable to those
 afforded by this Convention if it had been incorporated in the country of residence of the majority of
its shareholders.”

6. Issues related to the derivative benefit provision

We fully support the inclusion of a derivative benefits test and believe this is essential for privately owned
companies to effectively operate internationally. It should be noted that private ownership does not
necessarily mean that a group’s affairs are less complex, and there could be non-tax reasons for
intermediate holding companies. The most common example could be the acquisition of a group of
companies which cannot be rationalised post-acquisition without incurring an otherwise unnecessary tax

cost, from a third party purchaser. It is important that this commercial complexity does not automatically result in a treaty being unavailable.

We agree a derivative benefit provision should not create other BEPS concerns and therefore the drafting of this clause should be finalised once the OECD's work on the other Actions, particularly Actions 5 and 8, is complete.

8. Timing issues related to the various provisions of the LOB rule

In response to the specific issue raised, for the purposes of UK Corporation Tax, becoming publicly listed or ceasing to be publicly listed will not in itself trigger a new taxable period. As such, and as highlighted in the Discussion Draft, we agree that the 'publicly-listed entity' provision would necessarily be failed by any entity which became publicly listed or delisted during a taxable period. Given that there are significant economic consequences and costs of listing/delisting a business, coupled with the regularly traded requirement of the LOB, we do not consider it likely that many groups would consider undertaking a listing solely to obtain treaty benefits. We would therefore suggest that consideration is given to the removal of the 'throughout the taxable period' requirement. If this requirement cannot be removed, this is another area where discretionary relief should be considered and this point could be specifically covered in the related Commentary.

9. Conditions for the application of the provision on publicly-listed entities

We agree with the comments made at paragraph 29 of the Discussion Draft.

In our view, the definition of 'recognised stock exchange' needs to include a comprehensive list of exchanges and that this needs to be far wider than just the Contracting States and any EU/EEA provisions. The requirement that the company's or entity's primary place of management and control is in the Contracting State of which it is resident should prevent treaty abuse where the listing is not in the same country in which the company is resident. At the same time groups will have commercial flexibility as to where to list.

10. Clarification of the ‘active business’ provision

In addition to the Commentary set out in the Action 6, 2014 Deliverable Paper, we consider that parameters would be helpful in understanding the application of the ‘active business’ provision. For example, the US-Netherlands treaty, in particular, includes commentary on the substantial trade or business test. The guidance provides both a subjective test and quantitative safe harbour tests to deal with the concept of substantiality. This is included at Appendix 2 for reference. We would welcome the inclusion of safeguards in the Commentary to provide for certainty and ease of application of the treaty for the majority of cases. However, as with the US-Netherlands treaty, there should not be a single mechanical test that could be ‘passed’ or ‘failed’ in appropriate circumstances.

Headquarter companies can play a key part in a global organisation’s business (for example, managing subsidiaries across a region) and can make a significant contribution to tax revenues, often through employment taxes, in the country in which they are resident. We would therefore welcome the inclusion of a headquarter company test, such as that in the proposed new US-Poland treaty, in the active business rule. We have included the US Treasury guidance in relation to the headquarter test in respect of this pending treaty at Appendix 2. This test includes consideration of the global scope of the business requiring there to be supervised businesses in five countries. We would suggest that some flexibility is built into this requirement for headquarter companies that are starting up or winding down.
We would also recommend that the Commentary specifically covers investment in, and management of real estate for a resident’s own account and when, if ever, this could be viewed as a business.

12. Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the Principal Purposes Test (PPT) is only applied after approval at a senior level

We agree with the suggestions made in the Discussion Draft around establishing an administrative process involving senior level employees of the relevant fiscal authority before the PPT is applied. A PPT could be a new concept in many countries and it is important that it is applied in a consistent manner.

13. Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable

We consider that the application of the PPT rule is a suitable issue for the arbitration mechanism of Article 25 paragraph 5.

14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

We agree that the commentary on the PPT rule and the LOB discretionary relief provision that deal with the principal purposes test need to be aligned.

15. Whether some form of discretionary relief should be provided under the PPT rule

We consider that discretionary relief is justified where there is a re-characterisation of capital into income, such as in the example given in the Discussion Draft of ignoring the transformation of cross-border dividends into a capital gain on shares, or from one form of income into another. We consider that the fiscal authorities should have discretion to give relief by applying the Article which is relevant to the re-characterised income.

16. Drafting of the alternative ‘conduit-PPT rule’

We consider the examples set out in Appendix A of the UK Explanatory Memorandum to the UK-US Double Tax Treaty, which are referred to in the Discussion Draft, to be helpful.

17. List of examples in the Commentary on the PPT rule

As set out in the Discussion Draft, Funds will commonly use a non-transparent entity to aggregate holdings—for example, a corporate vehicle may own 100% of the interests in the Fund and investors will buy shares in the corporate vehicle. The use of a single corporate investor can reduce both tax (for example, one treaty claim rather than a number of treaty claims) and non-tax (for example, reporting to investors, administration). It would be helpful to include an example/examples in the Commentary on the PPT covering this type of structure.

It could be that the corporate vehicle is a Collective Investment Vehicle or Non-Collective Investment Vehicle in its own right. Any examples included should cover this possibility.

18. Application of the new treaty tie-breaker rule

The possibility of dual-residence is much more likely to arise due to the global mobility of senior executives rather than through tax-avoidance.
Although Competent Authorities may be encouraged to address requests as quickly as possible this may not always be possible due to other demands on their time. In the interim taxpayers and tax authorities could be faced with tax uncertainty and unnecessary additional costs (for example, tax filings in both countries until residence is agreed). This highlights the importance of Action 14 - Dispute Resolution and the need for the factors that Competent Authorities will consider when determining residence to be included in the treaty and/or Commentary.

19. The design and drafting of the rule applicable to permanent establishments located in third States

We would suggest that consideration be given to a purpose test for this rule which could supplement/replace the list of specific exclusions that may not be appropriate in all cases.

20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

We have no comments on this point.
Appendix 2


Article 26 Paragraph 4

Subparagraph (b) of paragraph 4 states a further condition to the general rule in subparagraph (a) in cases where the trade or business generating the item of income in question is carried on either by the person deriving the income or by any associated enterprises. Subparagraph (b) states that the trade or business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. Paragraph XXII of the Understanding elaborates on the purpose and application of the substantiality requirement. The requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (i.e., activities that have little economic cost or effect with respect to the company business as a whole).

The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each Contracting State (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State. In any case, in making each determination or comparison, due regard will be given to the relative sizes of the U.S. and Netherlands economies.

In addition to this subjective rule, Paragraph XXII of the Understanding provides a safe harbor under which the trade or business of the income recipient may be deemed to be substantial based on three ratios that compare the size of the recipient's activities to those conducted in the other State with respect to the preceding taxable year, or the average of the preceding three years. The three ratios compare: (i) the value of the assets in the recipient's State to the assets used in the other State; (ii) the gross income derived in the recipient's State to the gross income derived in the other State; and (iii) the payroll expense in the recipient's State to the payroll expense in the other State. The average of the three ratios must exceed 10 percent, and each individual ratio must equal at least 7.5 percent. For purposes of this test, if the income recipient owns, directly or indirectly, less than 100 percent of the activity conducted in either State, only its proportionate share of the activity will be taken into account.


Article 22 Paragraph 5

Paragraph 5 provides that a resident of one of the Contracting States is entitled to all the benefits of the Convention if that person functions as a recognized headquarters company for a multinational corporate group. The provisions of this paragraph are consistent with the other U.S. tax treaties where this provision has been adopted. For this purpose, the multinational corporate group includes all corporations that the headquarters company supervises, and excludes affiliated corporations not supervised by the headquarters company. The headquarters company does not have to own shares in the companies that it supervises. In order to be considered a headquarters company, the person must meet several requirements that are enumerated in paragraph 5. These requirements are discussed below.

Overall Supervision and Administration
Subparagraph 5(a) provides that the person must provide a substantial portion of the overall supervision and administration of the group. This activity may include group financing, but group financing may not be the principal activity of the person functioning as the headquarters company. A person only will be considered to engage in supervision and administration if it engages in a number of the following activities: group financing, pricing, marketing, internal auditing, internal communications, and management. Other activities also could be part of the function of supervision and administration.

In determining whether a “substantial portion” of the overall supervision and administration of the group is provided by the headquarters company, its headquarters-related activities must be substantial in relation to the same activities for the same group performed by other entities. Subparagraph 5(a) does not require that the group that is supervised include persons in the other State. However, it is anticipated that in most cases the group will include such persons, due to the requirement in subparagraph 5(g), discussed below, that the income derived in the other Contracting State by the headquarters company be derived in connection with or be incidental to an active trade or business supervised by the headquarters company.

Active Trade or Business

Subparagraph 5(b) is the first of several requirements intended to ensure that the relevant group is truly “multinational.” This subparagraph provides that the corporate group supervised by the headquarters company must consist of corporations resident in, and engaged in active trades or businesses in, at least five countries. Furthermore, at least five countries must each contribute substantially to the income generated by the group, as the rule requires that the business activities carried on in each of the five countries (or groupings of countries) generate at least 10 percent of the gross income of the group. For purposes of the 10 percent gross income requirement, the income from multiple countries may be aggregated into non-overlapping groupings, as long as there are at least five individual countries or groupings that each satisfies the 10 percent requirement. If the gross income requirement under this subparagraph is not met for a taxable year, the taxpayer may satisfy this requirement by applying the 10 percent gross income test to the average of the gross incomes for the four years preceding the taxable year.
Dublin Chamber Submission to the OECD Regarding Action 6 of the OECD’s Base Erosion and Profit Shifting (BEPS) project

About Dublin Chamber of Commerce (Ireland):

Dublin Chamber welcomes the opportunity to input into this public consultation on Base Erosion and Profit Shifting. With over 1,300 member companies, Dublin Chamber is the largest chamber of commerce in Ireland and the most representative and broadly-based business group in the Greater Dublin Area. The Chamber’s policy work focuses on promoting and improving the competitiveness of the Dublin region.

The Greater Dublin Area (the metropolitan area) accounts for 39% of the State’s population, 47% of GDP and nearly half of overall tax revenue. Dublin is also home to 10 of the top 10 global ICT companies and 9 of the top 10 global software companies, making this consultation highly relevant to our members.

Introduction:

Dublin is the capital city of a small country on the periphery of Europe, which has structured its enterprise strategy to overcome the advantages of larger countries through embracing a pro-business open trade and investment model.

The presence of domestic and international enterprises in Dublin is due to a number of competitiveness considerations. The principal disadvantage facing small periphery countries is the lack of access to markets, and this has required a more competitive tax policy. It is sound business thinking applied to policy – price yourself accordingly to the market.

Dublin Chamber welcomed the Irish Government’s commitment as stated by the Minister for Finance during the Budget 2015 Statement (14 October 2014):

“For over 60 years, foreign direct investment has been a cornerstone of Ireland’s economic development. We have competed for and won major investment into Ireland and Europe from some of the largest and most successful companies in the world. With over one hundred and sixty six thousand people employed in over one thousand one hundred companies, the Irish foreign direct investment sector has real substance. Our competitive corporate tax system plays a key role. Ireland’s corporation tax strategy has three key elements: Rate, Regime and Reputation.”

The decision by the Government to address the so called “Double Irish” demonstrates a commitment to address the concerns of OECD and EU partners in tackling the issue of aggressive tax planning by multi-nationals. Dublin benefits from having businesses that have a real presence that add to the eco-system and cluster effects necessary to create thriving international city regions.

Dublin Chamber is concerned that OECD’s draft discussion paper on Action 6 will create a system that unfairly hinders the future development of small countries.

Principal Purposes Test:

The “Principal Purposes Test” by the design outlined in the “Public Discussion Draft” (21 November 2014 – 9 January 2015) is of concern to Dublin Chamber.¹

The Chamber broadly supports the conclusion of the Irish Taxation Institute’s submission which states:

“A company carrying out arrangements and transactions in a larger economy will find it easier to demonstrate the natural business advantages that arise from that economy, than a company in a smaller economy.... Smaller country businesses face considerable uncertainty as to whether they can ever pass the Principal Purposes Test and actually may find it impossible to conclude with certainty that they do so. If the test is to remain part of the Action 6 proposals, then it needs to be substantially re-drafted.

In our view, the Principal Purposes Test and commentary on the rule should be drafted in a manner that does not impact on the certainty of access to treaty benefits for locally resident companies with the knock on adverse impact that uncertainty creates on investment location decisions for any business activity where it is intended that real substance and managerial control over the income flows related to that activity will be located in the territory.”

Following this line of reasoning, the Chamber believes that Submission from KPMG Ireland to the OECD (Appendix 1) draws an important conclusion on this point:

“It is clear therefore that companies will have far more certainty over passing a Principal Purposes Test if they locate in a larger economy than in ‘Smaller economies with tax treaties’ solely due to the larger positive externalities enjoyed by a larger economy.

... The inclusion of a Limitation-on-Benefits provision as an alternative test does not redress the unfair advantage granted to large economies by the Principal Purposes Test. Firstly, ... the Limitation-on-Benefits itself is heavily biased against smaller economies. Secondly, even if the Limitation-on-Benefits proposal is redrafted to remove the anti smaller country bias there will, no doubt, always be some cases where taxpayers cannot pass the Limitation-on-Benefits test. A large country can avoid this difficulty by implementing the Principal Purposes Test only option confident in the knowledge that the natural commercial advantages of its economy make it relatively easy for locally resident companies to pass the Principal Purposes Test – this strategy is not available to smaller economies.”

**Limitation of Benefits clause:**

The Limitation of Benefits clause adds a second hurdle for small countries to gain companies to invest. This proposal aims to prevent tax treaty use where the company is owned or financed from abroad (including public companies traded on a foreign stock exchange). Many companies operating in Ireland, even those that are clearly domestic, seek funding abroad and this is a difficultly. Due to the market size, Dublin positions itself as an EMEA hub for many multi-national companies as a base of their operations helping them to deliver to their global footprint. The Irish Tax Institute’s recommendations on this issue are broadly supported by Dublin Chamber.

**Conclusion:**

Dublin Chamber’s concerns on Action 6, as outlined above, have been echoed by Ireland’s business & professional community in the submission received as part of your consultation – including Irish Tax Institute, Ibec, and KPMG.

Dublin Chamber is acutely concerned that contrary to the intent of the OECD’s work on Action 6 the “Principal Purposes Test” and Limitation-on-Benefits clause will cause increased difficulty for small countries to compete fairly for investment.
Dear Mrs. De Ruiter,

Introduction
The NOB (the Dutch Association of Tax Advisers) welcomes the opportunity to provide comments on the latest Action 6 drafts (i.e. the September 2014 draft and the draft of 21 November 2014).

The NOB always comments on Dutch tax bills after (and sometimes before) these are sent to Parliament. As a non-political organisation, the NOB never comments on the desirability of legislative proposals. The NOB comments are an assessment of the technical merits of legislative proposals based on the following criteria only: (1) do the proposed rules achieve their stated objective without overkill, (2) do they not lead to legal uncertainty, (3) do they not conflict with EU law and (4) are they workable in practice?

We will adopt a similar approach in our comments on Action 6.

We understand that other organisations will propose improvements to the Limitation on Benefits article that should reduce the compliance burden as well as potential overkill without affecting the effectiveness of the proposed anti-treaty shopping measures. Therefore, when drafting our comments on Action 6, we have focused our comments mainly on the PPT.

We are very concerned about the PPT as currently drafted. We regret that it has been decided that the PPT will be a purposes test (plural) and that therefore it must be tested in each case whether the obtaining of a treaty benefit was one of the principal purposes of an arrangement or transaction. We are concerned that this feature will lead to legal uncertainty and give rise to many disputes with tax authorities around the world, which would undermine the overall
purpose of tax treaties – i.e. the enhancement of cross-border trade and investment. In this connection we stress that Action 6 should be limited to combatting treaty shopping and not take any of the other Action points on board, because including other Action points would, we think, further complicate the future application of tax treaties and risk – as we say in Dutch - ‘throwing out the baby together with the bathwater’.

We also think that the current PPT will conflict with EU law.

In light of the above, we have asked ourselves the following questions:

- Is the proposed Principal Purposes Test (“PTT”) compatible with EU law and if not, can we propose a remedy?
- Can we propose changes that would reduce overkill as well as the risk of the legal uncertainty and long drawn-out disputes with tax authorities under a PPT without undermining the effectiveness of the proposed anti-treaty shopping measures?

Our comments and text suggestions are set out below. We will not comment on the position of Pension Funds and Collective investment vehicles.

EU law

According to settled EU case-law (e.g. Saint-Gobain), Member States are free to allocate their taxing powers, provided they comply with EU law while exercising those powers. We will discuss below whether the PPT provision and the LOB provision comply with EU law.

We are of the opinion that the current PPT is too vague and too subjective and would therefore fail the legal certainty test. According to the European Court of Justice, an anti-abuse measure that is vague or unspecific, does not meet the requirement that such a measure be proportionate. [Reference is made to SIAT (C-318/10, para. 58) and ITELCAR (C-282/12, para. 44)]

Furthermore, the wording of the PPT suggests that it suffices for a tax authority to assert that “it is reasonable to conclude that ..... obtaining a treaty benefit was one of the main purposes of an arrangement or transaction” to shift the burden of proof to the taxpayer who then faces an onerous burden of proof, especially given the fact that the tax consequences of an arrangement or transaction, which will include treaty benefits, are always an important component of the decision leading to an arrangement or transaction. So the mutual burdens of proof are disproportionately in favour of the tax authorities. This uneven burden of proof, which lacks objective and verifiable criteria that may provide an indication that treaty shopping is afoot, would cause the PPT to fall foul of the EU law requirement that an anti-abuse measure must be proportionate. In this connection reference is made to the decision of the European Court of Justice in the SIAT case (C-318/10 considerations 54 through 56).

In its decision in the Itelcar case (C-282/12, consideration 44) the Court ruled that anti-abuse rules must, in the interest of legal certainty, be clear, precise and predictable. (Consideration 44 reads as follows: “That being so, the rules in question do not make it possible, at the outset, to determine their scope with sufficient precision. Accordingly, they do not meet the
requirements of legal certainty, in accordance with which rules of law must be clear, precise and predictable as regards their effects, especially where they may have unfavourable consequences for individuals and companies. As it is, rules which do not meet the requirements of the principle of legal certainty cannot be considered to be proportionate to the objectives pursued (see SIAT, paragraphs 58 and 59).”

From the above it follows that in order to make the PPT more compatible with EU law, the burdens of proof must be evened up: the tax authority that proposes to deny treaty benefits to a taxpayer, must do so on the basis of objective and verifiable criteria that may serve as prima facie indicators of treaty shopping and the taxpayer should be allowed to rely on objective and verifiable acknowledged circumstances to plausibly demonstrate that the obtaining of the treaty benefit was not one of the principal purposes of the arrangement or transaction at issue.

We will propose some changes to the text of the PPT article to even up the burdens of proof somewhat and to make this motive test less subjective.

The proposed LOB-provision contains rules that discriminate a company on the basis of the ownership of its shares. If Company X that is tax resident in EU State X receives income that arises in non-EU State Y and if State X and State Y were to have concluded a tax treaty that includes the LOB provision as currently proposed, Company X would be entitled to treaty benefits under article X, paragraph 2, subparagraph e) if at least 50% of its shares are owned by residents of State X. But if 50 percent or more of the shareholder’s rights in Company X are owned by shareholders of EU-State Z, Company X would not meet this shareholder’s test and would be entitled to treaty benefits only if it were to meet the ‘activity test’ (paragraph 4) or the derivative benefits test (paragraph 5). The derivative benefits test itself, however, also discriminates companies on the basis of share ownership.

This discrimination of a company on the basis of the ownership of its shares would conflict with EU law. We therefore suggest expanding the list of shareholders to include shareholders of the member States of the European Union and the European Economic Area.

Structuring the PPT to reduce legal uncertainty
We understand that it has been decided that this test will be a purposes test. This means that it must be tested in each case whether the obtaining of a treaty benefit was one of the principal purposes of an arrangement or transaction. This in essence means that it must be established whether, in a hypothetical world without any taxation under the domestic tax laws of the State in which the income arises, the parties to an arrangement or transaction would have entered into the same arrangement or transaction as the one they actually entered into. If it is plausible that they would have, except for the language in the underlying agreement dealing with taxation, they should be entitled to the benefits of the treaty at issue.

We propose the following changes to the PPT article to make it (more) compatible with EU law and to reduce legal uncertainty. Please refer to the text in red print.

Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude,
having regard to all relevant facts and circumstances and the commentary to this article, that the obtaining of that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention. The tax authority that has the intention to deny a treaty benefit to a taxpayer, because it suspects that obtaining that treaty benefit was one of the principal purposes of an arrangement or transaction entered into by that taxpayer, shall provide prima facie evidence to that effect to the taxpayer by way of a written notification. Subsequently, the taxpayer will be given the opportunity to rebut that suspicion by plausibly demonstrating (a) that, absent any taxation under the domestic tax laws of the State in which the income arises, the taxpayer would have entered into essentially the same arrangement or transaction as the arrangement or transaction the taxpayer actually entered into, except for the language concerning taxation or that (b) the beneficial owner of that item of income would have been entitled to essentially the same treaty benefits as the taxpayer absent this treaty article, had that beneficial owner received that item of income direct.

We would suggest using ‘artificiality’ and ‘lack of economic substance of the taxpayer invoking the treaty benefit’ as the prima facie indicators of a treaty shopping motive. As objective and verifiable indicators to rebut a presumed treaty shopping motive, we think that the following situations and circumstances should, as a minimum, be acknowledged as ‘safe harbour circumstances’ in the Commentary to the PPT article.

- Companies that serve a specific business purpose such as finance companies that serve to reduce external borrowing costs (e.g. companies that serve as the cash pool leader or that issue bonds and on-lend the proceeds of the issue to other group companies) and that have the substance required to perform that finance function;
- Companies that serve to structure a joint-venture;
- Companies that serve as the bidding vehicle for a take-over;
- Companies that serve to perform an oversight role;
- Companies that form part of the ‘legacy’ following a take-over of an active group or if companies serve a specific legacy role.
- Companies that serve as regional headquarter company.

We set out three examples to demonstrate the point.

Cash pool company
A cash pool is used for a bona fide business purpose which is to enable group companies with a short term funding need to borrow – via the cash pool leader – from group companies that have a temporary excess cash positions. As a result, the group borrower pays less interest when compared with a loan from a local bank and the companies with a credit position in the pool get a higher rate of interest than they would get from a bank. For the group as a whole, this leads to lower net external interest costs. Given the multitude of movements of the credit positions in the pool, it will usually be impossible to trace an interest payment by a group debtor in State A to an individual group creditor in State B. Hence it will be impossible to determine the hypothetical treaty withholding tax rate that would have applied on a look-
through basis. (Even if the source state of the interest were to lose out on some withholding tax, what it gets back is a local operating company with reduced interest costs which usually means higher taxable profits.) Almost all multinational companies have a cash pool to reduce the cost of external borrowing. This function is therefore performed by a group company as a legitimate activity. Withholding taxes on interest payments would disrupt the use of cash pools, but cash pools do not exist to make use of (or abuse) tax treaties. The cash pool arrangement would also be in place with the same countries in the event they did not levy any withholding tax on cross-border interest payments under their domestic tax laws. The obtaining of treaty benefits is therefore not one of the principal purposes of the cash pool arrangement. Therefore, the cash pool leader that charges interest to group companies with debit positions in the pool, should not be denied treaty benefits. The cash pool activity will usually be one of the activities of a treasury company which also attracts bank debt and other external debt. For this reason these activities and the related assets and liabilities must be concentrated in a stand-alone company.

**Bond issue company**
A group company that issues bonds, commercial paper or borrows from a consortium of banks and lends the funds so raised to other members of the group, would likewise be denied treaty benefits, because it will usually not be able to demonstrate that its interest payments to third party lenders are ‘good payments’. This type of finance company also serves a bona fide business purpose which is to enable the group to borrow at lower external interest rates. The loans from the bond issue company to other group companies would also be in place with the same countries in the event these countries did not levy any withholding tax on cross-border interest payments under their domestic tax laws. The obtaining of treaty benefits is therefore not one of the principal purposes of a bond issue company. Therefore, the bond issue company that charges interest to group companies in countries that would levy a withholding tax on cross-border interest payments in the absence of a tax treaty, should not be denied treaty benefits under those treaties. For legal reasons that have nothing to do with tax, this type of activity has to be performed by a special purpose company, i.e. a company that has no other activities that could complicate the recoverability of the debt instruments held by the public or the banks.

**Joint Venture Company and regional headquarter companies**
Often businesses choose to form a joint venture entity in a ‘neutral’ jurisdiction. This is generally driven by the business choice to lay down the agreements between the parties under the legal framework of a third country, instead of the legal framework of the country of one of the joint venture parties or the country in which the joint investment is made. Equally so, businesses and investors often have legitimate business reasons, other than tax treaty reasons, to set up a holding company in a country to pool foreign investments outside their country of residence, even when such pooling cannot immediately be considered a regional headquarter. This may, for example, have to do with investment protection or regulatory constraints. We believe that such business reasons should be the starting point in the analysis and not a presumed treaty abuse. In our opinion, a top-down approach (why does the entity exist from the perspective of the shareholders?) is preferable over a bottom up approach. Therefore, these business reasons from the third country shareholders’ perspective - if genuine - should, in our view, be acknowledged in the Commentary to the PPT article as 'situations and circumstances' that rebut a prima facie treaty shopping motive. Should the country of
residence feel that it is undesirable that its resident companies invest via a foreign holding company, CFC legislation could be the proper tool to combat this.

**PPT and mandatory arbitration and the need for verifiable criteria**

It is likely that the introduction of the PPT in tax treaties will, in spite of good intentions to the contrary, lead to uncertainty and disputes between taxpayers and tax authorities. We are of the opinion that this is acceptable only if such disputes will be resolved by mandatory arbitration within an agreed timeframe and with appropriate resources committed by the states signing up to the multilateral instrument. *In this connection we observe that arbitrators cannot arbitrate properly without a clear description of what it is that the taxpayer must plausibly demonstrate* (hence our suggestion to expand the text of the PPT article) and without guidance in the form of a set of verifiable acknowledged circumstances that may serve as safe harbours for the taxpayer.

**The LOB and the PPT should be ‘either or tests’**

From the Commentary on the PPT rule (paragraphs three, four and five) we understand that a taxpayer must pass the LOB tests as well as the PPT rule in order to be eligible for treaty benefits. We think that would-be treaty partners should select one of the above anti-abuse rules for inclusion in their bilateral tax treaty. An accumulation of anti-abuse rules would lead to additional administrative burdens for companies which are unnecessary. Each of the above anti-abuse rules – also if they are made less restrictive to prevent overkill and legal uncertainty – will be robust enough to counter treaty abuse effectively.

**The tie-breaker rule**

We are of the opinion that the tie-breaker rule should not be changed. The selection of the ‘place of effective management’ as the decisive criterion to break the tie, fits in with the nexus approach of the BEPS-project. Letting competent authorities deal with this, would add to unnecessary legal uncertainty and delays.

Yours sincerely,
de Nederlandse Orde van Belastingadviseurs

Marnix van Rij
Sicco Faber
Eugène Bartman
Bartjan Zoetmulder
For the attn. of  
Mrs. Marlies de Ruiter  
Head, Tax Treaties, Transfer Pricing and  
Financial Transactions Division  
OECD / CTPA

Sent via e-mail: taxtreaties@oecd.org

Ref. 15-4002  
09 January 2015

Dear Mrs. de Ruiter,

PUBLIC DISCUSSION DRAFT – FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE - 21 NOVEMBER 2014

EFAMA\(^1\) welcomes the opportunity to comment on the Public Discussion Draft "Follow up Work on BEPS Action 6: Preventing Treaty Abuse".

As a starting point we strongly concur with the recommendations of the 2010 CIV Report\(^2\) which in principle continue to be appropriate for widely held collective investment vehicles ("CIVs"), therefore they should not be substantially modified. In particular, no preferred single approach should be adopted.

As the representative of the European Fund Industry, we believe that treating European investment funds established according to Directive 2009/65/EC dated 13 July 2009 relating to Undertakings for Collective Investment in Transferable Securities ("UCITS") and UCITS-like comparable CIVs as qualified persons in general was appropriate. In detail we would like to comment as follows.

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\(^1\) EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 63 corporate members about EUR 17 trillion in assets under management of which EUR 11 trillion managed by over 55,000 investment funds at end September 2014. Over 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit [www.efama.org](http://www.efama.org).

Preliminary remark: Functioning of the industry

As already outlined in the 2010 CIV Report, there are a number of benefits of investing through CIVs.

The economies of scale from investments held through CIVs give access to markets, appropriately diversified, in which investors would otherwise not be able to invest. Were small investors to invest directly, they would incur substantial time and costs, not to mention the lack of market diversification. In the current investment climate it is imperative that investors are able to diversify risks across investments and international markets.

Given the significant move from defined benefit schemes to defined contribution schemes in the pensions market, there is more of an onus on investors than ever before to take ownership of their asset allocations over their lifetime to ensure their risk profile matches their age and timeline to retirement. This becomes even more relevant in current times of low interest rates to be achieved through e.g. classic secure investments like government bonds. CIVs allow small investors to gain the benefits of economies of scale even if they have relatively little invested.

In addition, investors in CIVs benefit from the market experience and insights of professional money managers.

Governments have long recognized the importance of CIVs as an important complement to other savings vehicles. In many countries, participants, through defined contribution retirement plans invest primarily in CIVs. Because CIVs allow small investments, they are ideally suited for such periodic savings plans. They are highly liquid, allowing withdrawals as needed by retirees. With ageing populations in many countries, CIVs will become increasingly important and their relevance cannot be overstated.

In this respect, EFAMA would like to reinforce the point that plain-vanilla widely held investment funds are not used for tax avoidance or treaty shopping purposes, but for (retirement) savings of a broad range of small investors. Therefore, investment funds should not be unnecessarily harmed by actions for preventing treaty abuse.


The 2010 CIV Report position

The 2010 CIV Report is limited to investment 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. The rationale for this limitation was the need to address the distinct burdens of establishing treaty eligibility for individuals – typically numbering in the tens or hundreds of thousands – who invest in CIVs through intermediaries such as banks or brokers. The 2010 CIV Report acknowledges this and intends to provide all CIV investors, regardless of how their CIV was structured or sold, with the opportunity to receive the treaty relief that they would obtain if investing directly.
The 2010 CIV Report proposes various alternative approaches – rather than a single method – for allowing a CIV to establish treaty eligibility. The background is that CIVs are not the same – in structure or legal form, in operation, in investor base, or in distribution strategy. The 2010 CIV Report therefore involves various procedures for establishing the treaty eligibility of CIVs.

For example, it may be appropriate to treat the CIV as satisfying any applicable limitation on benefits provision (“LoB”) because the CIV’s investors are predominantly resident in the CIV’s residence country. This situation could arise if the CIV were distributed only within its country of residence.

The 2010 CIV Report also noted that many CIVs are distributed in multiple countries with which a source country has a treaty. In such situations, where the CIV is distributed globally, EFAMA believes (in line with the 2010 CIV Report) it appropriate to treat all CIV investors who are resident in countries with which the source country provides equivalent treaty relief as treaty-eligible. We therefore support an equivalent beneficiary standard for any CIV that claims treaty relief in its own right to the extent that it must satisfy a LoB provision.

This “equivalent beneficiary” approach was provided only as an option in the 2010 CIV Report. Equivalent beneficiary treatment, however, is essential to ensuring appropriate treaty relief for investors in CIVs that are marketed globally, and therefore should be mandatory as an alternative approach. This would enable globally distributed CIVs to obtain appropriate treaty relief.

When investor treaty eligibility must be proven, according to the 2010 CIV Report, such proof generally should be required only annually and never more frequently than quarterly. Moreover, the 2010 CIV Report notes that countries should accept practical and reliable approaches for identifying investors (Germany and the US, for example, negotiated a statistical approach when proving the LoB clause, in applying an equivalent beneficiary approach). It is essential that appropriate achievable measures are used to deal with CIVs entitlement to treaty access. Entitlement should not be just in theory and a practical and workable solution is essential.

We would strongly recommend that any potential negative impact on CIVs ability to claim treaty benefits under BEPS Action 6 are deferred until such time as appropriate solutions are in place to deal with CIVs unique case. CIVs must be protected from any unintended consequences arising under BEPS Action 6.

Preliminary Conclusion:

The 2010 CIV Report in principle provides mechanisms for all CIVs – regardless of their differences – to secure treaty relief for their eligible investors on an even playing field. If only a single method was chosen, treaty relief would be restricted from an overall perspective. BEPS concerns on treaty shopping are not valid in the case of CIVs. CIVs are widely held and generally distributed to small investors only, with the main aim of retirement saving (and not treaty shopping).
UCITS and UCITS-like funds

From a European market perspective, we would strongly request that the position for UCITS funds (according to Directive 2009/65/EC) and UCITS-like funds meeting the same conditions be specifically reviewed in consideration of BEPS Action 6. According to the Directive 2009/65/EC, UCITS are highly regulated, open-ended vehicles the sole object of which is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk spreading. These funds are built on the principles of strong regulation and explicit authority for distribution purposes (as a brand) aimed at small investors as a secure (retirement) savings vehicle.

The UCITS passport provides for the opportunity to distribute funds in all European countries to small investors without the need for the UCITS to obtain separate distribution approval in each European country.

Although EU Member States have broad treaty network which would enable the UCITS distributed only in Europe to fulfil in theory the equivalent beneficiary rule easily, in practice it is difficult to prove. As the 2010 CIV report outlined, there may be layers of intermediaries between the CIV and the beneficial owner of the interests in the CIV. In many cases, those intermediaries will not be located in the country in which the issuer is located. Accordingly, as outlined in the report, CIVs are presented with practical issues on what information they should and can provide in order to claim the benefits of tax treaties. In this context, however, it should be kept in mind that - even if the UCITS is not only distributed in European countries - there is no material risk of “treaty shopping”. We believe this is true especially due to the following reasons:

- UCITS are open-ended, i.e. an unlimited number of investors can subscribe and redeem their fund units freely and on a daily basis. This limits the capacity of a single investor to control UCITS for treaty shopping purposes, and
- UCITS have risk spreading requirements, i.e. it cannot be used to hold a certain position in order to benefit from a specific treaty relief on this investment.

The same arguments shown above apply for UCITS-like funds meeting almost the same conditions as UCITS.

Also it has to be kept in mind that most of the treaties provide for treaty relief for individuals, if resident in European or third countries. In rare circumstances where the actual tax residence of the ultimate beneficial owners is known by the investment fund, the industry can see that most of them would qualify as “equivalent beneficiaries”. Thus looking through the chain of ownership would hardly bring any additional certainty and revenue to the tax authorities. For the fund industry, however, the costs of implementing any look-through is likely to be huge and has the potential to change the entire business model at a significant cost that ultimately will be passed on to investors.

Conclusion

As UCITS and UCITS-like funds are aimed at being distributed to the public and to small investors, there is no material risk for source countries that these funds are used for treaty shopping purposes. EFAMA therefore believes that OECD should consider for the purposes of the commentary on Article 1 of the model convention, that contracting states should be encouraged to treat UCITS and UCITS-like funds in general as qualified persons, without the need to satisfy any LoB provision.

The latest Public Discussion Draft on Action 6 raises the need for further consideration of the position of non-CIV investment funds. We would encourage discussion and engagement of such funds similar to the CIV process, through the OECD Informal Consultative Group.

With regard to Pension Funds and affording them treaty relief, it is widely accepted that they play a major role in the effective funding the retirement of workers. In recognizing their special case, many treaties afford pension funds with zero withholding tax rates on investment income. As already outlined above, they often use CIVs as their investment platform, principally to obtain appropriate economies of scale and exposure to global markets. Many Pension Funds also invest directly in the global equity and bond markets and it is imperative that they are not inadvertently negatively impacted by the introduction of LoB or PPT provisions.

It is essential that the small investors are encouraged to make appropriate provision through pension funding arrangements to obtain the necessary long term financial security for workers into their retirement years. The massive global pension under-provisioning (including the underfunding by governments of basic social welfare pensions) has been well documented and cannot afford to be ignored. It is crucial that their role is not lost in the treaty debate.

Significantly, US Foreign Account Tax Compliance Act and related Intergovernmental Agreements and the Common Reporting Standard have given them appropriate “deemed compliant” status. The BEPS Action 6 agenda should follow that lead and recognize Pension Funds as qualifying residents in their home jurisdiction (country of establishment), without restriction under LoB or Principal Purpose Test.

3. Comments on Issue B. Issues related to the Principal Purpose Test rule (“PPT”)

A PPT which is introduced unilaterally can undermine and create further uncertainty on the ability of CIVs to meet treaty qualification. CIVs operate under different tax regimes around the world with the intention of ensuring that investors are not impacted by an unnecessary additional level of taxation at the fund level. Also it is important that CIVs can operate under tax laws that give them greater certainty as to the tax impact at investment level, be it withholding tax or capital gains tax so that investors can manage their savings more effectively. We would strongly recommend that, for the reasons already explained above in relation to the importance of CIVs in the management of retirement funds of small investors and the low risk of treaty shopping by investors in widely held investment vehicles, CIVs should be expressly exempt from any PPT.

We are grateful in advance for your attention to the concerns expressed in this letter and we welcome the opportunity to discuss these with you. In case there is any additional information that we can provide, please contact EFAMA at info@efama.org or +32 (0) 2513 3969.

Kind regards,

Peter De Proft
Director General
9 January 2015

Marlies de Ruiter  
Head  
Tax Treaties, Transfer Pricing and Financial Transactions Division  
Centre for Tax Policy and Administration  
Organisation for Economic Cooperation and Development  
2, rue Andre Pascal  
75775 Paris Cedex 16  
France  

By email: taxtreaties@oecd.org

Comments on Discussion Draft on Follow Up Work on BEPS Action 6: Preventing Treaty Abuse

Dear Ms. De Ruiter:

EY appreciates the opportunity to submit these comments to the OECD on the public discussion draft of follow-up work relating to BEPS Action 6: Preventing Treaty Abuse, released November 21, 2014 (Discussion Draft). The Discussion Draft follows the report on Action 6 released by the OECD in September 2014 (September 2014 Report).

The OECD’s work on the Model Tax Convention and the related Commentary has been critically important to the ongoing expansion of the global network of bilateral tax treaties. These tax treaties serve to reduce or eliminate double taxation, which unrelieved would be a significant barrier to cross-border trade and investment. We recognize the need to protect against the granting of tax treaty benefits in inappropriate circumstances. At the same time, it is critically important to ensure that tax treaty benefits are granted in appropriate circumstances. It is vital that the OECD strike a proper balance between the two principles and we encourage the OECD to take the appropriate time that such proper balance warrants, even if this means extending the September 2015 deadline.

This submission by EY will provide some general comments on a selection of the issues identified in the Discussion Draft.
I. Treaty entitlement of Collective Investment Vehicles (CIVs) and non-CIVs

EY welcomes the decision that additional work must be done with respect to treaty entitlement of CIVs and non-CIVs. We would propose that the OECD evaluates these issues outside of the timeline that has been established for the work related to the BEPS Action Items (i.e., September 2015). Considering that it took a significant amount of time to complete the work related to the report entitled “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles”, issued in 2010 (the “2010 Report”), and that further work must be done to fully evaluate the issues related to CIVs and non-CIVs, it is not realistic to expect that this work may be completed by September 2015. For purposes of the 2010 Report (and the discussion below), a CIV is defined as a vehicle that is widely-held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established. Until further study of these issues may be undertaken, we would suggest that any new provisions not adversely affect CIVs and non-CIVs, and that the OECD acknowledge and continue to support the recommendations made in the 2010 Report.

According to the September 2014 Report, countries should adopt a minimum standard in order to eliminate treaty shopping, which may be implemented in various ways. For example, this report provides that the standard may be met by including (i) a principal purpose test (PPT) rule, (ii) a combination of the PPT and limitations on benefits (LOB) rules, or (iii) the LOB rule supplemented by a mechanism (such as a restricted PPT rule applicable to conduit financing arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties. Therefore, it is possible that countries will decide to eliminate treaty shopping in different ways. In making any recommendations in connection with treaty entitlement for CIVs and non-CIVs, we urge the OECD to consider and address how those recommended rules would work in relation to applying a LOB test, or a PPT test, or both.

Future work undertaken in this area must take account of the changes in the industry, the motivation to invest in CIVs and non-CIVs, and regulatory restrictions that exist in certain jurisdictions. For example, since the 2010 Report was published, investment in mutual fund assets alone has increased to almost US$30 trillion. A large portion of investors in CIVs and non-CIVs are individuals and institutional investors, which is not surprising given the growing need to self-fund retirement and provide for pension benefits. Further, there is a developing trend across the industry of product rationalization resulting in the proliferation of CIVs being sold outside their domestic jurisdiction to a wide and diverse range of investors. Within the EU, the UCITS Directive is well established and provides a common regulatory framework for CIVs

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that are sold on a pan-European basis. Similarly, this trend is reflected outside in the EU, particularly in Asia where the recently developed ASEAN CIS fund passport mechanism and the Hong Kong/China mutual fund recognition platform provide further examples of efforts made by governments to increase the availability of financial products to citizens and facilitate cross border investment.

Governments therefore recognize the importance of CIVs in terms of facilitating retirement security and certainly did not envisage that treaty benefits might be called into question as a result of changes made pursuant to BEPS Action 6. Investors in CIVs and non-CIVs generally are not seeking tax advantages from investing through those vehicles and therefore, there should not be BEPS concerns. Rather, investors are motivated to invest because they may pool their funds and benefit from reduced costs and economies of scale as well as the market experience of professionally managed funds. Moreover, the 2010 Report acknowledges the benefits of investing in this way to diversify risk across international markets. At the same time, in providing options for guidance on treaty entitlement for CIVs, the 2010 Report acknowledges the goal of trying to achieve neutrality in the international context such that the tax treatment for the investor should be the same whether the investor invested directly or through the CIV.

In order for institutional investors to satisfy a comprehensive asset allocation so that risk may be properly hedged, those investors invest in asset classes beyond securities. In some countries the term “securities” is defined as debt instruments. We assume that OECD will include stock in such definition and we suggest that the definition also include options, warrants and other equity derivative products. Pension and charitable funds often must invest a small portion of their funds in alternative investments such as commodities, derivatives and foreign exchange; investments which require specialized management and investment skills. Many CIVs with institutional investors have been formed for the purpose of investing in such alternative CIVs.

In addition, it is not uncommon for a small number of institutional investors to come together to pool their investments. As such, the guidance related to treaty entitlement contained within the 2010 Report would not cover these types of investments because that report defined a CIV as a vehicle that is widely-held, and holds a diversified portfolio of securities. Yet, a significant portion of the investors in these so-called non-CIVs or alternative funds are institutional investors (including public and private pensions, university endowment funds, health care endowment funds and other charitable investment funds) that are resident and tax exempt in treaty countries. Future work should consider these types of circumstances recognizing that the principle of neutrality is equally important with respect to investments in non-CIVs.
Considering that industry practice generally seeks to diversify risk across international markets, and that governments are increasingly facilitating such cross-border investment, qualifying CIVs and non-CIVs for treaty benefits should take account of the beneficial interests held by equivalent beneficiaries. Future work in this area should consider setting a threshold of ownership by equivalent beneficiaries above which benefits would be provided with respect to all income received by the CIV or non-CIV. An appropriate ownership threshold would protect against treaty shopping. Consideration should be given to providing proportionate treaty benefits in cases where this ownership threshold is not met. A practical and reliable approach of determining the extent to which the beneficial interests in the CIV or non-CIV are owned by equivalent beneficiaries could be established and agreed to.

It will also be important that any future recommendations made with respect to treaty entitlement of CIVs and non-CIVs in the context of the PPT take account of the commercial realities in connection with investing in such vehicles. Currently, the September 2014 Report includes an example in relation to the PPT in which the majority of the investors are residents of the country where the CIV is established. However, as noted above, many investors diversify risk across international markets. Moreover, the example makes no mention of the many non-tax reasons to invest through such a vehicle (such as pooling capital, cost efficiencies, diversification of risk, professional investment management, etc.), which would be important to evaluate in the context of applying a PPT because those non-tax reasons generally outweigh any tax motivated purpose in this particular context.

II. Issues related to the PPT rule

As noted above, EY recognizes the concern on the part of many governments in relation to treaty abuse and the desire to have a set of rules in place in order to prevent double non-taxation and eliminate treaty shopping. At the same time however, it is necessary to strike a balance so that treaty benefits are available in all appropriate circumstances. Tax treaties play a key role in facilitating international trade and investment including by preventing double taxation of cross-border transactions. It is therefore, imperative that any proposed changes with respect to

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2 Future work would also have to take account of the prior resolution of the issues relating to CIVs and their treatment as a person that is a resident of a contracting state and beneficial owner of the income received. The 2010 Report defined the term “equivalent beneficiary” as a resident of the Contracting State in which the CIV is established, and a resident of any other State with which the Contracting State in which the income arises has an income tax convention that provides for effective and comprehensive information exchange who, if he received the particular item of income for which benefits are being claimed under the particular Convention, be entitled under that convention, or under the domestic law of the Contracting State in which the income arises, 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 Convention by the CIV with respect to that item of income.
treaty entitlement as a result of the work related to BEPS are well understood because uncertainty regarding the availability of treaty benefits would seriously undermine the role of tax treaties and the function they are intended to perform and would impede cross-border commerce.

As noted above, the September 2014 Report provides, in part, that countries should adopt a minimum standard to eliminate treaty shopping and suggests that one of the ways to meet that standard would be to implement a PPT in the tax treaty. The PPT rule in the September 2014 Report provides that:

> Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

This test is vague and would add uncertainty to the treaty by introducing a subjective standard that would be difficult to evaluate and administer in practice because it is dependent on the intent of the taxpayer. Such uncertainty would interfere with how tax treaties function because business, pension entities and charitable organizations would have significantly less certainty about whether they qualify for benefits of a treaty until after the fact, potentially long after the fact. Many pension and endowment fund administrators or trustees are subject to fiduciary duties. They are charged with preserving the assets of the fund and they usually consider the tax effects of their investments including the fact that the CIV will or will not qualify for treaty benefits. It is not the predominate consideration but some countries could treat such prudent investor tax planning as “one of the principal purposes of the arrangement”.

We urge the OECD to eliminate such a subjective test or to make modifications to the test to make it more practical and to reduce the uncertainty. For example, where a transaction would have been undertaken for commercial reasons, notwithstanding whether a treaty benefit might be applicable, the PPT should not be applicable. The OECD should consider ways that taxpayers may demonstrate, through objective means, that they would have entered the arrangement absent the treaty benefit. In such cases, the PPT should not apply.

For example, assuming that a taxpayer seeking treaty benefits with respect to an item of income may demonstrate that they beneficially own the income and meet the base eroding prong of a derivative benefits test, and that the ultimate owner in the chain of ownership is a resident of a country entitled to treaty benefits that give a rate of tax at least as low as the rate applicable with respect to the income received by the beneficial owner, the OECD should consider a rule
that confirms that the PPT rule would not apply in these circumstances. In this case, the ultimate owner in the chain of ownership is a resident of a country, entitled to all of the benefits of a comprehensive tax treaty, and would have been entitled to a rate of tax with respect to a particular class of income that is at least as low as the rate applicable with respect to the income received by the payee. Concerns about double non-taxation as a result of the intermediate owners could be alleviated by focusing on other anti-treaty abuse rules. For example, in order to qualify for treaty benefits, the income must be beneficially owned by the payee. Moreover, applying the base eroding prong of a derivative benefits test would protect against concerns about base eroding payments to persons that are not qualified residents for treaty purposes.

In addition, active engagement in a trade or business in a country should suffice for treaty qualification purposes without being concerned that treaty benefits may be denied pursuant to a PPT. Such activity presumably demonstrates sufficient nexus to a particular country and commercial reasons for locating there. Thus, if the payee is a resident of a treaty county and is actively engaged in the active conduct of a business in that country, treaty benefits should be applicable with respect to items of income that are connected with that trade or business, and the PPT should not apply.

Where a country wishes to deny treaty benefits based on a PPT or a domestic general anti-avoidance rule (GAAR), there should be special procedures in place to evaluate that denial of benefits. EY welcomes the suggestion that countries consider establishing some form of administrative process to ensure that the PPT is only applied after approval at a senior level. In this regard, the OECD should propose that the application of the PPT or domestic GAAR to deny treaty benefits should be subject to review by the Competent Authority and that the denial of treaty benefits be subject to mandatory consultation between the Competent Authorities of the two jurisdictions. Finally, the application of the PPT rule should be subject to mutual agreement procedure (MAP) and arbitration under Article 25.

III. Issues related to the Limitation on Benefits Test

Derivative Benefits

The inclusion of a derivative benefits test that allows consideration of comparable benefits under a third-country treaty is essential to the functioning of an LOB provision. Moreover, such a rule would take account of the commercial realities and global nature of business today.

As currently drafted however, the derivative benefits test is too restrictive because it would require that each intermediate owner be an equivalent beneficiary. The Discussion Draft requests comments on possible changes that could be made to this rule to strike a balance
between preventing BEPS and providing treaty benefits in cases where intermediate companies are used for valid commercial reasons.

Rather than requiring that each intermediate owner be an equivalent beneficiary, as discussed above, concerns about double non-taxation as a result of the intermediate owners could be alleviated by focusing on other anti-treaty abuse rules. For example, in order to obtain treaty benefits, there is a requirement that the income received be beneficially owned by the payee. Moreover, the application of the base eroding prong of the derivative benefits test would protect against income stripping to persons that are not qualified residents for treaty purposes.

To bolster the beneficial ownership rules and anti-base eroding rules, and further protect against concerns of treaty shopping through a derivative benefits rule, the OECD could consider modifying that rule to include an anti-conduit component such as the anti-conduit rule proposed in the September 2014 Report. Specifically, consideration could be given to limiting treaty benefits in cases where there is a transaction or series of transactions that are structured as part of a conduit arrangement whereby the payee pays all or substantially all of the income to persons that would not have been entitled to treaty benefits. Such a rule should ensure that the inclusion of a derivative benefits test would not raise BEPS concerns.

As indicated above, having an objective set of criteria to evaluate when determining whether treaty benefits are applicable is critically important. Also important however, is the ability to seek discretionary relief when the objective criteria may not be met but the relevant facts and circumstances illustrate that the establishment, acquisition or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of treaty benefits.

Publicly-listed entity provision

Becoming a publicly-listed entity is quite a lengthy and expensive process that requires several steps including drafting the registration statement, conducting due diligence, waiting for and obtaining regulatory approval, conducting syndication and “road shows”, determining price and finally making the public offering. Any delay or significant hurdles encountered during the process can have a significant impact on the timing of the IPO. As a result, companies do not tend to acquire or give up their status as a publicly-listed entity very easily, and it would not be realistic for companies to consider qualification for the publicly-listed entity provision as a motivation for the timing of an IPO. Given the complexity associated with obtaining this status, and the safeguards against treaty shopping, the OECD should consider providing a rule that would treat the entity as a qualified person for purposes of claiming treaty benefits even when the corporation would meet the publicly-listed entity provision for less than a full taxable year.
Active Trade or Business

Consideration should be given to adding a safe harbor to measure substantiality in the active trade or business test in the LOB provision. The U.S. has included such a safe harbor in some treaties and such a rule could be helpful in lending more certainty and clarity to the active trade or business test. Under this test, the trade or business of the income recipient could be deemed to be substantial based on three ratios that compare the size of the recipient's activities to those conducted in the payor State. The three ratios compare: (i) the value of the assets in the recipient's State to the assets used in the payor State; (ii) the gross income derived in the recipient's State to the gross income derived in the other State; and (iii) the payroll expense in the recipient's State to the payroll expense in the other State. In one of the older U.S. tax treaties, the safe harbor provided that the average of the three ratios with respect to the preceding taxable year must exceed 10 percent, and each individual ratio must exceed 7.5 percent. A similar safe harbor could be considered in order to provide more certainty regarding the application of this provision.

IV. Concluding remarks

If you have questions or would like further information on any of the points discussed above, please contact Barbara Angus (barbara.angus@ey.com) or me (alex.postma@uk.ey.com).

Yours sincerely

On behalf of EY

Alex Postma
Ms Marlies de Ruiter
Head Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
OECD

Email: taxtreaties@oecd.org

Subject: EBF Comments on the OECD Discussion Draft on BEPS Action 6: Preventing Treaty Abuse

Dear Mrs de Ruiter,

The European Banking Federation (EBF) welcomes the opportunity to comment on the OECD’s current work on preventing treaty abuse as part of the Base Erosion and Profit Shifting (BEPS) project.

The EBF is committed to contributing constructively to the BEPS project, in the expectation that the final outcome will deliver fair, certain, sustainable and principled rules.

While the EBF is supportive of the efforts of the OECD to prevent treaty abuse, we are concerned that, when seen as a whole, the actions foreseen in the OECD’s report on BEPS Action 6 (the Report) could possibly conflict with the EU Internal Market principles, enshrined in the EU treaties, which are binding for a large number of the member countries of the OECD. Our concern arises because a series of entities carrying out legitimate cross-border activities on behalf of their group within the EU, for example bank subsidiaries and branches, would be affected with burdensome, and sometimes subjective, qualifications in order to benefit from tax treaties if the current proposals within the Report are not clarified.

Unrestricted treaty benefits for bank subsidiaries and branches within the EU

Banks branches and subsidiaries in the EU are under strict regulation and supervision not only of domestic but also of European banking supervision authorities. We are therefore concerned that the current wording of the report would go beyond the objectives of the BEPS treaty abuse actions undertaken therein by denying full treaty benefits to bank subsidiaries or branches operating in the EU for legitimate commercial purposes. Moreover, we consider that denying, or limiting, treaty benefits to banks subsidiaries and branches within the EU would potentially conflict with EU law. In this context we evoke the European Court of Justice (ECJ) breakthrough judgment in the Van Gend en Loos case (C-26/62) which sets the acknowledgment of direct effect of EU Treaty articles, and the primacy of European law vis-à-vis national legal orders of EU Member States, which account for a significant portion of the OECD Member States.

From a technical point of view, we believe that the proposed LOB provision in the Report, when applied to entities by virtue of Article X(2)(c)(ii), potentially conflicts with the EU’s freedom of establishment to the extent that it discriminates on the basis of ownership. In this respect, we note consistent ECJ case law declaring as unlawful discriminations affecting entities of the same group established in different EU/EEA Member States, be it a subsidiary based on the residence of its parent...
company (Lankhorst-Hohorst, C-324/00), a subsidiary and a parent company based on the residence of an intermediate entity (Papillon, C-418/07), or a non-resident parent company of a resident subsidiary (Denkavit, C-170/05, see also: EFTA court in Fokus Bank, E-1/04). We further note that in the aforementioned Denkavit and Fokus Bank cases, the ECJ and the EFTA courts refused to take into account the existence of a tax treaty to justify the discriminatory measure under review.

We would therefore call for an amendment of the applicable ownership test set out in the aforementioned provision in order to avoid denying, on an automatic basis, full treaty benefits to non-listed entities with less than 50% of qualified shareholding. The latter scenario of minority shareholdings is not uncommon in the banking sector, whereby bank subsidiaries are seldom owned by entities resident in the same Contracting State so that there is a risk, in the current stand of the drafting, that such subsidiaries will be able to solely rely on partial treaty benefit by virtue of either Article X(3) or Article X(4). Failing an amendment of the ownership test at Article X(2)(c)(ii), specific carve outs, in the first instance for banks and similar institutions, should be considered.

Other points of attention

The ‘derivative benefits’ clause at Article X(4) is a welcome addition to the extent such clause would entitle to treaty benefits certain entities that would otherwise not be able to do so pursuant to Article X. We are nevertheless concerned that the ownership test set out at Article X(4)(a) would conflict with the EU’s freedom of establishment for the same reasons as those explained earlier in the context of Article X(2)(c)(ii). Also, it should be considered whether or not in the case of entities owned by non-resident individuals, notably private investment entities, a comparable reasoning could apply in the context of the free movement of capital under EU treaties.

As for the discretionary relief at Article X(5), it should be reconsidered whether the shifting of the burden of proof to the taxpayer, whereby, essentially “relevant facts and circumstances” shall be established by the taxpayer, would not result in a significant trade barrier and therefore come into conflict with the EU principle of proportionality. Particular reference is made in this respect to the doctrine initiated by the ECJ judgment in the Cadburry Schweppes case (C-196/04), which limits the use of subjective criteria for the purpose of establishing the existence of artificial arrangements and leaves as a rule the burden of proof of abuse with governments. In other words, European taxpayers who conduct non-abusive economic activities should enjoy treaty protection without disproportionate compliance obligations and shifting of the burden of proof to the taxpayer.

Another point of concern is the current wording of the PPT rule set forth in Article X(7) in the Report, whereby in essence, this provision would have the effect of denying a benefit under a tax convention where “one of the principal purposes of an arrangement or transaction (...) is to obtain a benefit under the convention”. We feel that this criterion, which is very vague in its terms, is at risk of paving the way to subjective, and therefore unpredictable, interpretations on the part of tax authorities. The latter would result in substantial legal uncertainty virtually affecting all cross-border operations and potentially, depending on the applicable interpretation in a given jurisdiction, in a series of double taxation scenarios (e.g. in the case of withholding tax at source). For these reasons, we believe that the application of a LOB clause focusing on objective characteristics of the party seeking benefits should constitute the privileged avenue for the purpose of implementing Action 6. Should, nevertheless, the recourse to the PPT rule be envisaged, such recourse should be limited to exceptional circumstances. In this respect, we welcome the suggestion made in the current OECD Discussion Draft to subject the application of the PPT to appropriate administrative process.
EBF recommendations

In light of the above observations, we take the view that Action 6 should not apply to regulated and supervised bank subsidiaries and branches in the EU. We consider full treaty benefits on an unequivocal basis should be granted. In the case these benefits are not granted, clarification and adaptation of the provisions of the Report are necessary in order to reduce the burden for these institutions, especially in terms of administrative compliance.

When there is no treaty abuse, swift administrative relief should be granted in any case. To this end, further clarification would be welcome with respect to the procedure foreseen under Article X(5) of the Report and perhaps a review of the existing mutual agreement procedure set forth under Article 25, paragraph 5 of the OECD model tax convention could be considered as well.

Finally, the application of LOB provisions based on objective characteristics of the party seeking treaty benefit should be privileged over the application of the PPT rule for the purpose of implementing Action 6. A combined application of LOB and PPT rules on a general basis would bear the risk of multiplication of uncertainties and disproportionate burden of proof on the part of taxpayers. Should nevertheless the recourse to the PPT rule be envisaged, such recourse should be limited to exceptional circumstances and appropriate administrative process should be defined to this end so as to avoid excessive recourse to PPT on the part of tax authorities that would result in a lack of reliability of tax treaties.

We hope that our comments will contribute to the discussion. We remain at your disposal should you require any further clarification.

Yours sincerely,

Wim Mijs
European Business Initiative on Taxation (EBIT)

Comments on the OECD's Discussion Draft on
FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE

At the time of writing this submission, EBIT Members included: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, DIAGEO, INFORMA, JTI, LDC, MTU, NUTRECO, REED ELSEVIER, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCA, SCHRODERS and TUPPERWARE.
Dear Marlies,

EBIT welcomes this opportunity to provide comments on the OECD Public Discussion Draft entitled “FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE - 21 November 2014 – 9 January 2015” (hereinafter “the Discussion Draft”).

General comments

EBIT strongly supports the principle that treaties should not be used to create non-taxation or for treaty shopping and supports moves to eliminate the use of treaties in situations which were not envisaged when signed and can be considered abusive.

Treaties should, however, be available in all situations where there is a commercial transaction between parties with economic substance in both contracting states, and where neither party is a conduit to a person not entitled to treaty benefits. This is needed to ensure that international trade is not compromised by double taxation, unpredictability and uncertainty.

As stated before, EBIT also hopes that the OECD takes into account that there is a clear distinction between intended and unintended non-taxation. The OECD’s newly stated target of preventing non-taxation through treaty abuse negatively impacted on other key and essential targets of tax treaties, i.e. the elimination of double taxation, the creation of a predictable business environment, should not compromise the important work and achievements of the OECD since its inception.

The currently proposed PPT test is too wide and not targeted enough in EBIT’s view. EBIT recommends only specific and targeted anti-abuse provisions and the OECD should focus in the first place on substance with respect to the PPT. In this regard, EBIT Members hold the firm view that it is not reasonable, and probably it would breach EU Law / the European Court of Justice (ECJ)’s judgement in the Cadbury Schweppes case, as disproportionate, to conclude automatically and prima facie that obtaining treaty benefits was one of the main purposes in cases of misapplication or disagreement between competent tax authorities.

EBIT has concerns with regard to the proposed unilateral discretion and the inherent risk of anti-avoidance provisions being used selectively and unilaterally by tax authorities to deny treaty benefits based on subjective criteria. This would increase uncertainty and unpredictability and leave legitimate business much more reliant on local tax rulings, which cannot be the OECD’s aim.

With regard to the tie-breaker rule for determining the treaty residence of dual-resident companies, EBIT reiterates that we are very concerned that the OECD proposes to substitute a solid concept which works well with a U.S. based competent authorities test which will
EBIT Comments on FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE

inevitably result in an increased resource burden on tax authorities, significant delay and uncertainty for international business and many more instances of double taxation.

As stated before, EBIT appreciates that the way tax treaties should apply is changing, yet we do wish to reiterate to the OECD and G20 that there continue to be several issues in relation to the application of tax treaties (i.e. pure non application, application of tax treaties subject to such conditions that application remains uncertain, misinterpretation of clear provisions...) in important emerging economies. From our daily experience, many emerging economies still lack the required sophistication and technical and juridical expertise or the legal framework to be able to apply and interpret the OECD’s proposals in a correct and consistent manner. In such a context, it remains our view that maintaining the proposal to introduce a US style LOB, which can be applied much more easily in mature economies than in less mature economies, is coming too soon and going too far. Importantly, the existing gaps in treaty application between OECD members and the above mentioned economies is establishing two different worlds for international business practitioners in terms of complexity, treaty access, treaty interpretation, certainty, the duration of procedures and enforcement. This development is undesirable and in essence undermines the level playing field and competitiveness of OECD and European businesses.

EBIT urges the OECD again to fully take EU Law considerations into account in any of its BEPS proposals otherwise the OECD is proposing international recommendations which 23 out of the 44 BEPS countries will be unable to adopt.

Specific comments

A. Issues related to the LOB provision

3. Commentary on the Discretionary Relief provision of the LOB rule

Whilst EBIT agrees that a discretionary relief provision is required, in our view, such a provision should be an ultimate fall-back instrument to obtain treaty benefits in non-abusive situations, and should not be seen as a provision that will be commonly used. We have great concern that if too much reliance is placed on the discretionary relief provision in practice businesses will be denied relief in non-abusive situations, when the treaty should actually be sparing them from double taxation.

In EBIT’s view, the proposed discretionary relief provision approach will open the door, when the other tests in the LOB article are not met, to the risk of anti-avoidance provisions being used selectively and unilaterally by competent tax authorities to deny treaty benefits based on subjective criteria. According to EBIT, such an approach will reduce the value of treaties and encourage unilateral action, which cannot be the OECD’s aim. Ensuring the appropriate application of anti-abuse provisions such as the proposed discretionary relief provision is becoming very much dependent on competent tax authorities’ levels of technical expertise and “reasonable behaviour”, and this notably so - but not exclusively - in less mature economies.

EBIT urges the OECD to mention in its proposals that a tax authority should always consult with its treaty partner first before denying a request for treaty benefits by a resident of the treaty partner.

Discretionary relief provisions have been available under some treaties, [particularly those involving the US] for some time. However, Members of EBIT have reported that obtaining such relief has been a long and costly process. One EBIT Member has had an application for discretionary relief with a tax authority for two and a half years, in a case where the facts are quite straightforward. In that time, one supplementary information request has been received
and dealt with, but there is no indication of whether or not the relief will be granted. Such uncertainty is bad for business, and has delayed what should have been a non-tax sensitive, straightforward, inter-company reorganisation.

EBIT also urges the OECD to include a hard time limit of 6 months in its proposals for finalisation of applications for discretionary relief by competent authorities.

4. **Alternative LOB provision for EU countries**

EBIT generally welcomes the fact that Paragraph 13 of the Report acknowledges that the LOB rule (paragraph 16 of the Report) needs to be adapted to reflect EU Law requirements. We agree that there may be a need to draft alternative provisions that would accommodate the EU Law concerns of EU member states.

We consider that it is arguable that EU Law, and in particular the ECJ’s judgement in the 2002 *Open Skies* cases, would indeed support the view that a derivative benefits provision should be included. In *Open Skies* the ECJ considered that the “nationality clauses” in eight EU Member States bilateral international air transport agreements with the US were in breach of EU law i.e. contrary to the EU’s fundamental freedoms. In particular, the requirement in most of those bilateral agreements for more than 50% of the shares in their national airline to be held by nationals of that airline’s home country breached the freedom of establishment of the EC Treaty (now TFEU).

Similarly, in our view EU Law, in particular the ECJ’s judgment in the *Papillon* case requires EU/EEA countries to be able to trace bilateral treaty entitlement via any EU/EEA country entity, and not just via the relevant EU/EEA country and its treaty partner entities (see also point 5 below).

EBIT also notes that the original LOB provision did not include such requirement or limitation and that it was most probably changed to allay U.S. domestic policy concerns about inverted companies. EBIT strongly believes that such domestic policy concerns should be addressed under domestic law, however, and not through treaties.

5. **Requirement that each intermediate owner be a resident of either Contracting State**

EBIT considers that this proposed requirement is unduly restrictive and we consider that it should be omitted from the Discussion Draft, as further work by the OECD is needed to determine how treaty shopping concerns can be allayed in a different, more even-handed way with less collateral damage. Requiring that intermediate owners of the tested company must be residents of one of the contracting States will typically apply and pose an issue to MNCs which have many affiliates in several countries, and would not allow them to benefit from treaties anymore. EBIT wishes to stress that the choice of an MNC as to where a tested entity is situated within its organisational structure can be the result of many different factors, and is often the result of acquisitions. We believe that the proposed requirement is also not in line with EU Law (see also point 4 above).

6. **Issues related to the derivative benefit provision**

To EBIT’s Members and many MNCs for that matter, the derivative benefits provision is an aspect of LOB of critical importance as it ensures access to treaty benefits to a company if 95% or more of its shares are owned by companies that would be entitled to equivalent benefits under the bilateral treaty between the source state and the country of residence of the owners (and other criteria are met). EBIT is concerned that the proposed OECD Model Tax Convention will deny treaty benefits even where there is no treaty abuse, including situations where intermediary companies are also being tested, i.e. in addition to the ultimate beneficial owners. EBIT considers that intermediary company testing should not be included in the
Model Tax Convention and that the Contracting State of the ultimate beneficial owners should be the focal point.

EBIT understands that there is currently no consensus among the BEPS-44 on whether to include a derivative benefits provision which would also cover the use of intermediate entities and which has the potential to create treaty shopping risks in the OECD proposals. EBIT’s Members urge the OECD to clarify what treaty shopping risks it sees concretely.

7. Provisions dealing with “dual-listed company arrangements”

EBIT welcomes the OECD’s recognition of the unique circumstances of dual-listed company arrangements and encourage further study by the Working Group of this issue, as there are likely collateral issues, such as the appropriate application of the subsidiary of a publicly traded corporation that merit careful consideration and how to apply the substantial presence test.

9. Conditions for the application of the provision on publicly-listed entities

EBIT Members do not share the OECD’s view that the conditions in 2 c) of the proposed U.S. style LOB rule under A and B (the substantial presence test) are relevant to treaty shopping concerns and should be omitted. The proposed conditions are taken over from the current US treaty LOB article but are there because of a domestic policy concern over so-called corporate inversions. Domestic policy concerns should be addressed under domestic law, however.

10. Clarification of the “active business” provision

EBIT prefers the new Discussion Draft recommendation over the initially proposed anti-avoidance approach.

Commentary 20 on Article 1 currently describes a possible format for an LOB without the controversial restrictions included in the current US version. EBIT considers that the use of the LOB article in treaties other than those with the U.S. will probably be limited, the OECD should leave the current version in the Commentaries as a starting point with countries free to negotiate departures or refinements on a bilateral basis.

B. Issues related to the PPT rule

14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

We welcome aligning the Commentaries on the PPT rule and on the LOB discretionary relief provision that deal with the principal purposes test. Application of the discretionary relief rule of the LOB, and the PPT rule should both be under mandatory arbitration, and be subject to a 6 months’ time limitation from the PPT denial of the relevant treaty benefit for finalisation of applications by the competent tax authorities.

EBIT wishes to reiterate that the OECD include in its proposals that a tax authority should always consult with its treaty partner first before denying a request for treaty benefits by a resident of the treaty partner.

15. Whether some form of discretionary relief should be provided under the PPT rule

EBIT’s Members consider that in general, the denial of benefits under the PPT rule should always be proportionate to the perceived abuse, and, as stated under point 14 above, that a
EBIT Comments on FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE

16. Drafting the alternative “conduit-PPT rule”

EBIT considers that the proposed anti-conduit rule in paragraph 15 should be targeted to cases where it is evident that an intermediary company has been used for a principal purpose of accessing treaty benefits. We believe that the proposed rule will be an intrinsically subjective and arbitrary anti-abuse rule and that there is a high risk that the conduit rule could lead to inappropriate denial of treaty benefits and many legal disputes if it is not carefully defined. The “all or substantially all” threshold coupled with the PPT is in our view reasonable. However, we firmly believe that the “at any time” provision’s scope is too broad, as it would lead to an indefinite period of uncertainty for businesses as any future transaction could be taken into account to deny treaty benefits. Useful examples of practical anti-conduit arrangements can be found in the Annex to the US/UK tax treaty exchange of notes, and which we advocate to be included.

17. List of examples in the Commentary on the PPT rule

EBIT considers that the examples in the Report are quite specific and as such limited in providing adequate clarity on the application of the PPT rules on commercial arrangements entered into by MNCs. Two common situations are considered below:

1. M&A activity and holding company

Often, MNCs use a holding company in a territory with a favorable tax treaty with the target territory for acquisition purposes. Whilst tax will usually be one of many considerations that are taken into account in determining the economic viability of an acquisition, it is not clear from the examples whether the PPT rules could apply prevent MNCs from benefiting from the tax treaty in such a situation.

Also unclear in our view is whether the application of the PPT rule would be different if:

a) The MNC uses as the holding company to acquire the target, an existing group company in that territory that already has economic substance, OR
b) The MNC sets up a new holding company but has other group companies in the territory with economic substance, OR
c) The MNC does not have any economic substance in the territory prior to the acquisition but sets up a new company there for the purpose of the acquisition.

2. Intra-group financing and lending entity

When considering ways to debt finance a subsidiary, MNCs often have a choice between two or more lending entities in the group. As cash is fungible, two or more entities may be in a position to utilise group’s cash to provide funds to group entities as necessary. In such a scenario, it is not clear from the examples whether selecting a lending entity that provides for a more favourable tax treaty outcome would be caught by the PPT rule.

Whilst additional examples and guidance to provide more clarity would be welcome, with a purpose based test there will inevitably be disagreement as to whether treaty benefits should apply and accordingly denial of treaty benefits for certain situations. In such cases, EBIT believes that treaty relief should not be denied per se, rather the treaty benefit provided should be limited to what would have been available otherwise.
C. Other issues

18. Application of the new treaty tie-breaker rule

Any residence tie-breaker rule must provide a clear and predictable result in advance which is why the members of EBIT urge the OECD to move away from the proposed competent authority test and retain the effective management test in the Model Convention but with a recourse to ascertain a single residency via competent authorities. This should only serve as a fall back option, and with a maximum timeline of 6 months for the competent authorities to reach a final decision guaranteed expressly in the Model Convention.

EBIT wishes to reiterate that we are very concerned that the OECD proposes to substitute a 100 years old concept which works well with a U.S. based competent authorities test which will inevitably result in an increased resource burden on tax authorities, significant delay and uncertainty for international business and many more instances of double taxation.

19. The design and drafting of the rule applicable to permanent establishments located in third States

In EBIT’s view the bottom line should be clearly that the anti-abuse test for paragraph 42 of the Report should be whether the structure is a genuine business and has real substance. A country’s low rate of taxation as such is not a problem in this context, which the OECD has acknowledged itself in its 2013 BEPS Action Plan. EBIT Members consider that where there is no proof of abuse and the beneficial ownership of the income is with a resident of one contracting State, the source State should not be allowed to deny treaty relief.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are happy to discuss with, and remain committed to a constructive dialogue with, the OECD.

Yours sincerely,

The European Business Initiative on Taxation – January 2015

For further information on EBIT, please contact its Secretariat via Bob van der Made, Tel: +31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com).
On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

9 January 2015

To

Organisation for Economic Co-operation and Development (OECD)

Re


Introduction:

The Public Affairs Executive (PAE) of the European Private Equity and Venture Capital industry is pleased to provide its comments on the public discussion draft released by the OECD on Action 6 (“the Consultation Document”).

We write on behalf of the representative national and supranational European private equity (including venture capital) bodies. Our members cover the whole industry, from the institutional investors who provide the capital for investment to the private equity firms who invest the capital in European companies at all stages of their development. We endorse the response of the British Private Equity & Venture Capital Association (BVCA) as the content of their response also reflects our views.

In the context of the Consultation Document, private equity funds, irrespective of shape or form, typically raise and invest funds internationally and it is key that the location as well as the structure chosen for the fund is tax neutral for the investors. In other words, the co-investment or pooling of the investments via the fund entity should not trigger additional tax for investors when compared with a situation in which the investors invest directly in those companies. This is a general principle for structuring funds which is not unique to private equity.

How Private Equity Operates:

As requested in the Consultation Document, we would like to provide an overview of how private equity works. Private equity is a form of equity investment into private companies which are generally not listed on the stock exchange. It is a medium to long-term investment, characterised by active ownership. Private equity ownership builds better businesses by adding and strengthening

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1 The term “private equity” is used in this paper to refer to all segments of the industry, including venture capital. The term “venture capital” is used in specific contexts where there are issues that relate particularly to this segment.
management expertise, providing strategic guidance on delivery of operational improvements and helping companies to access new markets. Venture capital is a sub-segment of private equity focused on start-up companies. Venture capital funds back entrepreneurs with innovative ideas for a product or service who need investment capital and strategic advice in growing their companies.

What are commonly referred to as private equity funds in reality take many different shapes and form, ranging from the unitized fund structures seen in many European jurisdictions, and which are governed by the relevant fund laws, to co-investment arrangements typically in the form of negotiated limited partnership agreements (e.g. English or Delaware) governed by civil law. Irrespective of structure chosen, these private equity funds raise capital from institutional investors such as pension funds, insurance companies, sovereign wealth funds or family offices, etc. The private equity funds are managed by specialist investment managers (typically also investors in these funds) who invest the capital and know-how in companies across a wide variety of sectors, including consumer, industrial, engineering, life sciences, bio-technology, computer software, infrastructure, etc, and at various stages of the life of the company.

As illustrated, the whole sequence of raising capital from investors, investing that capital via long-term, closed-ended funds into companies, often via holding structures, and then providing returns to investors, is one inter-connected investment chain.
Each step of the fund’s activities is not an individual, stand-alone transaction but is part of the inter-connected investment chain. At the end of the life-cycle of the fund, if the investors are satisfied with their returns, they often then re-invest the returns they receive as capital in new funds and the cycle starts once more.

Investors into Private Equity in 2013

All Private Equity funds

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Academic institutions</td>
<td>5.2%</td>
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<tr>
<td>Banks</td>
<td>11.3%</td>
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<tr>
<td>Capital markets</td>
<td>11.7%</td>
</tr>
<tr>
<td>Corporate investors</td>
<td>4.7%</td>
</tr>
<tr>
<td>Endowments and foundations</td>
<td>3.7%</td>
</tr>
<tr>
<td>Family offices</td>
<td>0.7%</td>
</tr>
<tr>
<td>Fund of funds</td>
<td>3.7%</td>
</tr>
<tr>
<td>Government agencies</td>
<td>0.3%</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>0.3%</td>
</tr>
<tr>
<td>Other asset managers</td>
<td>11.3%</td>
</tr>
<tr>
<td>Pension funds</td>
<td>0.3%</td>
</tr>
<tr>
<td>Private individuals</td>
<td>2.5%</td>
</tr>
<tr>
<td>Sovereign wealth funds</td>
<td>2.7%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

Venture Capital funds

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Academic institutions</td>
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<tr>
<td>Banks</td>
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<tr>
<td>Capital markets</td>
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<tr>
<td>Corporate investors</td>
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<tr>
<td>Endowments and foundations</td>
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<tr>
<td>Family offices</td>
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<td>Fund of funds</td>
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<tr>
<td>Government agencies</td>
<td>2.7%</td>
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<td>Insurance companies</td>
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<td>0.3%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
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</tbody>
</table>

This information is contained in the EVCA Yearbook.² The Consultation Document is correct therefore when it states that “pension funds, like sovereign wealth funds, are often among the institutional investors that invest in alternative funds

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and private equity funds and these may be established in third countries”. Another important investor into private equity is insurance companies while government agencies also invest public money.

**All Private Equity - Fundraising geographic breakdown**

As can be seen from the illustration below, the investors into European private equity are located all over the world, with a significant proportion being located outside the EU. The choice of location for the private equity firm as well as for the funds managed and/or advised by the firm is normally made on the basis of various factors (residence of the management team, investment strategy, regional or national investment focus, addressed investor base, access to advisory infrastructure, stable and predictable tax and legal environment, etc).

**Importance of Private Equity in Financing the Real Economy:**

Private equity provides patient and engaged investment for the long-term, channelling finance to businesses across OECD countries, and particularly to Small and Medium-sized Enterprises (SMEs).

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The private equity industry participated in the stakeholder process that led to the G20/OECD High-Level Principles of Long-term Investment Financing by Institutional Investors in 2013. As set out in Principle 1.4, a pre-condition for long-term investment is “tax neutrality towards different forms and structures of financing”. This Principle also adds that “investment frameworks should as far as possible be made consistent across countries to facilitate the cross-border flow of long-term financing.” Any standards for addressing the issue of Treaty Abuse under the BEPS Action Plan must also be examined against this backdrop.

We would also like to highlight Principle 6.2 which states that “governments should avoid introducing or maintaining unnecessarily barriers to international investment - inward and outward - made by institutional investors, especially when targeted to long-term investment. They should cooperate to remove, whenever possible, any related international impediments.”

Private equity’s contribution to the real economy has been acknowledged by several institutions. As confirmed in the 2014 European Parliament Report on Long-term Financing of the European Economy, “private equity firms can provide valuable non-financial support, including consultancy services, financial advice, advice on marketing strategy, and training” to investee companies. This sentiment has been echoed in the recent European Commission Communication on Long-term Financing, which acknowledges the private equity industry as an important provider of investment opportunities to pension funds and financing to SMEs. Private equity represents all these qualities on a global, not just European basis.

Echoing this Communication, the 2014 OECD Report on Institutional Investors and Long-term Investment correctly identifies that pension funds are increasingly investing in private equity funds.

The presence of an appropriate tax environment to allow these funds to operate on a de minimis tax neutral basis is paramount, as acknowledged by the recent OECD Report on Long-term Investment. As the Report states, “[t]o increase foreign investment in the venture capital sector and stimulate the early stage venture capital sector governments may establish special vehicles to provide tax

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7 European Commission Communication on Long-term Financing of the European Economy, 27 March 2014, pp 6 & 13
concessions for registered venture capital funds that make equity investments in relatively high-risk start-ups and expanding companies.”

Private equity is therefore an important intermediary for providing long-term financing to the real economy, similar to Collective Investment Vehicles (CIVs). The importance of CIVs has been explored by the OECD in recent years, most notably in the 2010 Report. Private equity funds, in many respects, bear similarities to CIVs in the way they operate and provide financing to SMEs and other companies in the real economy.

**CIV Definition under OECD 2010 Report:**

The OECD 2010 Report states that for the purposes of the Report, “the term “CIV” is limited to 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.” The Consultation Document on BEPS Action Point 6 concludes that “[a]lternative funds/private equity funds generally do not meet these conditions because they typically have a limited number of institutional investors, may not hold a diverse portfolio and are not subject to the same investor-protection regulation.”

We believe that this conclusion does not recognise the many similarities in how private equity funds and CIVs raise and invest capital. These similarities should qualify private equity funds for equal treatment with CIVs and should be taken into account in order not to discriminate against private equity funds in the further work on BEPS. We would like to examine each of these issues in turn.

(i) Widely-held by investors:

As demonstrated above, the investors in a typical private equity fund will usually consist of numerous, globally dispersed investors. On average a private equity fund has 7 different types of investors (e.g. pension funds, sovereign wealth funds, etc) and a typical fund might have dozens of individual investors. The position is very similar to investors in a widely held instrument. These investors are either subject to (corporate) income tax in their country of residence.

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11 Ibid, pp3.
12 EVCA Research
(insurance companies, family offices), or are exempt from such tax by their nature (pension funds, charities).

(ii) Diversified portfolio of securities:

As can be seen from the following graph, private equity funds invest into a wide range of sectors. A typical private equity fund could therefore hold investments in sectors as diverse as industrial products, life sciences, computer & consumer electronics, energy & environment, transportation and agriculture.

Similarly, as can be seen from the subsequent pie-chart, the geographic regions where these investments are made is also varied, with some large markets such as UK & Ireland, France and Benelux as well as Scandinavia having a large share due to the long-standing and well-developed private equity industry in those countries. On average, a private equity fund holds investments in 9/10 companies.  

All Private Equity - Investments by sector

13 EVCA Research
All Private Equity - Investments by Region

Industry statistics

Market Statistics

Investments by Number of Employees

All Private Equity

Full time equivalent staff by interval

\[14\] Supra 2, pp 40, 52, 56
Furthermore, as can be seen above, the vast majority of companies which receive private equity financing are SMEs, a hugely important sector responsible for driving growth and innovation. SMEs typically find it more difficult (due to the higher risks involved) than more mature companies to find financing and this situation has been further aggravated in the wake of the recent financial crises.

Private equity is an important intermediary in channelling funds to SMEs and other unlisted companies. It provides the institutional investors with whom it co-invests the necessary skills for finding, analysing, valuing and negotiating the investment into interesting unlisted companies with value creation potential and then, through active board participation guides and monitors these companies until they are ready to take the next step in their development under the stewardship of new/additional owners. The management teams of these companies implement and execute the strategies originally facilitated by the private equity funds and subsequently adopted by the boards of directors.

(iii) Investor protection measures under AIFMD:

The Consultation Document judges that private equity funds “are not subject to the same investor-protection regulation” as CIVs. While private equity funds mainly raise funds from professional investors, the EU Alternative Investment Fund Managers Directive (AIFMD)\textsuperscript{15} entered into force on 22 July 2013 in the European Union. The objective of this Directive is to create a comprehensive and

\textsuperscript{15} Alternative Investment Fund Managers Directive 2011/61/EU
effective regulatory and supervisory framework also for Alternative Investment Fund Managers (AIFMs) at European level.

AIFMs are required to obtain authorisation and are subject to on-going regulation and supervision. In this way, the AIFMD aims to:

- Increase the transparency of AIFMs towards investors, supervisors and the employees of the companies in which they invest;

- Equip national supervisors, the European Securities & Markets Authority (ESMA) and the European Systemic Risk Board (ESRB) with the information and tools necessary to monitor and respond to risks to the stability of the financial system that could be caused or amplified by AIFM activity. In the De Larosière Report’s assessment of the causal effects of the financial crisis, the private equity industry is not identified as a contributing factor; 16

- Strengthen and deepen the EU single market, thereby creating the conditions for increased investor choice and competition in the EU, subject always to high and consistent regulatory standards;

- Increase the accountability of AIFM holding controlling stakes in companies towards employees and the public at large, and

- AIFMs are also required to inform competent authorities about their use of leverage at fund level, so that the authorities can assess whether the use of leverage by the AIFM contributes to the build-up of systemic risk in the financial system. This information is shared with the ESRB.

The AIFMD introduces safeguards to ensure that investors in alternative investment funds, who are mainly professional or semi-professional, are well-informed and adequately protected. For example, the AIFMD will require that:

- Conflicts of interest are avoided or managed and disclosed;

- AIFMs employ adequate systems to manage risks to which the fund is exposed, and to ensure that the liquidity profile reflects the obligations towards investors;

A fund's assets are safe-kept, or monitored, by an independent depositary subject to a high liability standard;

Valuation is performed properly and independently; and

Strict conditions are met when AIFM delegates functions to third parties.

Depending on the type of Alternative Investment Fund (AIF) they manage, an AIFM with assets under management amounting to less than €500 million (for unleveraged funds with long 'lock-in' periods) or €100 million for other types of alternative investment fund will be subject to a tailored regime. These AIFMs will be required to register with national authorities and comply with harmonised transparency requirements, as well as additional requirements applied at national level.

The AIFMD also provides for the possibility for these sub-threshold AIFMs to ‘opt-in’ so as to avail of passporting rights in return for full compliance with the AIFMD. Therefore, while not all fund managers will apply the AIFMD regime due to the size thresholds, the vast majority of EU-based private equity fund managers are regulated (authorised or registered) under the Directive as is their marketing to EU-based investors of the funds (AIFs) they manage.

For those registered sub-threshold managers of venture capital or social entrepreneurship funds for whom opting in to the full AIFMD is not an alternative due to size and available resources, the European Venture Capital Fund Regulation (EuVECA)17 and European Social Entrepreneurship Fund Regulation (EuSEF)18 also provide an alternative route to an EU-marketing passport, where the funds meet the criteria defined therein.

From the preceding three sub-sections, it is clear therefore that the Consultation Document is inaccurate when it states that “[a]lternative funds/private equity funds generally do not meet these conditions because they typically have a limited number of institutional investors, may not hold a diverse portfolio and are not subject to the same investor-protection regulation.” Therefore, while not identical, the similarities between private equity funds and CIVs are more than sufficient to warrant the former being given equal treatment to the latter. As a


minimum any regime should ensure that these funds are not discriminated against as their use of holding structures/Special Purpose Vehicles (SPVs) for their investments is not driven by tax avoidance or treaty abuse. Rather, such structures are merely to organize ownership at various levels and to safeguard the tax neutrality and the avoidance of double-taxation that investors legitimately expect.

In addition, it is not clear to us why the heading “alternative funds/private equity funds” is used. This implies a uniformity that does not exist. The range of fund types under the AIFMD family is quite diverse and private equity funds are one type that exists within the wide framework.

As mentioned earlier, the alternatives sub-group labelled private equity funds is a broad church of different legal structures ranging from unitized collective investment undertakings to co-investment arrangements typically in the form of negotiated limited partnership agreements. While there may be certain similarities between some private equity structures and structures used by other fund types (such as infrastructure, for example), private equity funds are quite different from many of fund types found under the AIFMD umbrella, such as hedge funds, as they neither issue securities that can be traded nor do they themselves trade in securities on a regular basis.

**Private equity fund structures:**

Private equity funds use financing instruments to meet the needs of both the companies being financed as well as the investors. These instruments play an important role in matching those seeking to invest capital with those requiring investment. Private equity funds - contrary to corporate structures - typically have a limited life (usually 10-12 years) with the possibility to extend this life (subject to consultation with investors) usually by an additional 3 years as a maximum (even if done year on year). This in order to avoid having to divest assets via a “fire sale” if market conditions are not optimal. This is of course in the best interests of the investors.

A key element of a typical private equity fund, irrespective of structure, is that the imposition of either the fund structure as such or the holding structure for each investment held should not change the tax attributes for investors. They should still be taxed as if they had made a direct investment into the underlying company.

The legitimate use of intermediaries is acknowledged in the OECD 2010 Report: “CIVs thus act as both issuers of securities and investors in securities. As a
result, there may be layers of intermediaries both below the CIV (i.e. between the issuer of the security in which the CIV is invested and the CIV), and above the CIV (i.e. between the CIV and the beneficial owner of the interests in the CIV). In many cases, those intermediaries will not be located in the country in which the issuer is located and may not be located in the country in which the investor is located.” 19 The intermediate holding company structure used by private equity funds should not disadvantage such funds in their tax treatment as the structure is not designed to facilitate tax avoidance. Rather, it exists to meet the needs of investors. It allows a fund to invest in an asset on the same level as other investors in that asset. It can also facilitate access to tax treaty provisions for investors in the fund without those investors having to make treaty claims individually (we explain this below).

A private equity fund cannot and does not attempt to structure its investments to be tax efficient for each investor. Whilst it is relatively simple for certain types of corporate groups (closely held company with a limited number of investors) to deal with the different tax attributes of group members that is not available to a private equity fund as in many cases it will not have access to full information regarding the underlying nature and tax treatment of the investors. For private equity funds, whilst the tax treatment at the intermediary holding company level can be ascertained, they are most unlikely to have information as to the tax treatment of the ultimate beneficial investors.

Some information may be available to the private equity fund but not the entirety as some investors will be funds of funds (as mentioned above) and therefore the available information as to the investor will be restricted to this point. Even if the information were to be available to the private equity manager in this instance, such details will be confidential. While not representative of the absolute majority of private equity funds, some funds will be open-ended or listed and in these circumstances the difficulties indicated above will be exacerbated as clearly it will be almost impossible to obtain information around a changing investor base. As indicated above, private equity investors are spread across the globe and it is simply impossible to understand each investor’s tax position.

The OECD 2010 Report acknowledges this same issue for CIVs - “[t]he difficulty in tracing of course also is compounded by the fact that interests in CIVs frequently are held through layers of intermediaries. In those cases, the CIV’s records will show the names of the intermediaries through which the investors

19 Supra 10, pp 6.
hold their interests in the CIV, rather than the names of the investors themselves.”

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Although a significant percentage of investors into certain fund structures are entitled to relief in their own right by making a claim through a double tax treaty, administratively it is far more efficient that they receive the correct return in the first place without having to resort to treaty claims.

This is especially so if the investor is tax exempt like most pension funds. In this case the tax levied becomes a de facto cost as there is no tax levied in the investor’s home jurisdiction against which this tax can be off-set. This is also an issue where withholding tax is applied to interest income (and also interest payments and dividends) or more importantly capital gains tax is levied on non-resident investors.

Should the fund manager take on the role of processing tax reclaims on behalf of investors, then it will still involve increased resources and costs, and thus also reducing returns. It will also mean that there could be a significant delay in some investors receiving all the proceeds due to them as the processing of repayment claims by tax authorities can be slow (sometimes taking years, rather than days). Without an intermediary holding company, funds could also be exposing their investors to local tax filing requirements.

How to Address These Issues Without Creating Opportunities for Treaty Shopping:

The private equity industry fully appreciates the concerns of the OECD that action is needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. We also support a coordinated and comprehensive international approach to tackle these important issues.

As we expressed in our response to the consultation earlier in the year, the private equity industry is concerned that the BEPS Action 6 Draft Plan (the “Treaty Abuse Draft”), if implemented, will disallow treaty access to many non-CIV fund structures (and their holding company structures used to organise investments and different types of co-ownership) used in the private equity industry. The Treaty Abuse Draft is likely to affect many funds that invest cross

20 Supra 10, pp7
border because most funds will simply not pass the proposed Limitations on Benefits (LOB) test. Disallowing funds from treaty access may easily result in double (or even triple) taxation.

As currently drafted, many private equity funds and holding companies owned by such funds would not meet the LOB test for several reasons:

(i) the fund and the holding companies will not be listed;

(ii) neither the fund nor the holding companies will be treated as carrying on an active trade or business for the purposes of the proposed LOB test. Under the formulation of the LOB test currently proposed, the making or managing of investments will be deemed not to satisfy this test unless carried on by a bank, insurance company or securities dealer;

(iii) the “derivative benefits” provision as currently proposed is very narrow. The proposed LOB test, as drafted, would disqualify a fund entity (including holding companies of a fund entity) as a “qualified person”, and would therefore deny tax treaty protection to the fund. This is because at least 50% of the beneficial interests in a fund are often not owned by persons that are resident in the country where the investment vehicle is resident. This is inherent to the nature of many private equity funds that raise capital from investors in many different jurisdictions, as explained earlier.

Holding companies in certain jurisdictions can ensure that fund investors are afforded greater certainty regarding insulation from legal liabilities that might flow out of a domestic structure to non-domestic parents. This matter is particularly relevant where shareholder consent outside of the investee jurisdiction is given, or entities are deemed to be subject to a controlling parent which can give rise to liabilities arising in the controllers' hands. An intermediate holding jurisdiction can often provide the only meaningful shield to these risks.

As a solution to this issue, we propose that CIVs and non-CIV funds of all descriptions can be explicitly excluded from the current Treaty Abuse Draft, and provision made in the proposed amendments to the model treaty to make clear that the LOB provision and/or purpose test will not act to restrict the ability of a CIV and non-CIV fund (or associated investment structure) from accessing treaty benefits.
Failing that, an alternative would be to include a CIV and non-CIV fund (and the aforementioned holding companies) in the definition of a “qualifying person”, provided that certain conditions are met (for example, that the fund is not controlled by one or a small number of investors, and/or that the fund is registered or is managed by a registered fund manager).

Any further requirements placed on the industry risk being inappropriate to its specific circumstances and disproportionate in their impact on private equity. A “one-size fits all” approach to regulating all types of fund structures will simply not be workable, as mentioned earlier.

Further work could, however, be undertaken on the creation of an additional category of qualified person, to include the concept of a ‘qualified fund’, provided this were tailored and appropriate to the private equity industry, based on existing reporting requirements and not on TRACE which is inappropriate for our industry.

We would be pleased to work with the OECD to develop this proposal further. We do not consider that any solution based on the principles of the TRACE project could be a practical solution for private equity funds. If the OECD feels that there is insufficient time to properly deal with such negotiations then we would ask that non-CIV funds are carved-out of the current proposals and the status quo maintained until such time as treaty entitlement for private equity funds can be properly addressed.

Principal Purposes Test:

Section 17 of the Consultation Document invites examples which could be included in the Commentary on the PPT rule. While we support the approach of having a PPT (and not an LOB) as part of a minimum standard, the current proposals are not conducive to international business because they do not provide reasonable certainty for any party to an investment transaction. While we support the aims of the work to prevent treaty abuse, the outcomes must also balance the need to support international investment, and we consider that, as currently drafted, an appropriate balance has not been reached.

As described above, private equity operates internationally, and all international funds will have experienced how different fiscal authorities view substantially identical fact patterns differently, leading to different treaty qualification outcomes. The current proposals will do nothing to alleviate this challenge and will indeed exacerbate the problem.
The main deficiency in the current proposals is that the PPT currently refers to “one of the principal purposes”. The commentary recognises that the test is subjective, but there is nothing which adequately explains the boundary between an acceptable activity of merely considering the tax consequences of a particular course of action on the one hand, and that consideration rising to become an unacceptable principal purpose on the other. It is inevitable that different tax authorities will interpret the test differently given the same set of facts. As a matter of principle, all parties to the BEPS process should consider this to be an unacceptable outcome in designing an appropriate PPT.

Principle 1.4 of the G20/OECD High-level principles on long-term investment financing by institutional investors report concludes that “Investment frameworks should as far as possible be made consistent across countries to facilitate the cross-border flow of long-term financing”. As currently drafted, the PPT will not ensure consistency across countries.

We consider that the PPT should be drafted so as to be a test of the principal purpose of an arrangement. We accept that this is a stricter standard which will require greater effort to apply. However, only by modifying the PPT in this way can the subjectivity which will be a barrier to international investment be minimised. The following examples for inclusion in the commentary are provided on the assumption that the PPT remains in substantially the same form as currently proposed.

Our experience suggests that certain fiscal authorities will interpret the same facts aggressively whereas others will be satisfied that no treaty abuse is occurring. As noted above, it is vital that the commentary delivers a PPT which is not only workable but will be applied consistently across all BEPS participant jurisdictions. It is therefore necessary to include a range of examples in the commentary, in order to deliver this consistency.

Example A: a fund structured as a limited partnership, which is not resident in any state, is marketed to a diverse range of potential investors and as part of this fundraising process indicates to potential investors that investments will be held via intermediate holding companies. In due course the fund is raised and it is necessary to form an intermediate holding company in anticipation of making a particular investment in a company in country S. The fund manager considers a range of potential jurisdictions for the intermediate holding company and as part of this process considers the treaty positions of companies in each potential jurisdiction as well as staff costs, property costs, regulatory costs, etc. The holding company is ultimately formed in country T.
Taking into account the fact that the investors into the fund and therefore into the holding company are diverse in jurisdiction and in nature, the fact that treaty entitlement was considered as part of the decision to form a company in country T rather than any other state cannot mean that treaty entitlement was a principal purpose of the arrangement. The holding company is not formed for the treaty abuse purposes of any investor or group of investors. The diversity of the investor group is a strong indication that obtaining treaty benefits was not a principle purpose of the arrangements.

Example B: same facts as Example A, but the fund manager is aware that a majority of investors into the fund are of a type which would not be entitled to treaty benefits in respect of an investment into country S, and there is no identifiable commercial purpose to establishing a holding company. The fund manager forms a holding company in country T in order to secure treaty relief for investors.

The PPT applies and the holding company formed in State T may not avail itself of treaty benefits in respect of this arrangement.

**Conclusion:**

Private equity operates very differently from the large multi-national organisations on which the OECD’s work on BEPS appears to be largely focused. It is vital that these differences are understood and accommodated in order that the industry is not inappropriately disadvantaged, which would in turn lead to a disruption in global investment flows, impacting countries that rely on inward investment and reducing economic growth across the globe.

Private equity funds are not in the business of treaty shopping. The primary purpose of private equity, just like other CIVs, is a business purpose, i.e. the co-investment arrangement or pooling of capital to make investments. As long as different countries’ interpretations of what constitutes a permanent establishment are not harmonised across the globe, tax treaty access will remain crucial in order to achieve tax neutrality for funds, and to avoid double or even triple taxation in genuine bona fide investment structures.
Contact

Thank you in advance for taking our comments into account as part of the consultation process. We would be more than happy to further discuss any of the comments made in this paper.

For further information, please contact Danny O’Connell at the European Private Equity & Venture Capital Association (EVCA).

Phone +32 2 715 00 35

danny.oconnell@evca.eu www.evca.eu
The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About EVCA

The EVCA is the voice of European private equity.

Our membership covers the full range of private equity activity, from early-stage capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. We represent 650 member firms and 500 affiliate members.

The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

We explain private equity to the public and help shape public policy, so that our members can conduct their business effectively.

The EVCA is responsible for the industry’s professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.

We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis.

The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is heard.
Follow-up work on Action 6: prevent Treaty Abuse

Introduction

EPRA has taken note of OECD’s invitation – made in the public discussion draft “Follow-up work on BEPS Action 6: Preventing Treaty Abuse”, dated 21 November 2014 (Follow-up Discussion Draft) - to submit comments on the preliminary proposals published by the OECD in connection with the prevention of the granting of treaty benefits in inappropriate circumstances. In particular, EPRA wishes to comment on the issues related to the application of the proposed anti-abuse provisions to collective investment vehicles.

Reference is made to EPRA’s submission dated April 9, 2014, as well as the EPRA submission dated May 23, 2014, containing the comments of eleven European professional real estate associations. In both submissions, clarification was asked for on the position of “Real Estate Investment Trusts” (REITs) in connection with the proposals on the prevention of treaty abuse.

Herein below, EPRA will:

i. re-iterate the importance of REITs to the world’s economy,

ii. make some observations on the particular position of REITs,

iii. outline the major problems that the proposals contained in the OECD’s proposals to prevent treaty abuse will have for the REIT industry,

iv. indicate how the proposals should be amended to eliminate the potential substantial and serious adverse consequences for REITs worldwide.

Importance of REITs

The use of Real Estate Investment Trusts (“REITs”) has significantly expanded worldwide and has a very substantial impact on today’s economy.

REIT regimes have been introduced over the years as a means to:

- Attract capital into the built environment/infrastructure through broad access of capital markets with daily liquidity;
- Make the benefits of investing into commercial real estate accessible for both institutional investors and small investors;
- Transparent business and markets reports through analysts and regular reporting;
- Professionalise the property sector (normally through the growth of the publicly quoted property sector) and create a more international level playing field;
- Lower the cost of capital for commercial property businesses;
• Prevent the proliferation of offshore property funds/private ownership.

In summary, we believe that the overall purpose of REITs can be described as achieving the objectives of

1) making the commercial real estate market more accessible to investors,

2) improving the quality and efficiency of the end-product – the built environment, which is extremely important to sustainable economic growth and development,

3) providing long-term capital perfectly matching the investors’ expectation for long term, stable returns.

The OECD has previously recognised the importance of REITs in its 2007 REITs report. REITs are increasingly investing cross-border, despite the fact that their privileged tax regime is typically not available in foreign jurisdictions resulting in full tax liability there. In the 2007 REITs Report, the OECD made reference to the legitimate concerns of the industry participants (including at the time EPRA representatives) in the group that prepared such report by indicating that:

“(…) in order to achieve a more efficient market for portfolio investment in immovable property, REITs established in one country need to be able to invest in foreign countries’ immovable property and in REITs established in other countries. Therefore, the tax obstacles that hinder such cross-border investments should be addressed”.

In addition, the OECD has recognised that “one of the primary purposes of tax treaties is to reduce tax barriers to cross-border trade and investment”. REITs with just one layer of final tax (at shareholder level) are simple and non-aggressive in eroding a tax base of the res situs territory.

The position of REITs

In the substantial September 2014, report on “preventing the granting of treaty benefits in inappropriate circumstances (the Abuse Report), the acronym “REIT” was only used in connection with an example that was given of an existing model tax treaty provision containing an anti-abuse rule. Otherwise, no attention was given to the REIT at all.

In the subsequent Follow-Up Discussion Draft of November 2014, the following is noted (paragraph 5):

“Whilst changes were made in the final version of the Report in order to deal with collective investment vehicles, no such changes were made to address comments that were received on the March 5 2014 discussion draft in relation to Real Estate Investment

1 Public discussion draft on Tax Treaty issues related to REITs, 30 October 2007, p. 13.
Trusts (REITs), sovereign wealth funds (SWFs), pension funds and alternative funds (including private equity funds)."

The footnote elaborates as follows on the position of REITs:

“REITs are covered by the 2010 Report on CIVs to the extent that they are widely-held and regulated. When that is not the case, they may face the issues described below in relation to alternative funds / private equity funds (see subsection iii)).”

However, the 2010 Report on CIVs does not refer to REITs. Rather, REITs are covered by the OECD public discussion draft of October 30, 2007, entitled “Tax Treaty Issues Related to REITs" (the 2007 REITs Report)³

Today, the definition of REITs has been widely accepted as it has been set out in the 2007 REITs Report and implemented into the 2008 OECD Model Tax Convention. REITs offer a specific taxation for real estate investments shifting the tax liability to the investor level rather than the vehicle itself.

There are various types of collective investment schemes built on national or EU harmonised investment fund legislation (AIFMD - Alternative Investment Fund Managers Directive) which invest in securities or any other alternative assets (hedge strategies, infrastructure, real estate etc.). In the OECD terminology, these vehicles are called “non-CIVs” (i.e., alternative investment funds like private equity funds, non-listed real estate funds, infra structure funds, hedge funds, etc.). These non-CIVs, are designed with a view to offering safe and regulated investment funds with many different strategies and asset classes and the goal of sound investor protection of private or institutional investors.

Contrary to non-CIVs, in most countries REITs are not subject to the regulatory supervision legislation that applies to these non-CIVs. For example, in most EU countries, REITs are not subject to the AIFMD. REITs are in many cases listed at the stock exchange and subject to the rules that apply to the listed sector. From a tax point of view, REITs benefit from a “flow through” regime (unlike most non-CIVs). EPRA wishes to ensure in respect to BEPS Action 6, the OECD will treat REITs as a separate class of investment vehicles, as confirmed in line with the cited OECD work related to REITs and CIVs.

A REIT is a going concern business activity led by a board, typically listed and widely held over recognised stock exchanges. REITs are a globally accepted capital market based asset class. Therefore, it remains correct to continue to treat such an operation, regardless if it is constituted as a trust or a corporation, as a person with access to tax treaties. That has been also the position of the US treaty practice for many years, from which OECD has taken the concept of the LOB.

³ Public discussion draft on Tax Treaty Issues related to REITs, 30 October 2007, p. 3.
Analysis of the adverse impact of the Abuse Report on REITs

As mentioned above, the OECD has recognised the importance of REITs and the need to remove tax obstacles and barriers that hinder cross-border investments. The objective of REIT regimes in many countries is to support the development of the property sector and to realise the objective of achieving tax neutrality between direct and indirect investment in real estate by pension funds, insurance companies, sovereign funds and the retail investors.

One of the key features of a REIT is that the point of taxation is moved from the entity (the REIT) to the shareholders. Moreover, substantially all REIT regimes contain specific provisions preventing abusive use of REITs and the possibility of undesired treaty shopping. Should these provisions not be in place, then countries would risk their taxing rights in respect of the property income earned by REITs. This is why substantially all REIT regimes provide for a “waterproof” system, whereby the property income is subject to tax on an annual basis based on the mandatory distribution of the REIT and the corresponding withholding taxes.

Moreover, most REITs are either stock listed, or subject to regulatory supervision with all related and appropriate reporting and transparency requirements. Dividends distributed by REITs are invariably subject to withholding tax. Hence, REITs can be seen as a solid concept to prevent the proliferation of offshore property schemes and aggressive tax structures, the exact type of structure, which the Abuse Report is focusing on. In addition, REITs are almost ideal taxpayers as the REIT withholding tax is flowing consistently with mandatory distributions which are made regularly, in some cases even monthly.

However, if the Abuse Report was to be implemented as proposed, it may well lead to the result that access to tax treaty benefits is denied to many bona fides REITs.

To illustrate this, we have applied the various tests in the suggested limitation on benefits provision (“the LOB”) to REITs with the following results:

1. **Legal form**: Considering their legal form, REITs are generally not qualified persons under paragraph 2.a) and 2.b) of the LOB (“company”).

2. **Stock exchange test**: REITs have to fulfil one of the following tests, mentioned under a) and b) below:

   a) REITs should either (i) be listed on a recognised stock exchange located in the Contracting State where the company is resident or (ii) be listed on a recognised stock exchange and the company’s primary place of management and control should be located in the Contracting State where the company is resident.

   There does not seem to exist a valid reason to limit the listing of the REITs to recognised stock exchanges located in the Contracting State where the company is resident and in various cases, this test will not be met. A listing can be obtained and maintained at different stock exchanges for various
commercial and regulatory reasons. Moreover, it is frequently the case that participations in REITs are traded in secondary markets, that do not fall under the definition of recognised stock exchange, or that a REIT is widely held, but not listed at an official stock exchange.

b) At least 50% of the company (voting power and value of shares) is owned directly or indirectly (with each intermediate owner being resident in either Contracting State) by five or fewer listed companies.

Under the current market practise, where many REITs have a broad international investor base, including other REITs – this being one of their advantages in order to raise the required capital for large institutional / infrastructural property projects - this test is highly unlikely to be met. Moreover, REITs often invest via subsidiaries situated in other States. These subsidiaries would often not qualify for this ‘derivative stock exchange test’. The ‘same state’ requirement, as well as the requirement that each intermediate owner is a resident of either Contracting State, are unnecessarily complicating things for REITs. There is no reason why a widely held vehicle listed at a regulated stock exchange should suffer disadvantages depending on its ownership base. A listed vehicle like a REIT is constituted to flexibly attract capital from whichever part of the world and the key element for granting treaty benefits is that the REIT has a business led by a central management and qualifies as a resident in a treaty country as defined by the treaty terms.

3. Charities/ Pension funds: REITs do not fall within the scope of the qualified persons under paragraph 2.d) of the LOB.

4. Shareholders’ test / equivalent beneficiary test: REITs may be considered as qualified persons under paragraph 2.e) of the LOB if the following two conditions are met:

   a) At least 50% of the REIT (voting power and value) is owned, directly or indirectly (with each intermediate owner being resident in the State of residence of the REIT) in the hands of qualified persons (as described in 2.a), 2.b), 2.c).i) or 2.d) of the LOB) which are resident of the Contracting State where the REIT is resident.

As previously mentioned, under current market practice, many REITs have a broad international investor base, including other REITs, and such condition is highly unlikely to be met. Moreover, also REIT subsidiaries located in other countries will not be able to benefit from this provision. It would be a major distortion of the international capital markets if REITs where de facto forced to restrict their ownership base in such a way. Since it has to be accepted that a widely held company with active trading of shares has to serve the purpose for
its shares being fully tradable any time without uncontrollable adverse tax consequences, such restriction is unrealistic for REITs.

b) Less than 50% of the income of the REIT’s tax income, is deducted by the REIT and paid or accrued, directly or indirectly to persons that are not residents of the Contracting State where the REIT is resident and are not considered as qualified persons (as described in 2.a), 2.b), 2.c).i) or 2.d) of the LOB).

Under the domestic tax law of many countries, in order to achieve the desired look-through approach in respect of REITs, REITs are required to distribute most of the income they have received as dividends to their participants and REITs are entitled to deduct from their tax base such income. In respect of REITs located in countries with this type of provisions, this second condition would neither be met. Furthermore, it effectively narrows the broad access to capital markets that REITs focus on.

Based on the above, it is unlikely that REITs meet the conditions set out in paragraph 2.e) of the LOB in order to be considered as qualified persons.

5. **Substantial business test:** Paragraph 3 of the LOB contains a “substantial business test”. However, it is uncertain whether REITs would pass this test and the business of making investments for its own account directly or indirectly could very well be excluded as a qualifying activity, based on paragraph 3.a) of the LOB.

6. **Derivative benefits test:** on the basis of Paragraph 4 of the LOB, a company will get treaty access if it is owned for 95% or more by equivalent beneficiaries. An equivalent beneficiary is an entity that would have been entitled to at least the same treaty benefit had the relevant treaty income flowed directly to such entity. In addition, a base erosion test is imposed.

   Again, given the widely held character (REITs often do not avail of the identity of all of its shareholders), it will be impossible to qualify for this test.

7. **Competent authority procedure:** Paragraph 5 of the LOB provides the possibility that competent authorities determine on case by case basis the application of the particular tax treaty (discretionary relief). However, it is well known that such request would involve an additional administrative burden for the REITs, with a highly uncertain outcome. Unless REITs would genuinely be accepted as treaty persons as promoted by the 2007 OECD REITs Report.

   As the illustration of the application of the LOB to REITs clearly demonstrates, the Abuse Report goes too far in restricting tax treaty access, without having a clear notion of where genuine use of tax treaties ends and where abuse starts. It seems as if the balance may flip to the other side: instead of tax treaties being primarily instruments to avoid double taxation, their objective would shift to merely prevent international tax avoidance.
It is clear that REITs will be severely affected by the Abuse Report and that many REITs face the risk of access to tax treaty benefits being denied. Being unable to access tax treaties may result in REITs being faced with a significant degree of uncertainty and with constant double taxation, which would result in an increase of the costs of cross border investing.

The Abuse Report is part of the exercise to prevent double non-taxation and cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. However, implementation of the recommendations in the Abuse Report in their current form would seriously hamper the interests of bona fides legitimate REITs and cross-border investors, without realizing the impact that this would have on the global economy, in particular on the international property market, where REITs play a fundamental role.

EPRA urges the OECD to reconfirm the recognition which has been granted by the 2007 REITs Report to REITs. REITs are one of the most transparent, simple and least tax aggressive investment forms which build capital through pensions funds, insurance companies and sovereign wealth funds allocating their resources to diversified REITs.

**Suggestion of additional wording on the LOB**

As explained above, REITs should be excluded from the scope of the “suspected persons”. EPRA suggests that REITs as defined in the 2007 REITs Report, as well as persons wholly-owned by REITs, be considered qualified persons for purposes of the LOB rule.

Moreover, EPRA invites the OECD to take the “principal purpose test” out of the Abuse Report and include in the Abuse Report the specific recommendations approved by OECD Working Party No. 1 on Tax Conventions and Related Questions in the 2007 REITs Report.

**About EPRA**

EPRA is the voice of the publicly traded European real estate sector: it is the representative association for commercial property companies that are quoted on the public stock exchanges of Europe and other exchanges around the world. With more than 200 active members, EPRA represents over EUR 350 billion of real estate.

EPRA’s membership also includes the institutional investors such as pension funds and insurance companies that invest in, or have an interest in investing in real estate indirectly via these listed property companies. Through the provision of better information to investors, improvement of the general operating environment, diffusion of best practices and the cohesion and strengthening of the industry, EPRA works to encourage greater investment in listed real estate companies in Europe with long-term and stable income producing assets.
Paris, le 9 janvier 2015

Madame,

La Fédération Bancaire Française (FBF), organisme professionnel regroupant l'ensemble des établissements de crédit en France, est heureuse de l'opportunité qui lui est offerte de présenter ses observations dans le cadre de la consultation organisée par l'Organisation de Coopération et de Développement Economiques (OCDE) sur le document de discussion relatif à l’action 6 du plan « BEPS ».

Ce document fait l’objet d’un certain nombre d’observations de notre part que vous trouverez dans la note ci-jointe, établie en anglais afin d’en faciliter la diffusion auprès des différents membres de l’OCDE et parties intéressées.

Nous restons à votre entière disposition pour tout renseignement complémentaire dont vous auriez besoin.

Je vous prie d’agréer, Madame, l’expression de mes salutations distinguées.

Blandine LEPORCQ
Directrice du département fiscal

Madame Marlies de Ruiter
Chef de l’Unité des Conventions Fiscales, Prix de Transfert et des Transactions financières
Centre de Politique et d’Administration Fiscale
Organisation de Coopération et de Développement Economiques (OCDE)
2 rue André Pascal
75775 Paris Cedex
APPENDIX: COMMENTS FROM THE FRENCH BANKING FEDERATION ON THE PUBLIC DISCUSSION DRAFT RELATING TO THE ACTION 6 OF THE BEPS REPORT “PREVENTING TREATY ABUSE”

PRELIMINARY REMARKS

The FBF, as the voice of the French banking sector representing the interests of over 400 banks operating in France, encompassing large and small, wholesale and retail, local and cross-border financial institutions, welcomes the opportunity to provide the OECD with comments on certain questions of the proposed Public Discussion Draft relating to the Action 6 of the BEPS Report “Preventing Treaty Abuse”. It is crucial for us to have the opportunity to provide our comments as well as our input, particularly given the complexity of certain issues under this discussion. We thank the OECD for the consultative process underway and call for a continued interaction with the private sector so that the voice of business is duly taken into account.

As preliminary remarks, we would however like to express some concerns about the “BEPS project”:

First, the subjects under discussion and the issues at stake are far-reaching and sometimes extremely complex. The accelerated pace planned by Member Countries of the OECD do not allow us to analyze thoroughly the topics, to consult our members as much as necessary and thus do not allow us to contribute as deeply as we would wish to. We believe that analyzing the consequences of the proposed changes is also a great challenge for both tax administrations and the private sector, which requires more dialogue and more time. We would therefore call for a more realistic timeframe, with more reasonable consultation periods in particular. It would also be extremely useful to have a track of the different changes brought to the various reports on every action issued by the OECD after collecting the comments of the stakeholders.

Besides, we fear that the proposed changes may introduce legal uncertainty (in particular due to divergences in interpretation by different Countries) and may create even more operational complexities for taxpayers, all of which may weaken the very purpose of tax treaties of eliminating double taxation. It seems that Member Countries may be losing sight of this objective which yet contributes to economic growth.

While we support the Governments’ will to tackle abusive behaviors of taxpayers, we believe that the proposals of the BEPS plan, in particular in the area of preventing Treaty abuse, may constitute a disproportionate answer from public authorities.

In particular, we would like to stress that the introduction of a LOB clause in addition to a PPT rule would be unnecessarily complex and burdensome and may lead to multiple interpretations by various tax administrations which would create double taxation situations. One of the other approaches may be adopted, but a combination of both should be avoided.

More generally, we observe that the aim of double-tax treaties is to eliminate double taxation, an issue which is still a major concern for taxpayers. Thus, double tax treaties should pursue the unachieved aim instead of being used as a tool to tackle tax avoidance. Such issues should primarily be dealt through domestic legislation. We note that many countries already introduced general anti-avoidance rules in the same vein as the PPT rule.

Finally, we would like to underline that banks are involved in the transfer of income, payments and other financial items and, as such, may be in charge of applying relief at source granted under tax treaties. Adding complexities to double-tax treaty relief is likely to deter investors from lower-yield investments or to generate additional costs due to increased or complicated processing – all of
which in turn would make cross-border less attractive. We are concerned that the proposals may result in a significant decrease in the ability of investors to receive treaty relief at source.

A. ISSUES RELATED TO THE LOB PROVISION

1. Collective Investment Vehicles (CIVs): application of the LOB and treaty entitlement

We believe that the recommendations of the 2010 CIV report remain adequate for widely-held CIVs and should not be particularly questioned. Although we do favor treating CIVs as “Residents” in their own right under tax treaties (i.e. “resident of a Contracting State” and “beneficial owner”, rather than adopting a look-through approach) as the preferred solution in the French context, we observe that the number of different structures and legal and operational frameworks in the CIV world simply make it impossible to agree on a single “preferred approach”. Such a single approach may deny treaty access to a number of CIVs.

2. Non-CIV Funds: application of the LOB and treaty entitlement

As a general remark, we would like to underline that combatting abusive situations should not entail an excessive answer whereby too stringent conditions would be imposed for treaty-relief access, which would lead to discriminate non-CIV Funds should not be discriminated against CIV Funds. Therefore, once the legal criteria have been defined for the funds, the same treatment regarding tax treaty should apply to all funds. In addition, non-CIV Funds are regulated within the EU which provides a certain level of comfort for public authorities.

3. Discretionary relief provision of the LOB rule

We welcome this rule as a fallback provision. However, this rule should not be used as a general principle as it may generate too much uncertainty and should thus remain a truly “fallback provision”.

4. Alternative LOB provisions for EU countries

We believe it is necessary to adapt the LOB provisions to make them compatible with EU law and avoid any discrimination challenge. We therefore welcome the idea of an alternative LOB rule should such a rule be introduced.

5. and 6. Requirement that each intermediate owner be a resident of either Contracting State / Derivative Benefit Provisions

We are particularly concerned that this requirement would be in breach of decades of international tax practice and totally unsuited to the economic reality of business.

First, we fail to understand the rationale of such a requirement: even if cases of treaty abuse have been identified where a group member is involved, we believe that such a broad requirement would constitute a totally disproportionate answer which would be likely to deprive double-tax treaties from any practical effects. It would also deny the bilateral nature of tax treaties which reflect the will of two specific countries.
This rule would also apply even when all intermediates would be residents of countries which do have a double tax treaty and where anti-abuse provisions may apply.

Moreover, this requirement merely denies the reality of business and of group structures which are governed by business, commercial and economic motivations. Taken to the extreme, it would mean that stand-alone companies would be granted treaty-benefits while companies within international groups would not. It would be shocking to impose considerable business restructuring simply to be able to continue benefiting from a double-tax treaty relief.

We therefore call for the removal of such requirement and would like to insist on the fact that one should focus on the ultimate beneficial owner. We note that domestic anti-avoidance clauses would be sufficient to address the potential abuses where intermediates would be involved.

Finally, a Derivative Benefit provision may indeed be useful. More generally, we are supportive of the introduction of a most favored nation clause in order to avoid any discrimination for taxpayers, an important feature within the EU context.

10. “Active Business” provision

We are supportive of the idea of introducing a rule whereby the holding company of an “Active” group would be considered as having an “Active Business” if its business is the management of such shareholdings. In the same vein, when the role of an entity is connected and serves the “Active Business” of other member entities of the group, such entity should also be deemed to carry out an “Active Business” as this reflects a certain way of structuring the business and activities of a group.

We would also suggest to clarify that the “Active Business” provision would be met when a company would also be considered as carrying on an “Active Business” in accordance with domestic rules.

B. ISSUES RELATED WITH THE PPT RULE

General comments relating to the PPT rule

As already expressed above, we would like to stress that the introduction of a LOB clause in addition to a PPT rule would be unnecessarily complex and burdensome and may lead to multiple interpretations by various tax administrations. One of the other approaches may be adopted, but a combination of both should be avoided.

We would also like to underline that the present drafting of PPT rule is particularly vague which may open the door to arbitrary and non-consensual interpretations by certain countries, thus creating an important source of legal uncertainty for taxpayers. In particular, the reference to “one of the main purpose” and to indirect benefits may be subject to endless discussions.

Group structures as well as the structuring of acquisitions in such or such a way are usually determined by a myriad of factors, among which the tax aspects may or may not be taken into account. Even when tax aspects are taken into account, one may not challenge a taxpayer who has lawfully chosen a more tax-attractive path than another. In addition, it may be difficult in certain situations to determine whether a double-tax relief constitutes “one of the main purposes” of the operation: here again, this may lead to endless discussions and divergences of interpretations.

Thus, the drafting PPT rule, because of the consequences it may trigger, needs to be more focused and precise. As a bare minimum, examples could be provided so as to show how tax administrations would apply such rules, with an illustration of abusive and non-abusive situations.
Given the uncertainties and complexities for taxpayers, as well as the risks for them of being “easily” deprived from treaty benefits (e.g. subject to the non-consensual interpretations that could be made by certain countries), we call for the LOB and PPT rule to be both under mandatory arbitrage in case of a difference of interpretation between tax authorities.

Finally, while the taxpayers would of course be expected to explain the rationale behind group structures or restructuring, it should be clearly specified that the burden of the proof shall always lie on the tax authorities when having recourse to a PPT rule.

14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary provision that dealt with the principal purposes test

As a general remark, we would like to point out that any divergences in drafting such rules may create additional sources of divergences in interpretation and application of the rule (please also refer to our previous comments).

19. Design and drafting of the rule applicable to permanent establishments located in third States

We are concerned by this proposal which may in breach of decades of international tax practice and may severely disrupt business and cross-border flows. The current drafting of this anti-abuse rule may unduly prevent branches established in third States from obtaining treaty-relief. The proof of the level of taxation may in particular be difficult to obtain and may give rise to endless discussions with tax authorities.
Ms. Marlies de Ruiter,
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division,
OECD,
2 rue André Pascal,
75116 Paris

08 January 2015
Ref.: TPG/PKR/PGI

Dear Ms Marlies de Ruiter,

Re: FEE comments on Public Discussion Draft – Follow-Up Work on BEPS Action 6 (Preventing Treaty Abuse)

(1) FEE (the Federation of European Accountants, www.fee.be) is pleased to provide you below with our comments in respect of the discussion draft that deals with follow-up work mandated by the Report on Action 6 “Preventing the granting of treaty benefits in inappropriate circumstances” ("the Report") of the BEPS Action Plan. The following comments focus on an EU perspective.

(2) FEE represents 47 professional institutes of accountants and auditors from 36 European countries, including all 28 European Union (EU) Member States. It has a combined membership of over 800,000 professional accountants, working in different capacities in public practice, small and big accountancy firms, businesses of all sizes, government and education. Adhering to the fundamental values of their profession – integrity, objectivity, independence, professionalism, competence and confidentiality – they contribute to a more efficient, transparent and sustainable European economy.

Item A.4. – Alternative Limitation of Benefits (LOB) provisions for EU countries

Background

(3) The OECD discussion draft acknowledges that the LOB rule needs to be adapted to reflect certain requirements within EU law. Therefore, there is a need to draft an alternative provision in order to accommodate the concerns of EU Member States. Although specific comment on this was not requested in this paper we believe that it would be useful to provide you with our comments on this matter in advance of further consideration.

(4) The most relevant requirements within EU law to be taken into consideration in this context are:
• The **Treaty on the Functioning of the European Union**, especially insofar as it pertains to the Fundamental Freedoms;

• **EU Directives** and their transposition into national law of the Member States (which may differ between Member States if options within the Directives are available), i.e.:
  o Parent-Subsidiary Directive;
  o Merger Directive;
  o Interest and Royalty Directive;
  o Savings Taxation Directive.

• The **EU Arbitration Convention**. This is a procedure for resolving disputes where double taxation occurs as a result of an enterprise being affected by an upward adjustment of profits by a Member State different to the one in which the company is resident for tax purposes. Whilst most bilateral double taxation treaties include a provision for a corresponding downward adjustment of profits of the associated enterprise concerned, they do not generally impose a binding obligation on the Contracting States to eliminate the double taxation. In situations where competent authorities do not agree on the treatment of a transaction or situation, thereby leading to the potential for double taxation and the consequent use of the discretionary relief provision, the EU Arbitration Convention would probably force the Contracting Member States to resolve the potential double taxation within a limited time frame.

**Issues Arising from Potential Conflicts between the EU Fundamental Freedom of Establishment and the Limitation of Benefits (LOB) Provisions**

(5) Paragraph 13 of the Report acknowledges that the LOB provisions, as currently drafted, need to be adjusted to take account of EU law. We have identified the following proposed amendments to the OECD Model Tax Convention that may be at variance with EU law and, therefore, may require alternative wording or a carve-out.

  a. Draft Article X para 2 c) ii - The rule that intermediate companies have to be **residents** of either Contracting State.

  b. Draft Article X para 2 e) i - The **ownership test**, which requires that (on at least half of the days of the taxable period) at least 50% of the voting power and value are owned by a qualified person **resident** in the Contracting State (or that each intermediate owner is a **resident** of that Contracting State.

  c. Draft Article X para 3 - The **active trade or business test**, which requires that the business of a person in **its country of residence** should be substantial compared to its own (or its associated enterprise’s) business in the other Contracting State, if the person derives income from the source state activity or associated enterprise.

**Justification of Infringements to the Freedom of Establishment**
(6) Infringements of the freedom of establishment can be justified in certain circumstances; in particular if intended to prevent abuse of law. However, the Court of Justice of the European Union (CJEU) accepts preventing abuse of law as justification for infringements of the Fundamental Freedoms only if certain requirements have been fulfilled.

(7) One requirement is that the taxpayer whose transaction is tackled by an anti-avoidance rule should have the possibility to demonstrate (without undue administrative constraints) that their actions were not abusive in the individual case under consideration.

(8) However, the discretionary relief provision in the BEPS Treaty Abuse proposals will probably not fulfil this requirement as it does not grant a right to the taxpayer to receive the treaty benefit if he can substantiate that his actions were not abusive. The final decision is left solely to the discretion of the competent authority of the Contracting State from which benefits are being claimed (sometimes after consultation with the competent authority of the other Contracting State). Consequently, the discretionary relief provision is unlikely to constitute a proper justification for the above-mentioned infringements of the freedom of establishment.

(9) The infringement could also be justified if the Contracting States implementing the infringing rule mutually agree on the allocation of the right of taxation. However, the current Article X OECD-MA draft takes a fundamentally different approach in that it does not allocate the right of taxation, but rather precludes the application of treaty benefits.

(10) It could be argued that agreeing to the OECD’s proposals constitutes an effective means of allocation of taxing right. However, the justification for infringement would still likely fail as such an allocation would not be in mutual agreement. The discretionary relief provision allows a unilateral decision from just one of the Contracting States (or without consensus between the competent tax authorities of the Contracting States).

Potential Issues Arising from Conflicts between the LOB Provisions and EU Directives as transposed into national law

(11) When a dividend received by a legal person under a double taxation agreement qualifies for a tax exemption under the EU Parent-Subsidiary Directive, it would then seem logical that the competent authority should not deny treaty benefits under the LOB rule.

(12) Likewise, if interest income or income from royalties received by a legal person under a double taxation agreement qualifies for a tax exemption under the EU Interest and Royalties Directive, it would then seem logical that the competent authority should not deny treaty benefits under the LOB rule.

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1 i.e. Centros case (C-212/97, point 24) - a Member State is entitled to take measures designed to prevent circumvention of their national legislation or to prevent improper or fraudulent advantage being taken of provisions of Community Law.
(13) In some cases similar conflicts can occur with regard to the Savings Taxation Directive and the Merger Directive.

Extension of the aforementioned comments regarding the LOB clause to the EFTA countries Iceland, Liechtenstein and Norway belonging to the European Economic Area (EEA)

(14) The freedom of establishment also applies to the EFTA States (Iceland, Liechtenstein and Norway)\(^2\). Consequently, FEE believes that the aforementioned constraints related to the freedom of establishment are also applicable with regard to the EFTA States and any adjustment of the LOB clause related to this should also be applicable to these States.

Item B.11.-17. – Principal Purpose Test and its application to EU/EFTA countries

(15) There are issues arising for EU/EFTA countries from the potential application of Article X, para 7. The Principal Purpose Test, as currently drafted in the OECD paper, could be applicable provided that obtaining a treaty benefit was "one of the principal purposes". The reference to "one of the principal purposes" means that obtaining a benefit under a tax convention need not be the sole or dominant purpose but merely one of the purposes of the transaction or arrangement. Based on current jurisprudence, neither the EFTA Court nor the CJEU would be likely to accept such wording as justification for an infringement of the freedom of establishment.

(16) According to the wording of the Principal Purpose Test treaty benefits can be denied if only one of the principal purposes of the taxpayer is to obtain a treaty benefit. This contradicts the judicial interpretation of the freedom of establishment. According to the view of the CJEU and the EFTA court, a restriction of the freedom of establishment is only justified if the only purpose of such a transaction is to obtain a tax benefit.\(^3\)

(17) In conclusion, FEE recommends that the Principal Purpose Test be amended in such a way that it will only be applicable when the only purpose of the transaction is to obtain a treaty benefit.

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\(^2\) Article 31 of the Agreement of on the European Economic Area - "...there shall be no restrictions on the freedom of establishment of nationals of an EC Member State or an EFTA State in the territory of any other of these States..."

Article 34 of the same agreements -: "Companies or firms formed in accordance with the law of an EC Member State or an EFTA State and having their registered office, central administration or principal place of business within the territory of the Contracting Parties shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of EC Member States or EFTA States. ..."

\(^3\) i.e. EFTA Court on 9 July 2014 (Olsen), the court stated that "What is decisive [to assess an artificial character] is the fact that the activity, from an objective perspective, has no other reasonable explanation but to secure a tax advantage" (see rec. 176) and similar terminology has been used in CJEU judgements, i.e. C-112/14 as of 13 November 2014, where the court used the phrase "to identify the existence of a wholly artificial arrangement entered into for tax reasons alone" (see rec. 27) in their consideration of whether a national rule could justifiably restrict the fundamental freedoms.
For further information on this letter, please contact Paul Gisby, Manager, from the FEE Team on +32 2 285 40 70 or via e-mail at paul.gisby@fee.be.

Yours sincerely,

Petr Kriz
President

Olivier Boutellis-Taft
Chief Executive
Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA
2 rue André Pascal
75016 Paris
FRANCE

Via Email: taxtreaties@oecd.org

Discussion Draft on Follow up Work on BEPS Action 6: Preventing Treaty Abuse

Dear Mrs. de Ruiter,

BDI1 refers to the OECD Discussion Draft “Follow up Work on BEPS Action 6: Preventing Treaty Abuse” issued on 21 November 2014. We would like to thank you for the possibility to provide our comments that allow us to engage with you on these important issues.

Tax treaties play an important role in cross border investments and transactions by providing relief from double taxation through the allocation of taxing rights between countries and thereby promoting economic growth and creation of jobs in the contracting states. Business acknowledges that the benefits of tax treaties should only be available in sound business structures and that it is legitimate for the treaty partners to avoid abuse of treaty provisions by generating double non-taxation in inappropriate circumstances.

However, anti-abuse rules must be designed in a way that they have a minimum impact on genuine business operations. Consequently, we believe that perceived inappropriate behaviour is best addressed with specific and targeted anti-abuse provisions. In our view, both the proposed highly complex and restrictive Limitation-Of-Benefits (LOB) provision as well as the vague and arbitrary “Principal Purpose Test” (PPT) fail in this respect, since they are too general in nature and not limited to abusive situations. Introducing provisions like these will undoubtedly increase legal uncertainty for businesses as well as tax authorities, add further complexity to treaty application and therefore induce additional disputes.

* BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 37 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.
Also, anti-abuse provisions should recognize that holding, financing and investment activities are normal and legitimate business activities that should not per se be excluded from treaty protection. Any perceived avoidance should be tackled by domestic law instead of denying treaty benefits to genuine business structures.

We have limited our specific comments to some provisions of the draft.

A. Issues related to the LOB provision

1. Collective investment vehicles: Application of the LOB and treaty entitlement
The 2010 CIV Report proposes various alternative approaches for a CIV to secure treaty relief for their eligible investors. As CIVs differ widely – regarding e.g. their structures, their investor base or their distribution strategy – we believe that one single approach would not account for these differences adequately. It would deny treaty access to numerous CIVs that should have access when the relevant standards are met. Therefore the recommendations of the 2010 CIV Report should not be modified.

3. Commentary on the discretionary relief provision of the LOB rule
We would suggest to include a set time frame for the competent authorities to agree a response in order to provide predictability for businesses. Also, mandatory arbitration should be applicable for the discretionary relief rule of the LOB clause (as well as the the PPT). In any case should a denial of treaty benefits not be dealt with by unilateral action of one authority but should require alignment.

4. Alternative LOB provision for EU countries
We agree with the observation that the LOB rule needs to be adapted to reflect EU law requirements. To bring the provisions in line with the EU fundamental freedoms will prove a very complex task and would most likely require significant changes within the existing system. The provision need to be adapted to a single market context and provide for a taxation without discrimination. Against this background we are particularly concerned as regards the prohibition of non-resident intermediaries in the ownership tests and the local stock exchange requirement in the publicly traded test.

Apart from these concerns we also doubt whether a “Principal Purpose Test”, as suggested in the Draft, would be compatible with EU law in view of the rationale of the ECJ’s jurisdiction in the “Cadbury Schweppes” case (C-196/04).

5. Requirement that each intermediate owner be a resident of either Contracting State
In our view the LOB rule should focus on the ultimate beneficial owner and not on intermediate companies. Generally, Contracting states should keep in mind that the main purpose of Double Tax Treaties still is to avoid double taxation and we strongly recommend against using tax treaties as a tool to combat tax avoidance. We agree
that treaties should not be abused, but the primary route to tackle avoidance must be through local tax law.

• 6. Issues related to the derivative benefit provision
We welcome a derivative benefits provision in the LOB. Such a provision would extend the granting of treaty benefits to entities that are controlled by entities that are resident of a third country and that would enjoy the same treaty benefits with the contracting state in question. Thus, there is no incentive for treaty shopping.

B. Issues related to the PPT rule

• 12. Suggestion that countries consider establishing some form of administrative process
If a PPT rule is introduced it needs to be ensured that it is not applied excessively. Thus we support the introduction of approval requirement at senior level.

• 13. Whether the application of the PPT rule should be excluded from the arbitration process
As already mentioned above mandatory arbitration in our view is a sine qua non condition if such a vague and subjective provision as the PPT rule is introduced. We expect such a rule to cause immense legal uncertainty and major disruptions to the legitimate operation of treaty benefits. Therefore, the probability is high that the competent authorities fail to reach an agreement under mutual agreement procedures. Without binding arbitration provisions installed this would result in double taxation for businesses involved.

C. Other Issues

• 18. Application of the new treaty tie-breaker rule
Our major concerns with regard to the so called “new” tie-breaker rule is a lack of predictability. In cases of dual residency, which may arise for purely commercial reasons (eg legal incorporation in Country A, but Board meetings taking place in the headquarters Country B), it would be hardly possible to predict the outcome of the agreement of the competent authorities. Even worse, the agreement might take a long time or there would perhaps be no result at all, as there currently is no agreement requirement for the competent authorities. Against this background we advise in favour of retaining the “effective management” test in treaties.

Please do not hesitate to contact us if you have any questions.

Sincerely,

Berthold Welling

Dr. Karoline Kampermann
Marlies de Ruiter  
Head Tax Treaties Transfer Pricing and Financial Transactions Division  
OECD Centre on Tax Policy and Administration  
2, rue André Pascal  
75775 Paris

By email: taxtreaties@oecd.org

Berlin, 9 January 2015


Ladies and Gentlemen,

ZIA, the German Property Federation (Zentraler Immobilien Ausschuss e.V.), represents German real estate business in its entirety, including real estate funds and real estate fund managers. ZIA speaks on behalf of individual member firms and 24 member associations, thus representing 37,000 branch members.

ZIA welcomes and supports the work of OECD aiming at ameliorating the existing international tax framework towards more predictability and legal certainty while closing tax loopholes and eliminating international mismatches. We encourage OECD to pursue this way to promote a sound taxation climate for the benefit of taxpayers, tax administrations, and the society as a whole.

With regard to the draft (issues 1 and 2), we emphasise the accuracy and validity of the 2010 report on CIVs. It is absolutely crucial to ensure neutrality between direct investments and investments through a CIV. Any other approach would cause macroeconomic distortions. Furthermore, this neutrality must not be limited to national borders. An up-to-date international tax system has to find a way to maintain this necessary neutrality even when investment vehicles cross borders.

To maintain this tax neutrality in cross border situations, one more step has to be done. A far reaching treaty entitlement needs to be established. “Far reaching” in this sense means, that the treaty entitlement of economically comparable investment vehicles should not depend on coincidental national legal traditions
or similar reasons why a collective investment vehicle, a non-CIV fund or an alternative fund are treated as transparent or opaque, liable to tax or not in the residence State. All these vehicles serve an economically similar purpose and should therefore all be treated in the same way by double taxation conventions. This equality is necessary to ensure a level playing field. Consequently, they all should regularly enjoy treaty entitlement.

In addition to the economic comparability of all the above mentioned investment vehicles further aspects to consider are

- the submission of investment vehicles under investor protection regulation and financial market supervisory as well as
- operability and manageability of investment vehicles with a potentially high and potentially staggering number of investors and
- the astonishing increase in availability of tax payer information to tax administrations.

In many parts of the world in the aftermath of the financial crisis the degree of regulation of products and players in financial markets has considerably risen. As compared to the situation while the 2010 report on CIVs was drafted, the legal background with regard to the above-mentioned investment vehicles is much more sophisticated. This sophistication could i.e. allow to distinguish investment vehicles from companies/corporations as well as from partnerships, thus giving room for a separate and adequate treaty regime for investment vehicles without interfering with well-established legal patterns. While recommending far reaching treaty entitlement of CIVs, non-CIV funds and alternative funds OECD could leave necessary fine-tuning to treaty negotiators with regard to the pertinent national or supra-national legal background.

Treaty entitlement of the above-mentioned investment vehicles could also promote the operability and manageability of the above mentioned investment vehicles. Especially investment vehicles with a high number of investors could benefit from a facilitation of their management. While recommending far reaching treaty entitlement of CIVs, non-CIV funds and alternative funds OECD could leave decisions about the exclusion of vehicles with a small number of investors to the discretion of the negotiators.

During the last few years a revolution with regard to the exchange of taxpayer information has taken place. If one compares the situation while in 2009 the “Progress Report on the Jurisdictions_surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard” was established with the upcoming new world of automatic exchange of information the difference couldn’t be bigger.

Given all these new legal and technical conditions, it is appropriate to take one step back and have a new look at the whole picture. CIVs, non-CIV funds and alternative funds should be granted treaty entitlement independent of their qualification as similar to companies/corporations or similar to partnerships. Their
submission under LoB or similar restrictions should be modified adequately. Adaptations to domestic regimes should be left to negotiators and national legislators.

With kind regards

Roland Franke
Head
Tax and Finance Department
Marlies de Ruiter  
Head, Tax Treaties,  
Transfer Pricing and Financial Transactions Division,  
OECD/CTPA  
2 Rue Andre Pascal  
75775 Paris Cedex 16  
FRANCE  

9 January 2015

Dear Marlies,

OECD Public Discussion Draft – Follow-up Work on BEPS Action 6: Preventing Treaty Abuse

Grant Thornton International Ltd, with input from certain of its member firms, welcomes the opportunity to comment on the OECD Public Discussion Draft entitled Follow-up Work on BEPS Action 6: Preventing Treaty Abuse, (Public Discussion Draft) issued on 21 November 2014.

Our observations and detailed comments are set out below. At a high level, we are concerned that the proposals will have the effect of encouraging OECD member countries to increase domestic and treaty rates of withholding tax and generally seek to impose their taxing rights more assertively and possibly overly so. This would have a negative impact on cross-border business and, in a worst-case scenario, create serious distortions in financial markets across the globe.

We also suggest that further work is carried out by the OECD to help ensure that the Action 6 proposals are fully compatible with existing international law such as the 1969 Vienna Convention on the Law of Treaties (Vienna Convention). This should both ensure that the proposals are robust enough technically to withstand a legal challenge and also protect Contracting States where appropriate from the potential over-assertion of taxing rights by other jurisdictions in the guise of anti-abuse measures which could prove to be very disruptive to cross-border business.

As a general comment, we recommend removing the proposed LOB article with reliance placed instead on a targeted general anti-avoidance provision.

A. Issues related to the LOB provision

1. Collective investment vehicles: application of the LOB and treaty entitlement

Background

The OECD 2010 CIV Report (CIV Report) recognises the principle of neutrality for investment held through CIVs should preserved and that it is essential for funds to claim treaty benefits so investors in funds are not disadvantaged compared with direct owners of securities. In this respect, funds serve as an important savings vehicle for smaller savers and investors, eg individuals are required increasingly nowadays to provide for retirement themselves.
We also note that one of the CIV Report’s objectives was to reduce uncertainty when dealing with funds claiming treaty benefits and to encourage governments to provide clarification on whether funds are entitled to treaty benefits in bilateral treaty negotiations. The Action 6: 2014 Deliverable (Deliverable) also mentions this in relation to policy considerations that countries should consider before deciding to enter into a tax treaty (15.5 of the new Section C says one of the considerations should be ‘the greater certainty of treatment for taxpayers who are entitled to benefit from the treaty’). Such principles are also consistent with the OECD TRACE project aimed at simplifying and harmonising countries’ treaty relief withholding procedures.

Access to double tax treaties

There is unlikely to be a single approach to treaty entitlement of funds given that there are so many different fund structures. However, the following principles may be helpful in dealing with the main categories of funds. As a starting point, funds that are corporates, or treated as corporates for tax purposes in their country of establishment, should be treated as persons in their own right under tax treaties.

In addition, CIVs will only be viable if there is a single level of tax at either investor level or at fund level. Most CIV tax regimes provide exemption from tax at the fund level. This is usually done explicitly or through broad exemptions from tax on types of income. An exemption from tax should not therefore prevent a fund from being resident for tax purposes.

Further, funds should be regarded as the beneficial owners of their income for double tax treaty purposes where the fund is widely held with the investors having no control over the assets of the fund which should be managed by an external investment manager to determine that funds are beneficial owners of income under double tax treaties.

It could be clarified that CIVs which take a particular legal form are all treaty eligible, or that CIVs that have a certain regulatory status (eg. an EU UCITS authorised CIV) should be eligible for treaty benefits.

LOB issues

There are specific difficulties for CIVs in meeting the conditions of an LOB clause. Interests in CIVs are widely held, and their interests are often held through intermediaries. We note the Action 6 Deliverable proposes that entities that are regularly traded on recognised stock exchanges should be regarded as qualifying persons under an LOB condition. The rationale for this appears to be that frequent changes in ownership of listed entities mean that meeting an LOB condition is difficult because of the lack of information on residence of underlying owners and listed and traded companies represent a low risk of being used for treaty shopping because shareholders are generally not able to exercise control over the company.

These points also apply to CIVs that are not regularly traded on a recognised stock exchange. Therefore, CIVs should not be required to meet an LOB condition. CIVs may not know the beneficial owners of their interests and may not have access to information on the residence status and/ or treaty eligibility of their investors.

Additionally, there should be no distinction between listed and non-listed CIVs. By way of analogy, in the OECD’s Common Reporting Standard on Automatic Exchange of Information, the OECD was persuaded that listed and non-listed CIVs could be substitutes in the hands of investors and therefore should be treated in the same way.

However, where an LOB clause is deemed necessary, it should be noted that in the EU, the UCITS Directive provides a common regulatory framework for CIVs that are sold to retail investors. This has led to a working Single Market within the EU for CIVs. CIVs domiciled in one EU country are frequently and commonly sold to investors in other EU Member States.
The consultation recognises that an LOB provision without equivalent beneficiaries presents a legal problem within the EU so it would be helpful if this point could be resolved. Furthermore, any LOB condition should not limit the number of possible equivalent beneficiaries because a cross border fund that is widely held could very easily have many such investors.

Allowing CIVs to make treaty claims on behalf of their investors may be a suitable approach for CIVs that are not persons under a tax treaty. However, in cases where a CIV is a person, it is likely that the CIV takes corporate form (or a legal form that is treated as a corporate) in most cases. A practical issue in this respect is that a CIV might not be able to allocate treaty benefits to specific eligible investors when the interests of the CIV are fungible.

The CIV Report limits the term CIV to 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. There are many types of funds that may not usually be considered as CIVs that could meet this condition such as offshore hedge funds and certain private equity, property, debt funds or securitisation vehicles. In an EU context, the Alternative Investment Fund Manager Directive now provides investor protection regulation for all funds that are not UCITS.

Therefore, further clarification on what is meant by a CIV may be needed. The main condition should be that a fund is widely held (or intended to be widely held and marketed as such, even if it does not transpire to be widely held in practice). Other relevant and necessary conditions are that its investor have no control over the assets of the fund, or that its assets are managed by an external investment manager.

There does not appear to be any justification for different treatment in treaties of funds that offer varying degrees of investor protection regulation, which have diversified assets, or only invest in securities (as opposed to other types of asset such as property).

2. Non-CIV funds: application of the LOB and treaty entitlement

Unlike widely held funds, funds that are not widely held may not typically represent a means of accessing capital markets for smaller investors. It may also be much easier in practice for such funds to obtain information about their investors. However, funds that are not widely held often provide broader non-fiscal benefits, eg a main source of capital for businesses and infrastructure projects. Therefore, such funds should be allowed access to treaty benefits to prevent business and governments from being deprived of capital but this may need to be by reference to the entitlement to treaty of their underlying investors, ie using an equivalent beneficiaries approach.

In this respect, we believe the example given on page 72 of the Deliverable is a useful starting point although it would be helpful to include further examples.

As far as sovereign wealth funds are concerned, such vehicles are not set up with tax avoidance as a main purpose and so it would be consistent with this to exclude such entities and their underlying interests from LOB provisions as proposed.

The exclusion for pension funds needs to be widened in the case of the EU or other regional groupings of States as noted by the Deliverable, in particular the requirement that more than fifty per cent of the beneficial interests in the pension fund are owned by individuals resident in either Contracting State.

We note that the Public Discussion Draft has not asked for comments on REITS or securitisation vehicles, the treatment of which also needs careful consideration and to which many of the issues mentioned here and in issue 1 above will also apply.
3. Commentary on the discretionary relief provision of the LOB rule

In terms of factors or examples that could be included in the Commentary on this provision, please refer to our comments on Issue 14 below.

We agree that claims under this provision will need to be processed expeditiously by competent authorities. We suggest that a timescale of no more than one month should be the target for the consideration of such claims by competent authorities. Further work on other procedural aspects of claims will be needed, e.g. consideration should be given as to whether appeal processes are needed for claims that are initially rejected while competent authorities may wish to have powers to revisit claims after a certain period of time, e.g. three to five years.

4. Alternative LOB provisions for EU countries

We welcome the OECD’s acknowledgment that the LOB rule needs to be adapted to be compatible with EU law including the Papillon (C-418-07) and RBS (C-311/97) cases. Please see our comments under issues 1 and 2 above and also under issue 5 below.

5. Requirement that each intermediate owner be a resident of either Contracting State

While comments are not specifically invited by the Public Discussion Draft on the above issue at this stage, we agree that the proposed rule dealing with indirect ownership is likely to be unduly restrictive in requiring that each intermediate owner be a resident of either Contracting State. We note that further work is being carried out on this point and one suggestion for dealing with the concerns voiced by some states might be to relax the existing requirement so that intermediate owners can be resident in third states with similar treaty rules and/or in the EU.

6. Issues related to the derivative benefit provision

We understand that this provision is to be further reviewed in due course in the light of progress with other parts of the BEPS Action Plan, in particular, Actions 5 (Counter harmful tax practices more effectively, taking into account transparency and substance) and 8 (Assure that transfer pricing outcomes are in line with value creation). This further review will focus upon whether the inclusion of a derivative benefits provision would not raise concerns regarding other parts of the broader BEPS Action Plan and at the same time examine if the scope of a derivative benefits provision could be widened without creating treaty-shopping opportunities.

In terms of areas where the derivative benefits provision could be broadened, it may be helpful to reduce the 95% aggregate voting power and share value test to 75% or possibly less given that, in most territories, the requirement for a tax grouping relationship is significantly less than 95%. The ‘directly or indirectly’ part of that test may also need clarification so that cases are not excluded where the holding at each stage in the chain is 95% (or 75% as the case may be) but indirectly this threshold is not met (please note there is a provision in the LOB article of UK/US double tax treaty which contains this type of concession in the case of dividend income).

There may be merits in amending section B) of Paragraph 6(f)(i) which considers dividend, interest and royalties so that the comparable rate is no more than 5% greater than the rate claimed under the relevant Convention rather than being at least as low as the applicable rate. This would eliminate the majority of cases where the benefits potentially offered by one particular Convention over another are essentially marginal and help to ensure that the LOB provision is instead targeted at the worst cases of potential abuse.

The above suggested changes should also reduce the administrative burden on competent authorities required to consider cases under the LOB discretionary relief provision which would be welcomed.
7. Provisions dealing with 'dual listed company arrangements'

We welcome the addition of provisions to deal with the above. While we do not expect this provision to be subject to treaty-shopping arrangements, any cases of misuse of the provision could be addressed using the PPT rule.

8. Timing issues related to the various provisions of the LOB rule

The requirement that an entity must be publicly listed ‘throughout the taxable period that includes that time’ is unduly restrictive and should be removed. In this regard, we believe it should be possible to address the possible artificial use of publicly-listed vehicles to obtain treaty benefits again through the separate PPT rule.

9. Conditions for the application of the provision on publicly listed entities

We have no detailed specific comments on Issue 9 at this stage other than that, in practice, there may be circumstances in which it may be more appropriate for this issue to be resolved under the LOB discretionary relief provision.

10. Clarification of the 'active business' provision

We welcome the suggestion that clarifications should be made to the above provision and related commentary given that the OECD acknowledges ‘the paragraph will provide treaty benefits in a large number of situations where benefits would otherwise be denied under Paragraph 1 because the entity is not a ‘qualified person' under Paragraph 2’. The specific wording and interpretation of this provision and related Commentary will therefore be significant given the OECD’s expectation that it will apply to a wide number of situations.

In terms of headquarters operations, the Commentary currently makes the assumption that such operations concern only the managing of investments. However, many headquarters operations will provide important support functions to their subsidiaries such as treasury management and funding, legal services, company secretarial, seconded staff and human resources. They will have a large number of local employees involved in the provision of these services who will be permanently based in local business premises.

Typically, subsidiaries will be charged an arm’s length fee for the provision of such services the centralisation of which in the headquarters company will often mean significant economies of scale are achieved for the group as a whole and without having to involve external service providers in the subsidiaries' territories of residence.

There may also be headquarters companies or group treasury companies which are heavily involved in providing finance to group companies. The benefit of this activity is that it helps to ensure the group’s funds are managed efficiently and short-term working capital and longer term loans, eg to make strategic acquisitions or expand foreign business premises can be provided without resorting to more expensive third party finance.

In some instances, while not specifically regulated by an independent financial authority, such companies are structured in the same way as third party banks with a 'regulatory' capital plus a commercial buffer to absorb the impact of potential non-performing loans. They will often make a very substantial number of loans (many hundreds or even thousands in some cases) on commercial terms and receive significant amounts of cash on deposit from a large number of different group companies. Such companies will have a number of employees who are highly-skilled in treasury management.

In practice, tax authorities including HMRC in the UK are often known to treat such entities in the same way as third party banks carrying on an active business of lending and/or deposit-taking.
We therefore consider that headquarters companies providing significant support services to their subsidiaries as well as being engaged in holding investments or group treasury companies (of non-financial services groups) with substantial operations should be regarded as carrying on an active business for the purposes of Paragraph 3.

Regarding activities that should be considered complementary, we note that the Commentary appears to discriminate against certain industry sectors such as funds and private equity which typically invest in a diverse range of businesses to spread commercial risk and maximise returns to their investors which will include, indirectly, pension funds (where the equivalent beneficiary rule may not apply due to the existence of intermediate entities).

These industry sectors often perform a significant role in supporting new and expanding businesses and in transforming existing businesses which are not performing as expected. It is therefore important that the Commentary addresses this point so that such businesses are not excluded.

Please also refer to our comments on issue 19 below.

**B. Issues related to the PPT rule**

11. Application of the PPT rule where benefits are obtained under different treaties

The suggestion is noted that the PPT rule itself should be reworded as opposed to this point merely being dealt with as part of the revised draft Commentary. In particular, the revised draft Commentary currently states that where an arrangement has been entered into for the principal purpose of obtaining benefits under a number of different treaties, it should not be considered that obtaining a benefit under one specific treaty was not one of the principal purposes of that arrangement. It also states that, similarly, purposes related to the avoidance of domestic law should not be used to argue that obtaining a treaty benefit was merely accessory to such purposes.

We do not believe that it is necessary to amend the wording of the rule itself as this could result in a lack of clarity as to when it should and should not apply. For example, it may not then be possible to distinguish situations which the revised draft Commentary say are not caught by the rule such as those set in Examples C and D.

Additionally, we do not consider that it would be equitable for the proposed rule to apply to certain well-established structures where e.g. the UK or Luxembourg (as is common in the private equity sector) is used as a holding location for European subsidiaries with an ultimate parent outside the EU. In this situation, the holding company often acts as a regional hub where key management and administrative functions are located. However, there will be incidental benefits arising from the existence of the holding company such as access to the EU Parent/Subsidiary Directive and/ or lower dividend withholding tax rates under treaties. We would be grateful if the draft Commentary could be amended to clarify this.

12. Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level

We agree with this proposal given that the application of the PPT could potentially have serious economic and political consequences for the relevant Contracting States. In particular, if the PPT rule is applied too widely, there is scope for certain financial markets and industry sectors such as the pensions industry and private equity to be destabilised which would appear to counter the overriding objective of the OECD to promote 'policies that will improve the economic and social well-being of people around the world'.
13. Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable

It would be sensible to include the application of the PPT in the matters which fall within the ambit of the arbitration provision above as this reflects the view of the majority of OECD member countries. This approach would also be consistent with the mechanics of the proposed LOB discretionary relief provision which involves consideration of the principal purposes of a resident of a Contracting State (please also see comments on 14 below).

The potential exclusion of the PPT from the arbitration mechanism should be merely optional and apply only where both Contracting States agree it is necessary.

14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purpose test

For the sake of clarity, consistency and certainty of treatment – and also to mitigate the potential administrative burden placed on tax authorities - we believe it is necessary to align the parts of the Commentary on the PPT rule and the LOB discretionary relief provision that relate to the principal purposes test. Indeed, this point highlights the potential duplication that exists within these two provisions and one option would be to define the concept of ‘principal purposes’ under the LOB discretionary relief provision by reference to the concept of ‘principal purposes’ in the PPT rule and the related Commentary.

It is likely there will be a large number of cases that potentially fall within the LOB discretionary relief provision and hence would need to be considered by the competent authority of the relevant Contracting State. There is therefore a concern that this could lead to a backlog of cases to be reviewed and associated risk of such cases not being considered fully due workload constraints of the relevant competent authority.

Therefore, it may be helpful to tax authorities if the Commentary on the LOB discretionary relief article could cross-refer to the Examples in the PPT Commentary of cases where relief may or may not be appropriate and to include further examples of situations where a competent authority might be encouraged to grant relief. Similarly, while we acknowledge that relief under Paragraph 5 of the LOB article is intended to be at the discretion of the relevant tax authority, without further clarification, there is considerable scope for the article to be applied inconsistently by different OECD member countries to the same structure which in itself could lead to treaty-shopping issues.

It would also be sensible if competent authorities requested to consider the application of the LOB discretionary relief provision could be encouraged to consider simultaneously the application of the PPT rule as taxpayers potentially affected would be likely to need comfort regarding their position under both provisions.

15. Whether some form of discretionary relief should be provided under the PPT rule

We agree with the suggestion that income and gains which a taxpayer has sought to re-characterise using an arrangement for avoidance purposes should in principle be able to benefit from the relevant treaty provisions that would have applied in the absence of the arrangement. Other examples here might include interest re-characterised as a dividend and vice versa.

Indeed, such relief may be a legitimate expectation of many taxpayers and therefore should not be on a purely discretionary basis. In particular, denying treaty relief completely in this situation or making it available only at the discretion of a competent authority would go beyond a ‘principal purposes’ approach and would effectively constitute the imposition of a ‘penalties-based’ regime since taxpayers would be put in a worse position than had they not contemplated specific tax planning.

The example given at page 12 of 'transforming what would normally be cross-border dividends... into a capital gain on shares' also raises significant concerns. This would potentially encompass share buy-back transactions used by many listed companies to repatriate funds to their shareholders.
Such transactions are commonly used in the market place for legitimate commercial reasons and are often reflected in the rights attaching shares which may be the subject of a public offer and are then publicly traded. Therefore, denying relief in this situation or making it discretionary could considerably distort financial markets and have a negative impact for investors as it could affect share prices in many listed entities. Confirmation that such transactions should be outside the scope of the PPT rule would hence be welcome.

16. **Drafting of the alternative 'conduit-PPT rule'**

We agree that the 'all or substantially all' threshold is too high and that the reference to a payment made 'directly or indirectly' and 'at any time' is too broad. For example, the application of the anti-conduit rule may be inappropriate where the intermediate company is not dependent on a particular source of income to meet interest payment obligations to its parent because the intermediate company has income derived from a number of different sources such as shares in subsidiaries, local trading operations and interest income from group companies.

In terms of further examples or guidance that may be appropriate to include in the Commentary, we believe that consideration should be given to the OECD’s own recent work on the concept of beneficial ownership found in the latest Commentary on the OECD Model Tax Convention (Articles 10, 11 and 12). We also note that in the UK the tax authorities (HMRC) have published guidance in their International Manual at Paragraph 332060 onwards on similar issues stemming from recent tax case law (Indofood International Finance Ltd v JP Morgan Chase Bank NA, [2006] STC 1195) concerning beneficial ownership. This guidance includes a number of examples which could be adapted for the purposes of the conduit PPT rule. A notable example refers the interposition of an intermediate lender which would not improve the withholding tax position of interest paid by the UK borrower, when compared to the withholding tax that would arise if that intermediate lender was not interposed.

17. **List of examples in the Commentary on the PPT rule**

We agree the examples could be better drafted and that further examples are needed to aid understanding of situations in which the PPT rule should or should not apply. Several such examples are mentioned previously in our comments on issues 11, 15 and 16 above.

18. **C. Other issues**

18. **Application of the new treaty tie-breaker rule**

It is noted that the Public Discussion Draft does not specifically invite comments on this particular issue. However, we assume that the OECD will still consider comments on the latest proposals in respect of this provision.

We agree it is important that the fact a person would not be entitled to relief and exemptions under the Convention (where agreements of a single State of residence is not reached) does not prevent that person from being considered a resident of each Contracting State for the purposes of other provisions of the Convention. However, it is not clear how residence would then be defined in this situation, e.g., for the purposes of Article 15(2)(b) where the residence of the employer is disputed by the Contracting States. It would be helpful if the OECD could propose how this matter should be dealt with. In particular, this point could lead to significant issues for employees who themselves are unlikely to be party, e.g., to the type of tax planning arrangements at which the new rule is aimed, i.e., arrangements entered into by their employer associated with claiming dual company tax residence.

It is essential that competent authorities are encouraged to address as quickly as possible requests for determination of a single state of residence under the new rule. The timescale for dealing with such a request should be limited to one month from the date of the request first being made. It may also be helpful to have States agree on a pro forma request application form setting out precisely the information required by the contracting states to arrive at a decision. There should also be an appeal process for more difficult cases, again subject to prescribed timescales.
We note in the Deliverable of 16 September 2014 that the OECD acknowledges some States believe a treaty tie-breaker rule based on the place of effective management is not open to widespread abuse. Therefore, the OECD concluded that States which shared this view and agreed on how the concept of place of effective management should be interpreted are free to include a tie-breaker rule based on this concept. It would be helpful if the OECD could confirm that it continues to support this approach in the case of such States.

19. The design and drafting of the rule applicable to permanent establishments in third states

The proposals to limit the anti-abuse rule to cases where the profits of the PE are exempt in the State of the enterprise to which the PE belongs appear proportionate and the exceptions to this rule seem appropriate for arrangements that are not tax motivated.

However, further clarification is necessary as to what is meant in this context by ‘the active conduct of a business through the permanent establishment’. The proposed LOB provisions and related draft Commentary use a similar concept and it would be helpful to understand to what extent this could also be applied in the context of the proposed anti-abuse rule relating to permanent establishments in third states.

It is also unclear precisely how the 60% tax threshold in the first-mentioned State would be calculated. For example, a more equitable result may be achieved through applying this threshold before the allocation of attributable expenses and ignoring loss relief.

20. Proposed commentary on the interaction between tax treaties and domestic anti-abuse rules

We agree that most of the proposed changes seem appropriate. However, there are concerns that the revised draft commentary does not address situations where, eg one Contracting State may seek to assert its taxing rights in an aggressive way not envisaged by the original treaty negotiations with the other Contracting State by introducing new domestic ‘anti-abuse’ laws.

The position in the revised draft Commentary does not provide much support to the other Contracting State which would have originally entered into the Convention in good faith before the relevant anti-avoidance rules in the other Contracting State were introduced. In this respect, the negotiation of a double tax treaty by the Contracting States is often finely balanced in terms of the allocation of taxing rights represented by the terms of the Convention which are ultimately agreed.

There may be circumstances in which the introduction of domestic anti-abuse provisions could upset that balance in a way which is not acceptable to the other Contracting State and which could prove a significant barrier to business. In a worst-case scenario, such rules could have the effect of the first Contracting State disadvantaging enterprises of the other Contracting State competing in the same markets as domestic enterprises, in a way which might be construed as circumventing the non-discrimination article of the Convention.

Additionally, it is possible that the option of introducing retaliatory measures may not be palatable to the other Contracting State for economic or political reasons. Therefore, it may be necessary for the Commentary to address the situation where the application of domestic anti-avoidance rules is not accepted by the other Contracting State, eg by making provision for suitable forms of arbitration.

The view expressed in the draft revised Commentary that domestic anti-abuse rules are not prevented by the Vienna Convention may be seen by some parties as problematic. It may make the position more robust if the revised Commentary is redrafted with a greater focus on the words of the Vienna Convention, specifically Article 31 of the latter dealing with the interpretation of treaties as this may make it easier for OECD member countries to apply the principles set out in the revised draft Commentary. At the same time, this would also give protection to Contracting States which do not agree that domestic anti-abuse rules of another Contracting State should take precedence.
Conclusions

We remain concerned by the breadth of the proposals which are likely to have a serious impact on businesses and capital markets worldwide. For this reason, we suggest that the proposed LOB article is removed since the targeted general anti-avoidance provision should provide sufficient protection from treaty abuse.

We appreciate the opportunity to contribute our comments. If you would like to discuss any of these points in more detail then please contact Martin Lambert, Partner for Grant Thornton LLP at martin.lambert@uk.gt.com.

Yours sincerely

Francesca Lagerberg
Global head - tax services
francesca.lagerberg@gti.gt.com
By email

Dear Ms De Ruiter

Representations of Herbert Smith Freehills to the OECD in response to Public Discussion Draft

**FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE**

Herbert Smith Freehills is a leading global law firm with over 2,000 lawyers, including 450 partners, in 24 offices worldwide.

Herbert Smith and Freehills announced their merger on 28 June 2012, after a resounding vote in favour by both partnerships. The merged firm was launched on 1 October 2012, combining Freehills’ leading position in Australasia with Herbert Smith’s strengths in Asia, Europe, the Middle East and the UK.

We are the largest fully integrated law firm in Asia Pacific and is one of the world’s top ranked and most experienced energy and resources firms; a globally pre-eminent and recognised firm in litigation, arbitration and contentious regulatory work; and an international leader in M&A, private equity, capital markets, infrastructure and banking and finance.

Our work frequently involves advice on, and disputes related to, tax treaties.

This note is to set out our representations on the Public Discussion Draft, **FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE (21 November 2014 – January 2015), "the November 2014 Public Discussion Document"**, which are as follows.
We should also like to send a representative to the meeting in Paris on 22 January, mentioned on page 3 of the November 2014 Public Discussion Document.

I Anti-abuse Rule and Limitation on Benefit provisions (Article X of the OECD Model Convention, paragraphs 18-22, 31-33 and 35 – 37)

Aligning the limitation on benefit rule, the principal purposes rule and the alternative anti-conduit rule

1. Representations have been invited on certain specific aspects such as:
   - Article X(4) of the OECD Model Convention,
   - the inconsistency between the "competent authority override" on the Limitation on Benefit provision (Article X(5)) and the anti-abuse rule in Article X(7) ("the PPT rule"),
   - the excessive scope of the principal purpose rule (Article X 7 in the OECD Model), and
   - the optional conduit arrangements rule (paragraph 15 of the modified Commentary on Article X(7) of the Model Convention).

2. We consider that it is unhelpful to deal with these issues piecemeal. In our view, anti-abuse arrangements should be:
   - Effective
   - Fair to taxpayers and
   - So far as consistent with those two objectives, easy for tax authorities to operate.

3. We do not consider that Article X meets the objectives identified in paragraph 2 above to any substantial degree, or that the Commentary remedies the shortcomings of the drafting.

In greater detail:

4. The Model and Commentary as now proposed do not address in any consistent and clear fashion the critical matter of the link between:
   4.1 the **purpose** of the arrangement or the taxpayer, on the one hand, and
   4.2 the **denial/allowance of treaty benefits** on the other.

   There are in the OECD material three different formulations of this link, as follows:
<table>
<thead>
<tr>
<th>Identifying letter</th>
<th>Provision in Model Treaty</th>
<th>Paragraph in Commentary on Article X</th>
<th>Subject-matter</th>
<th>Link between &quot;purpose&quot; and denial/allowance of treaty benefits</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formulation A</td>
<td>X(5)</td>
<td>[Paragraphs 1 to 6] 62 - 68</td>
<td>&quot;Competent authority override&quot; (whereby a recipient of income may obtain the benefit of the treaty, even though he is not a &quot;qualified person&quot;, following an appropriate determination by the competent authority in the state of source)</td>
<td>Determination that the establishment, acquisition or maintenance of the recipient of the income did not have as its main purpose or one of its main purposes the obtaining of benefits under the treaty</td>
<td>The test is purely factual – what were the actual purposes of the transactions? (It is assumed (as would be the case in most common law jurisdictions) that the competent authority will be required to behave rationally, and to bear in mind all relevant principles of law and relevant facts)</td>
</tr>
</tbody>
</table>
The lack of consistency between formulations A and C (and need for "alignment") is acknowledged in the November 2014 Public Discussion Document, paragraph 34, where it is explained that the lack of consistency is accidental, although no comment is made about the lack of consistency between formulation B, on the one hand and formulations A and C on the other. We strongly agree...
with the need (identified in the November 2014 Public Discussion Document at paragraph 34) to remove the inconsistencies. We also emphasise that Article X(1) – (7) have the effect of taking away from the recipient of the income a right, negotiated between the contracting states, to a reduced (or nil) rate of source state tax, which that recipient would otherwise enjoy, and the Article is, in that sense, expropriatory. It is accepted in most legal systems that expropriatory rules must be clear and unambiguous (to enable those affected by the rules to regulate their conduct appropriately) and the inconsistencies between Formulation A, Formulation B and Formulation C mean that these criteria are not satisfied by the current drafting. In our view, the best way of rectifying the inconsistencies would be to abolish the LOB rule (Article X(1) – (6)) altogether. It appears to be impossible to identify any type of treaty abuse which is caught by the LOB rule that is not also caught by the PPT rule (and consequently if a treaty incorporates both the LOB rule and the PPT rule, the LOB rule is otiose).

5. However, it must be recognised that some OECD member countries have adopted a policy of inserting LOB rules into their treaties, that such countries may be reluctant to change that policy and so for purely pragmatic reasons the LOB rule will have to be retained in the model treaty. Given the absence of any principled basis for including an LOB rule as well as a PPT rule in a treaty, we suggest that, for the guidance of treaty negotiators, the Commentary should contain a more balanced discussion of the (limited) results that can be achieved by an LOB rule (as compared with a PPT rule) and the relative merits of the LOB rule and the PPT rule (e.g. the LOB rule is not apt to deal with conduit arrangements whereas the PPT rule is, and the LOB rule can be very easily side-stepped, e.g. by obtaining a stock exchange quotation).

6. The OECD accepts that if a treaty contains an LOB rule (Article X(1) – (6)) and a general PPT rule (Article X(7)), the rules in Article X(5) and X (7) should be aligned, and, logically so should the alternative conduit PPT rule (Commentary, paragraph 15). The question which arises is which of the three formulations outlined at 4.above should be adopted for the three rules. Considerations of fairness strongly support formulation B because it is based on actual facts (or possibly formulation A, for similar reasons). Formulation C, by contrast, addresses not the actual facts about purpose but what an observer might think that the purposes are. This is capable of giving rise to anomalies and unfairness, e.g. the taxpayer does not intend to abuse the treaty (he may have been unaware of it when he
made the arrangements) but treaty benefits will nevertheless be withheld: equally, a taxpayer may be determined to abuse the treaty but the arrangements made do not present an abusive appearance (to the hypothetical observer) in which case the benefits must be granted. At the very least, we suggest that, to facilitate understanding by tax authorities and confer adequate protection on taxpayers:

6.1 the "reasonable to conclude" concept in Article X(7) is clarified (desirably in the Model treaty1) to confirm that the conclusion is one which would be drawn by a hypothetical observer independent of any relevant tax authority; and

6.2 it should be expressly provided that the hypothetical observer mentioned in 6.1 above should be assumed to have complete and accurate knowledge, not only about the relevant tax rules, but also of relevant commercial law and practice, so as to be able to reach an informed conclusion about purpose (i.e. the hypothetical observer's conclusion should not be a superficial, snap judgment based on outward appearances), to reduce the risk of withholding of treaty benefits in inappropriate circumstances. (It is difficult to make an accurate judgment about which of a number of purposes, including commercial purposes, are the main purposes without a knowledge of relevant commercial practice and commercial law).

7. Incidentally, we consider it most unfortunate that the Commentary refers to Article X(5) as "discretionary relief", because this phrase seems to suggest, contrary to the wording of Article X(5) and minimum standards of administrative fairness, that the tax authority has an untrammelled choice whether or not to apply Article X(5). Taxation at the choice of the executive branch of government (the taxing authority) is contrary to the constitutional principles of most common law countries.

8 We therefore strongly support the conclusion in the November 2014 Public Discussion Document, that the link between purpose and withdrawal of treaty benefits should be standardised across all the relevant provisions of the OECD Model, i.e. Article X(5), Article X(7) and the alternative conduit-PPT rule, and that that link should be the one that combines effectiveness with transparency, fairness and

1 Less desirably, in the Commentary.
the support of a uniform interpretation. **The first formulation, that the relevant arrangement "has as one of its purposes the obtaining" of treaty benefits, satisfies these criteria and should be adopted.**

9. We also note the proposal in paragraph 32 of the November 2014 Public Discussion Document that the Commentary should contain a suggestion that countries consider establishing a form of administrative process for approving the application of the PPT rule, such process being similar to similar to "approval by a committee composed of senior officials...in some cases...including academics and/or tax experts from the private sector."

This suggestion is valuable, but does not in our view go far enough: the application of the PPT rule should not depend on the decision of officials only but, to supply the expertise of commercial matters which is essential to the proper application of the PPT rule in its present form, private sector persons and possibly academics should be involved as well.

**Examples of application of the principal purpose rule**

10. Suggestions for additional examples (the current examples are in paragraphs 8 and 14 of the Commentary on Article X(7)) are invited in paragraph 17 of the November 2014 Public Discussion Document. We agree with the OECD's statement that "the justification for the result in some of these articles could be better articulated" but consider it to be an understatement. The explanatory value of the current examples is reduced – if present at all – by:

10.1 the failure to link the suggested result to the wording of the rule; and

10.2 the tendentious, anodyne and in some cases non-existent description of the commercial "drivers" of the arrangements made (see the example in in paragraph 8 of the Commentary and Examples A to E in paragraph 14).

In particular, in only one example (Example D) is there consideration of the effect of a commercial purpose **that causes an arrangement giving rise to a treaty benefit to be put in place.** To illustrate, a further possible example is set out below:
The S Group comprises a number of companies operating in different countries. It is having cash flow problems. One of the subsidiaries, SCo resident in state S, is in such a bad way that it can no longer borrow, which it needs to do to keep its business going. Another group company, TCo, resident in State T, is financially embarrassed but can still borrow from the bank. State S charges a 20% withholding on interest, which is reduced under the state R/state S treaty to nil, but state S has no treaty with state T. State R charges no withholding on interest. The commercial proposal is that TCo borrows from the bank and lends to RCo, which in turn on-lends to SCo, so restoring SCo's viability.

It is suggested that the TCo/RCo/SCo arrangements have a sole principal purpose of maintaining the S group's viability, and no principal purpose of taking advantage of the state R/state S treaty. The treaty benefits are an aspect, and an important aspect, but not a principal purpose, of the arrangements.

Those responsible for the preparation of the Commentary may find it helpful to the decision of the UK House of Lords in Brebner v IRC, [1967] 2 AC 18 (a copy of the report of the decision accompanies these representations, in case you wish to refer to it). This is a decision about a UK anti-avoidance provision (section 28 of the Finance Act 1960), which contained an exception for cases where the relevant transaction "did not have as one of its main objects the obtaining of a tax advantage". In that case the taxpayers were some of the shareholders in the Aberdeen Coal and Shipping Company Limited. In order to prevent the company being taken over, the taxpayers decided to buy the shares in the company owned by the other shareholders others, and entered into a contrived transaction (described at [1967] 2 AC 21 at letter C) to finance the purchase. The tax tribunal concluded as a matter of fact that the transactions entered into by the taxpayers did not have the obtaining of tax advantages as a main object and fell within the exception. On appeal, the House of Lords considered that that the tribunal's conclusion was sound in law. There can have been little doubt that if the taxpayers had entered into the same contrived transactions to finance the purchase of a luxury item, such as a yacht, the exception would not have applied: it was the taxpayers' ultimate purpose that was important. Similarly, in the example just given, the ultimate purpose of the transactions is to secure the S group's financial viability and so the PPT rule should not apply.
If you would like to discuss any of the above please do not hesitate to contact me at these offices.

Yours sincerely

Heather Gething
Partner
Herbert Smith Freehills LLP
January 9, 2015

Ms. Marlies de Ruiter  
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division  
Centre for Tax Policy and Administration (CTPA)  
Organization for Economic Co-operation and Development (OECD)  
By email: taxtreaties@oecd.org

Re: Consultation Response to BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Dear Ms. De Ruiter,

The Taxes Committee of the International Bar Association (IBA) would like to take this opportunity to respond to the Discussion Draft on Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, of the BEPS Action Plan.

The International Bar Association (IBA), the global voice of the legal profession, includes over 45,000 of the world’s top lawyers and 197 Bar Associations and Law Societies worldwide. The IBA is registered with OECD with number 1037 55828722666-53.

We are submitting our comments on behalf of the IBA Taxes Committee, comprised of 1037 members from around the world. The IBA Taxes Committee formed a Working Group to respond to this Consultation. The Working Group includes:

- Claire Kennedy, Bennett Jones, Canada;  
- Joanne Dunne and Elissa Romanin, Minter Ellison, Australia;  
- Francesco Capitta, Macchi di Celliere Gangemi, Italy;  
- Leandro M. Passarella, Passarella Abogados, Argentina;  
- Peter Maher, A&L Goodbody, Ireland;  
- Mark van Carstensen, Loyens & Loeff, Netherlands;  
- Stuart Chessman, Vivendi, U.S.A.;  
- Shefali Goradia, BMR & Associates, India; and  
- Ricardo Leon, Sánchez Devanny, Mexico.

The comments made in this report are the personal opinions of the Working Group participants (the “Working Group”) and should not be taken as representing the views of their firms, employers or any other person or body of persons, including the IBA as a whole, apart from the IBA Taxes Committee of which they are a member. All references to the IBA Taxes Committee, or “we” or “our” should be understood to be references to the Working Group and its participants.

Sincerely yours,

/s/ Simon Yates  
Co-Chair of the Working Group  
IBA Taxes Committee  
United Kingdom

/s/ Ricardo León  
Co-Chair of the Working Group  
IBA Taxes Committee  
Mexico
1. This is a submission in relation to certain of the issues upon which comments were invited in the paper issued on 21 November 2014 entitled 'Follow Up Work on BEPS Action 6: Preventing Treaty Abuse'.

2. Our comments are succinct in nature and relate only to selected issues because the limited timeframe given for the response coincided with yearend work commitments and the holiday season for members. We would be happy to supplement any aspect by submission in person, or by further written submissions if that would be helpful. We would welcome any such opportunity.

A. Issues related to the LOB provision

1. Collective investment vehicles ('CIV'): application of Limitation of Benefit ('LOB') and treaty entitlement.

Comments are invited as to whether the recommendations of the 2010 CIV Report continue to be adequate for widely-held CIVs and whether any improvements should be made to the conclusions included in that Report. Comments are invited, for example, on whether it would be advisable to provide a preferred approach with respect to the issues related to the tax treaty entitlement of the income of CIVs and the application of the LOB to CIVs, and if yes, on what that approach should be.

1.1. We consider that the recommendations of the 2010 CIV Report continue to be adequate for widely held CIVs.

1.2. A CIV, as referred to in the 2010 report, typically is "widely held, holds a diversified portfolio and is subject to investor protection regulation in its country of establishment". Many of the challenges faced by CIVs in obtaining treaty relief were articulated in the 2010 Report. The BEPS initiative was prompted largely by the taxation of the digital economy and the evidence of treaty abuse on any significant scale by CIVs is far from apparent. Such entities are not typically established in order to obtain the benefit of treaties; as outlined, they typically are widely held entities, subject to regulation in their country of establishment and, more often than not, are established so as to pass on to investors the benefits and economies of scale inherent in collective investment.

1.3. To the extent that LOB provisions are adopted as the principal mechanism for combatting treaty abuse, we consider that CIVs should expressly be stated to be a "qualified person" without further qualification. Applying an LOB style ownership test to CIVs (1) is likely to impose additional administrative burdens on CIVs over and above those that already apply; (2) hinder the continued development of cross-border international funds (e.g. UCITS); (3) discriminate against some of the leading international fund jurisdictions (e.g. Ireland and Luxembourg in Europe) because of difficulties in demonstrating ownership of the CIV only by residents of the two contracting states, and (4) in an EU context, potentially creates Treaty of Rome issues by limiting "good" ownership for LOB purposes to residents of the two contracting states.
1.4. Moreover, we believe that the “qualified person” classification should include holding entities through which the investments of CIVs are made provided that such holding entities are controlled by CIVs.

2. Non-CIV funds: application of the LOB and treaty entitlement

Comments are invited as to whether the preceding paragraphs accurately describe the treaty entitlement issues of sovereign wealth funds, pension funds and alternative funds / private equity funds. Comments are also invited as to how to address these issues without creating opportunities for treaty shopping.

Sovereign wealth funds

2.1 The tax treaty entitlement for special purpose vehicles established by sovereign wealth funds in jurisdictions other than their home jurisdiction may be governed by the ‘derivative benefits’ test. In other words, such special purpose vehicles should be entitled to tax treaty relief only to the extent provided by the tax treaty between the sovereign wealth fund’s home jurisdiction and the source jurisdiction.

Pension funds

Whether and how the issue of the treaty residence of pension funds should be addressed:

2.2.1 The issue of treaty residence of pension funds needs to be addressed by specifically considering pension funds to be ‘qualified persons’ and, for the purposes of Article 4, by considering them to be tax resident in jurisdiction in which they are set up and regulated.

2.2.2 Pension funds are predominantly constituted for the benefit of citizens of the jurisdiction in which they are established and, therefore, should be entitled to access the provisions of the applicable tax treaty. Admittedly, in addition to resident individuals, beneficiaries of pension funds may include (a) foreigners who contribute to the pension funds by virtue of their deputation / secondment to a particular jurisdiction, (b) individuals who may have migrated from the home jurisdiction on account of deputation / secondment to another country but continue contributing to pension funds in their home country and (c) beneficiaries of the pension fund who have retired and migrated to other countries. However, this should not disentitle pension funds from accessing the applicable tax treaty, since (a) they are not set up for tax avoidance purposes or with an objective to obtain treaty benefits, (b) a substantial part of a pension fund’s income provides retirement benefits for resident population, and (c) distributions from the pension funds do not retain the character of the underlying income that the pension fund receives.

2.2.3 The taxability of retirement benefits by the individual beneficiaries will be governed by the tax laws in the home country and the recipient individual’s residential status. Contributions to pension funds would present very limited, if any, opportunities for individuals to abuse tax treaty provisions. Thus, a look through approach should not be adopted for
pension funds and no threshold tests (in terms of percentage beneficiaries who are locally resident in home jurisdiction) should be included.

2.2.4 For jurisdictions whose pension funds earmark contributions received from individuals and implement investments through dedicated accounts for each individual beneficiary, a separate approach to be agreed to bilaterally between the two treaty partners may be considered by applying a look through approach.

(ii) Whether drafting changes should be made to the alternative provision included in paragraph 69 of the Commentary on Article 18 (e.g. restricting its application to portfolio investment income).

2.3 As an alternative to paragraph, 69 of the Commentary to Article 18 current wording contracting states could bilaterally agree that the exemption to foreign pension funds will be restricted to income arising from portfolio investments.

(iii) How the 50% ownership test applicable to pension funds could be modified in order to address cases where it may produce inappropriate results (e.g. in the case of the individual retirement fund of a pensioner who moves abroad) without creating opportunities for treaty shopping.

2.4 As discussed above, in the context of pension funds that do not segregate investments per individual beneficiary, no threshold on home jurisdiction ownership should be included. The inclusion of a 50 percent ownership test may be presented as an alternative that contracting states may agree bilaterally, considering typical structure or practice of pension funds in their jurisdictions.

Alternative funds / private equity funds

2.5 We generally agree with the description of the treaty entitlement issues of alternative funds / private equity funds under paragraphs 15, 16 and 17 of the Discussion Draft subject to the following specifications.

2.6 As a first remark, if alternative funds / private equity funds meet the conditions to be defined as CIVs (“funds that are widely held, hold a diversified portfolio and are subject to investor-protection regulation in the country in which they are established”), then they should be granted the same treatment reserved to CIVs (see paragraph 1. of this document) and therefore treated as a “qualified person” for LOB purposes (including holding entities controlled by such funds).

2.7 If an alternative fund / private equity fund does not qualify as a CIV (e.g. due to a limited number of investors, say less than 10, or because neither the fund nor the fund manager are regulated), our preferred approach is to treat the fund as a “qualified person” provided that at a certain date (i) it is owned for at least 50% by investors that would be entitled to treaty benefits had they directly invested in the source country (“equivalent
beneficiary” concept) and (ii) at least 50% of the fund profits are paid or accrued to such investors. Such approach - based on the assumption that a minimum 50% ownership by equivalent beneficiaries grants adequate protection from treaty shopping - would allow to avoid double taxation for investors and to maintain the application of the LOB relatively simple.

2.8 As an alternative (non-preferable) approach, the fund could be regarded as a “qualified person” for LOB purposes only in relation to the income that is preferable to investors that would be entitled to treaty benefits had they invested directly. Such approach would eventually determine the application of a distinguished tax treatment to a certain flow of income from the source country to the fund depending on the portions attributable to the investors, thus determining additional compliance and complexity. For example, if a dividend of 100 is distributed from a company resident in the source country, it will be necessary to identify which part of such dividend shall then be paid to investors who would be entitled to treaty benefits had they invested directly and which part shall be paid to investors who would not be entitled to treaty benefits. Issues may arise in relation to the type of documentation that the withholding agents should require in order to correctly apply treaty provisions.

3. Commentary on the discretionary relief provision of the LOB rule.

3.1 In our comments to the Discussion Draft on Action 6 of March 2014, we indicated our concern that the introduction of concepts such as a limitation of benefits provision (LOB provision) and general anti-abuse provisions, which are relatively unknown in many countries, will in itself create much uncertainty. With respect to the LOB provision, our main concerns were that the LOB provision is not a mechanical test, with a predictable outcome and that absent a derivative benefits test, the group of persons/entities potentially qualifying for the benefits of a treaty is too limited. The working of the discretionary relief provision of the proposed LOB is particularly unpredictable and unclear.

3.2 The discretionary relief provision provides the possibility to request the competent authority to grant treaty benefits in a specific situation, where the resident of the contracting state would otherwise be denied treaty benefits under the LOB provision. As described in the proposed paragraph 63 of the Commentary to the Convention, to obtain discretionary relief, it must be demonstrated to the competent authority that there were clear reasons, unrelated to obtaining treaty benefits, for its formation, acquisition, or maintenance and that any reasons related to obtaining treaty benefits were clearly secondary to those unrelated reasons. We are concerned that countries will not be inclined to easily accept the existence of such ‘clear reasons’. Or that any reasons to the obtaining of treaty benefits were ‘clearly secondary’ to those ‘clear reasons’. On top of that, paragraph 19 of the Discussion Draft states that the proposed paragraph 63 of the Commentary on the LOB rules should be adjusted to clarify that, in the case of a resident subsidiary company with a parent in a third state, whilst the fact that
3.3. A simple example to clarify.

- Country S levies 20% withholding tax on dividend payments under its domestic law.
- Country S has a treaty with Country R, which allows S to levy 10% withholding tax on dividend payments to qualifying residents of R.
- Country S also has a treaty with Country P, which allows S to levy 10% withholding tax on dividend payments to qualifying residents of P.
- If an entity, resident in S distributes a dividend to a resident of R, which is held by an entity resident in P, it is clear that R has not been interposed in order to abuse the S-R treaty, because without R in the structure, S would be entitled to the same withholding rate under the S-P treaty. If a country of source may withhold tax upon a payment made to an entity that is resident in turn the fact that a treaty does not result in a lower rate of withholding than the rate that would have applied for payments made to the parent of the specific entity.

3.4. In our view, the Commentary should clearly provide that in such a case discretionary relief be granted without the necessity of demonstrating ‘clear reasons, unrelated to the obtaining of treaty benefits, for its formation, acquisition, or maintenance’. This will make it clear that discretionary relief will be available in such a situation, without any of the uncertainties caused by the interpretation of terms such as ‘clear reasons’ and ‘clearly secondary’. In addition, we suggest adding to the discretionary relief provision, the possibility to apply the withholding rate between the source state and the resident state of the parent company, if this is higher than the treaty rate between the state of source and the state of residence of the intermediary entity, but lower than the domestic rate of the state of source.

3.5. Another example to clarify.

- Country S levies 20% withholding tax on dividend payments under its domestic law.
- Country S has a treaty with Country R, which allows S to levy 10% withholding tax on dividends to qualifying residents of R.
- Country S also has a treaty with Country P, which allows S to levy 15% withholding tax on dividend payments to qualifying residents of P.
• If an entity, resident in S distributes a dividend to a resident of R, which is held by an entity resident in P, the discretionary relief provision should entitle S to levy withholding tax up to 15%. If so, it is clear that R has not been interposed in order to abuse the S-R treaty, because without R in the structure, S would be entitled to the same withholding rate under the S-P treaty.

3.6. A similar result could be obtained while applying the derivative benefits test if the derivative benefits test would be amended so that the derivative benefits test would not only provide that the source country taxation will be reduced in accordance with the treaty in case of an equivalent beneficiary, but also, ultimately, to the rate provided by the treaty between the country of the shareholder (not qualifying as an equivalent beneficiary) of the company and the source country, if this is higher than the rate provided for by the treaty between the country of residence of the company and the source country, but still lower than the source country’s domestic rate. We will discuss this, alternative approach below.

3.7. Another recommendation we would like to make, in order to make the application of the discretionary relief provision more practical and useable, would be to include a ‘grandfathering-application’. Based upon this provision, an entity could still claim the benefits of the treaty for at least one year if it qualified for the treaty benefits for an uninterrupted period of at least 3 years and stopped qualifying for the benefits of the treaty because of a change in the facts. As an example, this provision could be effective, if a publicly listed entity would qualify as a qualifying person for 3 years in a row and would in year 4, stop meeting the minimum trading requirements of its stock. As it is clear that such a structure was not implemented to abuse the treaty, it would be reasonable that the benefits of the treaty would still be available, at least for a certain time even though the conditions would no longer be met. Based on the grandfathering-application, we recommend the discretionary relief provision provide that an entity would still be entitled to the treaty benefits for at least one year, provided that it qualified for treaty benefits for a period of at least three years and stopped qualifying due to a change in the relevant facts, such as the minimum trading requirements of its listed stock or the size or nature of activities (for the application of the “active business” provision). Depending on the circumstances, the competent authority could still decide that discretionary relief would be available for a longer period, but the provision we recommend would make clear that in any case a grandfathering period would be applicable.

3.8. Finally, even if our suggestions as described above would be included, the fact that it is not possible to file an appeal against a negative decision and the fact that the states do not have the obligation to process a request within a certain period of time, may still make a request for discretionary relief a theoretical possibility. We therefore recommend adding rules on the formal process of requesting discretionary relief, including certain legal terms as well as the possibility to appeal a negative decision.
4. Issues related to the derivative benefits provision

4.1. As indicated in our comments to the Discussion Draft on Action 6 of March 2014, the Working Group is of the view that if an LOB provision will be implemented, it should include a derivative benefits clause, for two reasons. First of all, an LOB provision without a derivative benefits clause will violate the non-discrimination clause of article 24(5) of the Model Convention. Secondly, absent a derivative benefits provision, the group of persons that will be entitled to the treaty benefits will be too limited, while including a derivative benefits clause should not lead to treaty abuse.

4.2. The Working Group believes that the derivative benefits test as currently proposed is too limited. Specifically intermediately held entities will not be able to qualify for treaty benefits under the derivative benefits test as currently proposed. This, because of the requirement that in case of intermediate ownership of the company that claims the treaty benefits, “each intermediate owner is itself an equivalent beneficiary”. In practice, only a publicly listed company can qualify as an ‘equivalent beneficiary’. As a result, in practice, the derivative benefits test will not be applicable for intermediately held entities (regardless of whether the ultimate owner is publicly listed and regardless of whether the intermediate owners have been included in the structure for commercial reasons).

4.3. Therefore, we strongly recommend deleting the requirement that “in case of indirect ownership, each intermediate owner is itself an equivalent beneficiary”. This would be identical to the derivative benefits test as included in the LOB provision of most of the treaties of the US.

4.4. Finally, the Working Group suggests that the derivative benefits test should not only provide that the source country taxation will be reduced in accordance with the treaty in case of an equivalent beneficiary, but also, to the ultimate rate provided by the treaty between the country of the shareholder (not qualifying as an equivalent beneficiary) of the company and the source country, if this is higher than the rate provided for by the treaty between the country of residence of the company and the source country, but still lower than the source country’s domestic rate. Alternatively, this can be implemented in the discretionary relief provision, as further explained above.

B. Issues related to the PPT

1. Principal purposes test: Possible inconsistencies between the Commentary in relation to the LOB discretionary relief rule and the proposed Commentary on the PPT rule
General Comments: GAARs and other anti-avoidance rules

1.1. In relation to the LOB discretionary relief rule and the PPT, the Working Group considers that the combination of the LOB discretionary relief rule, the PPT rule and domestic GAAR provisions or specific anti-avoidance provisions with different tests of purpose (e.g. "dominant purpose" (Australia), "main purpose" (UK), "more than merely incidental purpose" (New Zealand)), will lead to complexity and confusion that is antithetical to the purpose of bilateral tax treaties.

1.2. The existence of a GAAR or other avoidance provisions is noted in paragraphs 6 and 13 of the September 16, 2014 paper 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances: Action: 6: 2014 Deliverable' as a factor suggesting that for all countries a combination of both a LOB and PPT in Treaties may not be required. We note that in paragraph 14 of the September 16, 2014 paper that a general statement could be adopted in Treaties instead, but this is stated as something to be accompanied by a LOB and/or PPT. It is suggested that at least one is needed – presumably a LOB is the more likely. In our submission, this point goes further. If there is a GAAR or other anti-avoidance provision at domestic law that can counter Treaty abuse, then we submit that there is potentially no need for either a LOB or a PPT; that is, both could be unnecessary and indeed undesirable if the result is material lack of certainty. In this regard, we emphasize that taxpayers need to be able to determine with reasonable certainty, in advance of an investment decision, what their treaty position will be. In our opinion, it is not adequate, especially in the modern context of extensive cross-border investment (which we note OECD member states actively encourage in many cases), to leave taxpayers to the remedy of Competent Authority negotiation that can take years to complete and in respect of which taxpayers have no direct input.

1.3. The Working Group considers if there is a GAAR or other anti-avoidance provision under domestic law and it applies a different test of purpose (i.e. not "one of the principal purposes"), then countries should be encouraged where possible for there to be consistency in the purpose test in its Treaty provisions (be it the discretionary relief provision in a LOB or a PPT) with the domestic provision at issue. Such consistency would only assist in promoting certainty and compliance with both the domestic tax system and the international regime.

2. Whether some form of discretionary relief should be provided under the PPT rule

2.1. The Working Group considers there are two options here. The first is to establish a discretionery relief provision similar to that provided in the LOB (taking into account our comments made to the LOB provision), and the other is to adapt the PPT so that it only applies to situations of Treaty abuse.

2.2. In our opinion, the latter is to be preferred. The PPT should be better tailored only to abusive situations. This is especially the case if it arises in conjunction with a LOB. The existence of Treaty abuse should be established before the PPT can apply, not just the...
If a LOB does not apply or if discretionary relief is granted under a LOB, there should be a presumption of no Treaty abuse, with the tax authority being required to establish abuse before a PPT could possibly apply. It is of concern that a competent authority could grant discretionary relief from the LOB, after application from a resident and the accompanying compliance costs associated with any such application, yet that resident could still be denied Treaty benefits under the PPT by the same competent authority, in relation to the same issue. The Working Group position is that a Treaty abuse threshold would ensure that the PPT targets abuse it is intended to target, not that covered already by a LOB and it would ensure that a PPT with a widely drafted purposes provision (such as "one of the principal purposes" as compared to a "dominant purpose" or "the main purpose"), is appropriately focused on the relevant mischief it is designed to counteract.

Abuse must also be viewed in light of a comprehensive analysis of the PPT and not a tax driven analysis as proposed under the examples provided. The use of conduit companies is not necessarily tax driven. Factors, such as the existence of Bilateral Investment Protections treaties, often outweigh tax treaties. This is particularly true upon investment into emerging markets where investors seek to safeguard their patrimonial investment before they seek efficiencies that can stem from the benefits of a tax treaty. When structuring an investment, businesses consider variables that affect the structure used to try to fend off variables such as fair and equitable treatment, protection from expropriation, freedom of transfer of interest, rule of law and political risk and others. Financial risk is also a key consideration, country credit risk and a new entity credit risk are also business drivers that affect a business' decision making analysis. Using legal mechanisms that allow that business to reduce or eliminate such variables must be given greater relevance over tax when assessing a PPT, failure to do so will surely result in abuse.

As a general comment, CIV and non-CIV fund structures are aimed at achieving tax neutrality, i.e., granting to investors the same tax treatment that would have applied had they directly invested - and are therefore not characterized by tax avoidance purposes. Consequently, the PPT rule should simply not apply in relation to CIV and non-CIV funds in light of the fact that investors would have benefitted from treaty benefits had they invested directly. In fact, in such cases there is no additional tax benefit deriving from a particular arrangement or transaction.
2.6. In addition to the above, the PPT rule may raise issue in relation to investments of CIV / non-CIV funds made through holding entities that could deny treaty benefits, thus determining double taxation (assuming that investors are taxed on fund profits in their country of residence).

Examples where discretionary relief should be granted

2.7. The following example can be made to illustrate that obtaining an undue treaty benefit is not one of the main purposes of the typical fund structures, bearing in mind (as noted) that the treaty benefit can never be considered undue if it would in any case be granted to investors had they invested directly.

2.8. Example 1:

• An investment fund established in State F sets up a subsidiary in State S that will act as holding entity for an investment in a target company resident of State T. The decision to incorporate a holding entity in State S depends on the following reasons: (i) certain investors would be obliged to additional compliance obligations in case of direct investment of the fund (implying massive reporting obligations to the fund managers in relation to each underlying investment) and therefore the holding entity serves as “blocker”, thus limiting compliance obligations in relation to such holding entity (that aggregates all underlying investments); (ii) the holding company may borrow money from a bank resident of State S, the loan normally being granted under the condition that the borrower is a resident of that state; (iii) specific corporate governance rules applicable in State S accommodate the needs for the investment.
Under the tax convention between State F and State T, the dividend withholding tax rate is 15%. Under the tax convention between State F and State S and the tax convention between State S and State T, the dividend withholding tax rate is 5%. In making its decision to invest in State T through a holding entity in State S, the fund considered the benefit deriving from the combination of the tax convention between State F and State S and the tax convention between State S and State T; however this would not determine the application of the PPT rule. It is clear that there are prevailing non-tax reasons that the investment fund considered to incorporate the holding entity in State S without which the investment fund would have not chosen such location. Therefore, the tax benefit cannot be regarded as one of the principal purposes of the transaction for PPT purposes.

2.9. Example 2:

• An investment manager establishes a CIV in State T. The CIV expects to receive investments from several jurisdictions and will deploy its capital for making investments predominantly in State S. The tax treaty between State T and State S provides an exemption from taxation of capital gains, unlike tax treaties between the home jurisdictions of the investors in the CIV and State S. The CIV has been set up in State T on account of a combination of any of the following considerations:
• The investment manager is located in State T and is regulated by the financial services regulator of State T.

• Since the CIV expects to receive investments from various jurisdictions, an appropriate and neutral jurisdiction is required to be identified in order to pool investments from such investors.

• Several jurisdictions were evaluated on the following parameters:
  (a) Political stability;
  (b) Geographical location;
  (c) Time zone for being able to efficiently trade in State S;
  (d) Robustness of investor protection laws;
  (e) Applicable regulatory framework;
  (f) Applicable exchange control framework;
  (g) Applicable corporate law framework;
  (h) Ease of setup;
  (i) Low setting up and ongoing operating costs;
  (j) Availability of relevant qualified personnel with funds administration experience; and
  (k) Applicable disclosure requirements

• A few jurisdictions were shortlisted as being similar / comparable based on the above parameters. Thereafter, State T was shortlisted on account of tax neutrality of the CIV and the capital gains tax exemption provided in the tax treaty between State T and State S.

• In that case, the PPT should not apply, as the decision to establish the pooling vehicle in a neutral jurisdiction is underpinned by various non-tax considerations, although the last mile decision of selecting State T from among comparable jurisdictions may be said to be prompted by tax considerations

2.10. Rather providing additional new examples where discretionary relief should be granted and as a consequence of the limited time for comments coinciding with the holiday period, we respectfully direct your attention to the example in paragraph 27 of the public discussion draft (14 March - 9 April, 2014) and ask the OECD to reconsider it or at least to posit an example using the same basic fact pattern that should not be caught by the PPT. For
example, if TCo acquired shares and debt of SCo from SCo’s parent in a arm’s length transaction, which for example could have been part of a larger M&A transaction, and subsequently sold the debt of SCo to RCo for RCo debt on arm’s length terms retaining no direct or indirect interest in the SCo debt then why should the PPT deny RCo the benefit of the R-S treaty? What if State T and State S did have a treaty, one with a lower rate of withholding on dividends from wholly-owned subsidiaries than on interest and instead of selling the loans to RCo, TCo capitalized the SCo debt. Would the PPT apply to deny the dividend rate of withholding? In both of these cases the withholding tax consequences of holding one investment versus another are relevant (as they are for any rational commercial actor) but in neither case is the result abusive or at least not necessarily so depending on the background facts and context. We encourage the OECD to develop better examples that more clearly define the strictly abusive cases that should be caught by a PPT.

3. Drafting the alternative “conduit-PPT rule”

3.1. Respectfully, conduit financings, for example those using accommodating banks, that are not caught by a PPT with an explicit abuse threshold or by the beneficial ownership test in the dividend article should be addressed outside tax treaties, in domestic legislation. We point out that Canada recently strengthened its own laws regarding back-to-back financings. It is not the role of tax treaties to prohibit every tax advantageous arrangement that governments wish to curtail, especially when the tax advantage is a form of treaty withholding tax rate arbitrage that governments have facilitated by entering into treaties with differing rates. Trying to eliminate conduit arrangements that do not fail an abuse or beneficial ownership test will mean either tightening the PPT to the point that other, non-offensive arrangements are caught resulting in double taxation or will impose a test so open-ended for authorities to apply after the fact as they see fit that unacceptable levels of uncertainty will result at significant cost to business and to governments.
Submission on the OECD discussion draft on ‘Follow up work on BEPS Action 6: Preventing Treaty Abuse’

9 January 2015
Ms Marlies de Ruiter  
Tax Treaties, Transfer Pricing and Financial Transactions Division  
OECD Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris Cedex 16  
France  

By e-mail to: taxtreaties@oecd.org

9 January 2015

Ref: OECD public discussion draft on follow up work on BEPS Action 6: Preventing treaty abuse

Dear Ms de Ruiter,

I am pleased to communicate the views of Ibec and its members on the public discussion draft published by the OECD on ‘Follow up work on BEPS Action 6: Preventing treaty abuse’. Ibec represents the interests of Irish business including indigenous and multinational enterprises and SMEs, spanning all sectors of the Irish economy. Ibec and its sector associations work with government and policy makers at national and international level to shape business conditions and drive economic growth. Ibec is also a member of BIAC and Business Europe and broadly supports the views communicated by these partners in their submissions on the OECD discussion draft.

General comments
Ibec supports the intentions of BEPS Action 6, particularly in relation to preventing the granting of treaty benefits in inappropriate circumstances and clarifying that tax treaties are not intended to generate double non-taxation. But Ibec considers that in seeking to address treaty abuse by a minority of taxpayers, sight has been lost of the core objective of tax treaties; to facilitate and promote international trade and investment by removing double taxation and providing clear regulatory frameworks which provide certainty for business, helping to sustain and promote growth and employment.

Ibec is particularly concerned that the proposals in this discussion draft would be detrimental to small trading nations such as Ireland and run counter to the overall policy objectives of the tax treaty network. Over many years governments have developed comprehensive tax treaty networks which support trade, investment and economic development. Effective tax treaty networks have been central to the development of export markets by businesses in small open economies. Ibec believes that the changes proposed to tax treaties in the discussion draft would disadvantage those countries with small domestic markets and a reliance on exports. The draft proposes that in order for treaty benefits to be granted either a principal purposes test or a limitation of benefits test must be met. By their very nature both of these tests would discriminate against smaller countries and would be much easier to meet by businesses located in countries with larger domestic markets.

Ibec urges the OECD to specifically review the implications of the proposed changes on the trade and economic development of small open economies and to design a set of proposals which will not deliver an unfair competitive advantage to larger and more developed economies.
Principal Purposes Test (PPT)

The principal purposes test would deny treaty benefits in cases where one of the main purposes of an arrangement or transaction involving a local resident is the access to the benefit afforded by the tax treaty. The manner in which the rule is drafted is so broad that it potentially undermines the core attraction for a smaller open economy of putting in place tax treaties with its trading partners so as to offer greater certainty of avoiding double tax outcomes for trade flows with those countries. If by locating in a country a local resident can be said to have put in place an arrangement that directly or indirectly offers treaty benefits, residents in smaller open economies will face a far higher burden of proof in evidencing that one of the main purposes of such arrangements was not the benefits of having the tax treaty with the other contracting state.

By definition this test places a much greater burden of proof on businesses located in countries with smaller domestic markets and business infrastructure than it does on businesses located in larger developed economies. Business will be able to demonstrate multiple reasons for a commercial arrangement or transaction with a resident of a larger economy and indeed the overall business decision for locating there such as access to markets, labour or capital. It is more likely that the benefits of access to a tax treaty will be more to the fore of the benefits arising from arrangements effected by the company resident in a small open economy than those arising from location in a large economy. The manner in which the rule is currently drafted would discriminate against business resident in smaller economies without the obvious business location advantages. There are of course many genuine business reasons why enterprises would choose to conduct business and enter into international transactions when resident in smaller economies and it is vital that the proposed changes do not impact on such business operations.

The PPT is very broad in nature and would be highly subjective in its implementation. It would therefore create particular uncertainty for business, which in turn would disadvantage those locations most impacted by that uncertainty. Increased subjectivity will also mean that scale of resources in competent authorities may also influence business location decisions and could reinforce a location bias against smaller states.

Limitations of benefits clause (LOB)

The LOB clause will deny treaty benefits in cases where an entity is owned or financed from abroad or where its shares are traded on a foreign stock exchange. By definition this test will also clearly discriminate against smaller open and globalised economies with smaller stock exchanges. Businesses in smaller economies often need to seek international finance in order to fund expansion and are also much more likely to list on a foreign stock market.

While there are a number of dimensions to the LOB tests, each of them provides particular challenges for small countries. The publicly-listed test as currently framed would be particularly difficult to meet for companies resident in smaller countries and would clearly have a negative impact on normal business operations which have listed on a stock exchange outside the country of residence in order to access a deeper pool of capital. Rather than applying a test on the basis of an indigenous stock market listing, a comprehensive list of qualifying stock exchanges could be used which could be tailored to meet those exchanges typically used by companies resident in the treaty contracting states. This would allow entities resident in smaller countries to be listed on a foreign stock exchange and to be eligible to meet the traded company test.

The aspect of the test which requires a locally resident company which is not listed on its local stock exchange to have more of its senior management responsible for the day to day operations of the
company and its subsidiaries based in that country than in any other country will not be met by many businesses headquartered in smaller countries. Simply by virtue of being based in a smaller economy, it is more likely than not that the overseas operations of the group will comprise a greater part of group-wide operations. Senior management will need to exercise oversight of those overseas operations outside the country of the parent. A simplified test based on agreed recognised exchanges and trading volume on those exchanges would, in our view, satisfy any reasonable requirement for appropriate ‘nexus’ of the company with its state of residence and should be straightforward for taxing authorities to validate if required.

Given the constraints on capital markets access that can arise for business based in smaller economies, it is often the case that local business seeking to grow through international expansion will fund expansion through private capital placements or through reinvestment of profits. It is important that any LOB has a broad based derivative benefits test and that equivalent beneficiaries under such a test include privately owned companies. It is not clear why eligibility to be treated as an equivalent beneficiary should be denied to privately owned companies especially when the costs of raising capital in public markets are simply not commercially justified for many companies based in smaller economies with more limited and costly access to capital markets.

In addition to the business concerns in relation to the manner in which the publicly listed requirement is framed and the requirement for broad based derivative benefits and base erosion tests within the LOB, it is also our view that these aspects of the LOB provision would need to be conformed to EU law and to the wider policy measures aimed at developing the EU single market. The current draft should therefore be amended to reflect this and to be compatible with EU laws.

**Conclusion**

Ibec supports the BEPS objective on denying treaty benefits in inappropriate circumstances. We are concerned, however, that the proposals as currently drafted are too broad and would ultimately harm genuine business activity. In particular, we believe that the approach outlined would be more damaging to small open economies and would put them at a further disadvantage against larger developed economies. We therefore urge the OECD to reconsider the draft with a view to the likely consequences for trade, investment and economic development in smaller states.

Yours sincerely,

_______________________
Fergal O’Brien
Head of Policy and Chief Economist
fergal.obrien@ibec.ie
FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE

ICAEW welcomes the opportunity to comment on the Public Discussion Draft *Follow up work on BEPS Action 6: Preventing treaty abuse* published by OECD on 21 November 2014.

This response of 9 January 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty’s Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.
ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW’s regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 142,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
GENERAL COMMENTS

ICAEW comments on initial OECD public discussion draft published on 14 March 2014

1. ICAEW was one of the many organisations which responded to the original paper issued in March 2014. The full set of papers are available on the OECD website at http://www.oecd.org/tax/treaties/comments-action-6-prevent-treaty-abuse.pdf

2. In Annex 3 to that earlier response we set out a number of scenarios of international tax planning which we suggested should be covered in any guidance issued in relation to the Action 6 work of OECD.

RESPONSES TO SPECIFIC ISSUES RAISED IN THE CURRENT DISCUSSION DRAFT

A Issues related to the LOB provisions

Non CIV funds: applications of the LOB and treaty entitlement

3. The definition of the term “qualified person” for LOB purposes (in paragraph 16 of the Report) begs the question of what is a “person” for treaty purposes. While the US Model Income Tax Treaty defines “person” broadly to include, for example, trusts and partnerships such a broad definition is not generally adopted in bilateral treaties. This can cause problems in particular for institutional investors that are constituted as common law trusts when investing in civil law countries. Investment funds that are constituted as partnerships face similar problems in cases where the treaty status of partnerships is not addressed.

4. The exclusion of alternative funds/private equity funds from the definition of CIVs for the purposes of the 2010 Report (on the grounds that they generally are not widely held, do not hold a diversified portfolio of securities and are not subject to investor protection regulation in the country of establishment) is rather artificial. Whether or not these funds meet these conditions (and some of them clearly do), it is more relevant that they are formed for a genuine business purpose of collective investment. If it is accepted that in principle a person’s participation in a collective investment fund should not lead to a lower level of treaty entitlement than would be accorded to a similar direct investment by that person – which is surely a goal to be supported if cross-border investment is to be encouraged – the form that the fund takes should not be a factor in determining the treaty entitlement of the participating investors.

Pension funds

5. We welcome the extension to EU Pension funds.

Commentary on the discretionary relief provisions of the LOB rule

6. If the withholding tax rate provided in the Convention is not lower than the corresponding withholding tax rate in the tax treaty between the State of source and the third state then we believe that should, of itself, be sufficient to establish that the conditions for granting the discretionary relief are met.

7. At the moment the Commentary in paragraph 18 suggests that “that fact would not, in itself, be sufficient to establish that the conditions for granting the discretionary relief are met”.

8. We suggest that this statement be removed from the Commentary.

Alternative LOB provisions for EU countries

9. We welcome the recognition that there needs to be an alternative version of the LOB for EU and EEA countries.

10. We believe that the provisions in Article 2 c)iii) re intermediate owners being a resident of either Contracting State would breach the EU Treaty freedom of establishment and would not be appropriate in treaties between member countries of the EU/EEA. We note that the provision is in brackets and paragraph 23 of the current document indicates that this is
because “some States consider that the requirement is unduly restrictive”. While that may be the case it would also be helpful to recognise the EU/EEA difficulties with such a provision.

**Requirements that each intermediate owner be a resident of either Contracting State**

11. A substantial number of collective investment funds (whether or not they meet the CIV definition in the 2010 Report) that pool funds from different treaty country investors are based in offshore jurisdictions that have limited access to tax treaties. The funds are based in offshore locations for commercial reasons, namely that the jurisdiction concerned provides an enabling legal framework for such funds and reliable local fund administration and professional advisory services. If the jurisdiction does not have access to a suitable tax treaty network the fund will often seek to establish a subsidiary holding company in a country that has treaties with the countries where the fund’s portfolio investments are situated. It would be helpful if the OECD recognised that this is not necessarily an inherently abusive situation, at least to the extent that the fund’s use of an intermediary entity is not generating any greater treaty benefits than would have been available to a similar direct investment by a participant in the fund.

**Issues related to the derivate benefit provision**

12. The derivative benefits test in draft LOB article 4a) should not be restricted by reference to the number of shareholders in the company concerned that are equivalent beneficiaries. Limiting the relief to companies with seven or fewer shareholders would unjustifiably exclude from treaty relief widely-owned companies that are not engaged in any tax avoidance.

**Conditions for the application of the provision on publicly-listed entities**

13. We agree that provision needs to be made re the LOB rule and the publicly listed entity requirement where small countries are involved and the listed parent company is listed on a foreign stock exchange e.g. because of the lack of sufficient liquidity on the local stock exchange. We would suggest that such a provision should at a minimum allow listing in a regional stock exchange. For example, within the EU listing on an exchange in another EU Member State should in our view be accepted as a local listing.

14. While this point is not specifically raised in the current Discussion Draft we are concerned that the other main listed company route to “qualified person” status involves a new and untested concept of a company’s “primary place of management and control” which - despite the definition in the draft LOB article 6d) - will surely require a court to determine its meaning in a particular context. If a company that is resident in country A where its main class of shares is listed subsequently obtains a secondary listing for those shares in country B it would need to ensure that its primary place of management and control remains in country A, otherwise it would risk losing access to treaty benefits if its shares became primarily traded in country B.

**Clarification of the “active business” provisions**

15. US groups with UK subsidiaries should be able to rely on activities in other EU countries to satisfy the test.

16. Draft LOB article 3a) specifically excludes from the definition of an active business a business of “making or managing investments for the resident’s own account”. The Commentary should clarify that this does not exclude the business of a resident that involves the making or managing investments on behalf of other persons.

**B Issues related to the PPT rule**

Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level

17. The principles set out in paragraph 32 are reasonable but it needs to be borne in mind that the application of the GAAR is by exception but in the UK you have to apply for treaty relief and you need to know whether the GAAR is going to apply or not. There needs to be some
limitation in the period of time, say 2 months, during which the administrative process should be completed.

**Whether some form of discretionary relief should be provided under the PPT rule**

18. We suggest that the use of intermediary owners in appropriate circumstances, see our comments under Requirements that each intermediate owner be a resident of either Contracting State is an instance where treaty relief would be justified.

**Drafting of the alternative “conduit-PPT rule”**

19. Given that the object of many collective investment funds is to distribute the whole of their returns to their investors (whether or not in the form of dividends), it would be quite inappropriate to characterise a fund or a fund-owned subsidiary holding company as a conduit solely on the basis of this fact pattern. The Commentary should make this clear.

**C Other issues**

**Application of the new treaty tie-breaker rule**

20. We believe that it will be absolutely essential to put in place a tight deadline in respect of requests made under this new law. We would recommend that the deadline should ideally be 1 month but it certainly should not be longer than 3 months.
APPENDIX 1

ICAEW TAX FACULTY’S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person’s tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax-tax-faculty/-/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)
By Electronic Delivery

8 January 2015

Marlies de Ruiter
Head of Division
Tax Treaties, Transfer Pricing and Financial Transactions
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue André Pascal - 75775 Paris Cedex 16

RE: CIVs and Follow-Up Work on BEPS Action 6 (Prevent Treaty Abuse)

Dear Ms. de Ruiter:

ICI Global supports strongly the work done over the past ten years by the OECD and its members to improve treaty access for collective investment vehicles (CIVs) and their investors. We also support strongly both (1) the CIV Report that was produced by the Informal Consultative Group (ICG) in which we participated actively and (2) the inclusion of the Report’s conclusions in the 2010 Update to the OECD Model Tax Convention Article 1 Commentary. The Commentary developed in the Report provides alternative approaches by which individual investors in all CIVs, regardless of the manner in which a CIV is organized, operated, or distributed, can receive treaty relief. More specifically, these CIV investors have the opportunity to receive the same treaty relief that they would receive had they invested directly in the securities held by the CIV.

Turning to BEPS Action 6, we appreciate greatly that the comments we submitted on 8 April 2014 regarding BEPS Action 6 and Treaty Benefits for Collective Investment Vehicles were incorporated fully in the Action 6 2014 Deliverable. We also appreciate that the Deliverable

1 The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.2 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.


includes, on pages 72-73, one example of a CIV investment that would not raise principal purpose test (PPT) concerns.

This letter responds to questions asked in the Public Discussion Draft regarding Follow Up Work on BEPS Action 6: Preventing Treaty Abuse⁶ that was released on 21 November 2014. We appreciate this opportunity to share our views and look forward to discussing them during the public consultation on 22 January 2015.

Background

ICI Global’s comments are limited to those investment funds that are the subject of the OECD’s CIV Report. Specifically, our comments address only “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.”⁷

The benefits provided by these funds, as the CIV Report notes, include: “allow[ing] small investors to gain the benefits of economies of scale;” “provid[ing] access to a number of markets that might be closed to the small investor;” providing a “highly liquid” investment; and allowing for “highly efficient reinvestment of income.”⁸ CIV investors also “benefit from the market expertise and insights of professional money managers” and receive “the benefits of diversification that otherwise would require much greater investment.”⁹ Consequently, the CIV Report notes, “Governments have long recognized the importance of CIVs as a complement to other savings vehicles in terms of facilitating retirement security.”¹⁰

To achieve these benefits efficiently, domestic tax laws effectively provide that a CIV’s income is taxed only once: in the hands of either the CIV or its investors. This “no additional level of tax” feature helps provide CIV investors with tax treatment that is roughly comparable to that received by a direct investor in securities.

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⁷ See, CIV Report, page 3, paragraph 4. Our comments do not address “investments through private equity funds, hedge funds or trust or other entities that do not fall within the [Report’s] definition of CIV.” Id.

⁸ All quotes in this sentence are from CIV Report, page 4, paragraph 8.

⁹ The quotes in this sentence are from CIV Report, page 4, paragraph 9.

Issues Related to the LOB Provision

Question 1: Collective Investment Vehicles: Application of the LOB and Treaty Entitlement

Support for the CIV Report

ICI Global submits that the recommendations of the 2010 CIV Report are sound. No improvements should be made to the conclusions included in the Report. Moreover, we submit that it would not be advisable to provide a “preferred approach” for CIV tax treaty entitlement issues and the application to CIVs of a limitation on benefits (LOB) provision. Each of these conclusions is explained in detail below.

The CIV industry, beginning with a 2005 meeting of Working Party 1 at which we were one of the invited business representatives, has supported enthusiastically the OECD’s work on CIV treaty entitlement. This work was undertaken because various differences in CIVs’ legal form and tax treatment were generating starkly different treaty entitlement results. These differing results led to reciprocity concerns and denial of treaty relief for CIVs that clearly qualified as persons, residents, and the beneficial owners of their income.

The Report expressly recognized that “differential treatment could be seen as violating the general policy goal of treating economically similar structures similarly.” This result of differential treatment also could be viewed as “possibly violating the implicit assumption of reciprocity.”

To achieve neutrality between CIV investors and direct investors on the one hand, and between investors in different types of CIVs on the other hand, the Report correctly provided alternative approaches for providing treaty relief. Those CIVs that meet the treaty requirements should receive treaty relief in their own right. Other CIVs should be allowed effectively to claim treaty relief on behalf of their eligible investors (including by treating a CIV as transparent so that pension funds, for example, receive any applicable exemption).

As the Report noted, “[d]eveloping practical solutions that ensure that the CIVs that are common in each jurisdiction have access to treaty benefits, even if on different terms, is likely to be more beneficial for both countries in the long run.”

The practical procedures for establishing the treaty eligibility of CIV investors is another key aspect of the CIV Report. If all CIVs were treated identically, CIVs that are distributed only in their country of residence and are subject to tax rules that make them generally unattractive to nonresident investors most likely would suffer. As the Report notes, it may be appropriate in this case to treat the CIV as satisfying any applicable limitation on benefits provision without further examination because the CIV’s investors will reside predominantly if not exclusively in the CIV’s residence country. Importantly, even when proof of the treaty eligibility of a CIV’s investors is required, the CIV Report states that this proof generally should be required only annually and never more frequently than quarterly.

“Practical and reliable” approaches for identifying investors also should be provided. Practical approaches are necessary as a CIV may have tens or hundreds of thousands of

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11 CIV Report, page 13, paragraph 50.

12 Id.

13 CIV Report, page 13, paragraph 51.
individual investors. Moreover, as the Report notes, CIV interests “acquired through
intermediaries often are registered at the CIV level through nominee/street name accounts.”
In this situation, only the intermediary (e.g., the broker) knows the treaty eligibility of its
customers. Ensuring reliable treaty-eligibility claims in this situation was addressed by the
OECD in its Treaty Relief and Compliance Enhancement (TRACE) implementation
package – which we support unequivocally and for which we urge prompt adoption.

Equally importantly, the Report recognized that a CIV distributed cross-border (e.g., a
“globally-distributed CIV”) would be disadvantaged unless all of its investors who are
resident in countries with which the source country provides comparable treaty relief are
treated as “eligible” investors for treaty-entitlement and LOB purposes. CIVs organized in
Europe under the UCITS Directive, for example, typically are distributed widely in European
countries that have broad treaty networks.

The equivalent beneficiary standard, the CIV Report notes,

serves the goals of neutrality as between direct investments and investments
through a CIV. It also decreases the risk of double taxation as between the
source State and the State of residence of the investor to the extent that there is
a tax treaty between them. It is beneficial for investors, particularly those
from small countries, who will consequently enjoy a greater choice of
investment vehicles. It also increases economies of scale, which are a primary
economic benefit of investing through CIVs. Finally, adopting this approach
substantially simplifies compliance procedures.

Equivalent beneficiary treatment is essential to ensuring appropriate treaty relief for investors
in globally-distributed CIVs.

Specific ICI Global Recommendations on CIVs, Treaty Entitlement, and LOB

ICI Global supports strongly the position taken in the BEPS Action 6 2014 Deliverable to
incorporate the conclusions of the CIV Report. Most particularly, we support the alternative
approaches for determining treaty eligibility that are reflected in the BEPS Action 6 2014
Deliverable; these alternatives are essential to providing neutrality between different types of
CIVs and between CIVs and direct investment. The legal and tax treatment differences
between CIVs preclude a “preferred approach.” If a revised BEPS Action 6 paper included a
“preferred approach,” treaty relief for investors in any CIV that is treaty-entitled in its own
right and distributed only in the CIV’s country of residence surely would be restricted.

Any LOB clause should be applied appropriately to CIVs to maximize the value to CIV
investors of the many benefits that CIVs provide. To that end, we support strongly
including an equivalent beneficiary standard in any LOB. Limiting treaty relief to those
CIVs distributed only within the two treaty partners would lead to double taxation and the

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14 CIV Report, page 6, paragraph 18.
16 CIV Report, page 14, paragraph 35.
17 Any PPT likewise should be applied appropriately to CIVs. We discuss PPTs in our response to Question
17, below.
inequitable results discussed above. Globally-distributed CIVs, investors in small countries, and others would be harmed.

**Question 2: Non-CIV Funds: Application of the LOB and Treaty Entitlement**

**Non-CIV Investment Funds**

The CIV Report did not consider other types of funds, such as alternative and private equity funds, because they present treaty entitlement issues different from those presented by CIVs. As the OECD’s Informal Consultative Group process worked well, in the CIV context, to identify issues and develop practical solutions, it would be appropriate to pursue a similar approach for non-CIVs. Because of differences between CIVs and other investment vehicle types, however, any work on non-CIVs should not impact the CIV Report or its conclusions.

**Pension Funds**

Pension funds, whether they invest in CIVs or not, present unique treaty-entitlement issues. As noted above and in the CIV Report, the treatment of pension funds that invest through CIVs has been considered. The CIV Report included recommendations that would treat a CIV held by a relatively small number of pension funds as transparent and permit direct tracing of the CIV’s income to its (generally exempt) investors. This treatment would maximize the benefit to a pension fund and its participants/beneficiaries of all relevant treaty provisions.

Pension funds, like CIVs, promote important social goods – including long-term financial security. Countries benefit when their senior citizens have sufficient assets to support themselves without relying upon publicly-funded assistance programs (whether or not designed specifically for the elderly).

The tax-favored treatment typically provided to pension funds (such as no taxation on the fund’s income or assets) enhances the amounts available to the fund’s pensioner beneficiaries. Countries limit the types of pension funds and other retirement arrangements that receive this favorable treatment to prevent the benefits from being abused.

One illustration of the conscious decision to treat pension funds as non-abusive is the treatment provided by the United States to implement the Foreign Account Tax Compliance Act (FATCA); the favorable treatment was provided both by regulations and in the Intergovernmental Agreements (IGAs) that the US negotiated with other countries. By treating pension funds as “deemed compliant” financial institutions, the US Government effectively provided that they cannot be utilized by individuals for abusive tax purposes.

One starting point for defining the term pension fund would be the Commentary to the Common Reporting Standard (CRS).\(^\text{18}\) The Commentary, drawing from FATCA, includes within the definition of “non-reporting financial institution” a Broad Participation Retirement Fund, a Narrow Participation Retirement Fund, and a Pension Fund of a Governmental Entity, International Organization or Central Bank. While maximizing definitional consistency between BEPS Action 6, the CRS, and TRACE should be an important goal for these related initiatives, crafting appropriately-inclusive rules also is

important. To that end, plan participants resident in any country with which the source
country provides a pension fund exemption should be treated as “good” for any definitional
purpose (such as the Narrow Participation Retirement Fund rule that not more than 20% of
the fund’s assets be held by non-residents).

We question whether the treaty eligibility of a pension fund that meets the applicable
requirements for tax-favored treatment in its country of residence should be subjected to
LOB (or a PPT). As pension funds perform an important social role and provide little if
any ability to be used for tax avoidance purposes, they generally should receive the
maximum possible treaty relief benefit; this relief should be restricted only in narrowly-
defined situations in which the abuse potential is significant.

We observe that whenever the pension fund, its participants, and beneficiaries all reside in
the same country, any potentially-applicable LOB (or PPT) clause would have no practical
effect. This “no impact” situation presumably would apply to any pension fund organized
by a business operating only within a single country.

When a business operates across borders, however, additional complexities may arise. A
global business that creates a single pension fund, for example, presumably would have as
participants and beneficiaries individuals resident in every country (and perhaps more) in
which the firm conducts business. Treaty-eligibility issues also might arise if the business
organized a separate pension fund for each country in which it operates. Employees
working in one country, who are nationals of another country, might retire and move back
home – thereby becoming non-resident beneficiaries for treaty purposes. Moving back
home, however, should never cause a pension fund to lose its exempt status.

In sum, we recommend that:

- A tax exemption be provided for a pension fund’s portfolio investments;
- A pension fund be defined broadly for this purpose;
- LOB (and PPT) clauses (or any other “anti-abuse” rule) be applied narrowly, if at
  all, to pension fund cross-border investments; and
- Any LOB should treat as “good” participants/beneficiaries any person who is
  resident in any country with which the source country provides a pension fund
  exemption.

Questions 4-6 – LOB and the EU, Intermediate Owners and Derivative Benefits

ICI Global recommends that treaties be applied to CIVs by treating all equivalent
beneficiaries as residents of a treaty partner and by looking through any street name/nominee
account to the underlying investors.

Adopting the equivalent beneficiary approach included in the CIV Report, for the reasons
discussed in the response to Question 1, will address CIV concerns with certain European
Union law requirements. Any derivative benefits rule that limits treaty eligibility to a
company with a fixed number of equivalent beneficiaries (e.g., seven) should not apply to
CIVs that, as defined in the CIV Report, are widely held.

Likewise, any rule applicable to “intermediate owners” should reflect the fact that banks,
brokers, and others holding CIV interests for their clients in street name/nominee accounts do
not “own” the interests even if they have legal title to them. Beneficial ownership principles
– in which the street name/nominee account “owner” is acting merely as an agent – should be
applied to determine who owns CIV interests for LOB purposes. The status of a nominee as
resident in a non-treaty jurisdiction should not prevent its customers residing in treaty-partner jurisdictions – whose assets were used to purchase the CIV interests – from being treated as the owners for LOB purposes; information regarding these underlying owners would be available to any country that adopts TRACE.

Questions 7-9 – Publicly-Listed Entities

CIVs that trade on recognized stock exchanges should be eligible for any treaty relief provided to publicly-listed entities. A CIV that is treaty-entitled in its own right and that trades on a stock exchange in its residence jurisdiction should satisfy the publicly-traded LOB (without regard to the number of its investors) by applying the CIV Report’s equivalent beneficiary approach. Trading on exchanges in multiple jurisdictions should not impact negatively a CIV’s ability to rely on the publicly-listed rule; CIVs are listed on multiple exchanges to facilitate the availability of CIV interests to investors of moderate means. If a CIV is not listed on an exchange of its residence country, and claims treaty benefits on behalf of its investors (rather than in its own right), it likewise should be able to claim relief by applying the CIV Report’s equivalent beneficiary approach.

Questions 12-14 – PPT Rule Relief

A PPT applied unilaterally by a government could create substantial uncertainty for CIVs. As discussed in the CIV Report, CIVs have a keen interest in tax certainty as they typically must determine each day the value of their assets and liabilities to price their CIV interests. For a CIV to price its interests, it needs to know each day how much foreign tax it will owe on the income and gain from its cross-border investments.

We submit that a PPT should be applied only upon the agreement of both Contracting States. At a minimum, effective and expeditious mechanisms for reviewing PPT application – such as administrative procedures that involve committees of experts and mandatory arbitration – are essential for CIVs to gain the requisite certainty. These mechanisms serve at least two purposes. First, their availability may limit inappropriate application to CIVs of a PPT. Second, when a PPT is applied inappropriately, these mechanisms – particularly if they are applied expeditiously – will shorten the period of uncertainty.

We support strongly mechanisms for resolving unilateral application of a PPT. These mechanisms will assist CIVs in ascertaining expeditiously their tax liabilities on cross-border investments.

Question 17 – List of examples in the Commentary on the PPT Rule

We also recommend that CIVs generally be exempt, expressly or effectively, from any principal purpose test. Example D, on pages 72-73 of the BEPS Action 6 2014 Deliverable, provides an excellent starting point for effecting this recommendation. The CIV in this example makes investment decisions that “take into account the existence of tax benefits provided under [the CIV’s residence country’s] extensive tax convention network.” Taking into account a treaty between the CIV’s residence country and a country in which the CIV invests, the Example states, “alone would not be sufficient to trigger [the PPT]. Because “[t]he intent of tax treaties is to provide benefits to encourage cross-border investment . . . it is necessary to consider the context in which the investment was made.” In conclusion, the example provides, “unless [the CIV’s] investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining [treaty benefits], it would not be reasonable to deny the benefit of the . . . treaty to [the CIV].
While very helpful, this example’s application is limited because it assumes: (1) that a majority of the CIV’s investors are resident in the CIV’s country of residence and (2) the CIV distributes annually to investors almost all of its income and pays residence-country tax on any amounts retained. The example, on its face, does not apply to most globally-distributed funds or to any fund (even if distributed only within a single country) that retains, rather than distributes, its income.

We recommend that any final report on BEPS Action 6 include a second example in which a majority of the CIV’s investors are resident in any country with which the source country provides treaty relief comparable to that provided to the treaty partner. This recommendation effectively would embed into the PPT the equivalent beneficiary approach that we submit is essential to provide appropriate treaty relief to globally-distributed CIVs.

We likewise recommend that the example apply to a CIV that retains, rather than distributes, its income. Without this change, the investors in a “non-distributing” CIV will suffer double taxation – first when the CIV receives income and a second time when the investor disposes of his/her CIV interest. At a minimum, an example with the assumptions we recommend above should be provided for those countries that support equivalent beneficiary treatment and seek to prevent double taxation (as opposed to preventing only double taxation that occurs within a single year).

Our recommendations are being advanced because the widely-held CIVs covered by the CIV Report and the BEPS Action 6 2014 Deliverable are designed to assist individual investors, particularly those of moderate means, in saving for long-term needs such as retirement. Globally-distributed CIVs, as discussed above, serve a wide range of important objectives; tax manipulation is not one of them. Any concern about potentially abusive arrangements should be addressed by including in the PPT examples a specific illustration of the concern; one such concern would be a CIV organized in a treaty country and distributed predominantly, and purposefully, only within countries that do not have treaties with the source countries in which the CIV invests. Factors that would support this abusive principal purpose would include: (1) an investment objective that targets countries with which the expected investor base does not receive treaty relief; and (2) promotional materials that highlight the ability to receive treaty benefits that would not be received by investing in the source countries directly or through other investment vehicles.

TRACE

The TRACE implementation package approved by the OECD’s Committee on Fiscal Affairs in January 2013 provides many important tools for combating tax treaty abuse. Importantly, TRACE’s investor documentation and reporting mechanisms will provide countries with additional assurances that the claims investors make for treaty relief are appropriate. Authorized intermediaries, having entered into agreements with source countries to provide accurate information and have their compliance procedures examined by an independent reviewer, will be strong partners in preventing treaty abuse.

We urge that countries adopt TRACE as they implement other investor-related initiatives (including any arising from BEPS Action 6). TRACE is beneficial because it will both enhance the effectiveness of treaty-abuse initiatives and reduce situations in which two countries tax the same income amount; reducing double taxation, after all, is the primary reason for negotiating treaties.
Please feel free to contact me (at lawson@ici.org or 001-202-326-5832) at your convenience if you would like to discuss this issue further or if we can provide you with any additional information. My colleagues Karen Gibian (at kgibian@ici.org or 001-202-371-5432) and Ryan Lovin (at ryan.lovin@ici.org or 001-202-326-5826) also may be called upon for assistance.

Sincerely,

Keith Lawson
Senior Counsel – Tax Law

cc: taxtreaties@oecd.org
Invitation for comments on BEPS Action 6: Preventing Treaty Abuse

Dear Mrs de Ruiter,

We would like to thank you for the opportunity to respond to the OECD Public Discussion Draft regarding follow up work on BEPS Action 6: Prevent Treaty Abuse.

Besides the issues on which the OECD has requested comments, we believe it is necessary to add some general remarks from a German perspective on the approach taken by the OECD.

The overall approach of the LOB-clause is to prevent treaty abuse by granting treaty benefits only under certain objectified criteria. These criteria are laid down in a number of tests, which are only seemingly objective. These tests are unable to take full account of all possible cases and characteristic features of national tax systems correctly and therefore need to be modified to conform to the various legal systems relevant in the Contracting States. If the approach were to be implemented via a multilateral instrument this task would be almost impossible to fulfil.

A double taxation agreement needs to be self-executing i.e., the regular case is that it should operate without the need to apply to a competent tax authority for a treaty benefit. Art. X OECD-MA draft can only be considered adequate in practice if it leads to a self-executing solution of double taxation in the vast majority of cases. This is due to the fact that preventing double taxation in the vast majority of cases is generally the rational for Contracting States to agree on tax treaties in favor of their economic cooperation. It must be kept in mind, that only
a small minority of cases are actually driven by an intent to abuse the law. Therefore, the tests need to be designed to broadly fit all cases not perceived as treaty shopping. In conclusion, recurring to the discretionary relief provision must be the exception.

At the same time, it is essential to avoid the LOB clause becoming overly complicated and difficult to operate in practice. If the tests of the LOB clause are not designed to be sufficiently clear and self-executing, taxpayers will be unsure as to whether treaty benefits will be granted in relation to a vast number of items of income. Where this is the case, the taxpayer would need to apply for the treaty benefit under the discretionary relief provision; i.e., if the taxpayer is not sure that the test of the LOB clause is met and if the treaty benefit is granted. There is therefore a risk that tax authorities would be swamped with applications under the discretionary relief provision and unable to deal with such workload. The LOB clause needs to be sufficiently clear to allow tax authorities and taxpayers to manage all practical consequences.

The individual LOB clauses need to be designed with the two Contracting States in mind. The current draft focusses on the U.S. tax system in some points, and thus cannot also serve other national tax systems. The publicly traded test, for example, seems to be designed to fight "inversions" that are a characteristic of the U.S. tax system but rarely occur in the rest of the world. The test needs to be redesigned to reflect the national requirements in the tax systems of other countries. The discretionary relief provision also needs to be a realigned for countries not contracting with the U.S.

The following remarks deal with the requests for comment.

A. Issues related to the LOB provision

1. Regarding the invitation for comments on item A.3. – Commentary on the discretionary relief provision of the LOB rule

   **Issues on which comments are invited**

   Suggestions are invited as to possible factors or examples that could be included in the Commentary on the discretionary relief provision of paragraph 5 of the LOB rule in order to clarify the circumstances in which that provision is intended to apply.

   The LOB rule follows a negation rationale, i.e. it basically states that treaty benefits do not apply. Treaty benefits are an exception and only apply in a
limited number of conditions listed in a catalogue. In cases where these conditions are not met, paragraph 5 of the LOB rule assigns the right to decide on the application of treaty benefits to the competent authority of a Contracting State. The procedure requires the treaty subject to apply for the treaty benefit to the competent tax authority. A decision is made at that authority’s discretion (so called ‘discretionary relief provision’).

- **Procedural aspects of the discretionary relief provision**

Currently, there is no practical experience with applications to obtain treaty benefits. The procedural requirements and legal nature of such application remains unclear:

- Form of the application (in writing, electronic form, without formal requirements, oral application, necessarily as part of tax return, Contracting States free to agree upon form),
- Time limit for application,
- Definition of the relevant tax authority to receive the application (local tax office, centralized tax office, which forwards information to local tax office, etc.)
- Potential other formal reasons for the rejection of an application,
- Etc.

Since there is neither a common procedural law nor does the tax treaty contain procedural provisions, it seems that the procedural responsibility is to be handed over to the national procedural tax law of the respective Contracting State. The tax treaty should implement minimum standards to preclude national procedural law from being more restrictive than these minimum standards. Otherwise, in the extreme, a Contracting State could de facto abolish the discretionary relief provision by imposing unfulfillable formal application requirements. This is not simply a hypothetical concern, but one that occurred in recent cases where a taxpayer relied on the EU Arbitration Convention. Some countries (in this case Italy) simply denied access to arbitration due to a lack of procedural provisions in national law. The occurrence of such cases needs to be avoided.

Besides the abovementioned, the most important procedural minimum standards should be:

- allow joint applications; avoid separate application for each item of income;
- maximum response time (e.g. six months) for the relevant tax authority, combined with an automatic grant of treaty relief requested by the taxpayer should the response time not be met;
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- obligation for the relevant tax authority to set out the application requirements;
- obligation for the relevant tax authority to set out how to appeal against a negative decision;
- arbitration mechanism, when the relevant tax authorities are of different opinions.

Ref. to para 8. of the Commentary: If a tax authority determines at a later point in time (e.g. during or following a tax audit) that the taxpayer has interpreted paragraphs 2 – 4 improperly and thus does not automatically qualify for treaty benefits and has consequently not filed an application pursuant to paragraph 5, the taxpayer should be allowed to apply for the treaty benefit at that later stage of the procedure.

- Factors or examples that could be included in the Commentary on the discretionary relief provision

We understand that the LOB clause as proposed by the Action 6 Deliverable draws from U.S. treaty practice which, as mentioned above, has its own specific background. As a result, some of the limits included in the Action 6 Deliverable far exceed the intention of the BEPS Actions, in general. Specific examples include the limitation to five or fewer companies in Art. X 2 c) ii) and the limitation to seven or fewer persons in Art. X 4 a). There may be a number of situations in which despite the above limitations not having been met, no treaty abuse whatsoever was intended. These situations may vary; in the following we provide some possible examples:

- An entity or a company does not constitute a qualified person, because more than five publicly traded companies (themselves qualified persons) hold the majority of the company’s shares (cf. Art. X (2) c) ii) drafted OECD-MA).
- Derivative benefits test: All requirements are fulfilled and the case is without abusive intention, but more than 7 equivalent beneficiaries exist. Example: A family owned company used to meet the seven or fewer requirement of the derivative benefits test, but due to an expansion of the family ownership the company, now has more than seven owners.

One additional factor that should be considered, at least in the Commentary (if not the treaty itself), is that there will be a number of situations where a company used to meet the standards of the LOB clause and therefore was entitled to treaty benefits, but then a change in the company’s situation occurs which deprives the company of its treaty entitlement purely on the basis of the wording of the LOB clause, likewise without any intent of treaty abuse. Again, there are potentially many varied situations, as the following examples illustrate:
A company used to be publicly traded and therefore passed the respective test of the LOB clause, but is then acquired (and de-listed) so that it no longer qualifies as publicly traded entity. It may even be that the new owner is eligible, but closing has not yet occurred.

A company used to be owned by a government, but is then privatized.

Finally, the active conduct of business test pursuant to paragraph 3 will fail if the substantiality requirement is not met. E.g. if the business is just being set-up and not yet substantial, abusive reasons do not exist. This case should be taken up in the Commentary. This is necessary because companies established in the second half of a taxation period are, by definition, not able to fulfil the ownership test pursuant to paragraph 2 e), because they do not exist for more than six months and thus do not have an ownership consistently during this period of time.

2. Regarding the invitation for comments on item A.4. – Alternative LOB provisions for EU countries

The OECD discussion draft acknowledges that the LOB rule needs to be adapted to reflect certain EU law requirements. Therefore, an alternative provision needs to be drafted in order to accommodate the concerns of EU member states.

The most relevant requirements of EU law to be taken into consideration are:

- EU Treaty, especially the Fundamental Freedoms,
- EU Directives and their different transposition into the respective national law of each member state, i.e.:
  - Parent-Subsidiary Directive
  - Merger Directive
  - Interest and Royalty Directive
  - Savings Directive
  - Mutual Assistance Directive (exchange of information)
  - Recovery Directive
- EU Arbitration Convention: Procedure to resolve disputes where double taxation occurs between enterprises of different Member States as a result of an upward adjustment of the profits of an enterprise of one Member State. Whilst most bilateral double taxation treaties include a provision for a corresponding downward adjustment of profits of the associated enterprise concerned, they do not
generally impose a binding obligation on the Contracting States to eliminate the double taxation. If the EU Arbitration Convention were applicable to cases concerning the discretionary relief provision, Contracting Member States would probably be forced to resolve double taxation within a limited time frame where competent authorities disagree on the treatment and a situation of double taxation occurs.

Issues in this respect arise at different levels, e.g.:

- Conflicts with EU Fundamental Freedoms
  - The rule that intermediate companies have to be residents of either Contracting State does not comply with the EU freedom of establishment.
  - The ownership test resp. the base erosion test containing the condition that the shareholders of the company are residents of the (same) Contracting State and that the recipients of the income are located in one of the Contracting States does not comply with the EU freedom of establishment.
  - The active trade or business test requires that the business of a person in its country of residence should be substantial compared to its own or its associated enterprise’s business in the other Contracting State, if the person derives income from the source state activity or associated enterprise. Potentially, such a rule would not comply with the EU freedom of establishment.

Abovementioned infringements of the freedom of establishment can be justified if:

- the rule causing the infringement is designed and appropriate to prevent abuse of law. However, the Court of Justice of the European Union (CJEU) CJEU accepts preventing abuse of law as justification for infringements of the Fundamental Freedoms only where the rule effectively allows the taxpayer to give evidence that his actions were not abusive in the individual case. The discretionary relief provision does not grant a right to the taxpayer to receive the treaty benefit, if he can substantiate that his actions were not abusive. Any final decision is left to the discretion of the competent authority of one Contracting State. Thus, this reasoning would likely be insufficient to justify the abovementioned infringements of the freedom of establishment.

- the Contracting States implemented the infringing rule to mutually allocate the right of taxation. However, the current Art. X is not directed at the mutual allocation of the right of taxa-
tion, but instead serves to deny the application of the double taxation agreement. Further, even if this were rejected as a formal argument by the CJEU and the CJEU accepted that a rule of a double taxation agreement is always destined to allocate the right to tax between the Contracting States, the allocation would not be mutual. The discretional relief provision allows a unilateral decision without consensus between the Contracting States or even without consensus between competent tax authorities of Contracting States. Thus, this reasoning should likely be insufficient to justify the abovementioned infringements of the freedom of establishment.

- Conflicts with EU Directives and their transposition into national law, e.g.
  - If a dividend received by a person under a double taxation agreement qualifies for a tax exemption pursuant to the EU Parent-Subsidiary Directive, there seems no room left to deny e.g. the withholding tax exemption under a LOB clause.
  - If interest income or income from royalties is received by a person subject to a double taxation agreement qualifies for a tax exemption by the EU Interest and Royalties Directive, there seems no room left to deny e.g. the withholding tax exemption under a LOB clause.
  - In some cases similar conflicts might occur with regard to the Savings Directive and the Merger Directive.

The freedom of establishment also applies to the EFTA States Iceland, Liechtenstein and Norway (see Article 31 of the Agreement of on the European Economic Area, EEA) which reads as follows:

"Within the framework of the provisions of this Agreement, there shall be no restrictions on the freedom of establishment of nationals of an EC Member State or an EFTA State in the territory of any other of these States. This shall also apply to the setting up of agencies, branches or subsidiaries by nationals of any EC Member State or EFTA State established in the territory of any of these States. …".

Article 34 of the same agreements reads as follows:

"Companies or firms formed in accordance with the law of an EC Member State or an EFTA State and having their registered office, central administration or principal place of business within the territory of the Contracting Parties shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of EC Member States or EFTA States. …".
Thus, in our view, the aforementioned constraints related to the freedom of establishment are also applicable with regard to the EFTA States Iceland, Liechtenstein and Norway. Any adjustment of the LOB clause related to this should also be applied to the EFTA States.

In the following we provide a suggestion as to how an LOB clause could be construed without violating the EU/EEA principles outlined above:

3. **Regarding the invitation for comments on item A.6. – Issues related to the derivative benefits provision**

<table>
<thead>
<tr>
<th>Issues on which comments are invited</th>
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<tbody>
<tr>
<td>Suggestions are invited on possible changes that could be made to the derivative benefit provision (paragraph 4 of the LOB rule), the definition of equivalent beneficiary (paragraph 6 of the LOB rule) or other provisions of the Model Tax Convention in order to assist in the work on other parts of the Action Plan and ensure that the inclusion of a derivative benefit provision would not raise BEPS concerns whilst providing that cases where intermediate companies are used for valid commercial reasons are not excluded from treaty benefits.</td>
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- Comments on the derivative benefit provision (paragraph 4 of the LOB rule)

Art. X (4) a) OECD-MA Draft requires an ownership test and a base erosion test simultaneously. The ownership prong of the test is that

> “95% of the aggregate voting power and value of the company’s share is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary”.

While the base erosion prong is met if

> “less than 50% of the company’s gross income, as determined in the company’s State of residence for the taxable period [...] is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm’s length payments in the ordinary course of business for services or tangible property) that are deductible for the company’s State of residence.”

As mentioned above, the ownership prong of the derivative benefits test – limiting its application to situations where a company is effectively controlled by seven or fewer persons – stems from the U.S. background to the rule, but is not appropriate outside the U.S. First, there is no obvious reason why 95% of the shares should not be held by eight equivalent beneficiaries without such a structure giving rise to a suspicion of treaty shopping. Second, there will be a number of situations – e.g. in cases of takeovers – where, at least for a certain period, more than 5% of the shares in a company will be
owned by minorities without the controlling shareholder being able to insti-
gate a squeeze out. In fact, it will be more likely that a shareholder control-
ling 95% or more of a company will be able and motivated to squeeze out
minorities than a shareholder owning substantially less than 95%. Contrary
to this, in our view, the ability to use an (intermediate) company for treaty
abuse purposes is greatly reduced if less than 50% of the shares are owned
by a person otherwise not entitled to treaty benefits. Therefore, to determine
a balanced derivative benefits standard the threshold of 95% should be re-
duced to 50% and the limitation to seven or fewer persons should be delet-
ed. It should be sufficient if 50% or more of the shares of a company are
owned directly or indirectly by equivalent beneficiaries.

As mentioned above, the restrictions on intermediate owners as currently
foreseen – according to which each intermediate owner itself has to qualify
as an equivalent beneficiary – would constitute a violation of EU/EEA princi-
pies. Therefore, this should be deleted. In fact, including such restriction on
intermediate owners would – in our view – not increase the degree of pre-
vention against treaty abuse; it would merely constitute additional limitations
to its application reaching far beyond the aim of the BEPS Actions.

Referring to the base erosion prong of the derivative beneficiary test of Art.
X (4) b) OECD-MA Draft, needs to clarify the relation required between the
payments that the company receives and for which it wishes to receive trea-
ty benefits, and the potentially base eroding business expenses to other
non-equivalent beneficiaries. In our view payments and business expenses
should not be in a nexus to one another (e.g. interest expenses and inter-
est income) but the test should focus on the entity itself.

- Comment on the definition of equivalent beneficiary (paragraph 6 of the
LOB rule)

Again, bearing in mind the aim of the BEPS Actions, we suggest including
any company that qualifies for treaty benefits under the income tax treaty
between that company’s country of residence and the source country as an
equivalent beneficiary. Currently, the corporate category only includes pub-
licly traded companies. There is no obvious reason why – for instance – a
family owned company fully active in the conduct of a trade or business
should not qualify as an equivalent beneficiary.

Furthermore, the current wording of Art. X (6) f) i) B) OECD-MA Draft im-
plements an “all or nothing” approach, i.e. if – for instance – the withholding
tax (WHT) rate of the tax treaty concluded by the source state with the coun-
try of residence of the equivalent beneficiary is higher than the one of the tax
treaty the application of which is desired, then no relief at all is granted. This,
again, appears to go beyond the general aim of the BEPS Actions. If the ap-
plicable WHT rate of the tax treaty with the third state is higher than the
WHT rate of the applicable tax treaty, rather than denying the qualified per-
son status altogether, the higher WHT rate as laid down in the tax treaty with
the third state should be applied. In this case the company would not receive more favourable treaty benefits than the equivalent beneficiary had obtained if the latter had a direct relationship with the Contracting State.

Finally, in a chain of equivalent beneficiaries, the test should be applied step by step up the chain until either the ultimate level of treaty benefits is reached or the taxpayer cannot prove the existence of any further equivalent beneficiaries. Tax authorities should engage in information exchange concerning their respective knowledge of the chain of equivalent beneficiaries.

- Additional comment on compatibility with EU law

In some cases tax treaties between EU Member States still include WHT provisions which are overruled when the Parent-Subsidiary Directive or the Interest and Royalties Directive are applicable. However, the derivative benefit provision compares a treaty benefit only to other treaty benefits. Thus, treaty benefits could be denied where the above Directives grant a WHT-free receipt of income to the equivalent beneficiary while the less favourable tax treaty still retains a high WHT rate without practical relevance. This should be amended in EU and EEA tax treaties.

- Alternative language

Bearing the above in mind, we would like to provide an alternative wording for the current derivative benefits provision, as follows:

3. A company that is a resident of a Contracting State shall also be entitled to the benefits of this Convention if:

a) at least 50 percent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by persons that are equivalent beneficiaries, and

b) less than 50 percent of the company’s gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm’s length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the company’s State of residence.

5 e) the term “equivalent beneficiary” means a resident of any other State, but only if that resident

i) A) would be entitled to the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed, provided that if such convention does not contain a comprehensive limitation on benefits article, the person would be entitled to the benefits of this Convention if such person were a resident of one of the States under Article 4 of this Convention; and
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B) with respect to income referred to in Articles 10, 11 and 12 of this Convention, the rate of tax that would be available under such convention to a company resident in such other State and eligible for benefits under such convention (and otherwise comparable to the company claiming benefits under this Convention) with respect to the particular class of income for which benefits are being claimed under this Convention is at least as low as the rate being claimed under this Convention; or

ii) is a resident of a Contracting State that is entitled to the benefits of this Convention by reason of paragraph 2 of this Article.

If – while all other requirements of paragraph i) of this provision are met – the rate of tax on income referred to in Articles 10, 11 and 12 of this Convention that would be available for a company resident of the other State is higher than the rate being claimed under this Convention the company shall nonetheless be regarded an equivalent beneficiary; however, in this case this Convention shall be applied as if it included a rate of tax similar to the one included in the convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed. Where in cases of indirect ownership the intermediate owner also qualifies as equivalent beneficiary, but according to the previous sentence would be entitled to a rate of tax higher than the one available to the ultimate owner the rate of tax available to the ultimate owner shall apply; in any case the rate of tax of this Convention shall be the minimum rate available.

4. Regarding the invitation for comments on item A.7. – Provisions dealing with “dual-listed company arrangements”

We welcome the Working Group’s decision to undertake further work on this topic. However, by their nature, these provisions will have very limited application, although currently much emphasis is being put on this area. In our view, this could result in tax authorities being compelled to apply it to situations for which it was not intended. We would therefore like to suggest particular clarification be made to the effect that only exceptional cases will be subject to these provisions.
5. **Regarding the invitation for comments on item A.8. – Timing issues related to the various provisions of the LOB rule**

**Issues on which comments are invited**  
Comments are invited on the rules concerning the temporal aspects of the various provisions of the LOB rule (paragraph 16 of the Report). One particular issue on which comments are invited is whether it would be possible for an entity to become, or cease to be, publicly-listed without such event triggering a new taxable period and, if yes, whether this could create a problem for the application of the LOB.

In this regard we refer to our comments above. It is of special concern to us that – on the basis of the current wording of the LOB clause – there will be a number of cases that inadvertently lead to a denial of treaty benefits due to a mid-year change in the status of a taxpayer. This would far exceed the intended aim of BEPS Action.

To be more precise, it is not obvious why – for the prevention of treaty shopping – it is necessary that a company or entity should be regularly traded on a recognized stock exchange (Art. X (2) c) i) OECD-MA Draft) throughout the entire taxable period. In contrast, it should be sufficient if the (equivalent) beneficiary is regularly traded on a recognized stock exchange at the moment in time of receipt of the item of income subject to the treaty benefit (e.g. the interest is paid or the dividend is distributed). A more lenient view that the treaty benefit should be granted even if the public listing occurs later during the taxable period in which the income is received would take the sort of timing issues into account that typically occur when a company registers at a stock exchange.

6. **Regarding the invitation for comments on item A.9. – Conditions for the application of the provision on publicly-listed entities**

**Issues on which comments are invited**  
Comments are invited as to whether and how subparagraph 2 c) of the LOB rule (the “publicly-listed entity” provision) could be modified to take account of the concerns of small countries that do not have important stock exchanges whilst ensuring that a publicly-listed entity has a sufficient nexus with a country to warrant the application of the provision.

We support the view that any public listing and regular trade on a recognized stock exchange should be accepted and not be suspected as treaty shopping. It should not be necessary that the stock exchange be in one of the Contracting States if the Contracting States agree upon which foreign stock exchanges qualify as recognised stock exchange under the tax treaty. This should be amended. Where necessary for U.S. purposes, the U.S.A. should implement individual provisions in their tax treaties.
The alternative clause of Art. X (2) c) ii) OECD-MA Draft in connection with Art. X (6) d) OECD-MA Draft does not help sufficiently in such cases. The definition of a company’s “primary place of management and control” requires that the majority of day-to-day decisions with regard to the company and potential (direct and indirect) subsidiaries are exercised in the state of residence of the company. If a group of companies with ultimate shareholders located elsewhere interposes intermediate holding companies this requirement will be very difficult to meet. Obviously, there are valid business reasons to interpose a (e.g. European or Asian) intermediate management holding company in a state other than the Contracting States. The location of the management holding would, in such cases, be the place where the local day-to-day decisions are taken and exercised. It should suffice, for only the company located in the Contracting State to be managed by employees located in that Contracting State.

7. **Regarding the invitation for comments on item A.10. – Clarification of the “active business” provision**

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The active business test should be extended to other sources of income beyond trade or business income.

Example: All States involved shall be EU Member States. A natural person not resident in the Contracting States solely owns a company resident in the first Contracting State. This company owns and lets real estate located in both Contracting States for rental. Art. X (2) e) i) OECD-MA Draft is not met. Therefore, the company is not a qualified person. Art. X (3) OECD-MA Draft would, in most cases, not be met because letting real estate does not qualify as a business in many EU countries.

Obviously, as a network of double tax treaties implementing Art. 6 OECD-MA exists throughout Europe, this structure should not give rise to a suspicion of treaty shopping. We propose the term “business” be interpreted within the activity clause with regard to each item of income for which the tax treaty provides the treaty benefit, rather than it being interpreted as the business as a whole.

Further, in contrast to the last sentence of paragraph 48 of the Commentary, a management holding business should be deemed sufficient to meet the active business test (especially for dividends). A definition of a management holding would then be needed. The German definition of a managing holding in the unilateral German anti-treaty shopping provisions provides a feasible
approach. Such management holding is seen as a trade or business for purposes of the German Income Tax Act and also for the purposes of acting as the parent of a German tax group ("Organschaft"). Moreover, in the event that such a management holding provides services to its subsidiaries (such as book-keeping services), this should qualify as the active conduct of a business.

Furthermore, the active business test is, again, currently construed as an all-or-nothing provision: If any income of a company – active in a trade or business – is not fully linked to that trade or business, the test will not be met. There will be a number of situations where this link only partly exists. We therefore suggest changing the test such that it is sufficient if substantially all of the income is derived in connection with, or is incidental to, that trade or business.

Finally, again neither the wording of the active business test nor the Commentary including the proposed examples actually factor in any changes in a company’s situation. Such changes will inevitably occur numerous times in the globalized trade. One example:

Company A – resident of country A, privately owned and not listed – manufactures pharmaceutical goods. It acquires Company B in country B, which is also active in the business of manufacturing pharmaceutical goods. In addition, Company B manufactures cosmetics. This business is not considered to be core business; therefore, after the acquisition it is sold on to a third party. The gain from this sale is distributed to Company A. According to the current wording of the active business test and the guidance provided by the Commentary the sale of the cosmetics business is neither connected with Company A’s business nor incidental to it. Therefore, Company A is deprived of any benefits related to the distribution under the treaty concluded between country A and country B.

We therefore suggest including examples such as the above within the Commentary as an example of circumstances that are not deemed harmful to the entitlement to treaty benefits.

B. Issues related to the PPT rule

We fully welcome the Working Group’s openness for further comments on the PPT rule, since the inclusion of a main purpose rule – as currently drafted – in the treaty would eliminate the principal benefits of the LOB clause, which are to provide certainty and predictability. A PPT would seriously reduce the role of tax treaties in promoting bilateral trade and investment, especially as such a rule relies largely on subjective criteria – as opposed to measurable and, thus, objective criteria. This poses a significant risk, as in many countries general anti-
abuse rules were introduced relatively recently or have yet to be introduced – and, hence, the domestic tax authorities or courts have no, or limited, experience in applying such a rule. In countries that already have a similar rule (i.e., Germany) the interpretations by the courts have varied, adding to the uncertainty. There is a clear risk that increasing controversy may take up more and more of tax administrators’ and taxpayers’ valuable time.

In addition, the PPT – being highly prone to subjective interpretation – might lead to a significant number of double-taxation cases. One country may apply this rule in a way that it denies – for instance – a WHT relief, while the other does not apply the rule in the same manner, therefore denying the credit of the increased WHT.

Germany, being one of the major capital exporting countries and therefore naturally concerned about tax avoidance schemes, has, for instance, taken a different route. Almost all of the treaties concluded recently include a number of provisions aimed at the avoidance of treaty shopping – but nonetheless these treaties provide sufficient certainty regarding their application. These provisions include:

- Correspondence rule – according to this rule any payment received by a person in one of the Contracting States is only subject to tax exemption if it is not deductible at the level of the paying entity (similar to the D/NI defence rule of the Deliverable on Action 2 – Hybrid Mismatch Arrangements);
- Subject to tax rule – treaty benefits (in particular granting of a tax exemption for income generated by a permanent establishment held in one Contracting State by a person resident in the other Contracting State) will only be granted by the first Contracting State if the respective income is effectively taxed in the other Contracting State;
- Switch-over rule – denies the tax exemption of income, and offers only the credit of foreign taxes, in cases where both Contracting States apply different rules to any item of income or apply the treaty in a different manner. As a result, such item of income may effectively be low-taxed or un-taxed.

In addition, Germany has a history of applying the beneficial ownership concept – also in the context of cross-border transactions.

We consider the above set of rules to be very comprehensive. Combined with specific German tax provisions they cover a great variety of potential treaty shopping situations, without leading to an increased degree of uncertainty as would be the case if a PPT were included in the treaties. We urge the Working Group to consider similar rules before finalizing their work on the PPT.

If the concept of a PPT rule is to be adhered to, we strongly suggest factoring in the resultant increased potential for double-taxation when there was a lack of coordination between the countries involved in respect of the application of the PPT. The Working Group could, for instance, consider – either as part of the rule or at least as part of the Commentary – whether an application of the PPT
rule should be subject to an increased obligation for information exchange between the countries involved and to an arbitration mechanism. This would both achieve corresponding treatment and avoid adverse consequences for the great variety of taxpayers not aiming at any treaty shopping whatsoever.

In the following we add specific comments to the issues addressed in the public discussion draft.

8. Regarding the invitation for comments on item B.11.-17. – PPT and its application to EU/EFTA countries

The PPT rule as drafted currently will deny treaty benefits if obtaining a treaty benefit was “one of the principal purposes”. Based on current jurisprudence, the CJEU as well as the EFTA Court would probably qualify such wording as contradictory to the freedom of establishment. In the judgement of the EFTA Court as of 9 July 2014 (Olsen) the court stated that

“What is decisive [to assess an artificial character] is the fact that the activity, from an objective perspective, has no other reasonable explanation but to secure a tax advantage”

(see rec. 175). In the same way the CJEU ruled in its decision C-112/14 as of 13 November 2014 where the court stated that

“... to identify the existence of a wholly artificial arrangement entered into for tax reasons alone, …”

(see rec. 27). According to the wording of the PPT rule treaty benefits can be denied if only one of the principle taxpayer's purposes is to obtain a treaty benefit. This contradicts the judicial interpretation of the freedom of establishment. According to the view of the CJEU and the EFTA court a restriction of the freedom of establishment is only justified when the only purpose of such a transaction is to obtain a tax benefit.

In conclusion, we recommend amending the PPT rule in EU and EEA cases in a way that such denial is only applicable when the only purpose of the transaction is to obtain a treaty benefit.

9. Regarding the invitation for comments on item B.11. – Application of the PPT rule where benefits are obtained under different treaties

Although a common international understanding of a general anti-abuse clause would be very helpful, we doubt that such an understanding would be grandfathered by the draft of the PPT rule. The currently drafted PPT rule will probably be drafted differently in the finalised tax treaties and, in any case, will subsequently be within the jurisdiction of the national tax courts. As a consequence the tax courts of the various states will interpret the PPT rules differently (cf. for example the very limited application and narrow in-
interpretation the German national General Anti Abuse Rule (GAAR) by the German "Bundesfinanzhof", i.e. the Highest German Federal Tax Court). Further, there might be various different PPT rules within EU legislation (GAAR) (e.g. potentially included in the Parent-Subsidiary-Directive, etc). The OECD could suggest the implementation of a coordinated GAAR (perhaps with a drafting proposal by the OECD) in order to tackle those treaty abuse situations not covered by the LOB, and should, in addition, provide clear and restricted guidance on the interpretation of the GAAR/PPT.

10. Regarding the invitation for comments on item B.13. – Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable

PPT rule issues should be subject to the arbitration provision of paragraph 5 of Article 25. It is necessary that at least the two Contracting States develop a coordinated approach as to what is deemed to be abusive behaviour and what is not. Diverse interpretations of the PPT rule would lead to double taxation.

11. Regarding the invitation for comments on item B.15. – Whether some form of discretionary relief should be provided under the PPT rule

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<td>Commentators are invited to suggest examples where some form of discretionary relief would be justified following the application of the PPT rule.</td>
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First, we would like to emphasize the need for a corresponding treatment of any item of income by the two Contracting States, as already pointed out in our opening remarks on the PPT rule.

Apart from this, the PPT rule should not explicitly be within the discretion of one Contracting State. The tax authorities of that Contracting State will, in any case, interpret the PPT rule in the way they deem to best serve their own specific purpose. In the beginning this will potentially lead to wide variations in interpretations, which will materialise in tax assessments. In the course of time, national Tax Courts will develop separate interpretations and case by case jurisdiction on the PPT rule. The mechanism allows independent judges to narrow the interpretation by the tax authorities where necessary. In Germany, for example a discretionary decision may only be subject to limited review by German tax courts and this restriction would severely limit a practical and reasonable review process in our jurisdiction.

It would be helpful for the Commentary to the PPT rule to clarify that the Contracting State applying the PPT would apply the treaty benefits of the "re-qualified" transaction, i.e. the transaction that the taxpayer would have
pursued if the principal purposes had not been to obtain a treaty benefit. However, from a business perspective the IDW would not be in favour of such a suggestion.

A look-through approach should be applied when an intermediary company has been established with the sole purpose of obtaining treaty benefits. Consistently, the tax treaty with the State of the shareholders of the parent company should be applied instead, if such treaty exists.

12. Regarding the invitation for comments on item B.17. – List of examples in the Commentary on the PPT rule

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<td>Commentators are invited to suggest additional examples that could be included in paragraph 14 of the Commentary on the PPT rule (paragraph 17 of the Report). For example, representatives of investment funds are invited to suggest an additional example that would deal with the non-tax motivated use of a special purpose vehicle in order to pool the investment of various institutional investors from different countries.</td>
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The examples currently set out in the proposed Commentary are extreme examples at either end of the spectrum. As a result, rather than adding clarity they merely serve to raise more questions as to the scope of the PPT. We are concerned that including further examples would exacerbate this, since each example that illustrates the inapplicability of the PPT may give rise to interpretations as to its applicability in similar circumstances; circumstances that are not within the scope of the example.

We believe that any potential example illustrating where the PPT would apply introduces facts that could be better addressed by means of anti-abuse rules targeted to the specific situation – such as that described above which is included in German treaties. Hence, we suggest no further examples be included. Instead detailed anti-abuse rules (switch over clauses, subject to tax clauses, etc.) should be developed further.

13. Regarding the invitation for comments on item C.18. – Application of the new treaty tie-breaker rule

We firmly support the Working Group continuing its work on the tie breaker rule. Rapidly increasing globalization has led to a significant increase in the number of instances where a company’s management consists of individuals resident in more than one country. We assume that this issue will become increasingly significant in future. As a consequence, there will be an increasing number of cases where a tax nexus to more than one country exists.
For several years, taxpayers have been able to rely on relatively clear standards applying to such situations. Using the effective place of management as decisive factor has proven to be a good criterion in determining the main tax nexus. To the extent that it has occurred at all, we envisage that there would have been only a very small number of cases of abuse of these standards for the purposes of treaty shopping.

If the tie breaker rule currently proposed were included in the treaties, the situation for the international community would change dramatically. In numerous cases taxpayers would need to analyse whether a competent authority process should be instigated – without being able to predict the timing or the outcome.

Therefore, there should be clear criteria to deal with instances of double residence. If the catalogue of criteria proves insufficient, a structured decision procedure involving all parties (i.e. the tax authorities of the Contracting States, the dual resident person, and any other state potentially involved) is needed. The respective tax authorities would need to hear the case of the person with dual residency in order to come to a mutual decision within limited period of time.

A generally accepted arbitration board stipulated in the treaty should be responsible for a decision in cases where the respective tax authorities have not reached mutual agreement. The person should have the opportunity to appeal against this decision in front of the tax courts in the country of residence that had been decided.

14. Regarding the invitation for comments on item C.20. — Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

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<td>Apart from the changes described above, are there other clarifications/additions that should be made to the Commentary changes in paragraph 49 of the Report?</td>
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In principle, the treaty anti-abuse rule will take precedence over any specific domestic anti-abuse rule (see para. 5 of the Commentary). If the requirements of a treaty anti-abuse rule are not met, the treaty benefits could not be denied based on a specific domestic anti-abuse rule (see para. 9 of the Commentary).

The statement in para. 12 of the Commentary, that in principle a domestic general anti-abuse rule (GAAR) would not conflict with the treaty anti-abuse rules is highly questionable. German tax courts generally apply e.g. the German domestic GAAR (§ 42 Abgabenordnung) very restrictively. According to the jurisdiction of the German Federal Tax Court, the German GAAR would not be applicable if a specific anti-abuse rule exists elsewhere within
the law. It is currently unclear, whether the German Federal Tax Court would determine that treaty anti-abuse rules qualify as specific anti-abuse rules. Further, it is not clear, whether the specific anti-abuse rules deal comprehensively with the situations that need to be tackled.

Should you have any questions regarding our comments please do not hesitate to contact Jörg Peter Müller from the IDW Team on +49 (0)211 4561 403 or via e-mail at mueller@idw.de.

Yours sincerely,

Hamannt     Marita Rindermann
Executive Officer    Technical Director Taxes and Law
Dear Ms. De Ruiter,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association) kindly find below the comments on the Public Discussion Draft on the Follow-up Work on BEPS Action 6: “Preventing treaty abuse”.

COMMENTS ON THE FOLLOW-UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE

A. Issues related to the LOB provision

1. Collective investment vehicles: application of the LOB and treaty entitlement

Comments are invited as to whether the recommendations of the 2010 CIV Report continue to be adequate for widely-held CIVs and whether any improvements should be made to the conclusions included in that Report. Comments are invited, for example, on whether it would be advisable to provide for a preferred approach with respect to issues related to the tax treaty entitlement of the income of CIVs and the application of the LOB to CIVs, and if yes, on what that approach should be.

Comments:

Although recommendations of the 2010 CIV Report continue to be adequate for widely-held CIVs, it is advisable to further discuss on granting a preferred approach with respect to issues related to the tax treaty entitlement of income of CIVs and the application of the LOB to CIVs, regardless that some of these issues have been included in paragraphs 6.4 to 6.38 of the Commentary on Article 1 of the Convention.

The discussion has been raised on whether a CIV is a “person” and if so, Contracting States should clarify that for purposes of their conventions the definition of “person” should be modified to include them.

The second issue that arises is the one related to determine whether a CIV is in fact a “resident” of a Contracting State, which would lead to the application of treaty benefits.
Finally, even where it is determined that a CIV is indeed a “person” and a “resident” of a Contracting State, the question would be if it qualifies as the beneficial owner of the income it receives.

All these discussions have been generally resolved in paragraphs 31 to 43 of the Commentary on the LOB rule. However, the concern on whether a CIV could be granted treaty benefits and therefore claim benefits on its own regard still persists.

The restriction of benefits to CIVs through anti-abuse or anti-treaty shopping rules as suggested in paragraphs 52 through 57 of the 2010 CIV Report continue to be applicable.

The inclusion of any such rules will entirely be left to negotiators since all characteristics of the different types of CIV forms, according to domestic legislation of each Contracting State, should be taken into account.

2. Non-CIV funds: application of the LOB and treaty entitlement

Comments are invited as to whether the preceding paragraphs accurately describe the treaty entitlement issues of sovereign wealth funds, pension funds and alternative funds/private equity funds. Comments are also invited as to how to address these issues without creating opportunities for treaty shopping.

As regards more specifically the situation of pension funds, comments are invited on:

- Whether and how the issue of the treaty residence of pension funds should be addressed.

- Whether changes should be made to paragraph 69 of the Commentary on Article 18, which deals with the source taxation of income of foreign pension funds, in order to ensure that two States that follow similar approaches with respect to the taxation of retirement savings consider more thoroughly the appropriateness of including in their bilateral treaty a provision exempting such investment income from source taxation in order to achieve greater neutrality with respect to the taxation of capital.

- Whether drafting changes should be made to the alternative provision included in paragraph 69 of the Commentary on Article 18 (e.g. restricting its application to portfolio investment income).

- How the 50% ownership test applicable to pension funds could be modified in order to address cases where it may produce inappropriate results (e.g. in the case of the individual retirement fund of a pensioner who moves abroad) without creating opportunities for treaty-shopping.

- How the description of pension funds found in subparagraph 2 d) of the LOB rule (“person that ... was constituted and is operated exclusively to administer or provide pension or other similar benefits”) could be clarified.

Comments:
According to paragraphs 8.6 and 8.7 of the Commentary on Article 4, in many States, a person such as a pension fund, is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax; however, in some States, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws.

Based on the above, we are of the opinion that a precision should be included in the LOB rule to specifically establish that a pension fund would be treated as a “resident” of the State in which it is established because the pension fund is subject to comprehensive taxation in that State, even when the income is taxed at a zero rate or is exempt from tax. This would be a wording similar to that included in paragraph 6.12 of the Commentary on Article 1 in the case of CIVs.

As far as the provision stated above is included in the LOB rule, no need would there be to change paragraph 69 of the Commentary on Article 18, since no doubt would there be that even when income is derived by a resident of the other Contracting State constituted and operated exclusively to administer or provide pension benefits, such entity would be a “resident” of a Contracting State, thus subject to benefits and limitation of benefits established under treaty provisions.

According to paragraph 2 d) ii), a resident of a Contracting State shall be a qualified person at a time when a benefit would otherwise be accorded by the Convention if, at that time, the resident is a person, other than an individual, that was constituted and is operated exclusively to administer or provide pension or other similar benefits, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State.

Clarification could be made by including a commentary on the LOB rule stating that the provision was drafted with the only intention of granting treaty benefits exclusively to persons constituted to administer or provide pension or other similar benefits but only to the extent that this task is limited to performing such activities. In no way a person constituted for such purpose may perform activities different to those specifically addressed in paragraph 2 d) ii).

3. Commentary on the discretionary relief provision of the LOB rule

Suggestions are invited as to possible factors or examples that could be included in the Commentary on the discretionary relief provision of paragraph 5 of the LOB rule in order to clarify the circumstances in which that provision is intended to apply.

Comments:

In line with the Commentary included in paragraph 19 of the Report, we consider that clarification is indeed needed since not all tax authorities may be in line with the intention of extending treaty benefits per the LOB rule to persons who, in principle, are not subject to them. Given that paragraph 5 provides a discretionary ability to the competent authority of a Contracting State, certain guidance should be provided in order to eliminate subjectivity upon a request by a resident of a Contracting State.

Some authorities, mainly in civil law countries, have a ‘form over substance’ approach, regardless that they seem to be moving away from it. In these specific cases, some kind of guidance should be provided as to set up rules that enable a unification of criterion that align the way authorities should resolve such requests.
Apparently the last sentence of paragraph 5 of the LOB rule may establish some sort of mutual agreement, since it provides that the competent authority to which the request has been made will consult with the competent authority of the other State before rejecting a request made under said paragraph. However, neither the LOB rule nor the Commentary itself, provides clarification in case an authority decides to reject a request and the other authority is not in agreement with such resolution.

Indeed paragraph 68 of the Commentary on paragraph 5 of the LOB rule encourages States to publish guidelines on the types of cases that they consider will and will not qualify for discretionary relief, but no general guidance is provided as under which basis these general guidelines should be drafted.

6. Issues related to the derivative benefit provision

Suggestions are invited on possible changes that could be made to the derivative benefit provision (paragraph 4 of the LOB rule), the definition of equivalent beneficiary (paragraph 6 of the LOB rule) or other provisions of the Model Tax Convention in order to assist in the work on other parts of the Action Plan and ensure that the inclusion of a derivative benefit provision would not raise BEPS concerns whilst providing that cases where intermediate companies are used for valid commercial reasons are not excluded from treaty benefits.

Comments:

We understand that the discussion draft recommends the inclusion of a specific anti-abuse rule as established by paragraph 4 of the LOB rule. Such provision specifically refers to examples included in treaties concluded by the United States (US) with the general US approach to these type of anti-abuse rules.

Many income treaties concluded with the US that have LOB provisions contain a “derivative benefits” clause in such provision. In general, according to the US approach, a company that does not satisfy any of the other LOB tests may qualify for treaty benefits if a specified percentage of its shares is owned, directly or indirectly, by a given number of “equivalent beneficiaries” and a base erosion test is satisfied.

This would, for example, ensure that an entity owned by non-resident shareholders (i.e.: equivalent beneficiaries) may qualify for treaty benefits, even if the other LOB tests are not satisfied, when it is clear that such entity was not used for treaty shopping purposes.

In line with the US approach, an “equivalent beneficiary” generally means any person that:

a) In connection with certain European country treaties, is a resident of a member state of the European Union (EU), any state of the European Economic Area (EEA), a party to the North American Free Trade Agreement (NAFTA), or in some cases Switzerland or Australia (a “Qualifying Country”);

b) Is entitled to the benefits of a comprehensive income tax treaty between such Qualifying Country and the Contracting State from which treaty benefits are claimed and satisfies certain LOB requirements (even if that treaty has no LOB article); and

c) In the case of dividends, interest, royalties, and possibly certain other items (such as insurance premiums), would be entitled under the treaty between the qualifying country and the
Contracting State in which the income arises, to a rate of tax with respect to the particular class or item of income for which benefits are claimed that is “at least as low as” the rate provided for under the treaty between the Contracting States.

We consider that the derivative benefits rule as drafted in paragraph 4 of the LOB rule, cannot only be utilized to obtain a more favorable local tax regime, but may allow third-country residents to achieve a lower tax rate by investing through an entity resident in another jurisdiction than would otherwise be available if those residents invested directly in a Contracting State.

8. Timing issues related to the various provisions of the LOB rule

Comments are invited on the rules concerning the temporal aspects of the various provisions of the LOB rule (paragraph 16 of the Report). One particular issue on which comments are invited is whether it would be possible for an entity to become, or cease to be, publicly-listed without such event triggering a new taxable period and, if yes, whether this could create a problem for the application of the LOB.

Comments:

Aside of publicly-listed entities, another temporal aspect that should be taken into account is that related to CIVs, under the different scenarios provided in paragraphs 36 through 43 of the Commentary on the LOB rule. In these cases, a resident of a Contracting State shall be a qualified person if at that time the resident is: a) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the CIV are owned by residents of a Contracting State in which the collective investment vehicle is established or by equivalent beneficiaries, or b) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established.

In any of the cases mentioned above, it might happen that throughout that time the beneficial interests in the CIV can be owned by a person different than a resident of the Contracting State in which the CIV is established, or that the owner of such beneficial interests is no longer a resident of the Contracting State in which the CIV is established.

If that were the case, this situation might be solved through paragraph 5 of the Commentaries on the LOB rule; however, the waiting might take too long for the person requesting for confirmation of the competent authority to resolve if it is indeed entitled to treaty benefits. Furthermore, in many cases, it would be very hard or almost impossible to define who the owner of the beneficial interests is, situation which would very likely end in double taxation or non-taxation relief under the LOB rule.

Depending on domestic legislation, a situation may occur in which an entity residing in a Contracting State becomes a publicly-listed entity throughout the taxable period that includes that time, as provided by paragraph 2 of the LOB rule.

This particular issue is not dealt within the LOB rule itself nor its Commentaries. If given the circumstances an entity becomes a publicly-listed entity which does not fulfill any of the thresholds provided under subparagraph c) –again under domestic legislation–, then it would definitely lose treaty benefits, even when before becoming publicly-listed, it was a resident of a Contracting State subject to treaty benefits.
This would definitely disincentive entities wishing to become publicly-listed companies to take part of a recognized stock exchange, situation that would have economic repercussions that go beyond tax implications.

9. Conditions for the application of the provision on publicly-listed entities

Comments are invited as to whether and how subparagraph 2 c) of the LOB rule (the “publicly-listed entity” provision) could be modified to take account of the concerns of small countries that do not have important stock exchanges whilst ensuring that a publicly-listed entity has a sufficient nexus with a country to warrant the application of the provision.

Comments:

Residents of a Contracting State are entitled to treaty benefits. However, a resident will only be entitled to the benefit of the treaty if the entity meets at least one of the tests to determine if the entity claiming the treaty has sufficient nexus with the country to justify awarding the benefit of the treaty.

A possible test in addition to those established in subparagraph 2 c) i) of the LOB rule could be drafted as follows:

“c) a company or other entity, if, throughout the taxable period that includes that time

i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:

A) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or
B) the company’s or entity’s primary place of management and control is in the Contracting State of which it is a resident; or
C) has an active trade or business in the Contracting State in which the company’s or entity’s shares are traded; or”

By including subdivision i) C), a company resident in a Contracting State will be entitled to the benefits of the convention, even when requirements under subdivision i) A) or i) B) are not met, as long as it fulfills this last requirement.

For example, if a company does not have its principal class of shares being traded on one or more recognized stock exchanges located in the Contracting State of which the company or entity is a resident (because its residence is in a small country) nor its primary place of management and control is in the Contracting State of which it is a resident, it will be entitled to treaty benefits as long as it has an active trade or business in the Contracting State in which the company’s or entity’s shares are traded, assuming that the shares are being traded in a recognized stock exchange of the other Contracting State.

This will ensure that a publicly-listed entity of a small country has sufficient nexus with the other Contracting State, in order to be awarded with the application of treaty benefits. Indeed having an active trade or business in the other Contracting State, will have as a consequence that source income earned by the publicly-listed entity of the small country in the other Contracting State is subject to treaty benefits, where applicable.
As indicated in paragraph 44 of the Commentary on paragraph 3 of the LOB rule, a resident of a Contracting State may qualify for benefits under paragraph 3 whether or not it also qualifies under paragraph 2.

The additional subdivision i) C) will be similar to the “active business” provision set forth in paragraph 3 of the LOB rule, but in this case it will only be a conditional test to determine whether or not the issuer of the shares is a “qualified person” under paragraph 2.

10. Clarification of the "active business" provision

Comments are invited as to possible clarifications that could be made concerning the interpretation and application of the “active business” provision found in paragraph 3 of the LOB rule (paragraph 16 of the Report).

Comments:

Per the last sentence of paragraph 48 of the Commentary on paragraph 3 of the LOB rule, ‘Since a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in the active conduct of a business for purposes of paragraph 3’.

A headquarters company should be subject to the generally applicable income taxation rules in its country of residence. This means that this type of company should be subject to income taxation rules to which any other company would be subject to.

Typically, activities carried on by a headquarters company or even by a holding company consist precisely on managing investments, risks and banking for a Group of companies. Hence, these type of activities are the core business or core activities for which they were formed. Establishing that performing any such activities would not be considered to be the active conduct of a business, drives away the intention of groups of companies to constitute a headquarters or holding company with the final purpose of diminishing risks and achieving corporate efficiency.

The limitation of benefits to a headquarters company would only make sense if one of the countries has or introduces a special tax legislation that imposes a lower tax rate on headquarter companies than that imposed to any other company, provides for a special tax regime or grants incentives to a headquarters company that lead to lower taxation.

We consider that the wording included in last sentence of paragraph 48 of the Commentary on paragraph 3 of the LOB rule should be modified to state the following:

“(…) Since a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in the active conduct of a business for purposes of paragraph 3, unless it carries out banking, insurance or dealer business that are not part of the headquarters company business.”

B. Issues related to the PPT rule
14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

Comments are invited as to possible inconsistencies between the Commentary on how the phrase “did not have as one of its principal purposes the obtaining of benefits under this Convention” should be applied in the context of the discretionary relief provision of the LOB rule (paragraph 16 of the Report) and how the phrase “obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit” should be interpreted in the context of the PPT rule (paragraph 17 of the Report).

Comments:

The phrase in the context of the LOB rule does not mention that the arrangement or transaction must result directly or indirectly in a certain unwanted benefit, unlike the phrase in the context of the PPT rule, for which we could conclude that for purposes of determining if a certain situation which indirectly derived a treaty benefit is abusive of a treaty, we might end up determining that for purposes of the LOB rule it may not be the case because the LOB rule does not mention “that resulted directly or indirectly” for which we may conclude that the phrase only makes reference to a situation where the transaction resulted directly in an unwanted benefit.

For purposes of the PPT rule however, it might so be the case, since the phrase in said context does include situations where an arrangement or transaction resulted “directly or indirectly” in a certain benefit. Hence one of the inconsistencies which may derive from the different wording of these two phrases.

In this case, the phrase in the PPT rule (includes “that resulted directly or indirectly”) proved to be broader than that of the LOB rule (by not mentioning “that resulted directly or indirectly” one could interpret that it makes reference only to situations where a transaction resulted “directly” in a benefit).

Another inconsistency comes from the fact that the phrase in the context of the LOB rule does not limit the actions of a taxpayer to an arrangement or transaction, while the PPT rule does. For this, in case a taxpayer carries out an action which may not qualify as an arrangement or transaction, but might have as one of its principal purposes the obtaining of benefits under the Convention, this may be regarded as treaty abusive for purposes of the LOB rule but not for purposes of the PPT rule.

In this case the phrase in the LOB rule context proved to be broader than that in the PPT rule context, because it covered any action which derived in a benefit, and not only arrangements or transactions which derived in a benefit.

Thus, the two rules which we understand aim the same target, will have different unwanted results.

15. Whether some form of discretionary relief should be provided under the PPT rule

Commentators are invited to suggest examples where some form of discretionary relief would be justified following the application of the PPT rule.

Comments:
Before suggesting specific examples where some form of discretionary relief would be justified following the application of the PPT rule, we would like to stress that in our opinion the PPT rule as drafted seems discretionary already and seems to be punishing any situation where one of the principal purposes of a transaction is the obtaining of a treaty benefit in case the tax authority finds that obtaining to be not in accordance with the object and purpose of the relevant provisions of the Convention.

We agree that when carrying out a transaction or arrangement, if the principal purpose of that transaction or arrangement was the obtaining of a benefit under a tax treaty, and the taxpayers carried out artificial arrangements for such purpose, said situation is abusive of a tax treaty.

However, we find deriving a benefit from a tax treaty to be natural. This is, we believe the purpose of the execution between countries of tax treaties is to grant benefits to their taxpayers in order to encourage cross-border investments by not punishing them with double taxation.

Thus, if only one of the principal purposes, but not the principal purpose of a transaction was to derive a benefit under a tax treaty, this should not be regarded as abusive of a treaty, unless the transaction carried out is artificial.

We believe it is too broad to leave it to the tax authority to determine when a treaty benefit is in accordance with the object and purpose of the relevant provisions of the Convention. In our opinion, as explained above, only in case that the principal purpose of a transaction was to derive a treaty benefit and said transaction was artificial, the treaty benefit should be considered as not in accordance with the object and purpose of the relevant provisions of the tax treaty.

Many other issues of uncertainty derive for the taxpayers from the PPT rule, as to when and how will it be determined that a tax benefit is in accordance with the object and purpose of the relevant provisions of the tax treaty. Should the taxpayer request a ruling before a transaction and wait until the tax authorities issue said ruling in order to carry out a transaction which market conditions require it to be carried out at a given moment? Should the taxpayer bare the uncertainty that the transaction it carried out might be totally and discretionally disregarded by the tax administration in the future because said administration considers the tax benefits were not in accordance with the object and purpose of the Convention?

We do know this was subject to discussion under the first draft written on Action 6 in March, 2014 and that many tax practitioners and organizations delivered comments in this sense and that this is not subject to discussion under the current discussion draft of Follow-up work on BEPS Action 6. Nonetheless, our point is that if the PPT rule, which we consider very discretionary already, should be final, then at least it should certainly provide for relief in all cases, and not only discretionary relief.

This is, in our opinion, in every case and not in a discretionary manner, where the tax authority by making use of this powerful PPT rule disregards a certain transaction carried out by a taxpayer because in its opinion one of the principal purposes of said transaction was the obtaining of a benefit that is not in accordance with the object and purpose of the relevant provisions of the tax treaty, then said tax authority should be obliged to establish which transaction the taxpayer did carry out (in cases of relative and not absolute simulation) and, as a consequence, the applicable benefits of the tax treaty should follow.
In summary, if the tax administration re-characterizes a transaction (which it must do in case of a relative simulation), it must allow the tax benefits under the tax treaty that are applicable to the transaction said to be truly carried out by the taxpayer.

Thus, if for example the tax administration considers that the taxpayer is simulating a sale of shares for which it denies the application of Art. 13(5) of the Model Tax Convention, then said administration should establish if the simulation is absolute or relative, and if it is relative, it must establish which transaction the taxpayer did carry out, which in its opinion might have been receiving cross-border dividends, and then, said tax administration must allow the application of the benefits for cross-border dividends under the tax treaty in order to respect the taxpayers’ rights.

We suggest the tax administration grants the taxpayer this benefit in case the taxpayer does not contend the tax administration’s decision of disregarding the sale of shares or until a final ruling has been issued on the matter in case the taxpayer alleged it did carry out a sale of shares, under a mutual agreement procedure or under litigation.

Another example would be the following:

SCo, a company resident of State S, is the subsidiary of TCo, a company resident of State T. State T has a tax convention with State S under which any dividend paid by SCo to TCo is subject to a withholding tax on dividends of 5 per cent, while any interest paid to TCo is subject to a 10 per cent withholding. TCo enters into a loan agreement with SCo, pursuant to which SCo must pay TCo interest and withhold taxes at the 10 per cent. Should the tax administration interpret that TCo did not lend SCo any funds but invested in SCo said funds, said tax administration should not merely disregard the loan agreement and deny the application of the 10 per cent withholding rate, but it must establish with evidence, what other transaction it believes the taxpayer did carry out and grant the applicable tax benefits that may derive from the State S-State T tax treaty, which for dividends, is a withholding tax rate of 5 per cent.

This, in case SCo did not challenge the tax administration’s denial of the 10 per cent withholding rate on interest, or while the matter is being decided in case the taxpayer did challenge said denial.

16. Drafting of the alternative "conduit-PPT rule"

Comments are invited on the various features of the “anti-conduit rule” in paragraph 15 of the Commentary on the PPT rule (paragraph 17 of the Report).

Commentators (Sic) are also invited on possible examples that could be included in the Commentary in order to illustrate the application of this “anti-conduit rule”.

Comments:

We share the opinion of many others that some features of the “conduit-PPT rule” are too broad. E.g.: the “all or substantially all” threshold is too high and uncertain (What shall be interpreted as “substantially all”?) and the reference to a payment made “directly or indirectly” and “at any time” is too broad, since a company may make a payment to another unrelated company, which may many years later make a payment to a third party, which may or may not be related to the first company. In our opinion it would be very harsh to qualify said transaction as a “conduit arrangement” and it would disregard the taxpayers’ freedom to distribute funds or make investments.
Also, in our opinion this “conduit-PPT rule” in most of the cases shall result to be repetitive since the beneficial ownership rule already covers cases where benefits of Articles 10, 11 and 12 will not be accorded to a taxpayer in respect to income obtained by said taxpayer through another party which was entitled to tax treaty benefits that the first taxpayer would not have been entitled to should it had received the income directly and not through said other party.

Thus, we believe that if the “conduit-PPT rule” is more general and covers benefits of many provisions of the Convention (e.g. those of Articles 7, 10, 11, 12 and 21) as mentioned in paragraph 15 of the Commentary on the PPT rule, then there would be no need to have a beneficial ownership rule, as so many anti-abusive rules, general and specific, might result overlapping, excessive or confusing.

With regard to letter a) of paragraph 15 of the Commentary on the PPT rule (paragraph 17 of the Report), we believe it is unnecessary to include cases where one or more persons receive an item of income to which tax treaty benefits are applied under a certain tax treaty, which are equivalent to those benefits said person or persons would have received had they received that item of income direct from the other Contracting State and not through a resident of the other Contracting State.

This is, we believe it is too broad and unfair to deny the application of tax treaty benefits if it is proved that the equivalent benefits would have been derived had that taxpayer received the income directly and not through another party or a company believed to be “conduit”. As a consequence, we suggest removing the words “equivalent to, or” from letter a) of paragraph 15 of the Commentary on the PPT rule, as follows:

“a) which is structured in such a way that a resident of a Contracting State entitled to the benefits of this Convention receives an item of income arising in the other Contracting State but that resident pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to one or more persons who are not resident of either Contracting State and who, if they received that item of income direct from the other Contracting State, would not be entitled under a convention for the avoidance of double taxation between the State of which those persons are resident and the Contracting State in which the income arises, or otherwise, to benefits with respect to that item of income which are equivalent to, or more favourable than, those available under this Convention to a resident of a Contracting State; and”

For these purposes, it is worth noting that letter b) of paragraph 15 of the Commentary on the PPT rule only makes reference to “increased benefits as are available under this Convention” and not to benefits “which are equivalent to those available under this Convention to a resident of a Contracting State”, which shows inconsistency.

We also believe that letter b) of paragraph 15 of the Commentary on the PPT rule (paragraph 17 of the Report) contradicts the whole spirit of the “conduit-PPT rule”. This is, we understand the “conduit-PPT rule” is suggested as an alternative in cases where the PPT rule is found to be unacceptable for some States (probably because of its high discretionary features and likeness of deriving many litigations against it).

Notwithstanding this, letter b) of the “conduit-PPT rule” is even broader than the PPT rule itself, since it establishes that the benefits of the provisions of the tax treaty or of some of them will
not be accorded in respect of any income obtained under, or as part of, a conduit arrangement, which for example is a transaction or series of transactions “which has as one of its principal purposes obtaining such increased benefits as are available under this Convention”. In this regard, at least the PPT rule provides that said benefits are to be denied “unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention”.

In the case of letter b) of the “conduit-PPT rule” however, apparently a “conduit arrangement” means a transaction or series of transactions which has one of its principal purposes obtaining such increased benefits as are available under the tax treaty, without mentioning as the PPT rule does, that the tax administration must reasonably conclude, having regard to all relevant facts and circumstances that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted in that benefit and that it must be established that the benefit (or the increased benefits in this case) are not in accordance with the object and purpose of the relevant provisions of the tax treaty.

The following examples illustrate the application of the “anti-conduit rule” and were drafted considering the examples listed in the exchange of notes between the United Kingdom and the United States concerning the application of the “conduit arrangements” rules of the 2001 treaty between these two States, as suggested by paragraph 36 of the Draft:

- Example A: TCo, a publicly-traded company resident in State T, owns all of the outstanding stock of RCo, a company resident in State R. SCo, a company resident in State S, which does not have a tax treaty with State R, would like to purchase a minority interest in RCo, but believes that the 30 per cent State R domestic withholding tax on dividends would make the investment uneconomic. TCo proposes that RCo instead issue preferred stock to TCo, paying a fixed return of 4 per cent plus a contingent return of 20 per cent of RCo’s net profits. The maturity of the preferred stock is 1 year. SCo will enter into a separate contract with TCo pursuant to which it pays to TCo an amount equal to the issue price of the preferred stock and will receive from TCo after one year the redemption price of the stock. During said year, TCo will pay to SCo 4 per cent plus 20 per cent of RCo’s net profits.

This arrangement constitutes a conduit arrangement because: (i) TCo did not have valid business reasons to carry out said transaction, but only participated in the transaction in order to achieve a reduction in State R withholding tax for SCo. It cannot be considered it is a valid business reason for TCo to contract with SCo, since the fixed return rate is not at arm’s length conditions but at the same rate as that agreed with RCo and (ii) the maturity of the preferred stock is of less than 2 years, which might be considered a reasonable period in which a taxpayer may invest for valid commercial reasons and not only to obtain tax treaty purposes.

- Example B: TCo, a publicly-traded company resident in State T, owns all of the outstanding stock of RCo, a company resident in State R. SCo, a company resident in State S, which does not have a tax treaty with State R, would like to purchase a minority interest in RCo, but believes that the 30 per cent State R domestic withholding tax on dividends would make the investment uneconomic. TCo proposes that RCo instead issue preferred stock to TCo, paying a fixed return of 4 per cent plus a contingent return of 20 per cent of RCo’s net profits. The maturity of the preferred stock is 20 years. SCo will enter into a separate contract with TCo pursuant to which it pays to TCo an amount equal to the issue price of the preferred stock and will receive from TCo after 20 years the redemption price of the stock. During the 20 years, TCo will pay to SCo 3.75 per cent plus 20 per cent of RCo’s net profits.
This arrangement does not constitute a conduit arrangement because: (i) the fixed return rate of 3.75 per cent agreed between TCo and SCo is at arm’s length conditions and (ii) the maturity of the preferred stock is 20 years, which is such a long period that contributes to believe there are valid business reasons for said investment and not an artificial arrangement to turn around State R’s domestic withholding.

- Example C: TCo, a company resident in State T, has issued only one class of stock, common stock that is 100 per cent owned by RCo, a company resident in State R. RCo also has only one class of common stock outstanding, all of which is owned by SCo, a company resident in State S, which does not have a tax treaty with State T. RCo is engaged in the manufacture of electronics products, and TCo serves as RCo’s exclusive distributor in State T. Under paragraph (X) of Article (X) (Limitation on Benefits), RCo will be entitled to benefits with respect to dividends received from TCo, even though RCo is owned by a resident of a third country.

This seems to be a perfectly acceptable and normal commercial structure with real economic activity in both State R and State T. The payment of dividends by subsidiary companies is a normal feature of commercial life. Accordingly, in the absence of evidence that dividends were flowed through to SCo in terms of the beneficial ownership provision of this Convention, these transactions would not constitute a conduit arrangement.

- Example D: SCo, a company resident in State S, a country that does not have a tax treaty with State T, loaned $1’000,000 to TCo, its wholly-owned State T subsidiary in exchange for a note issued by TCo. Two years later, SCo needs cash flow to carry out its daily activities and cannot afford to await TCo’s payment. Thus, SCo realizes it can access to cash easily by assigning the note issued by TCo to an unrelated party at an arm’s length price and for an upfront price. This assignment was made having examined the scenario of many third parties which offered equal market conditions, and that a benefit may derive from the tax treaty executed by State R, which is RCo’s country of residence and State T, by avoiding the State T withholding tax by assigning the note to said unrelated party. Accordingly, SCo assigns the note to RCo in exchange for a note issued by RCo. The TCo note pays 7 per cent and the RCo note pays 6.75 per cent, having a discount difference of .25 per cent.

The loan was assigned at an arm’s length basis, to an unrelated party and to easily access to cash flow. It was specifically assigned to a resident of State R, which has a tax treaty with State T by which there is no withholding of tax on interest, having examined other options with unrelated parties under the same market conditions but which were not residents of countries with which State T had a tax treaty, thus turning the transaction more convenient from an economic aspect, which is a valid and a core business reason for all taxpayers.

As a consequence, the transaction does not constitute a conduit arrangement as defined in the treaty.

- Example E: SCo, a company resident in State S, a country that does not have a tax treaty with State T, loaned $1’000,000 to TCo, its wholly-owned State T subsidiary in exchange for a note issued by TCo. SCo later realizes that it can avoid the State T withholding tax by assigning the note to its wholly-owned subsidiary, RCo. Accordingly, SCo assigns the note to RCo in exchange for a note issued by RCo. The TCo note pays 7 per cent and the RCo note pays 6.75 per cent.

Unless more elements are provided, there is no valid business reason in this transaction although the 6.75 per cent seems to be agreed at an arm’s length basis.
Thus, it could be derived that the loan was assigned to avoid State T income tax on the payment of interest and that the transaction constitutes a conduit arrangement as defined in the treaty as both the objective definition and the motive test at Article (X) (X) and (x) respectively are met and there are no other valid business reasons.

- Example F: SCo, a company resident in State S, which does not have a tax treaty with State T, owns all of the stock of TCo, a company resident in State T. SCo has for a long time done all of its banking with RCo, a company resident in State R, because the banking system in State S is relatively unsophisticated. As a result, SCo tends to maintain a large deposit with RCo. RCo is unrelated to SCo and TCo. When TCo needs a loan to fund an acquisition, SCo suggests that TCo deal with RCo, which is already familiar with the business conducted by SCo and TCo. TCo discusses the loan with several different banks, all on terms similar to those offered by RCo, but eventually enters into the loan with RCo, in part because interest paid to RCo would not be subject to State T withholding tax, while interest paid to banks organized in State S would be.

The fact that the State R-State T tax treaty benefits are available if TCo borrows from RCo, and that similar benefits might not be available if it borrowed elsewhere, is clearly a factor in TCo’s decision (which may be influenced by advice given to it by its 100 per cent shareholder). It may even be a decisive factor, in the sense that, all else being equal, the availability of treaty benefits may swing the balance in favor of borrowing from RCo rather than from another lender. However, whether the obtaining of treaty benefits was “one of the principal purposes” of the transaction would have to be determined by reference to the particular facts and circumstances.

Similarly, for the “conduit-PPT rule” to apply it would have to be established that the interest paid by TCo was “flowing through” RCo to SCo as explained by the beneficial ownership provision of this treaty. The fact that SCo has historically maintained large deposits with RCo might, if anything, be a counter-indication.

On the specific facts as presented, the transactions would not constitute a conduit arrangement as defined by the treaty.

However, if RCo’s decision to lend to TCo was dependent on SCo providing a matching collateral deposit to secure the loan, the indication would be that SCo was in substance lending to TCo direct but in form routing the loan through a bank with whom it has a close relationship in order to obtain the benefit of the treaty. In such circumstances the transactions would constitute a conduit arrangement as defined by the treaty.

- Example G: RCo, a publicly-traded company resident in State R, is the holding company for a manufacturing group in a highly competitive technological field. The manufacturing group conducts research in subsidiaries located around the world. Any patents developed in a subsidiary are licensed by the subsidiary to RCo, which then licenses the technology to its subsidiaries that need it. RCo keeps only a small spread with respect to the royalties it receives, so that most of the profit goes to the subsidiary that incurred the risk with respect to developing the technology. SCo, a company resident of State S, with which State T does not have a tax treaty, has developed a process that will substantially increase the profitability of all of RCo’s subsidiaries, including TCo, a company resident of State T. According to its usual practice, RCo licenses the technology and sub-licenses the technology to its subsidiaries. TCo pays a royalty to RCo, substantially all of which is paid to SCo.

Because SCo is conforming to the standard commercial organization and behavior of the group in the way that it structures its licensing and sub-licensing activities and assuming the same
structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favorable benefits, the inference would be that the absence of a treaty between State S and State T is not influencing the motive for the transactions described.

Therefore even though the specific fact pattern, as presented, meets the first part of the definition of a “conduit arrangement” at Article (X) (X) (x), on balance the conclusion would be that “one of the principal purposes” of the transactions was not the obtaining of State R-State T treaty benefits. So the structure would not constitute a conduit arrangement.

- Example H: SCo is a publicly-traded company resident in Country S, which does not have a tax treaty with State T. SCo is the parent of a worldwide group of companies, including RCo, a company resident in State R, and TCo, a company resident in State T. TCo is engaged in the active conduct of a trade or business in State T. RCo is responsible for coordinating the financing of all of the subsidiaries of SCo. RCo maintains a centralized cash management accounting system for SCo and its subsidiaries in which it records all inter-company payables and receivables. RCo is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. RCo enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of RCo are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. RCo has 50 employees, including clerical and other back office personnel, located in State R.

SCo lends to RCo $10 million in exchange for a 10-year note that pays interest annually at a rate of 5 per cent per annum. On the same day, RCo lends $10 million to TCo in exchange for a 10-year note that pays interest annually at a rate of 8 per cent per annum. RCo does not enter into a long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

TCo appears to be a real business performing substantive economic functions, using real assets and assuming real risks. RCo appears to be bearing the interest rate and currency risk. It is assumed that the transactions are typical of RCo’s normal treasury business and that that business was carried on in a commercial manner.

So, on the specific facts presented, the transactions would not constitute a conduit arrangement as defined by the treaty.

17. List of examples in the Commentary on the PPT rule

Commentators are invited to suggest additional examples that could be included in paragraph 14 of the Commentary on the PPT rule (paragraph 17 of the Report). For example, representatives of investment funds are invited to suggest an additional example that would deal with the non-tax motivated use of a special purpose vehicle in order to pool the investment of various institutional investors from different countries.

We drafted these two examples considering those that are included in paragraph 14 of the Commentary on the PPT rule (paragraph 17 of the Report). We suggest adding them after Example E of said paragraph as follows:
14. The following examples illustrate the application of the paragraph:

- Example F: TCo, a company resident of State T, owns shares of SCo, a company listed on the stock exchange of State S. State T does not have a tax convention with State S and, therefore, any dividend paid by SCo to TCo is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on dividends paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State. TCo needs cash flow to finance its operations and cannot afford to wait for SCo to distribute it dividends. Once TCo has explored many options, it enters into an agreement with RCo, an independent financial institution resident of State R, pursuant to which TCo assigns to RCo the rights to the payment of dividends that have been declared but have not yet been paid by SCo. This assignment is agreed at a discount determined on an arm’s length basis.

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that even though one of the principal purposes for the arrangement under which TCo assigned the right to the payment of dividends to RCo was for RCo to obtain the benefit of the exemption from source taxation of dividends provided for by the State R-State S tax convention, this is not contrary to the object and purpose of the tax convention, but rather is in accordance to them, since it is encouraging cross-border investments.

This, because: (i) there were valid business reasons for carrying out the above transactions such as (a) for TCo obtaining from RCo cash flow before than originally agreed with SCo and probably at a higher amount than if the assignment had been executed with a resident of a State with which State S does not have a tax treaty and (b) for RCo obtaining dividends at a discount price, which is lower than the price it would have paid if it had invested directly and originally in SCo had that chance may in fact actually been available to RCo; (ii) the consideration for the assignment was fixed at an arm’s length basis and (iii) RCo was an independent financial institution.

- Example G: SCo, a company resident of State S, is the subsidiary of TCo, a company resident of State T. State T does not have a tax convention with State S and, therefore, any dividend paid by SCo to TCo is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, the applicable rate of withholding tax on dividends paid by a company of State S to a resident of State R is 5 per cent. TCo is in the need of cash flow and cannot afford to wait until SCo distributes it dividends. Therefore, TCo analyzed the many options that arose to sell its usufruct to residents of different states. TCo concluded that if it entered into an agreement with RCo, an unrelated financial institution resident of State R and a qualified person under subparagraph 3 a) of this Article, considering State R has a tax treaty applicable with State S, a greater benefit could derive compared to executing the same agreement with another party which State of residence did not have a tax treaty with State S.

Thus RCo acquires the usufruct of newly issued non-voting preferred shares of SCo for a period of three years. TCo is the bare owner of these shares. The usufruct gives RCo the right to receive the dividends attached to these preferred shares. The amount paid by RCo to acquire the usufruct corresponds to the present value of the dividends to be paid on the preferred shares over the period of three years (discounted at the rate at which TCo could borrow from RCo and determined at an arm’s length basis).
In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that although one of the principal purposes of the arrangement under which RCo acquired the usufruct of the preferred shares issued by SCo was to obtain the benefit of the 5 per cent limitation applicable to the source taxation of dividends provided for by the State R-State S tax convention, said transaction would add to TCo’s business income, which is the purpose of any business and hence a valid and natural business reason encouraged in a cross-border context by the State R-State S tax convention. In this manner, it would be in accordance to the object and purpose of the tax convention to grant the benefit of that limitation.

What would not be a valid business reason is if TCo is presented with many options, all of which offer the same features except that the one with RCo offers it a greater benefit because there is a tax treaty between State R and State S, and nonetheless for other hidden or counter-productive reasons, TCo chooses a different option.

As in the previous example, it is reasonable to conclude that the tax treaty benefit must not be denied because: (i) there were valid business reasons for carrying out the above transactions such as (a) for TCo obtaining from RCo cash flow before than originally agreed with SCo and probably at a higher amount than if the usufruct had been sold to a resident of a State with which State S does not have a tax treaty and (b) for RCo obtaining dividends at a discount price, which is lower than the price it would have paid if it had invested directly and originally in SCo had that chance may in fact actually been available to RCo; (ii) the consideration for the usufruct was fixed at an arm’s length basis; (iii) RCo is an independent financial institution; (iv) the term of three years seems long enough to consider this was not a sham transaction but a real investment and (v) the dividends will not be flowed through RCo to TCo, but RCo is the beneficial owner of said dividends.

C. Other issues

19. The design and drafting of the rule applicable to permanent establishments located in third States

The anti-abuse rule included in paragraph 42 of the Report is currently restricted to cases where the profits of the PE are exempt in the State of the enterprise to which the PE belongs. Are there other situations where the rule should apply?

Are the exceptions included in subparagraph e) and f) of the anti-abuse rule sufficient to address cases where the rule would otherwise affect arrangements that are not tax-motivated?

Do these exceptions raise potential BEPS concerns?

Comments:

We find it suitable to restrict the situation where the profits of the PE are exempt in the State of residence of the enterprise to which the PE belongs.

However, we have some comments on this new anti-abuse rule as it is drafted.

We think there might be inconsistencies in the wording of paragraphs 40 and 41 of the Report and 71 of the Commentary on Article 24 of the Convention.

At times it seems that the state where the PE is situated is the third state, and at times it seems that it is the State of source, which adds to the confusion.
For instance, paragraph 40 of the Report states the following:

“40. Where the State of residence exempts, or taxes at low rates, profits of such permanent establishments situated in third States, the State of source should not be expected to grant treaty benefits with respect to that income”.

In this case, we understand the State of residence is State R and RCo is a resident therein and the owner of a PE situated in a third State (State T). We derive that paragraph 40 of the Report makes reference to a situation where State R exempts, or taxes at low rates, profits of the PE situated in State T and thus suggests that the State of source (State S) should not be expected to grant treaty benefits with respect to that income under the State R-State S tax treaty.

However, paragraph 41 of the Report reads as follows:

“41. The last part of paragraph 71 of the Commentary on Article 24 deals with that situation and suggests that an anti-abuse provision could be included in bilateral conventions to protect the State of source from having to grant treaty benefits where income obtained by a permanent establishment situated in a third State is not taxed normally in that State:”

From said paragraph we interpret that an anti-abuse provision could be included in bilateral conventions to protect the State of source (State S) from having to grant treaty benefits where income obtained by a PE situated in a third State (State T) is not taxed normally in that State (State T).

The inconsistency relies on the fact that under paragraph 40 of the Report what seems to matter is that the profits of the PE are exempt or low-taxed in the State of residence (State R), whereas under paragraph 41 of the Report what seems to matter is that the income of the PE situated in a third State is not taxed normally in that State (State T).

On the other hand, paragraph 71 of the Commentary on Article 24 of the OECD Model Tax Convention states the following:

“71. Another question that arises with triangular cases is that of abuses. If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment”.

From said paragraph, it seems that the third State (State T) is the State of source (State S), which we believe is different in paragraphs 40 and 41 of the Report.
We believe a third State is a state different from the State of residence (State R) and the State of source (State S) under the State R-State S tax treaty, this is, that the third State is not a party to said tax treaty.

Last, we believe that the paragraph 2 on the Commentary to this new anti-abuse provision, should be adjusted to remove the reference to “discretionary relief provision of paragraph 5 of Article [X]”, since as we explained above, said relief should not be discretionary but mandatory in cases of relative simulations of acts found to have occurred according to the tax administration.

We find that the exception included in subparagraph e) is not sufficient when it does not recognize that holding companies have as their main core business activity simply holding investments, for which in that case, the income derived from the other Contracting State shall be considered to derive in connection with, or to be incidental to, the active conduct of a business carried on in the third State through the permanent establishment, and the exception to the exception (“other than the business of making, managing or simply holding investments for the enterprise’s own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively”) is over-inclusive and shall not be applicable in the case of holding companies which regime is specifically recognized and so agreed by the Contracting State itself under its domestic laws in order to encourage inbound investments.

Also, we find the exception included in subparagraph f) to be insufficient since it should not only cover royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the enterprise through the permanent establishment, but it should cover any royalty which is paid over intangibles that were or are acquired at an arm’s length value and any royalties which are paid at an arm’s length value.

In our opinion these exceptions do not raise potential BEPS concerns, since other anti-abuse rules remain applicable, such as the beneficial ownership rule for the case of dividends, interest and royalties, the specific rules each item of income may have, and the many other general and specific anti-abuse rules such as those proposed in the deliverable on Action 6 of the BEPS Action Plan.

20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

Apart from the changes described above, are there other clarifications/additions that should be made to the Commentary changes in paragraph 49 of the Report?

Comments:

We believe there is a typo in the suggested new paragraph 9 of the Commentary on Article 1 when it says: “... Whilst this facilitates their application and provide greater certainty, it may sometimes result in the application of such a rule in a case...” We think it should instead read “Whilst this facilitates their application and provides greater certainty, it may sometimes result in the application of such a rule in a case...”

On the other hand, apart from the changes described in paragraph 49 of the Report, we would like to see clarifications on the presence or absence in a treaty of the specific mention that there is no conflict or, even if there is a conflict, the application of the domestic rules is allowed.

This is, is there a difference between a treaty executed between State R and State T that specifically mentions that the application of Controlled Foreign Corporations (CFC) or thin
capitalization rules is allowed under the treaty, with respect to a treaty between State R and State S that does not specifically mention that the application of those domestic rules is allowed?

In our opinion there is a difference and unless the Contracting States so specifically agreed, it should be understood that the application of the domestic CFC or thin capitalization rules results in a treaty override, denying taxpayers benefits that the Contracting States had agreed to grant them under the treaty.

In order to grant more legal certainty, in our opinion it should be recognized that there is a difference between the fact that the Contracting States included a specific provision in a tax treaty allowing the application of domestic CFC or thin capitalization rules, compared to the fact that one of said Contracting States when entering into a tax treaty with another State did not include such specific provision. We are not certain that if the “saving clause” is included in the Convention, this problem would be solved.

The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA Branch, and in no case in the name or on behalf of Central IFA or IFA as a whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

* * *

Sincerely,

IFA Grupo Mexicano, A.C.
Dear Ms De Ruiter,


We hope again to provide a meaningful contribution to your work to support the development of a sound regulatory framework and remain available should you have any specific questions about the non-listed real estate fund industry.

Kind regards,

Matthias Thomas
Chief Executive INREV

Attachment:

Submitted via email: taxtreaties@oecd.org

About INREV: the voice of the European non-listed real estate investment industry

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide guidance and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe. In addition, INREV undertakes research and surveys of the industry and constructs the INREV Index which covers the performance of institutional non-listed real estate funds investing in Europe.

INREV currently has 344 members. Our member base includes institutional investors from around the globe such as pension funds, insurance companies and sovereign wealth funds, as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into non-listed real estate vehicles in Europe.

Our fund manager members manage more than 500 European non-listed real estate investment funds, as well as joint ventures, club deals and separate accounts for institutional investors. INREV’s members represent almost all jurisdictions of the European Union’s internal market and a range of underlying long-term investment vehicle structures, both CIVs and other non-listed real estate investment vehicles, the vast majority of which are Alternative Investment Funds (“AIFs”) subject to regulation under the European Alternative Investment Fund Directive (“AIFMD”).

Concerns regarding the Discussion Draft on Treaty Abuse

As we have publically stated before, INREV shares the concerns of the G20 and the OECD that action is needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. INREV also supports a coordinated and comprehensive international approach to tackle these important issues.

As we stated in earlier submissions, including our response dated 7 April 2014 and the comments we made jointly with a large number of European real estate associations on 23 May 2014, the BEPS Action 6 discussion draft proposes measures that could inadvertently have a significant negative impact on the future development of institutional real estate investment and institutional investment in related sectors such as infrastructure that generally use the same or very similar investment fund structures. The potential loss to the European economy of the benefits of investment in real estate and infrastructure funds, in terms of economic stimulation, job creation and growth, would be incalculable.

Public Discussion Draft Follow Up Work on BEPS Action 6

INREV welcomes the opportunity to comment on the recent OECD Public Discussion Draft: follow up work on BEPS Action 6 – preventing treaty abuse (the “Follow Up Discussion Draft”). We are very pleased that the OECD seeks the view of the stakeholders in the investment management industry in order to find appropriate solutions for CIVs and non-CIVs in connection with the work on BEPS Action 6 – Treaty Abuse.

The Follow Up Discussion Draft accurately highlights on page 6, paragraph 16:

The problems that the LOB rule creates for CIVs may also be encountered by private equity funds / alternative funds (i.e., since their investor base is not restricted to a single country, they would be denied benefits under the LOB rule and would probably not get the active business exception; any provision dealing expressly with CIVs would not apply to them). Also, these
funds face many of the treaty issues that were addressed in the 2010 OECD Report on CIVs (e.g., whether they qualify as residents).

Indeed, the currently proposed LOB rule basically only allows treaty entitlement to extend to shareholders in the same country of residence as the fund claiming treaty benefits; it is also true that the active business exception would not apply to them. The proposed standard for eligibility of the LOB rule is therefore very narrow in that it is not possible for most European non-listed real estate funds and other investment vehicles to meet the requirements as currently structured, as most of them are “non-CIVs” in OECD terminology (even though, confusingly, most are considered “CIVs” under the EU’s AIFMD). This result follows because they typically have an institutional investor base with diverse countries of residence. Ironically, this is true even though it is safe to say that each of their institutional investors, if investing directly in the real estate rather than investing indirectly through non-listed real estate investment vehicles, would be entitled to the benefits of double tax treaties.

These non-listed real estate investment vehicles are employed for numerous, quite legitimate financial and operational purposes, and not for the inappropriate purpose of taking advantage of treaty shopping opportunities. More importantly, however, these structures do pay a fair share of tax in the relevant country, not only on the fund profits in the form of rental income and gains, but also in the form of real estate transfer tax, property tax and payroll tax. The investors in these structures are typically either subject to corporate income tax in their country of residence (insurance companies), or are by nature exempt (pension funds) but regularly pay pension benefits that are fully subject to tax in the hands of the recipients of the payments (retired workers).

The structures and their underlying investors take advantage of the double taxation treaties only in order not to be subject to double or even triple taxation. We provided a number of real-world examples in our previous submissions of fund structures that would not be able to claim treaty benefits under the current proposal.

These non-listed real estate investment structures are important vehicles for pension funds, insurance companies and other institutional investors to invest in real estate and thereby generate returns needed to meet their obligations to pensioners and policyholders. They invest via funds or other similar investment vehicles in a portfolio of real estate situated in various countries in order to diversify their investment portfolios while funding their long-term obligations.

**Comments and recommendations regarding BEPS Action 6**

INREV offers the following comments and recommendations on the Follow Up Discussion Draft as it applies to non-CIVs (private equity / alternative investment funds), in particular regarding the application of the proposed LOB rule and Principal Purpose Test.

**Premises**

In developing our recommendations, we have built on the following premises, supported in some parts by the comments made in the sections above:

- Non-CIVs, such as non-listed real estate funds and other investment vehicles, are not established with the purpose of achieving double non-taxation, which is the legitimate target of the various BEPS actions. Rather, these vehicles, which play an increasingly important role in matching capital flows in the global economy and the capital markets, are structured as they are for many other legitimate commercial reasons, only in part including not having to pay double or potentially even triple taxation in separate jurisdictions on the same income.
• The policy defined by the OECD in the 2010 CIV report should be upheld: the goal should be to put the investors in non-listed real estate vehicles in the same tax position that they would be if they invested directly in the underlying assets. In other words, there should be tax neutrality between direct investments and investments via a non-listed real estate fund or other investment vehicle, whether it is a CIV or a non-CIV.

• Moreover, in many jurisdictions non-listed real estate vehicles are structured as partnerships, which are typically tax transparent, mostly with limited liability. OECD has addressed treaty issues of partnerships and partners in separate reports and guidance. New proposals under the BEPS initiative should be consistent with those guidelines, so in situations where partners to a qualifying partnership can claim treaty entitlement because of the partnership’s transparent tax treatment, it should not be lost or unduly complicated by the new proposals.

• Application of tax treaties by non-listed real estate vehicles should be straightforward. The anti-abuse solutions should not render the application of tax treaties significantly more complex, legally uncertain and costly, thereby hindering cross-border flows of capital and global economic development as a result. For example, a “derivative benefits test” would still create uncertainty in many cases regarding the circumstances in which an investment vehicle would qualify.

• The various developments in the field of international transparency, including FATCA, CRS, EU Savings Directive, as well as the EU AIFM Directive, significantly mitigate the risk of non-listed real estate funds and other investment vehicles being used for inappropriate reasons including tax avoidance; most of these vehicles are entities with regulatory reporting obligations under the recently enacted transparency and regulatory supervision regimes.

• For a variety of legitimate legal, practical and business reasons, real estate investment funds and other investment vehicles structure their investments via investment holding and real estate operating companies (i.e., via subsidiaries); these subsidiaries should also be able to benefit from tax treaty access. The use of investment holding and real estate operating companies should not prevent non-listed real estate funds and other investment vehicles from making use of treaty benefits, as these structures are extremely useful, but are not designed to facilitate tax avoidance.

Proposed solutions

Based on the above, INREV proposes that treaty benefits should continue to be available to non-listed real estate funds and other investment vehicles because, like public companies, they are either widely held, or in many instances are held by investors that would be entitled to similar treaty benefits if they owned the underlying assets directly. This can be achieved by defining CIVs and non-CIVs as “qualified persons” under the LOB. In this respect, we would like to draw your attention to paragraph 56 of the 2010 CIV report, where a simple solution is considered in order to grant treaty access to CIVs taking into account the objective of fighting abuse (treaty shopping):

Such a provision could be structured in various ways. The simplest would provide a binary application; an entity should either receive 1) full treaty benefits if the requirements for benefits are satisfied, or 2) no treaty benefits if the requirements are not satisfied. This is the standard approach under many anti-treaty shopping provisions. However, that approach would create a pure “cliff”, which effectively would deny benefits to investors who otherwise would be entitled to treaty benefits. For that reason, those countries that have developed provisions to specifically address the treatment of CIVs generally have allowed a CIV to make claims in proportion to its “good” ownership, whether defined to include only residents of the same State or other treaty-entitled investors as well. Procedures could be further simplified, without
significantly increasing the risk of treaty shopping, by providing that, once the CIV has passed some threshold of “good” ownership, the CIV would be entitled to benefits with respect to 100% of the income it receives. This dual approach would avoid the “cliff” effect described above. On the other hand, the “cliff” effect applies equally above the threshold, in that some investors who might not have been entitled to benefits nevertheless would benefit. This might argue for the adoption of a high threshold. A higher threshold might also be justified if a broader class of investors, such as all treaty-entitled investors, were treated as “good” owners. Because of these variables, the choice of threshold is best left to bilateral negotiations.

In summary, if it can be demonstrated that a CIV or non-CIV has a certain percentage of “good” owners (equivalent beneficiaries), such CIV or non-CIV and its subsidiary investment vehicles should be entitled to full treaty benefits.

With respect to the topic of a “principal purpose test”, our view is that is should not be applied to qualifying non-listed real estate funds or other investment vehicles. From the examples given in the OECD publications on Action 6, it seems that conduit companies inappropriately taking advantage of treaty entitlement are an important reason to propose a principal purpose test. However, as explained above, qualifying real estate funds and other investment vehicles are not in the business of treaty shopping. We believe that the goal of the principal purpose test can be more effectively achieved by anti-conduit measures, along with beneficial ownership requirements (SAARs instead of GAARs).

We agree with the point made in section A.2. of the Follow Up Discussion Draft that a solution should be sought for all CIVs and non-CIVs; that is, for all types of alternative investment funds (non-listed real estate funds, private equity funds, infrastructure funds, etc.).

Based on the above considerations, we would propose the following amendments to the current draft BEPS Action 6 model tax treaty provisions:

- CIVs and non-CIVs should be considered “qualified persons” under Article X, paragraph 2, f) of the proposed LOB provision, using an “equivalent beneficiary” approach, meaning that if on at least half the days of the taxable period, at least 50 per cent of the aggregate voting power and value of the interest in the CIV or non-CIV fund is owned by persons that are resident of any other State with which the State of source has concluded a convention for the avoidance of double taxation.

- The terms “collective investment vehicle” (CIV) and non-CIV should include:
  - any entity that is subject to investor protection regulations, or whose manager is subject to such regulations, in its country of residence; and
  - any entity that is either directly or indirectly controlled by a CIV or non-CIV established in a State with which the State of source has concluded a convention for the avoidance of double taxation, including a vehicle that is considered tax transparent in the country where it is established and, either directly or through its manager, is subject to investor-protection regulations.

It should be expressly stated that the “principal purpose test” does not apply to qualifying CIVs or non-CIV.

INREV understands that these recommendations effectively carve out qualifying alternative investment funds and other investment vehicles from running through the set of tests included in the proposed LOB provision (article X). The alternative is to amend the proposed LOB rules to make sure that alternative investment vehicles can qualify under one or more of the tests (most likely the derivative benefits test).
However, this approach is more complicated and would require a very substantial amendment of the LOB tests, as the tests, as currently proposed, contain many elements such as the intermediate entity condition that give rise to undesired complications and uncertainties if applied to alternative investment funds and other vehicles with an internationally spread investor base.

Furthermore, as mentioned above, the new rules under BEPS Action 6 should be consistent with the existing OECD guidance and reports on treaty issues of partnerships and partners, and should provide clear guidance regarding investment vehicles that are partnerships or tax transparent trusts. This could, for example, be achieved by clarifying that a tax transparent non-CIV is deemed to be an equivalent beneficiary of real estate investment vehicles of which it owns the shares/interests.

Given the potentially significant and far-reaching adverse impact that the current OECD proposals on Treaty Abuse could have on non-listed real estate investment funds and other investment vehicles, INREV urges the OECD to carefully consider the treaty entitlement of non-listed real estate investment vehicles, along with other alternative investment funds, taking into account both our premises and recommendations.

We believe our recommendations are fully in line with the recommendations made by the OECD in various earlier reports and guidelines and appreciate very much being given the opportunity to submit comments as part of the public consultation process. We plan to attend the public consultation meeting in Paris on 22 January 2015; however, we do not wish to speak in support of our comments at that meeting. Of course, we remain available should you desire any further explanation or input regarding our comments.
To: Marlies de Ruiter,
Head, Tax Treaties,
Transfer Pricing and Financial Transactions Division
OECD/CTPA

(sent via email to taxtreaties@oecd.org)

6 January 2015

Dear Marlies,

Follow-up work on BEPS Action 6: Preventing Treaty Abuse

IHG welcomes the opportunity to submit comments on the OECD Discussion Draft ‘Follow Up work on BEPS Action 6: Preventing Treaty Abuse on BEPS Action 6’ (‘The Follow Up Report’). That report follows up re certain issues in the Action 6 Deliverable Report ‘Preventing the Granting of Treaty Benefits in Inappropriate Circumstances’ (‘The Report’).

About IHG

IHG (InterContinental Hotels Group) [LON:IHG, NYSE:IHG (ADRs)] is a global organisation with a broad portfolio of nine hotel brands, including InterContinental® Hotels & Resorts, Hotel Indigo®, Crowne Plaza® Hotels & Resorts, Holiday Inn® Hotels & Resorts, Holiday Inn Express®, Staybridge Suites®, Candlewood Suites®, EVEN™ Hotels and HUALUXE® Hotels and Resorts.

IHG manages IHG® Rewards Club, the world’s first and largest hotel loyalty programme with over 82 million members worldwide. The programme was re-launched in July 2013, offering enhanced benefits for members including free internet across all hotels, globally.

IHG franchises, leases, manages or owns over 4,700 hotels and 697,000 guest rooms in nearly 100 countries, with almost 1,200 hotels in its development pipeline.

InterContinental Hotels Group PLC is the Group’s holding company and is incorporated in Great Britain and registered in England and Wales.

Our Summary Comments

IHG is supportive of the BEPS Action Plan in general and of the specific Action 6 objectives of preventing abuse of tax treaties. For the reasons set out below we remain concerned however that some aspects of the proposals in the Report and Follow Up Report would create a material impediment to the primary objective of tax treaties of facilitating international trade by achieving an agreed allocation of taxing rights between treaty parties and reducing risks of double taxation.
We have had the benefit of seeing the submissions being made by BIAC and by the CBI and we support the comments made in those submissions. In view of the significance of the Action 6 proposals for our business we also wish to reiterate and illustrate some of the concerns expressed by BIAC and the CBI in the specific context of a business model and commercial history such as ours. Our primary concerns relate to the LOB provisions which, as presented, seem inflexible and onerous – and much more restrictive than would be expected of a ‘minimum standard’ suitable for any country which chooses an LOB approach.

In our view the following key amendments are needed to the provisions outlined in The Report and Follow Up Report in order that those LOB provisions could operate appropriately as a minimum standard. Item 3 is suggested for both LOB and PPT models. We believe that these limitations and taxpayer/tax authority protections are necessary to minimise the risk of unintended damage to international trade which may otherwise arise:

1. As a generic matter the LOB clauses should not include provisions which are intended to address BEPS outside the area of Treaty Abuse, and are not necessary in order to counter Treaty Abuse. By their nature such additional provisions are not well targeted (because they are using the wrong tool for the relevant task) and are much more likely to inappropriately deny treaty benefits to normal commercial arrangements. As such we believe that these types of additional provisions should not appear in treaties at all. Excluding such provisions from the minimum standard LOB does not however prevent countries which take a different view from pursuing a broader LOB. Exclusion is thus the best approach to allow flexibility while avoiding setting an unduly broad LOB as the norm;

2. In our view one specific example of such an excessive limitation is the requirement in Subdivision 2(c)(ii) that each intermediate owner be a resident of the same contracting state as the company seeking qualified person status. Others are the similar requirement in 2(e)(i), and also the requirement in paragraph 4(a) of the LOB rule that each intermediate owner is itself an equivalent beneficiary; and

3. A proposed denial of treaty benefits (whether under LOB or other provisions) should be subject to Competent Authority agreement (i.e. the taxpayer should have an appeal right to request Competent Authority review of its claim for treaty benefits, with benefits only being denied if it is the view of both Competent Authorities that that is appropriate). Such a process is necessary given that a denial of benefits is a very significant matter not only for the individual taxpayer but also for the counterparty jurisdiction (who may secure a lower amount of domestic tax as a result of the denial of treaty relief- and whose residents and economy may be adversely affected by an in-consistent and asymmetric interpretation of a treaty).

As the reasons for limiting the Report proposals in this way are given above and also expanded on at some length in the BIAC and CBI submissions we do not propose to give extensive additional comment. We do however provide some limited additional explanation below by reference to IHG’s history and experience.

Additional commentary and explanation

That specific context for our comments is IHG’s experience of continuous change over many years. At an operational level the history of our current business centres around two major hotel businesses (the InterContinental and Holiday Inn businesses). Although those businesses have been part of a UK parented group for several decades, they originated and initially grew up in the US. As that original business expanded globally (and expanded into new brands) its operational functions and management developed accordingly to meet the needs of that global development. As a result the business operations are now in the main managed and driven regionally rather than directly from a single global centre. From a longer term context I also note that the UK group which made those hotel business acquisitions several decades ago itself had several centuries of history. The personal experience with IHG of the author of this letter is of approaching 25 years of continuous change.
involving multiple acquisitions and disposals of complex international groups (or parts thereof) and various significant business model changes (including a move away from hotel ownership to a model which is now primarily a franchise and management business).

Whereas it is possible that this IHG history is exceptionally complex, I do not believe it is unusual for multinational groups to have long histories which incorporate significant changes over time in both legal entity structures and operational structures. It is also of course important to look ahead and anticipate such changes continuing into the future. As set out in our prior, 28 March 2014, submission we believe that, for tax treaties to fulfil their primary purpose of facilitating international trade by minimising the competitive barriers and distortions of double taxation it is essential that:

(i) Companies entering into international trade can have confidence that normal commercial arrangements will benefit from treaty provisions; and

(ii) Countries entering into tax treaties can have confidence that their treaty partners will grant treaty benefits to those normal commercial arrangements.

In each case those requirements need to hold over a long period of time as groups change and evolve- and not just during initial stages of organic or other growth which results in simple two tier/two jurisdiction structures. Treaty provisions, while containing suitable protections against abuse, therefore need to be flexible enough to readily accommodate normal commercial structures and changes which result in:

(a) Multi-tier structures (whether through sequential acquisition, or regionalised operating structures which are mirrored by regionalised legal structures, or a combination of both); and

(b) Legacy legal structures which often can-not change as fast as operating structures change.

It is important to recognise in this respect that the time-scale over which both operating change and legal change may take place will often be over many years and that they cannot always happen in tandem. For example operating change may either be gradual over many years or sudden as a result of acquisition or reorganisation. Legal structure change will however typically take a long time because of legal or commercial obstacles, complexity or cost. IHG’s business, for example, involves long term third party service agreements which may last 20, 30 years or more –the surrounding fact pattern at the end of those contracts is unlikely to be the same as at the beginning but generally, even if the underlying internal IHG operational and functional support structures change, we must stick to the external legal agreements and relationships which prevailed at the outset.

When set in the context of this type of commercial experience and history we believe that the narrower LOB limitations and other taxpayer/tax authority protections set out in our summary are both appropriate and necessary.

We believe that this type of context is also of relevance to some of the specific questions raised for comment in The Follow Up Report. In particular:

1. We believe that justifications by reference to this type of commercial operational development, or acquisition history, should be factors which (where necessary) should be capable of justifying the granting of discretionary relief in accordance with paragraph 5 of the LOB rule. We recognise that tax authorities may have concerns of such justifications applying inappropriately in perpetuity. There seems no obstacle however to such discretionary agreement being subject to caveats, time limits or longer term transition agreements as are appropriate to the facts-and that could perhaps be covered in guidance;

2. We have already commented above in relation to the relevance of the above to the derivative benefits provision in paragraph 4 of the LOB rule-and the need to ensure the existence of intermediate companies does not result in the inappropriate denial of treaty benefits; and

3. In our view the Commentary concerning ‘headquarters operations’ in paragraph 48 (in the
context of the ‘active business’ provision) uses an inaccurate or inappropriate concept of a headquarters operation as normally or necessarily being concerned primarily with the business of managing investments. In our view and experience it is quite the reverse - i.e. that because a company or jurisdiction is, or has been, a regional or global headquarters company as an operational matter, it will own or acquire joint venture or subsidiary shareholdings in the region it has operational responsibility for. It will however typically have large scale operating functions which are primarily service functions of one form or another and not primarily to do with the making or management of investments. The latter role is incidental to the former.

We trust that our above comments and suggestions are constructive. We would be happy to provide additional explanation and comment whether within the forum of the proposed public consultation or otherwise.

Yours faithfully,

C.P. Garwood
Head of Group Tax
January 9, 2015

VIA E-MAIL

Ms. Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy & Administration
Organisation for Economic Co-operation and Development
2, rue André-Pascal
75016 Paris
France
taxtreaties@oecd.org

Re: Comments on Discussion Draft entitled Follow Up Work on BEPS Action 6: Preventing Treaty Abuse

Dear Ms. de Ruiter:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, mining, telecommunications, oilfield services, transportation, computer technology, energy, pharmaceuticals, entertainment, software, IT systems, publishing, beverages, and electronics.¹ The group’s purpose is to promote the development and application of international tax rules and policies

¹ The current membership of the IAPT is made up of the following companies: Adobe Systems, Inc.; Anheuser-Busch InBev SA/NV; A.P. Møller-Mærsk A/S; AstraZeneca plc; Baker Hughes, Inc.; Barrick Gold Corporation; BP plc; Chevron Corporation; Cisco Systems, Inc.; ExxonMobil Corporation; Hewlett-Packard Company; Johnson Controls, Inc.; Microsoft Corporation; Procter & Gamble Co.; Reed Elsevier plc; Repsol S.A.; Sony Corporation; Texas Instruments, Inc.; Thomson Reuters Corporation; Tupperware Brands Corporation; and Vodafone Group plc.
based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

The Alliance appreciates the opportunity to provide input to the OECD with respect to its Discussion Draft on Follow Up Work on BEPS Action 6: Preventing Treaty Abuse (Discussion Draft) released on November 21, 2014. Our comments are set forth in the Annex to this letter.

As you know, the IAPT submitted comments on April 9, 2014 on the March 14, 2014 discussion draft on BEPS Action 6. The comments set forth in the Annex to this letter build upon those earlier comments.

As outlined in our attached comments, we support the idea of having a minimum standard to prevent treaty abuse but believe a number of improvements can be made to the proposals referenced in the Discussion Draft. In our view, the wisest course of action at this point would be for the OECD to refrain from including model text of a Limitation on Benefits (LOB) provision in its final Action 6 report and instead simply describe the broad elements an LOB provision should contain. We are concerned that the specific proposals for the LOB and principal purpose test (PPT) provisions in the September 2014 Action 6 Report create too much uncertainty and are liable to be applied too broadly to deny treaty benefits in cases where those benefits should be available. This could create real barriers to the international trade and investment treaties are designed to promote. We have made every effort to provide constructive suggestions on how we believe the Discussion Draft can best be improved and to set forth the rationale for our suggestions.

Once again, the Alliance appreciates the opportunity to comment on this important element of the BEPS project and stands ready to respond to any questions or to provide further input as the work of the OECD on this item continues. As previously indicated by e-mail, I would appreciate the chance to speak on this topic on behalf of the IAPT at the public consultation to be held on January 22, 2015.

Sincerely yours on behalf of the Alliance,

Mary C. Bennett
Baker & McKenzie LLP
Counsel to the Alliance

Annex: Comments on the November 21, 2014 Discussion Draft on BEPS Action 6
ANNEX

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON NOVEMBER 21, 2014 DISCUSSION DRAFT, FOLLOW UP WORK ON
BEPS ACTION 6: PREVENTING TREATY ABUSE

JANUARY 9, 2015
IAPT Comments on the November 21, 2014 Discussion Draft, Follow Up Work on BEPS
Action 6: Preventing Treaty Abuse

1. Executive Summary

1. The IAPT continues to support in principle the inclusion of a properly crafted, objective Limitation on Benefits (LOB) provision in treaties as the principal tool to address treaty shopping concerns, but we recognize that the decision has been made to offer countries a certain amount of flexibility in determining how to satisfy the minimum standard for the provisions to include in treaties to prevent treaty abuse. Our comments have been developed with that decision in mind and are directed towards recommendations for the best approach to defining and implementing that minimum standard.

General comment

2. As an initial point, we recommend that the OECD consider a new approach to the LOB element of the proposed minimum standard. Specifically, we recommend that the OECD refrain from publishing the text of a model LOB provision as part of its Action 6 work and instead simply broadly describe the general elements an LOB provision should contain. This is the more sensible approach due to the small number of countries that prefer the LOB approach, the number and complexity of the issues to be resolved in designing an appropriate LOB provision, and the current state of flux in the development of LOB provisions by the countries that actually use them.

Comments regarding the LOB provision

3. If, contrary to our recommendation, the OECD decides to proceed with developing a model LOB provision, we have the following comments on specific LOB-related questions raised by the Discussion Draft:

4. Issue #2: Pension funds play a critical role in providing retirement security for countless workers across the globe, and it is very important that LOB provisions not operate in practice to as a barrier to their access to legitimate treaty benefits on their cross-border income. We urge the OECD to work with pension funds to develop workable approaches to confirming pension funds’ eligibility for treaty benefits.

5. Issue #3: We have several suggestions regarding the granting of discretionary benefits under an LOB provision:

   - Because there is so seldom any treaty shopping concern where there is an equivalence of potential treaty benefits between an entity and its owner, the Commentary should state that the presence of that equivalence should in itself be sufficient to establish that the conditions for granting discretionary relief with respect to the equivalent benefit being sought are met, in the absence of other conditions that create a treaty shopping concern.
• Given the near universality of non-tax driven structures within MNE groups that involve centralization of certain functions, either globally, regionally, or by business lines, in particular companies resident outside the group parent’s jurisdiction, the Commentary should require the competent authority to consider the following factors in applying the LOB article’s discretionary relief provision:
  
  • Business rationale for having the entity’s functions conducted by a separate entity (e.g., regional holding or headquarters function, regional distribution function, treasury center, purchasing center, IP holding company, “center of excellence” for certain aspects of the group’s core activities, etc.)
  
  • Business considerations for the entity to be resident in its jurisdiction (e.g., skilled workforce, good infrastructure, language, currency, legal system, proximity to the affiliates or third parties with whom the company will primarily interact, etc.)
  
  • The fact that an entity almost satisfies, but does not quite satisfy, the conditions of one or more of the objective safe harbors in the LOB article should also be treated as a positive (though not necessary) factor.
  
  • We support the alignment of the discretionary benefits standard with the principal purpose test (PPT) and to strengthen that alignment we recommend that:
    
    • Any examples of “good” situations included in the Commentary to illustrate the operation of the PPT provision also be explicitly treated as eligible for favorable treatment under the LOB discretionary benefits provision.
    
    • The wording of the LOB discretionary benefits provision be amended to include the possibility that a benefit will be granted upon a finding that “granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention”.
    
    • We endorse the Discussion Draft’s suggestion “that the Commentary on the discretionary relief provision should encourage the competent authority that receives a request for relief under that provision to process that request expeditiously.”
    
    • While we continue to believe that neither the LOB nor PPT provision should operate to deny a person treaty benefits offered by that person’s State of residence, we recommend that, at the very least, a competent authority of a Contracting State have an obligation to consult with the competent authority of the other Contracting State before denying a request from one of its own residents for discretionary benefits.

6. **Issue #5:** We continue to recommend elimination of the intermediate owner residency restrictions from the LOB provision because of their devastating impact on MNE groups and the presence
of so many better targeted safeguards against any possible concern, but at the very least, we would suggest these restrictions should not apply to entities whose ultimate parent companies are resident in countries with territorial systems of taxation.

7. **Issue #6:** The “equivalent beneficiary” restriction for intermediate owners should likewise be dropped from the derivative benefits provision, not only for the same reasons supporting elimination of the intermediate owner residency requirements more generally but also because, as drafted, it is impossible to satisfy.

8. **Issue #8:** With respect to the timing of qualifying for the publicly traded company test, because a company may begin to be, or cease to be, publicly traded partway through a taxable period without triggering a new taxable period, we suggest that it would be appropriate to treat the company as satisfying the test if it is publicly listed on the date of receipt of the relevant income and if it satisfies the regular trading test throughout a 365-day period that includes that date. More generally, we suggest that it may also be appropriate in certain cases to base qualification for benefits upon a taxpayer’s status during a period preceding the one in which benefits are claimed, in order to minimize practical difficulties, especially in withholding tax contexts.

9. **Issue #9:** We continue to recommend elimination of the alternative conditions for satisfying the publicly traded company safe harbor in paragraph 2(c) of the LOB provision, on the grounds that they can in principle and do in practice have an overly restrictive impact, particularly given the increasing trend toward cross-border listings and the factual complexity of determining the location of the “primary place of management and control” of large multinational groups. If, however, the OECD wants to retain this requirement in some form, we suggest that the “primary place of management and control” requirement be replaced with a requirement that the company have, in effect, the equivalent of a permanent establishment in its country of residence.

10. **Issue #10:** Our current and prior comments identify a large number of points under the active business test for which clarification is needed in order to make that test useful in practice.

**Comments regarding PPT provision**

11. As an introductory comment we continue to have serious reservations about the advisability of the PPT test and note our disappointment that the proposed PPT is poorly designed and suffers from at least the following serious flaws, all outlined in more detail in earlier comments by us and other commentators:

   - the possibility that the PPT could be layered on top of the LOB leads to untenable uncertainty and overkill;
   - the provision unnecessarily applies to treaty benefits made available by a Contracting State to its own residents;
contrary to the assertion at paragraph 1 of the proposed Commentary on the PPT rule, the PPT provision as drafted differs materially from the principles currently included in the Commentary on Article 1 of the Model Tax Convention;

- the proposed Commentary is heavily unbalanced in favor of the denial of benefits under the PPT;
- the proposal includes no guarantee that the Contracting States will have provided explanations as to the object and purpose of particular provisions in the relevant treaty, seriously undermining the ability of the taxpayer to counter effectively any assertion of the PPT provision by either State;
- the proposal includes no safeguards that the country invoking the PPT provision will have provided adequate guidance on their substantive interpretation of the PPT provision or any procedural mechanism (e.g., a ruling process or high-level review) for ensuring that taxpayers can achieve certainty on a timely basis and an assurance of equal treatment; and
- the proposal includes no safeguards (not even prior consultation) to ensure that the two Contracting States agree on the provision’s applicability, opening the door to the possibility that it could be invoked unilaterally by a Contracting State to deny benefits contrary to the intention of the other Contracting State.

12. **Issue #11:** We recommend against unbalancing the PPT provision’s consideration of all relevant factors by introducing individual factors into the text of the provision itself, and we see serious risks in language that would preclude taking into account an entity’s consideration of the availability of benefits under other treaties or domestic law in deciding upon its structure.

13. **Issue #12:** We support the idea that countries adopting a PPT should have an administrative process requiring senior level review before applying the PPT to deny benefits, and that the review panel should include persons outside the tax administration. We believe that additional procedural safeguards should include: (i) a ruling process through which taxpayers could seek timely confirmation of the inapplicability of the PPT to their situation; (ii) the issuance of guidance from the Contracting State on its interpretation and application of the PPT, including redacted summaries of its rulings; (iii) participation of the other Contracting State in any decision to deny benefits under the PPT, preferably through their concurrence but at the very least through a requirement that they be consulted (as is the case for the LOB provision); and (iv) some process by which the two Contracting States, ideally jointly, issue information as to their views of the object and purpose of specific treaty provisions, to ensure that taxpayers have a reasonable opportunity to establish that their arrangements are consistent with those objects and purposes.

14. **Issue #13:** Because we believe that a failure to address denials of treaty benefits based on unilateral arguments of “abuse” by tax administrations who are unwilling to allow their arguments to be reviewed by their treaty partners or to be part of the normal procedures for resolving treaty disputes would seriously undermine the usefulness of the MAP provision, we feel that the minority of countries that wish to retain the right to deny access to arbitration unilaterally on PPT cases should be willing to
acknowledge that position openly through a reservation, observation, or other public position on the OECD Model.

15. **Issue #14:** We support general alignment between the guidance for applying the discretionary relief provision under the LOB article and the guidance for applying the PPT provision, and our comments include specific suggestions to help achieve that.

16. **Issue #15:** We support the suggestion that it may be desirable for a competent authority to have the discretion to grant some “fallback” treaty relief in appropriate cases if it determines that the primary relief claimed must be denied under the PPT rule, and we note this possibility could avoid difficulties of interaction between the PPT and the beneficial ownership test.

17. **Issue #16:** We think it would be very useful for the OECD to draw upon the specific examples under the US-UK Treaty’s conduit provision in its Commentary illustrating not only the alternative conduit-PPT rule but also the basic PPT itself.

18. **Issue #17:** We note the serious need for better examples to provide a much more realistic series of guideposts for distinguishing situations that should trigger a denial of benefits under the PPT from those that should not, and we make a number of recommendations improved examples.

*Other issues*

19. Regarding other issues raised by the Discussion Draft, we have the following comments:

- The Commentary should encourage competent authorities to address as quickly as possible requests that will be made under the new treaty tie-breaker rule.

- The rule regarding permanent establishments located in third States, including its exceptions, is reasonably well designed and does not need to be expanded.

- We include a number of suggestions for improving the proposed Commentary’s discussion of the interaction between tax treaties and domestic law anti-abuse provisions.

2. **Introduction**

20. The IAPT appreciates the opportunity to comment on the follow-up work being done on BEPS Action 6. As indicated in our comments filed in April, we support in principle the inclusion of a properly crafted, objective LOB provision in treaties as the principal tool to address treaty shopping concerns. We understand, however, that the decision has been made to offer countries a certain amount of flexibility in determining how to satisfy the minimum standard for the provisions to include in treaties to prevent treaty abuse. Accordingly, our comments have been developed with that decision in mind and are directed towards recommendations for the best approach to defining and implementing that minimum standard.
21. We will, therefore, provide our views on the specific areas for which comments have been requested. As an initial point, however, we would recommend that the OECD consider a new approach to the LOB element of the proposed minimum standard.

22. It is clear from a review of current treaty practice and from informal reports of the discussions that have taken place at the OECD around Action 6 that the number of countries interested in having an LOB provision as a main pillar of their anti-treaty abuse standard is very small indeed, probably in the low single digits. It is also clear from the amount of commentary received on the earlier Action 6 discussion draft and from the number of LOB-related issues put out for comment in the current Discussion Draft that a significant number of the specific features of the draft LOB provision in the current Discussion Draft are legitimately the subject of ongoing debate. Attempting to resolve all of those issues in the context of the BEPS Action 6 work and to come up with an OECD model LOB provision strikes us as unwise, particularly given

- the number and complexity of the issues and the time limits imposed on that work,
- the small number of participating countries that bring significant experience with those issues to the table or a significant sense of ownership in their resolution, and
- the fact that the United States (i.e., a country whose LOB provisions served as the model for the draft provision in the Discussion Draft) has publicly stated that it is currently in the process of reviewing its model LOB provision and has yet to hold a public consultation with stakeholders on that review.

23. Under these circumstances, we strongly recommend that the OECD refrain from publishing a model LOB provision as part of its Action 6 work. Instead, we believe the more sensible course of action would be to leave the specific design and drafting of an LOB provision to those States that are contemplating including such a provision in their bilateral tax treaties. The OECD could simply broadly describe the general elements an LOB provision should contain: a general denial of source State treaty benefits unless the taxpayer is a “qualified resident” of the other State, plus a variety of routes to being treated as a qualified resident (i.e., classification as an individual, a government, or a publicly traded company, or satisfaction of conditions based on ownership/base erosion requirements, derivative benefits requirements, requirements for a subsidiary of a publicly traded company, an active business test, or receipt of a discretionary grant of benefits from the competent authority of the source State).

24. Taking this approach would have salutary effects for the BEPS project. It would free up precious time of the treaty specialist delegates to address treaty-related BEPS issues for which more harmonized solutions are likely to be broadly acceptable and relevant. It would prevent the Action 6 work from turning the OECD into a forum where negotiations take place that are better suited for bilateral discussions, and where conclusions are hastily reached on a model provision that is currently the subject of ongoing re-evaluation by even its most active supporters. It would reflect the fact, acknowledged in the September Report, that any effort to produce model provisions would result in model provisions “that
need to be adapted to the specificities of individual States and the circumstances of the negotiation of bilateral conventions”.² It would be consistent with the OECD’s traditional approach of refraining from trying to arrive at detailed consensus positions on provisions that are of interest to only a small minority of the participating countries.

25. Accordingly, we recommend that the OECD refrain from publishing a model LOB provision as part of its Action 6 work. In case, however, the OECD acts contrary to that recommendation and decides to proceed with the finalization of such a provision, we provide our comments below on the specific issues on which comments have been solicited.

3. Issues Related to the LOB Provision

3.1 Collective investment vehicles: application of the LOB and treaty entitlement

26. The IAPT commends the work that was done by the OECD on the 2010 CIV Report and has no specific recommendations for its improvement.

3.2 Non-CIV funds: application of the LOB and treaty entitlement

27. In light of populations’ ever-increasing life expectancies, pension funds play a critical role in ensuring an adequate post-retirement standard of living for workers. Moreover, the globalization of business means that pension funds must be able to internationalize their portfolios to diversify risk and maximize potential returns for their beneficiaries.

28. The IAPT therefore supports a treaty policy that provides benefits for, and ideally grants a reciprocal exemption to, the investment income of pension funds of each Contracting State in order to ensure they obtain similar tax treatment regardless of the destination of their investments. The IAPT encourages countries to negotiate specific treaty provisions to guarantee that treatment. We underscore the importance of ensuring that countries clearly define the specific retirement arrangements that qualify for that treatment. We also emphasize the importance of ensuring that any conditions attached to that treatment are reasonable and capable of being applied in practice without undue administrative burden on the funds. We note that in producing the 2010 CIV Report and the subsequent TRACE Implementation Package, the OECD did careful work, in close coordination with the investment fund industry, to analyze the substantive and procedural issues around the entitlement of CIVs to treaty benefits, and the IAPT believes that a similar effort may be warranted to address the comparable issues faced by pension funds. We are particularly concerned that the practical application of anti-abuse requirements to pension funds, whether under an LOB provision or a PPT provision, may result in the effective denial of treaty benefits to qualifying funds due to the administrative hurdles that may be associated with establishing satisfaction

of those requirements (e.g., relating to proof of residence of underlying beneficiaries). This problem has already begun to manifest itself in a serious way under existing treaties that have such provisions, so we hope the OECD will take this opportunity to work with pension funds to find appropriate solutions and will not simply exacerbate the problem by encouraging the proliferation of anti-abuse provisions without simultaneously and thoughtfully addressing their application to pension funds.

3.3 Commentary on the discretionary relief provision of the LOB rule

29. The discretionary relief provision in the LOB article will be very important to preventing the article from having the effect of creating a barrier to cross-border trade by denying legitimate access to treaty benefits, particularly if the objective safe harbors are tightly drawn.

30. As an initial point, we would like to comment on the relevance of the factor of the equivalence of the withholding rate between the source State’s treaty with the entity claiming benefits and the rate in the source State’s treaty with that entity’s owner. Paragraph 19 of the Discussion Draft says that while the Commentary should clarify that this is a “relevant factor” to consider under the discretionary relief provision, the fact “would not, in itself, be sufficient to establish that the conditions for granting the discretionary relief are met”. We are on record as emphasizing the critical need for a derivative benefits safe harbor. Our support for the derivative benefits concept is based on a simple rationale: the vast majority of cases in which there is an equivalence of potential treaty benefits between an entity and its owner present no risk of treaty shopping concerns. Accordingly, while we accept that this may not be the only factor worth considering in granting discretionary relief, we believe the presence of this factor should in itself be sufficient to establish that the conditions for granting discretionary relief with respect to the equivalent benefit being sought are met, in the absence of other conditions that create a treaty shopping concern. We recommend that any clarification in the Commentary appropriately reflect this level of importance of the presence of this factor.

31. The approach to granting discretionary relief should appropriately reflect that there are certain mainstay realities of the vast majority of MNE structures which are not primarily motivated by treaty shopping. For example, MNEs with geographically far-flung operations typically have regional holding or headquarters companies or regional distribution companies. MNE groups also have very commonly made the business decision to centralize certain functions, either globally, regionally, or by business lines, in particular companies. This could include treasury centers, purchasing centers, IP holding companies, “centers of excellence” for certain aspects of the group’s core activities, or a variety of others. In deciding where to locate such companies, groups typically review a variety of conditions in candidate jurisdictions, including factors such as skilled workforce, good infrastructure, language, currency, legal system, proximity to the affiliates or third parties with whom the company will primarily interact, etc.

While tax is inevitably a consideration that is also taken into account, including both the national tax system and the availability of potential treaty benefits for the income likely to be derived, this typically occurs as part of the overall business analysis. In a huge number of cases, we therefore believe that it would be entirely reasonable and appropriate for a competent authority to determine, “after consideration of the relevant facts and circumstances” with respect to such a company having its residence outside the
parent company’s jurisdiction, “that the establishment, acquisition or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention”. Accordingly, we suggest that among the relevant factors for the competent authority to consider under the LOB article’s discretionary relief provision should be the following:

- Business rationale for having the entity’s functions conducted by a separate entity (e.g., regional holding or headquarters function, regional distribution function, treasury center, purchasing center, IP holding company, “center of excellence” for certain aspects of the group’s core activities, etc.)

- Business considerations for the entity to be resident in its jurisdiction (e.g., skilled workforce, good infrastructure, language, currency, legal system, proximity to the affiliates or third parties with whom the company will primarily interact, etc.)

32. Another factor which should be considered as a potential positive indicator for granting discretionary benefits would be coming close to qualifying for one or more of the objective safe harbors, but not quite satisfying the requirements. The exact parameters of particular conditions for the objective safe harbors in the LOB article are by necessity somewhat arbitrary, so a company that comes close to satisfying them but “just misses” is likely to be a good candidate for favorable consideration in the absence of other factors weighing against qualification. On the other hand, the fact that the LOB objective safe harbors are fairly limited and narrowly drawn means that there can be a wide variety of cases that are deserving of favorable consideration but are not covered by the objective safe harbor categories. Accordingly, while the failure to come close to satisfying an objective safe harbor should not be treated as a negative or precluding factor, we believe favorable consideration should be given to the following factor:

- The fact that the person almost satisfied, but did not quite satisfy, the conditions of one or more of the objective safe harbors in the LOB article.

33. We support the notion that there should be alignment between the LOB article’s discretionary benefits provision and the PPT test. Accordingly, we suggest that any examples of “good” situations included in the Commentary to illustrate the operation of the PPT test should also be explicitly treated as eligible for favorable treatment under the LOB discretionary benefits provision. In addition, to further align the two provisions, we suggest that the wording of the LOB discretionary benefits provision be amended to read as follows in relevant part:

“...if such competent authority, upon request from that resident and after consideration of the relevant facts and circumstances, determines either that the establishment, acquisition or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention, or that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.”
34. We wholeheartedly endorse the suggestion at paragraph 20 of the Discussion Draft “that the Commentary on the discretionary relief provision should encourage the competent authority that receives a request for relief under that provision to process that request expeditiously.”

35. Finally, we respectfully question the drafting of the discretionary benefits provision, and the accompanying explanation at paragraph 64 of the September Report, which indicates that the obligation of one competent authority to consult with the other competent authority before denying a request does not apply where the request is filed by a resident of the first competent authority’s own State. We are on record in our prior comments as opposing the notion that the LOB provision (or the PPT provision) should apply at all to claims for benefits made by an entity to its own State of residence. Those types of claims, which typically relate to double taxation relief under Article 23 or nondiscrimination protection under Article 24, do not raise treaty shopping concerns. A third country resident simply does not establish an entity in a Contracting State, thereby creating liability to tax for the entity in that State, in order to gain treaty access to relief from that very liability. Where that State has by treaty granted primary taxing jurisdiction to a source State with respect to the income of that entity, it would fundamentally undermine the treaty bargain with that source State for the first State to say it would not grant double taxation relief to its resident entity (e.g., because the entity had a third country owner). It would similarly fundamentally undermine the bargain with its treaty partner for a Contracting State to say it would not allow its resident entity to invoke the nondiscrimination provisions (e.g., with respect to the equal treatment from a deductibility perspective of payments to the residents of the treaty partner). By providing that the LOB provision does not restrict benefits to Article 9(2) or Article 25, the Discussion Draft has essentially recognized that it would fundamentally undermine the bargain with its treaty partner for a Contracting State to say that its resident entity could not invoke MAP (e.g., to seek a corresponding adjustment to eliminate double taxation in cases of transfer pricing adjustments by the treaty partner against the entity’s associated enterprise). The preceding examples are no different in principle from that situation. In all such cases, factors such as the third country ownership of the entity in question should be wholly irrelevant to the obligation of that entity’s residence State to grant the benefits it committed, in its bargain with its treaty partner, to give to its residents that engage in transactions with the treaty partner.

36. So our basic recommendation is that the scope of the LOB (and PPT) provisions be limited to claims by a resident of one State for treaty benefits from the other Contracting State under the provisions relating to the taxation of income and capital (i.e., Chapters III and IV of the Model Tax Convention, comprising Articles 6-22). If, however, contrary to that recommendation, the OECD leaves the wording of the proposed LOB provision as it stands, we recommend that, at the very least, a competent authority

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3 We note with approval that the September Report made some progress on this point, compared to the earlier Action 6 discussion draft, by providing that the LOB provision would not apply to a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9, or Article 25.
of a Contracting State have an obligation to consult with the competent authority of the other Contracting State before denying a request from one of its own residents for discretionary benefits. Without that safeguard, we foresee that the LOB provision could have widespread effects of allowing double taxation or discriminatory treatment to prevail in cases where subsidiaries within MNE groups engage in legitimate commercial transactions with countries with which their governments have entered into treaties where those countries have appropriately exercised their taxing rights under those treaties.

3.4 Alternative LOB provisions for EU countries

37. We have no specific comments on this topic, other than to note that the very need to consider this issue is another reason, in addition to those we have cited above, for the OECD to refrain from trying to draft a model LOB provision as part of its Action 6 work, and instead to leave specific decisions about the particular elements of the provision to those individual States that may be inclined to include the provision in their bilateral treaties.

3.5 Requirement that each intermediate owner be a resident of either Contracting State

38. The Discussion Draft notes that the proposed safe harbor for indirect subsidiaries of publicly traded companies contains a bracketed requirement that each intermediate owner between the subsidiary and the publicly traded parent be a resident of either Contracting State, and the proposed “ownership/base erosion” safe harbor contains a bracketed requirement that each intermediate owner between the entity claiming benefits and its qualifying ultimate owner be a resident of the entity’s State. We indicated in our earlier comments that we found such restrictions on the residence of intermediate owners in the LOB provisions to be a highly disproportionate and unjustified reaction to any concerns that might exist, particularly in light of the variety of other mechanisms that exist to address those concerns (e.g., the beneficial ownership requirement in various treaty articles, the CFC rules of the parent country, the base erosion element of the ownership/base erosion test, the conduit arrangement overlay to the LOB test, the harmful tax practices initiative, etc.).

39. We pointed out, for example, how very common it is for MNE groups to acquire multi-country ownership chains through normal merger and acquisition activity. It is worth noting that reports indicate that cross-border M&A deals have exceeded US$ 1 trillion in 2014 and now represent 25-40% of all M&A transactions. In a recent survey, more than half of senior executives from MNEs around the world reported an increase in cross-border M&A in recent years. A failure to accommodate non-same country

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or third country intermediate owners would effectively deny treaty coverage to a very large number of lower tier entities within MNE groups, with untold ramifications for the normal conduct of commercial activity around the world.

40. Accordingly, we reiterate our recommendation to drop these intermediate owner residency restrictions from the LOB provision. Including them could hugely overwhelm competent authorities due to the widespread need for discretionary relief to obtain legitimate benefits, and where such relief is not easily and speedily available it would unduly interfere with normal cross-border trading and investment activity. At the very least, we would suggest that these restrictions should not apply to entities whose ultimate parent companies are resident in countries with territorial systems of taxation, since such countries would generally not tax distributions from their indirect subsidiaries whether made directly to the parent country or to an intermediate entity.

3.6 Issues related to the derivative benefit provision

41. We wish to reiterate our strong support for having a well-functioning derivative benefits provision. We particularly welcome the fact that the drafting of the proposed derivative benefits provision potentially recognizes residents of any treaty partner of the source State as “good” owners, rather than restricting that treatment to a subset of treaty partners.

42. The language in the proposed provision which restricts intermediate owners to “equivalent beneficiaries” is highly problematical. First, as drafted, it is impossible to satisfy, because the definition of equivalent beneficiaries includes only persons that cannot be intermediates in an ownership chain (i.e., it is limited to individuals, governments, publicly traded companies, and exempt organizations and pension funds). Second, for the reasons outlined above in respect of the intermediate ownership restrictions in other parts of the LOB article, the restriction on the residency of intermediate owners should also be dropped from the proposed derivative benefits provision. The assumption that intermediate owners from other countries pose a concern justifying such restrictions is woefully off base, particularly given the other mechanisms better designed to address any potential concerns (e.g., the beneficial ownership requirement in various treaty articles, the CFC rules of the parent country, the base erosion element of the derivative benefits test, the conduit arrangement overlay to the LOB test, the harmful tax practices initiative, etc.).

3.7 Provisions dealing with “dual-listed company arrangements”

43. We have no specific comments on this topic, other than to note that the very need to consider this issue is another reason, in addition to those we have cited above, for the OECD to refrain from trying to draft a model LOB provision as part of its Action 6 work, and instead to leave specific decisions about the particular elements of the provision to those individual States that may be inclined to include the provision in their bilateral treaties.
3.8 Timing issues related to the various provisions of the LOB rule

44. As drafted, paragraph 1 of the proposed LOB article requires a person to be a “qualified person” as defined in the article “at the time that the benefit would be accorded”. The various objective safe harbors include different language for purposes of determining whether that test is satisfied. For example, the safe harbor for publicly traded companies and their subsidiaries looks to whether its tests are met “throughout the taxable period that includes that time”. The “ownership/base erosion” safe harbor looks to whether the ownership test is met “on at least half the days of the taxable period that includes that time” and looks to whether the base erosion test is met “for the taxable period that includes that time”. The “active business” safe harbor does not specify a particular time period for which its tests must be satisfied. The “derivative benefits” safe harbor looks to whether its ownership test is satisfied “at the time when that benefit would be accorded” and looks to whether its base erosion test is satisfied “for the taxable period that includes that time”.

45. With respect to the publicly traded company safe harbor, we believe it is quite possible for a company to begin to be, or cease to be, publicly traded partway through a taxable period without triggering a new taxable period. This does raise a question as to whether the LOB provision’s safe harbor, as drafted, would allow the publicly traded company to qualify with respect to income it derives in any such year during its period of being publicly traded. One approach to addressing this issue might be to treat the company as satisfying the test if it is publicly listed on the date of receipt of the relevant income and if it satisfies the regular trading test throughout a 365-day period that includes that date.

46. It may also be appropriate in certain cases to base qualification for benefits upon a taxpayer’s status during a period preceding the one in which benefits are claimed, in order to minimize the practical difficulties that can arise from having to wait to the end of the taxpayer’s taxable period to know whether it is eligible for benefits with respect to income derived during that period. This is the approach, for example, that was recommended with respect to determining whether CIVs satisfied certain “good” ownership requirements in the 2010 CIV Report. Further thought could be given to whether that approach is appropriate in other contexts, particularly for purposes of applying withholding tax relief.

3.9 Conditions for the application of the provision on publicly-listed entities

47. The IAPT is on record in its previously filed comments as taking the view that the requirement in paragraph 2(c) of the proposed LOB article that either the company’s principal class of shares be “primarily traded” on a home country stock exchange or the company’s “primary place of management and control” be in its country of residence is not well-grounded in traditional treaty “abuse” concepts, was

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6 See paragraph 6.31 of the Commentary on Article 1 of the OECD Model.
inspired by a desire to discourage corporate inversions by the United States, and can in principle and does in practice have an overly restrictive impact, particularly given the increasing trend toward cross-border listings and the factual complexity of determining the location of the “primary place of management and control” of large multinational groups.

48. Accordingly, we continue to recommend that this requirement be dropped from the publicly traded company safe harbor.

49. Nevertheless, if the OECD wants to retain this requirement in some form, contrary to our recommendation, we suggest that the “primary place of management and control” requirement be replaced with a requirement that the company have, in effect, the equivalent of a permanent establishment in its country of residence. This would establish nexus with that country beyond the pure fact of residence there, and should be sufficient to respect the status of the company as publicly traded and hence a very low risk from a treaty shopping perspective.

3.10 Clarification of the “active business” provision

50. The Discussion Draft requests comments as to possible clarifications that could be made concerning the interpretation and application of the “active business” provision found in paragraph 3 of the proposed LOB article. The IAPT is on record in its prior comments as suggesting that clarification would be useful on the following issues:

- What constitutes an “active trade or business” (and whether a company must conduct that through its own employees);
- Whether group financing activities can be considered an active trade or business;
- What it means for income to be derived “in connection with, or incidental to” the active business in the treaty country, particularly in relation to income such as dividends, interest, and royalties;
- How similar or related the two businesses must be; and
- How to determine whether the residence country business is “substantial” in relation to the source country business, including questions such as

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7 See testimony of Barbara M. Angus, International Tax Counsel, U.S. Department of the Treasury before the Senate Committee on Foreign Relations on Pending Income Tax Agreements, September 24, 2004, regarding the first introduction of this requirement, in the U.S.-Netherlands Treaty (“the revisions to the test were intended to be forward looking, to prevent any potential for the U.S.-Netherlands treaty to be exploited by what is really a U.S. company in some possible future evolution of corporate inversion type transactions”).
• What percentage constitutes “substantial”; and
• If a three factor formula is used, how the factors are measured.

51. For example, an important issue can be how one determines whether and to what extent a payment of dividends, interest, or royalties by a source State company should be treated as derived from a business in the source State which is connected to an active business conducted in the residence State, particularly if the payment comes from one member of a multi-member affiliated group in the source State. Similarly, what standards will apply for purposes of determining the “types” of products or the “similarity” of services? Are petroleum products and chemicals the same “type” of product? Are there industrial classification codes that could be used for this purpose?

52. In addition, there is the question of where a business is deemed to be carried on. For example, certain companies may not be sure whether their businesses will be deemed to be carried on where their employees actually work or whether their customers are located.

4. Issues related to the PPT rule

53. We have previously expressed our serious reservations about the advisability of including PPT provisions in treaties in lieu of more objective LOB provisions. Recognizing, however, that many countries feel more comfortable with a PPT provision, we made a number of suggestions in our April 2014 comments on how the proposed PPT provision in the March 2014 discussion draft could be improved. We were therefore very disappointed to see that the version of the PPT in the September 2014 Report reflected none of the suggestions for improvement offered by us or other commentators. Indeed, it included some new language which raised new problems of its own. We were likewise disappointed at how limited were the requests for comment on PPT issues in the current Discussion Draft, apparently reflecting a lack of ongoing consideration of many of the issues raised by prior comments. Accordingly, while we offer comments below on the specific issues outlined in the Discussion Draft, we note once again for the record that we believe the proposed PPT is poorly designed and suffers from at least the following serious flaws, all outlined in more detail in our earlier comments:

• the possibility that the PPT could be layered on top of the LOB leads to untenable uncertainty and overkill;
• the provision unnecessarily applies to treaty benefits made available by a Contracting State to its own residents;
• contrary to the assertion at paragraph 1 of the proposed Commentary on the PPT rule, the PPT provision as drafted differs materially from the principles currently included in the Commentary on Article 1 of the Model Tax Convention;
• the proposed Commentary is heavily unbalanced in favor of the denial of benefits under the PPT;
• the proposal includes no guarantee that the Contracting States will have provided explanations as to the object and purpose of particular provisions in the relevant treaty, seriously undermining the ability of the taxpayer to counter effectively any assertion of the PPT provision by either State;

• the proposal includes no safeguards that the country invoking the PPT provision will have provided adequate guidance on their substantive interpretation of the PPT provision or any procedural mechanism (e.g., a ruling process or high-level review) for ensuring that taxpayers can achieve certainty on a timely basis and an assurance of equal treatment; and

• the proposal includes no safeguards (not even prior consultation) to ensure that the two Contracting States agree on the provision’s applicability, opening the door to the possibility that it could be invoked unilaterally by a Contracting State to deny benefits contrary to the intention of the other Contracting State.

4.1 Application of the PPT rule where benefits are obtained under different treaties

54. We note the statement at paragraph 31 of the Discussion Draft that consideration is being given to clarifying the language of the PPT rule itself to avoid any doubt about the concept, already set forth at proposed paragraph 13 of the Commentary on the PPT found in the September Report, that “where an arrangement is entered into for the purpose of obtaining benefits under a number of treaties or under both a treaty and domestic law, this should not lead to the conclusion that obtaining one benefit under one treaty was not a principal purpose for that arrangement.” We respectfully suggest that no effort be made to try to inject language into the PPT itself to put a finger on the scale for any single factor, as that would undermine the concept of the PPT which is to consider all the relevant facts and circumstances and weigh all the evidence. In particular, we believe that even the existing proposed Commentary on this point is overly broadly worded and could lead to inappropriate results, and an effort to reduce its message to text for inclusion in the PPT itself is likely to exacerbate the situation.

55. As an example of the concern this raises, suppose an MNE has operating subsidiaries in ten countries (A-J) in a region and decides for legitimate business reasons (e.g., management, coordination, reporting, etc.) that it needs to house those under a single regional holding company. The parent company, resident in country X, is considering two candidate jurisdictions (Y and Z) in the region for establishment of its holding company. Both Y and Z provide comparable advantages from a non-tax perspective (e.g., skilled workforce, good infrastructure, language, currency, legal system, proximity to the affiliates with whom the company will primarily interact, etc.), and they are the only countries in the region to provide such an attractive combination of non-tax factors. Country X has treaties with countries A through G which provide for a 5 percent withholding rate on dividends from the subsidiaries there, as well as a treaty with country H which provides for a 10 percent rate, but it has no treaty with countries I or J. Country Y has treaties with all of the countries A through J which provide for a 5 percent rate. Country Z has treaties with only countries A and B, and those provide for a 5 percent rate. In selecting Country Y over Country Z, the parent company puts substantial weight on the fact that Country Y’s treaty network is better than Country Z’s with respect to countries C through J and equivalent to Country X’s with respect to countries A through G. The fact that Country Y’s treaty network is better than
Country X’s with respect to countries H, I, and J is recognized, but is not the principal purpose for either establishing a regional holding company or locating it in Country Y rather than Country Z. It would be wholly inappropriate for country H, I, or J to ignore the parent company’s consideration of country Y’s access to treaty benefits in countries A through G in determining whether getting access to the benefits of their respective treaty with country Y was one of the principal purposes for establishing the regional holding company in country Y.

56. The more general point, which we addressed above in relation to the LOB provision, is that an inescapable business reality of MNE groups is that they have concentrated certain functions on a global, regional, or business line basis in individual entities (e.g. regional holding or distribution companies, treasury centers, purchasing centers, IP holding companies, “centers of excellence” for certain aspects of the group’s core activities, or a variety of others) for commercial reasons, and that decisions about whether and how to do so necessarily involve analysis of a wide range of factors. A PPT provision which arbitrarily narrows the recognition of factors that are considered would risk calling into question the availability of treaty benefits in a wide variety of legitimate business structures in common usage around the world.

57. We also note that paragraph 13 of the proposed Commentary says that “purposes related to the avoidance of domestic law should not be used to argue that obtaining a treaty benefit was merely accessory to such purposes.” This language is unaccompanied by any explanation and is potentially dangerously over-broad. It should be reconsidered, not elevated to treaty text.

58. For one thing, the language does not specify whether the “domestic law” being avoided is domestic tax law only or any domestic law. For example, supposing an enterprise wishes to expand its commercial operations into a certain area but its home country regulatory regime (whether labor law, environmental regulation, licensing requirements, etc.) would make it impossible or financially prohibitive or unattractive to do so there. Is the enterprise “avoiding domestic law” by deciding to carry out the expansion through a foreign subsidiary? Could a jurisdiction argue that the domestic law considerations should be ignored as a factor? For example, could a jurisdiction argue that the decision to build the manufacturing plant in the low-cost country described in Example C of proposed Commentary paragraph 14 of the September Report was based on avoiding “domestic law” requirements that contributed to the higher cost of expanding domestically, and say that factor should be ignored in determining whether access to a treaty benefit was one of the principal purposes? The answer is obviously no, and yet the proposed Commentary language at paragraph 13 opens the door to denying treaty benefits based on such an argument.

59. Even if one interpreted the proposed reference to domestic law to include only domestic tax law, the language is much too broad. What if the principal factor in the manufacturing plant example is that the home country corporate tax rate on manufacturing profits is 35 percent, and the subsidiary country rate is 25 percent? Is the enterprise engaging in “avoidance of domestic [tax] law” by deciding to expand its operations by building in the subsidiary country? Should that different domestic corporate tax be ignored in determining what the enterprise’s principal purposes were for deciding where to build its
manufacturing plant? Manufacturing profits are not a type of income that most countries believe should be covered by CFC regimes, and an overall difference in corporate tax rates between two countries is in no way an issue that raises harmful tax competition concerns (quite the contrary). This example illustrates how dangerous it can be to include loose language in the Commentary on the PPT without analyzing its potential implications.

4.2 Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level

60. We note that paragraph 32 of the Discussion Draft indicates that consideration is being given to including a suggestion in the Commentary on the PPT that countries consider establishing an “administrative process that would ensure that the PPT is only applied after approval at a senior level”. We certainly support the idea that countries adopting a PPT should have such an administrative process, and that the review panel should include persons outside the tax administration. That is the very least of the procedural safeguards that should be associated with including a PPT provision in a treaty. As indicated in our prior comments, we believe that additional procedural safeguards should include: (i) a ruling process through which taxpayers could seek timely confirmation of the inapplicability of the PPT to their situation; (ii) the issuance of guidance from the Contracting State on its interpretation and application of the PPT, including redacted summaries of its rulings; (iii) participation of the other Contracting State in any decision to deny benefits under the PPT, preferably through their concurrence but at the very least through a requirement that they be consulted (as is the case for the LOB provision); and (iv) some process by which the two Contracting States, ideally jointly, issue information as to their views of the object and purpose of specific treaty provisions, to ensure that taxpayers have a reasonable opportunity to establish that their arrangements are consistent with those objects and purposes.

4.3 Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable

61. We note that paragraph 33 of the Discussion Draft states that a minority of countries believe the application of the PPT rule is not an issue suitable for the arbitration mechanism of Article 25(5), and that consideration will have to be given to “whether and how the views of the minority should be reflected

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8 The Discussion Draft refers to the possibility of including “academics and/or tax experts from the private sector”. In comments we provided with respect to Action 6 on October 16, 2013, we noted similar recommendations with respect to comparable domestic law GAAR regimes from such respected sources as the UK’s GAAR Study Group led by Graham Aronson QC (which recommended having an Advisory Panel, with relevant expertise and a majority of non-tax administration members, to advise whether the tax administration would be justified in seeking counteraction under the GAAR (and who would publish anonymized digests of its advice)) and India’s Shome Committee (which recommended a 5-member Approving Panel (including a retired High Court judge, 2 knowledgeable private sector members, and 2 Chief Commissioners of Income Tax)).
when the final version of the PPT rule and its Commentary are included in the Model Tax Convention”. We strongly believe the majority view on this point is the correct one. The Commentary on Article 25 takes a firm position on broad access to MAP generally, and it specifically notes at paragraph 26 the obligation to make MAP available, including for cases where improper use of the Convention is alleged by one State, in the absence of specific treaty provisions authorizing the denial of MAP. Assuming there is no such specific treaty provision keeping the issue out of MAP and that the OECD Model version of Article 25(5) applies, it is clear that the issue would be potentially subject to arbitration under that provision.

62. Paragraph 66 of the Commentary on Article 25 indicates that the two Contracting States could agree to an arbitration provision which is narrower than the OECD Model. Some treaties that include arbitration allow the two Contracting States to exclude a case from arbitration if the competent authorities agree, before the date on which arbitration proceedings would otherwise have begun, that the case is not suitable for determination by arbitration. If the OECD decides to accommodate the possibility of excluding PPT cases from arbitration under the OECD Model, it should do so only in the context of such a bilateral agreement under which both competent authorities agree that the particular case should be excluded. It should not sanction any approach that would deny the availability of arbitration for PPT cases where only one Contracting State thinks the case appropriately involves a denial of benefits under to the PPT provision. Countries who believe such purely unilateral support for a denial of treaty benefits under the PPT provision is appropriate should openly reflect that view in a reservation or observation (or other public position) on the OECD Model.

63. One-sided assertions of treaty “abuse” to justify denial of benefits and denial of access to MAP were already becoming a serious problem when the OECD undertook its dispute resolution project ten years ago, and that problem was the genesis of the language added at paragraph 26 of the Commentary on Article 25 to stress the availability of access to MAP in such cases. That language was agreed to by all OECD countries and was not objected to by any of the 33 non-OECD countries that have published their positions on the OECD Model. Notwithstanding the clear guidance on that point reflected in that Commentary language, however, the problem has grown considerably in scale in the intervening years. Particularly since the advent of the BEPS project, taxpayers have seen a significant increase in adjustments based on so-called “BEPS principles”, without regard to whether those principles are actually reflected in existing law or treaties, and have experienced denial of access to MAP based on BEPS-tinged allegations of “abuse”. We believe that a failure to address these one-sided denials of treaty benefits by tax administrations who are unwilling to allow their arguments to be reviewed by their treaty partners or to be part of the normal procedures for resolving treaty disputes would seriously undermine the usefulness of the MAP provision and call into question the extent to which taxpayers can rely on treaties as a whole.

64. Consistent with the OECD’s conception of the arbitration mechanism in Article 25(5), we view it as an extension of MAP itself. While we understand the temptation to give some tax administrations an ability to exclude disputes from arbitration (i.e., in the hope they will be more willing to accept arbitration more generally), we would caution against accommodating the exclusion of PPT cases from arbitration
under the OECD Model. That would put too great and untested a weapon into the hands of the tax administrations most inclined to act arbitrarily. Countries that wish to retain the right to deny access to arbitration unilaterally on PPT cases should be willing to acknowledge that position openly through a reservation, observation, or other public position on the OECD Model.

4.4 Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

65. As indicated above, we believe there should be general alignment between the guidance for applying the discretionary relief provision under the LOB article and the guidance for applying the PPT provision.9 Accordingly, we make the following recommendations regarding the Commentary:

- The factors identified for consideration in LOB discretionary requests should also be used for PPT determinations; and
- examples of good PPT determinations should also be treated as cases justifying favorable LOB determinations.

66. As also indicated above, to further align the two provisions, we suggest that the wording of the LOB discretionary benefits provision be amended to read as follows in relevant part:

“…if such competent authority, upon request from that resident and after consideration of the relevant facts and circumstances, determines either that the establishment, acquisition or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention, or that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.”

4.5 Whether some form of discretionary relief should be provided under the PPT rule

67. We note the suggestion at paragraph 35 of the Discussion Draft that it may be desirable for a competent authority to have the discretion to grant some “fallback” treaty relief in appropriate cases if it determines that the primary relief claimed must be denied under the PPT rule. We support this suggestion. We note that including such a possibility could avoid prickly questions in some cases, such as whether a denial of benefits has taken place under the PPT rule or under the “beneficial ownership” standard in Article 10, 11, or 12. For example, the Commentary on those provisions states that even though treaty withholding tax relief may be denied to an entity receiving income as an intermediary on the grounds that it is not the “beneficial owner” of the income, treaty relief remains available to the actual

9 Consistent with our view on the desirability of alignment, we find it somewhat illogical to deny MAP to discretionary LOB determinations given that it’s allowed for PPT determinations.
beneficial owner. It would be odd to conclude that relief was available to the true beneficial owner when an intermediary’s claim was denied under the beneficial owner test, but that it could not be made available when the intermediary’s claim was denied under the PPT rule.

4.6 **Drafting of the alternative “conduit-PPT rule”**

68. We note that the alternative “conduit-PPT rule” appearing at paragraph 15 of the proposed Commentary on the PPT rule is very closely based on the “conduit arrangement” provision which appears in the 2001 Treaty between the United States and the United Kingdom. We believe that such a provision represents a reasonable approach to addressing conduit arrangements of the type that are likely to be of concern to governments. The application of the US-UK Treaty conduit arrangement provision is very helpfully illustrated by six examples set out in an exchange of letters between those two governments, and we think it would be very useful for the OECD to draw upon those specific examples in its Commentary illustrating the alternative conduit-PPT rule. The examples involve: (i) a sale of parent company tracking stock in a subsidiary to a third country resident; (ii) a first tier manufacturing subsidiary of a third country parent which receives dividends from a second tier subsidiary which acts as its distributor; (iii) a third country parent company’s assignment of a note from one subsidiary to a second subsidiary for a note from the second subsidiary which closely mirrors the first note; (iv) a subsidiary’s borrowing from an unrelated bank which has a long-standing relationship with (and deposit from) the subsidiary’s third country parent; (v) the use of a multinational group’s member company to act as the centralized IP licensing entity for all IP developed by group members, including IP developed by a third country subsidiary; and (vi) a third country parent’s use of one subsidiary to act as a global cash management company for all members of the group, where the third country parent lends funds to the cash management subsidiary. We believe the conclusions expressed in that exchange of letters are reasonable, and we note that the examples could also usefully serve to illustrate the application of the basic PPT test itself.

4.7 **List of examples in the Commentary on the PPT rule**

69. As noted in our previous comments, we believe that the examples in the September Report’s proposed Commentary on the PPT rule (with the exception of the most recently added one, Example 5) are so close to the far ends of the spectrum of what should or should not trigger the PPT as to be virtually useless as guideposts for the kind of reasonable evaluation the rule purports to require. We believe the “conduit arrangement” examples under the 2001 US-UK Treaty just mentioned provide a much more realistic series of guideposts for distinguishing situations that should trigger a denial of benefits under the PPT from those that should not.

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10 See, e.g., paragraph 12.7 of the Commentary on Article 10.
70. The holding company example we provide at paragraph 55 of this letter could also be used as a good example.

71. Generally speaking, it would be helpful if the examples to illustrate the PPT rule (as well as those to illustrate the discretionary LOB provision) were based on realistic examples where application of the rule may not be clear. Such examples could be based on common situations found in MNE groups, such as regional holding or headquarters companies or regional distribution companies, treasury centers, purchasing centers, IP holding companies, “centers of excellence” for certain aspects of the group’s core activities, centralized principals for dealing with all third party contract manufacturers, or the like. The factors to be taken into account in resolving those situations should include (and serve to illustrate) the factors that are taken into account in making the discretionary LOB determination (including the factors we recommend above for that purpose).

72. Assuming (contrary to our recommendation) that the OECD goes forward with including model text for an LOB provision in the OECD Model, we believe it would be very helpful if the Commentary would indicate that, absent other factors not taken into account in determining satisfaction of the LOB article’s objective safe harbors, examples of cases that satisfy one or more of those safe harbors would also be examples of cases that did not run afoul of the PPT rule.

5. Other issues

5.1 Application of the new treaty tie-breaker rule

73. With respect to the new tie-breaker rule proposed in paragraph 39 of the September Report, we note the Discussion Draft’s statement that it may “be useful to encourage competent authorities to address as quickly as possible requests that will be made under the new rule”. We agree and recommend that a statement be included in the Commentary to provide that encouragement.

5.2 The design and drafting of the rule applicable to permanent establishments located in third States

74. The Discussion Draft asks whether there are circumstances other than those where the profits of a third country PE are exempt in the State of residence of the enterprise to which the PE belongs which should be covered by the “anti-triangular” rule in paragraph 42 of the September Report. We do not see any justification for expanding the application of the anti-triangular rule beyond that situation. The whole justification for the rule is that the profits in question are attributable to the third country PE and are exempt from tax in the residence State on that basis.

75. On the whole, we believe that the exceptions in subparagraphs (e) and (f) of the anti-triangular rule for income “derived in connection with or is incidental to the active conduct of a business carried on through the permanent establishment” and for “royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the enterprise through the permanent establishment” are reasonably well designed. We do not believe that they present BEPS concerns, because they are both based on the conduct of substantive, value-adding activities.
5.3 Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

76. We appreciate the invitation to suggest clarifications or additions that should be made to the Commentary changes at paragraph 49 of the September Report, and we have several comments in that regard.

77. Proposed Commentary paragraph 8 references cases in which provisions of the Convention depend on the application of domestic law and suggests that specific anti-abuse rules found in domestic law will have an impact on how these provisions of the Convention apply. It gives as an example a domestic law provision that characterizes certain payments in redemption of stock as dividends. While we agree with this principle as a general matter, we think there can be situations where specific anti-abuse rules in domestic law are intended, explicitly or implicitly, to have effect only for purposes of affecting the application of treaties. For example, a domestic law provision which treated a payment in redemption of stock as a dividend only in situations involving payments to persons resident in treaty partners should not be treated as a domestic law provision that would require the payment to be considered a dividend for treaty purposes. To conclude otherwise would leave the door open to countries undermining the treaty bargain under the guise of enacting “domestic law” anti-abuse provisions.

78. Proposed Commentary paragraph 8 also describes Article 3(2) of the Convention as making “domestic rules relevant for purposes of determining the meaning of terms that are not defined in the Convention”. We believe that it would be important to clarify in this context that Article 3(2) only does so “unless the context otherwise requires”. In other words, a domestic law definition cannot be relied upon in the name of anti-abuse principles to affect the meaning of an undefined term in a treaty provision if the context of the provision requires a different meaning to be given to that term.

79. Proposed Commentary paragraph 12, in referring to domestic general legislative anti-abuse rules, says that in the “vast majority” of cases, such rules will not conflict with the provisions of a treaty for either of two reasons: first, that the treaty specifically allows the application of such rules (see paragraph 7 of the proposed Commentary); or second, that the relevant treaty provision depends on the application of domestic law. We respectfully question the accuracy of that statement in proposed paragraph 12. We believe that there are many situations where domestic law GAARs would conflict with treaty provisions and would not be either specifically authorized by the treaty or used to affect a treaty provision that depends on the application of domestic law. This broad scope for conflict arises in particular where the GAAR is enacted after the conclusion of the treaty in question (such that the treaty could not include a specific provision authorizing the GAAR). We suggest that the language of paragraph 12 be amended to remove this inaccuracy.

80. We believe it would also be useful for the Commentary to clarify that the inclusion of the PPT in a treaty should have the effect of preempting domestic law anti-abuse rules that are targeted at treaty benefits and that apply a different standard from the PPT. Otherwise, countries would get no certainty.
with respect to their treaty partner’s application of treaty anti-abuse principles by negotiating the inclusion of the PPT in the treaty.

81. We also believe that the reference to thin capitalization at proposed Commentary paragraph 4 should be cross-referenced to existing paragraph 3 of the Commentary on Article 9 in order not to lose sight of the fact that domestic law thin capitalization provisions are consistent with treaties only “insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm’s length situation”.

82. Finally, we note that paragraph 41 of the Discussion Draft reiterates that the changes to the Commentary proposed in paragraph 49 of the September Report will need to be reviewed in order “to take account of recommendations for the design of new domestic rules that may result from the work on various Action items, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing”. In this connection, we simply wish to reiterate the caution from our earlier submission that any new domestic anti-abuse rules that are designed to address other BEPS Action Items would prevail over treaties only per the description in the proposed Commentary (i.e., where they are specifically allowed in the treaty, where the treaty benefit refers to domestic law for its application, or where they are consistent with the PPT / Commentary paragraph 9.5 standard).
Comments to the OECD Discussion Draft on Follow up Work on BEPS Action 6: Preventing Treaty Abuse

The International Chamber of Commerce (ICC) welcomes the opportunity to provide comments on the Discussion Draft regarding the follow-up work on BEPS Action Point 6 on preventing the granting of treaty benefits in inappropriate circumstances. The aim of preventing the abuse of tax treaties through both treaty provisions and domestic law anti-abuse rules is fully supported by ICC. As stated in our prior comments on this topic (dated April 2014), ICC has serious concerns that the Discussion Draft is focusing only on combating treaty abuse without due regard for the fact that the vast majority of potential beneficiaries of income tax treaties do not engage in abusive practices and, in many cases could be deprived of the certainty and predictability that is the fundamental goal of tax treaties and which is essential to facilitate cross-border investment.

ICC is aware that it is very challenging to reach full consensus in the given timeframe of the OECD/BEPS project. However, complex issues require the time and care to work through the analysis and study the repercussions of any changes. Failure to take the time necessary to do this will result in faulty rules which will create difficulties for businesses – significantly hampering cross border trade and economic growth – and take years for governments to correct. The impact on the global economy and the prospect of developing countries is not to be underestimated.

The lack of time for appropriate consideration is apparent from the follow-up OECD Discussion Draft itself. There is essentially no new guidance on the important issues that remain to be resolved. Rather the Discussion Draft is simply a solicitation of comments on the various open issues. Therefore it is hard not to repeat prior comments made in the earlier Discussion Draft. ICC notes that there may be merit in returning to this topic towards the conclusion of the OECD/BEPS project when other deliverables will be in a more final state.

Paragraph 6 of the 2014 Deliverable states: “When examining the model treaty provisions included in this report, it is also important to note that these are model provisions that need to be adapted to the specificities of individual States and the circumstances of the negotiation of bilateral conventions.” ICC strongly agrees with this statement. Presumably, the OECD intends to implement the guidance through the negotiation and adoption of a multilateral instrument. While a laudable goal, this is inconsistent with the OECD’s own recognition of the need to adapt approaches to account for different circumstances. This conflict may prove difficult to resolve. The drive to create a multilateral instrument may lead to trying to resolve on a multilateral basis issues that can only effectively be resolved on a bilateral basis. ICC believes that much of the complexity of the 2014 Deliverable and the unresolved issues in the Discussion Draft reflect this tension. In ICC’s view, given the constraints of the process, it will be impossible to resolve all of these issues and the model provisions should focus on outlining the necessary elements without providing the detail that will need to be worked out in the context of bilateral negotiations between States.
With regard to the issues raised in the Discussion Draft:

- In the course of endorsing effective anti-abuse measures, ICC recommends to provide a clear mandate for countries to adhere to the fundamental precept already recognised in the Commentaries that – consistent with the goal of promoting bi-lateral trade and investment through establishing rules that provide the greatest degree of certainty and predictability for bona fide beneficiaries of tax treaties – rules that create subjectivity and uncertainty, or that rely on cumbersome pre-clearance procedures straining the resources of tax administrators are to be avoided;
- ICC advises to abstain from the overly restrictive standards in the proposed Entitlement to Benefits article that is patterned after the current U.S. Limitation on Benefits article and adhere more closely to the version that already appears in the Commentaries;
- ICC agrees with BIAC that the current principal purpose test (PPT) (“one of the main purposes”) is widely framed. Even with the examples in the Commentary, there is a risk of misinterpretation, or misapplication by tax authorities. ICC, like BIAC, would recommend focusing on substance. The clearest possible guidance, with examples, ought to be provided in order to create as much clarity and certainty as possible in what is a highly subjective area.
- In applying the PPT test, particularly if it applies in combination with a Limitation of Benefits (LOB) test, ICC recommends to make clear that it is not intended to undercut the LOB provisions, but rather is directed towards conduit financing or clearly artificial and tax abusive arrangements.
- ICC advises the OECD to consider a pre-clearance process under which treaty benefits are granted if the Competent Authority does not affirmatively deny them within a given (relatively short) time frame.
9th January 2015

Marlies de Ruiter
Head,
Tax Treaties, Transfer Pricing and Financial Transactions Division,
OECD/CTPA,
Paris

For e-mail transmission to:  taxtreaties@oecd.org

Dear Ms de Ruiter,

Discussion Draft – follow-up work on BEPS Action 6: Preventing Treaty Abuse

Thank you for inviting comments on the Discussion Draft, BEPS Action 6: Preventing Treaty Abuse, issued on 21st November 2014. The insurance industry has actively participated in the OECD consultations to date on BEPS and has a special interest in the discussions relating to Action 7 (Permanent Establishment) and Action 9 (Transfer Pricing of Risk and Capital). However, there are a couple of aspects of the paper on Action 6 about which we wish to express some concerns.

The International Underwriting Association of London (IUA) represents international and wholesale insurance and reinsurance companies operating in or through London. Its purpose is to promote and enhance the business environment for its members. We estimate that premium income for the London company market in 2013 was some £24bn.

Although, broadly, the IUA understands the desire of the OECD to prevent the use of Treaties to achieve double non-taxation, we believe that the OECD, in seeking to combat Treaty abuse by a minority of taxpayers, may have failed to recognise the importance of the Double Taxation Treaty network in promoting international trade and investment without incurring double taxation.

The draft provisions assume that, in order to qualify for the benefits of a Treaty, either the principal purposes test or a limitation on benefits test should be met and both of those tests are discriminatory in that they would put smaller trading nations with less established stock markets at a distinct disadvantage when it comes to locating their businesses. That would in turn be detrimental to the economies of those nations, as multinational businesses would find it hard to compete if they are unable to take advantage of the Treaty network in order to manage tax cost.
We have commented below only on the questions relevant to IUA members.

A. **Issues related to the LoB provision**

3. **Commentary on the discretionary relief provision of the LoB rule**

We have no suggestions for possible factors to include in the Commentary, but we do consider it essential that the decision of any competent authority should be delivered within a reasonable period, which we suggest should be twelve months. In the event that the decision is not delivered within the twelve-month period the obvious sanction is that the applicant should be entitled to treaty benefits.

4. **Alternative LoB provisions for EU countries**

5. **Requirement that each intermediate owner be a resident of either contracting state**

6. **Issues related to the derivative benefits provision**

There is a risk that the intermediate owner requirement could exclude the operation of treaty benefits inappropriately and so we suggest that, where intermediaries are included in the ownership chain for bona fide commercial reasons, their country of residence should not be relevant.

We do also consider that a derivative benefits provision is valuable, though the proposal in the original Action 6 Discussion Draft is too narrow.

11. **Conditions for the application of the provision on publicly listed entities**

The LoB clause as drafted will deny Treaty benefits where an entity is owned or financed from abroad or where its shares are traded on a foreign stock exchange. There is an obvious concern over the application of the publicly listed entity provision for residents in states that do not have important stock exchanges. Businesses in smaller economies often seek financing from foreign stock exchanges, which gives them access to a greater variety and number of investors. Including this provision as drafted would have a negative impact on their economies. Nor does the draft consider the possibility of trading on more than one stock exchange. Rather than requiring businesses to trade on stock exchanges in their country of residence, we would suggest that, as long as a business is trading on a recognised stock exchange from a qualifying list, then the LoB test should be satisfied.

B. **Issues related to the PPT rule**

13. **Application of the PPT rule where benefits are obtained under different treaties**

14. **Suggestion that countries consider establishing some form of administrative process**

15. **Whether the application of the PPT rule should be excluded from the arbitration process**

16. **Aligning the commentary on the PPT rule and the discretionary relief provision**

The principal purpose test (PPT) would deny Treaty benefits where one of the main purposes of locating in a particular country is to gain access to its network of Treaties. The text is too widely drawn to be sensibly commercial. Our strong view is that it should be what the words imply and therefore should be applicable only where the principal purpose is tax avoidance, not one of the main purposes. We also consider that the “reasonable to conclude” language is too low a bar for such a critical test.
We also consider it essential that there should be time limits around the assessment of PPT and that it is an issue that should fall squarely within the treaty arbitration mechanisms.

17. **Whether some form of discretionary relief should be provided under the PPT rule**

We can see no reason why discretionary relief should not be provided under the PPT rule.

We hope that you find our comments useful and we welcome the opportunity to contribute to these discussions further.

Yours sincerely,

Nick Lowe  
Director of Government Affairs
Marlies de Ruiter  
Head, Tax Treaties, Transfer Pricing and  
Financial Transactions Division  
Centre for Tax Policy and Administration  
Organisation for Economic Co-operation and  
Development  

By email: taxtreaties@oecd.org

Date: 9 January 2014

Dear Ms de Ruiter

RE: OECD DISCUSSION DRAFT ON BEPS ACTION 6

The Investment Association1 welcomes the opportunity to comment on the BEPS Action 6 follow up consultation. We are grateful to the OECD for recognising the particular concerns of the funds industry in this follow up consultation.

We have been strong supporters of the work that the OECD has previously carried out in relation to treaty entitlement of funds, and BEPS affords a valuable opportunity to re-examine the issues that funds face in claiming treaty benefits nearly five years since the OECD report on The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles (the ‘2010 Report’).

The ability of funds to claim treaty benefits is essential in ensuring that investors in funds are not disadvantaged in comparison to direct owners of securities. Funds are an essential savings vehicle, particularly for smaller savers and investors that otherwise lack the scale for cost effective access to the capital markets. All of this is recognised by the OECD in the 2010 Report. The importance of funds as a vehicle for long term saving is all the more relevant today, when citizens are increasingly being called to make their own provision for retirement.

Over $30 trillion of net assets are held by CIVs globally2. This represents over 40% of Gross World Product3. At least 39% of the world’s equity CIVs invest cross border and for UK CIVs the figure is closer to 50%. CIVs are a vital instrument of choice throughout the world for many pension funds and smaller private savers.

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1 The Investment Association (formerly the Investment Management Association) represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around $5.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.

2 International Investment Funds Association International Data Exchange – 2013: Q4

CIVs represent a key source of investment capital, and the ability of CIVs to access the protection afforded to investors by double tax treaties is vital to ensuring that capital invested through CIVs is available for cross border investment and the long-term financing of economies.

We recognise the importance of combating treaty abuse and treaty shopping, and we also support the broader objectives of the BEPS Action Plan.

In summary:

1. We believe that all the recommendations of the 2010 Report remain valid and relevant.

2. We believe that it is not necessary to change the overall findings or recommendations of the 2010 Report. However, it would be beneficial to reinforce some of the points that have presented greatest difficulties for funds in the recent past, and enhance some of the recommendations on application of LOB clauses. These are detailed below.

3. Practical experience suggests that some countries are not following the recommendations of the 2010 Report in the implementation of treaties. The 2010 Report has not resulted in greater certainty for CIVs and CIVs have found it increasingly difficult to access treaty benefits since its publication.

4. Governments should be encouraged to agree specifically on the treatment of CIVs in treaty negotiations, and agree on specific procedures and documentation necessary to claim treaty benefits.

5. The distinction between CIV and non-CIV funds should be made clearer, and policy differences should be informed by factors relevant to claiming treaty benefits.

6. A LOB approach to treaty entitlement presents significant problems for CIV funds, as has been widely discussed. However it may be a beneficial approach for non-CIV funds that are not widely held.

Our detailed comments on the questions relevant to CIVs are as follows.
Comments are invited as to whether the recommendations of the 2010 CIV Report continue to be adequate for widely-held CIVs and whether any improvements should be made to the conclusions included in that Report. Comments are invited, for example, on whether it would be advisable to provide for a preferred approach with respect to issues related to the tax treaty entitlement of the income of CIVs and the application of the LOB to CIVs, and if yes, on what that approach should be.

We believe that the findings and recommendations of the 2010 Report are good, and remain as relevant today as they were in 2010, and probably more so.

However, one of the objectives of the 2010 Report was to reduce uncertainty when dealing with funds claiming treaty benefits and to encourage governments to provide clarification on whether funds are entitled to treaty benefits in bilateral treaty negotiations. This objective is also highlighted in the BEPS Action 6 deliverable, in relation to policy considerations that countries should consider before deciding to enter into a tax treaty. In 15.5 of the new Section C says one of the considerations should be “the greater certainty of treatment for taxpayers who are entitled to benefit from the treaty”.

The experience of the last five years suggest that this objective has not been met, and in fact the opposite has happened. Funds are encountering increasing administrative and legal obstacles in accessing treaty benefits, and uncertainty over treaty access for funds is widespread.

General approach to treaty entitlement for CIVs

Notwithstanding the above, we do not believe that an overarching single approach to treaty entitlement of funds is feasible or currently desirable, for the same reasons as highlighted in the 2010 Report - there are too many different fund structures, and no single approach could work to preserve the intended treaty treatment for investors in all funds.

However more work is needed to persuade governments that uncertainty around the treatment of CIVs is harmful to savers and should be dealt with in treaty negotiations. In particular with reference to the following factors:

- Funds that are corporates, or treated as corporates for tax purposes in their country of establishment should be regarded as persons under tax treaties.

- The viability of CIVs depends on there being only a single level of tax at either investor level or at fund level. The vast majority of CIV tax regimes provide exemption from tax at the fund level (either explicitly, or in practice by providing broad exemptions from tax on types of income). An exemption from tax is an indispensable feature of CIVs. An exemption from tax should not in itself preclude a fund from being regarded as resident for tax purposes.

- In determining whether funds are the beneficial owners of income under double tax treaties, countries should have regard to the above points, together with other features of funds, such as being widely held, that their investors have no control over the assets of the funds, and their assets are ultimately managed by an external investment managers.

Although each of these points is already made in the 2010 Report (and more subtly in the Commentary to the MTC), the practical experience of claiming treaty benefits for funds has deteriorated, and not improved. Therefore it would be beneficial to strengthen guidance to countries negotiating treaties to reinforce the point that funds can, and in most cases should, be eligible to treaty benefits in their own right and without reference to who the underlying investors are (subject to the existence of an LOB clause – see below).
Approved list of entity types

It would be helpful to reinforce the benefits of providing certainty in relation to specific fund vehicle-types, as is highlighted in the Commentary on Article 1 at 6.17. We believe that governments should be persuaded to prioritise clarification of CIV treatment in treaty negotiations. For example, countries could clarify that CIVs that take a certain legal form, or that CIVs that have a certain regulatory status (eg. A UCITS authorised CIV) should be eligible for treaty benefits. It is our members’ experience that absence of specific clarification often leads to uncertainty and confusion.

It would also be helpful for the Commentary to clarify that countries should only seek documentation in support of a treaty claim that is relevant to that treaty claim.

For example, unless a treaty contains an LOB condition, there should be no reason why a country should need to establish treaty entitlement of a CIV by reference to the underlying investor if the conditions listed above are met. Therefore a tax administration should not request confirmation or certification of the status of underlying investors in a CIV unless that is specified as a requirement under the treaty.

A further example: a UK treaty might provide treaty benefits to Authorised Investment Funds that are incorporated as Open-Ended Investment Companies or Authorised Unit Trusts. Authorised Investment Funds are widely held and subject to investor protection regulation. The vast majority are authorised to be sold to retail investors in the UK, either under the EU UCITS Directive, or otherwise as Non-UCITS Retail Schemes. However UK funds are frequently asked to provide evidence of UCITS status, even where UCITS status is irrelevant under the particular treaty, because the treaty provides benefits to all Authorised Funds. This is an important point because it will be different government agencies that are able to provide certifications of status. For example, HM Revenue & Customs can certify that a fund is a UK Authorised Investment Fund, but cannot certify that a fund is UCITS compliant – this falls to the Financial Conduct Authority. Only HM Revenue & Customs will routinely provide treaty documentation. Documentation being required of other agencies can lead to delays, or loss of treaty benefits.

Approach to limitation on benefits in the MTC

The 2010 Report presents three possibilities for countries in opting to apply anti-treaty shopping provisions in the form of an LOB clause:

[6.17] A CIV is entitled to treaty benefits without reference to an LOB condition
[6.21] A CIV is entitled to treaty benefits if a proportion of investors are themselves treaty eligible, or are equivalent beneficiaries
[6.26] A CIV is entitled to treaty benefits if a proportion of investors are themselves eligible to the same treaty (no equivalent beneficiaries)
[6.28] Treaty benefits are assigned to investors in a CIV (a look through basis).

For reasons that have been widely discussed elsewhere (including in 6.29 of the Commentary), CIVs face particular difficulties in meeting the conditions of an LOB clause. Interests in CIVs are widely held, and their interests are often held through intermediaries. CIVs do not know the beneficial owners of their interests and are not able to access information regarding their respective residence status and/or treaty eligibility. (However, they are normally able to make informed assumptions treaty eligibility based on how the CIV is distributed – see section below on practical implementation of limitation on benefits).
The Action 6 Deliverable proposes that entities that are regularly traded on recognised stock exchanges should be regarded as qualifying persons under an LOB condition. As we understand it, the reasons for this are:

- frequent changes in ownership of listed entities mean that meeting an LOB condition is difficult because of the lack of information on residence of underlying owners; and
- listed and traded companies represent a low risk of being used for treaty shopping because shareholders are generally not able to exercise control over the company.

Both of these points are equally true of CIVs that are not regularly traded on a recognised stock exchange.

For these reasons, and for the reasons highlighted above to reinforce arguments on beneficial ownership and residence, we believe that the appropriate and proportionate approach is that a CIV should not have to meet an LOB condition.

One final point is that distinguishing between listed and non-listed CIVs could represent a significant and unwarranted commercial distortion between listed and non-listed vehicles. Such a distinction was deliberately avoided in the OECD’s Common Reporting Standard on Automatic Exchange of Information because the OECD was persuaded that listed and non-listed CIVs could be substitutes in the hands of investors and therefore should be treated the same.

Notwithstanding the above, we recognise that certain countries may insist on including a LOB clause in their treaties.

CIVs are widely held and are often sold across borders. In the EU, the UCITS Directive provides a common regulatory framework for CIVs that are sold to retail investors, and it has established within the EU a working Single Market for CIVs. CIVs domiciled in one EU country are frequently and commonly sold to investors in other EU Member States. The consultation recognises that LOB without equivalent beneficiaries presents a legal problem within the EU. We would add that it presents an urgent practical problem to CIVs within the EU.

Outside the EU, the recently developed ASEAN CIS fund passport scheme, and the Hong Kong/China mutual fund recognition platform provide further examples of efforts made by governments to increase the availability of financial products to citizens, and facilitate cross border investment. Such schemes allow residents in one country to freely access investment in CIVs in another country. The LOB rule without an equivalent beneficiaries condition could present an impediment to the success of these schemes. We note that these mutual recognition regimes are not required by law (as in the case of the EU Treaty) but are government policies, but are no less meriting of special consideration with regards to application of the LOB rule.

6.26 of the Commentary notes that some countries might believe that including third country investors as equivalent beneficiaries violates the bilateral nature of treaties. Whilst this may be true, adopting this position presents problems, and will render treaties increasingly ineffective in the face of the globalisation of financial markets. Evidence that LOB without equivalent beneficiaries represents a barrier to cross border investment is given by the examples above related to CIVs.
6.28 of the Commentary outlines the alternative approach that countries might allow CIVs to make treaty claims on behalf of its investors. This should be the treatment that corresponds to CIV that are not persons under a tax treaty – in which case the CIV (or its agent) is simply acting as agent for the investor. However in cases where a CIV is a person, it is likely that the CIV takes corporate form (or a legal form that is treated as a corporate) in most cases. This creates the practical problem that a CIV might not be able to allocate treaty benefits to the specific eligible investors, when the interests of the CIV are fungible. Where treaty benefits are shared equally between all investors, this would create adverse selection and free rider problems.

In conclusion, our view is that any LOB clause needs to be accompanied by an equivalent beneficiaries condition that can be used by CIVs. Critically the LOB condition should not limit the number of possible equivalent beneficiaries because a cross border fund that is widely held could very easily have many such investors.

**Practical implementation of limitation on benefits**

We believe that the 2010 Report provides relevant and useful guidance on how a LOB clause should be applied in practice to CIVs (incorporated into the Commentary to Article 1 of the MTC at 6.30/31).

The Commentary at 6.30 explains that in many cases, CIVs will be overwhelmingly domestic. We think it is also true that, even where a CIV in distributed across borders, many distribution agreements will be overwhelmingly domestic – i.e. targeting investors in a particular jurisdiction. So we believe that the Commentary at 6.30 could be expanded to include similar conclusion in respect of distribution agreements – for example “it may be appropriate to assume that interests in a CIV are owned by residents of Country A if those interests are held in a nominee account of a distributor that distributes the CIV interests only in Country A, or where, for example, the distribution agreement provides that it will distribute only in Country A”.

We believe it would be helpful to expand on the Commentary at 6.31 with examples of practical steps a CIV might take when distributed across borders. For example, we understand some advisers believe that a CIV needs to obtain investor self-certifications (or US W8-BEN forms) from underlying beneficial owners in order to satisfy the requirements to collect information. We believe it would be helpful for the Commentary to specify that a CIV may obtain simple confirmations of the proportion of aggregate accountholders from a particular jurisdiction and is not required to obtain investor-by-investor information of tax residence.

**Comments are invited as to whether the preceding paragraphs accurately describe the treaty entitlement issues of sovereign wealth funds, pension funds and alternative funds / private equity funds. Comments are also invited as to how to address these issues without creating opportunities for treaty shopping.**

**Definition of CIV and non-CIV funds**

The term CIV is limited to 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 (para. 4, 2010 Report).

We note that there are many funds that may not typically be thought of as CIVs that could meet this condition. For example, many hedge funds established in the Cayman Islands or other typical offshore locations could claim to meet these criteria, as could some private equity, property, debt funds or securitisation vehicles. We note that within the EU, the Alternative Investment Fund Manager Directive now provides investor protection regulation for all funds that are not UCITS.
If different criteria are to apply in treaty negotiations for CIVs and non-CIV funds (and we believe that this is justified in some cases – see below), we think it will be helpful to provide greater clarity on what it meant by the terms. We think that the distinction should be based on criteria that is relevant to the tax treatment and treaty entitlement. The key condition should be whether a fund is widely held (or more accurately whether a fund intends to be widely held and is marketed as such, even if it is not in practice). Other relevant and necessary conditions are that its investor have no control over the assets of the fund.

We do not see the reason for a distinct analysis in treaties of funds that offer different degrees of investor protection regulation, or of funds that have diversified assets, or that invest solely in securities (as opposed to, say, property). It is the case, however, that funds that have greater investor protection regulation are more likely to be funds that are offered to a greater variety and number of investors, and are therefore more likely to be widely held. So in many cases it will be appropriate to include regulated funds in a list of types of entity qualifying for treaty benefits.

Treatment of non-CIV funds

For funds that are not widely held some of the arguments made above about the treatment of CIVs will not apply. It cannot be said that a fund which is not widely held provides a means of accessing capital markets for smaller investors, and neither is it true in general that a fund that is not widely held cannot conceivably obtain information about its investors in order to meet an LOB condition.

However, funds that are not widely held do provide significant social benefits. Such funds provide vital source of capital to companies, particularly to small and medium businesses, and provide significant capital (often invested across borders) to infrastructure projects, property development and other economic activities. The exclusion of these funds from obtaining treaty benefits is a barrier to cross border capital, and a disincentive to invest, and could ultimately deprive businesses and governments of vital capital.

We see no reason why the analysis above under “General approach to treaty entitlement for CIVs” should not also apply to non-CIV funds except that where a fund is not widely held, it may be appropriate to determine its entitlement to treaty benefits by reference to the entitlement to treaty benefits (or equivalent benefits) of its underlying investors. In this case an LOB (with equivalent beneficiaries) might be an optimal approach. This is because a relatively small numbers of investors and low investor turnover make it feasible to comply with an LOB. It would also ensure that a limited number of large institutional investors are not disincentivised from pooling investment in a fund to make capital available to markets because they would have a worse treaty outcome than if they invested directly.

Commentators are invited to suggest additional examples that could be included in paragraph 14 of the Commentary on the PPT rule (paragraph 17 of the Report). For example, representatives of investment funds are invited to suggest an additional example that would deal with the non-tax motivated use of a special purpose vehicle in order to pool the investment of various institutional investors from different countries.

PPT rebuttable presumption

We concur with the comments made by ICI Global that the example given on p. 72 of the Deliverables report is an excellent starting point, but that it would be helpful to include further examples of funds that are non-distributing and that are majority owned by investors that are equivalent beneficiaries, rather than treaty beneficiaries.
We believe that these two modifications in the example serve well to deal with the position of non-CIV funds. For example a special purpose vehicle resident in Country R manages a portfolio of properties in Country S. Under the tax convention between R and S the withholding tax rate on dividends is reduced from 30% to 10%. RCo’s investors are resident in countries A, B and C, each of which has a tax treaty with Country S. In each case the treaty reduces the withholding tax to 10%, except in the case of the tax treaty between Country S and Country C, in which the withholding tax rate is 15%. RCo has no specified distribution policy. In most cases income is not expected to arise, but where it does, it may be retained by RCo for further investment or development. Otherwise the same facts exist as in example D, and the same outcome should arise.

We note that if in the above example, countries A, B and C had no treaty with Country S, and in incorporating RCo, Country R was deliberately chosen so that investors could obtain the benefits of the R-S treaty, this may serve as a useful example where a PPT might be invoked.

Finally, I would like to thank for the opportunity to comment on the discussion draft and we appreciate the considerable efforts that have been made to consider factors that are uniquely relevant to the funds industry. We hope to be able to continue to contribute to the consultation and I am available at your convenience to discuss anything in this letter at jorge.morley-smith@theinvestmentassociation.org or on +44 (0)20 7831 0898.

Yours sincerely

Jorge Morley-Smith
Director, Head of Tax

cc. Mike Williams HM Treasury
    Tom Matthews HM Revenue & Customs
January 9, 2015

By Electronic Mail: taxtreaties@oecd.org

Marlies de Ruiter,
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue André Pascal, 75775 Paris Cedex 16

Dear Ms. de Ruiter:

RE: CIVs and Follow-up Work on Action 6 (Prevent treaty abuse)

This submission is made in response to the Public Discussion Draft on "Follow-up Work on the Report on Action 6 (Prevent Treaty Abuse)" (the “Discussion Draft”) issued by the OECD on November 21, 2014. Our comments are principally directed to the issue whether the recommendations of the 2010 CIV Report1 continue to be adequate for widely-held collective investment vehicles (“CIVs”). In brief, we submit that such recommendations continue to be adequate.

The Investment Funds Institute of Canada ("IFIC") is the national association of the Canadian mutual funds industry. Our members include managers and distributors of publicly-offered mutual funds that are widely held, distributed within Canada, continuously offered and redeemable on demand by the investor, subject to investor-protection regulation, and invested in a diversified portfolio of securities.

Submission by IFIC

IFIC would like to express its support for the OECD’s inclusive BEPS consultation process. We acknowledge the importance of preventing treaty abuse as well as the effort made by the OECD to address CIVs in the September 16, 2014 Report on the work on Action 6 of the BEPS Action Plan (the “Action 6 Report”).

IFIC believes that the results of Action 6 should be aligned with the extensive, multi-year work of the OECD on treaty eligibility for CIVs and their investors.2 As a result of that work, treaty eligibility for CIVs was confirmed in the Commentary to Article 1 of the OECD Model Tax Convention (updated July 22, 2010). We submit that Action 6 should not change the treatment of CIVs as discussed in the Commentary unless a CIV is “abusive” as discussed therein.3 Any

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1 OECD, “Granting Treaty Benefits with respect to the Income of Collective Investment Vehicles”, adopted by the Committee on Fiscal Affairs on April 23, 2010 (the “CIV Report”).

2 Canada was an active participant in the OECD work on CIVs. In a comment letter on the December 9, 2009 draft of the CIV Report, IFIC submitted that Canadian CIVs, which are structured either as taxable trusts or corporations and are predominantly held by Canadian resident investors, should be entitled to treaty benefits in their own right. (See January 31, 2010 letter from IFIC to the Director of the OECD’s Centre for Tax Policy and Administration.)

3 See paragraph 6.19 of the Commentary to Article 1.
changes made under Action 6 should be guided by the underlying principle that investors in a CIV should be no worse off than if they invested directly in the securities held by the CIV.

The focus of our comments is on CIVs as defined in the CIV Report – that is, funds that are widely-held, hold a diversified portfolio of securities and are subject to local investor-protection regulation. However, we strongly believe that non-CIV funds should not be prejudiced by proposals to clarify treaty benefit availability for CIVs, and we therefore endorse the general approach adopted in the CIV Report, the Commentary and the Action 6 Report of making available a suite of different potential treaty provisions addressing different contexts and circumstances. This broader approach will not only facilitate the accommodation of the wide array of CIVs, but will also provide greater flexibility to address non-CIV funds, which should not be inappropriately denied treaty benefits.

Discussion

CIVs provide investors of all sizes and types with access to efficiencies with respect to pricing, liquidity, and investment management. For individuals saving for retirement, CIVs are often the only reasonably affordable means by which to assemble a professionally-managed diversified portfolio.

While the tax treatment of CIVs varies depending on the specific legal form and local tax regime, the goal of most domestic tax systems is to tax the income of a CIV only once, either at the investor or CIV level. The underlying policy is one of tax neutrality between direct investment and investment through a CIV.

The OECD’s BEPS project targets “corporate tax planning strategies that exploit gaps and loopholes of the current system to artificially shift profits to locations where they are subject to more favourable tax treatment”. While such corporate tax avoidance is very far from being the reason why investors invest in investment vehicles holding large, professionally-managed diversified portfolios, if a comprehensive limitation on benefits (“LOB”) rule is to be adopted as a result of Action 6 of the BEPS project it will affect CIVs established in treaty countries just as much as multi-national enterprises making use of holding companies established in treaty countries.

In crafting rules designed to ensure treaty benefits for CIVs in appropriate circumstances, the OECD has been rightly mindful of the considerable differences among CIV markets worldwide.

In some countries, such as Canada, a number of factors combine to result in an overwhelming majority of investors in CIVs being resident in the country in which the CIV is established and managed (such countries constitute the “domestically-oriented CIV market”). Such factors include

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4 The CIV Report recognized the importance of CIVs in this regard: “CIVs allow small investors to gain the benefits of economies of scale even if they have relatively little invested. They provide access to a number of markets that might be closed to the small investor. These benefits are provided in a form that is highly liquid, as securities issued by a CIV may be redeemed on a frequent...basis at net asset value...or can be transferred with minimal restrictions. CIVs also allow for highly efficient reinvestment of income. Distributions on portfolio securities held by the CIV can be reinvested by the CIV. It would be difficult for individual investors to reinvest small distributions on an efficient basis. In addition, investors in CIVs benefit from the market experience and insights of professional money managers....Governments have long recognised the importance of CIVs as a complement to other savings vehicles in terms of facilitating retirement security” (CIV Report, paras. 8 to 10).

the domestic population size, securities regulations and tax laws. For instance, if a country’s
domestic tax laws impose substantial withholding taxes on CIV distributions to non-residents, it is
highly unlikely that CIVs in that country would be used for treaty shopping by third country
residents. It would be helpful if follow-up work on Action 6 and CIVs were to include an express
statement regarding the low likelihood that CIVs in a country that imposes such withholding taxes
and has a domestically-oriented CIV market would be used to abuse treaties.

In other countries, where conditions are different, investors in a domestically-established CIV are
primarily non-residents who may, or may not, be resident in a country that has a tax treaty with
the country in which the CIV is established (such countries constitute the “global CIV market”).
According to the CIV Report, such CIVs can aggregate very large pools of invested capital that
can benefit from the economies of scale described above to a greater extent than smaller CIVs.

In a hypothetical world of perfect transparency – where every CIV could reliably ascertain the
residence of each of its investors at all times (since a CIV may receive a payment that could
qualify for treaty relief at any time) – it might be possible to craft a “preferred approach” that would
cover both the domestically-oriented CIV market and the global CIV market, as well as non-CIV
funds, with a single set of treaty rules. However, in many countries (including Canada in the case
of all exchange-traded CIVs and in the case of some unlisted CIVs), due to the degree of
intermediation between the CIV and the ultimate investor, CIV managers do not have access to
the identity of their investors (since the CIV does not have a direct relationship with the ultimate
investor). Moreover, even where a CIV manager knows the identity of the investor, it may not
have information as to the investor’s treaty residence and eligibility for benefits under an LOB.

In a world where “real-time”, perfectly accurate investor residence information is unavailable but
where policymakers in two contracting states have a good understanding of the extent to which
their domestically established CIVs are held by non-residents, contracting states with clearly
domestically-oriented CIV markets ought to be able to address CIVs in a manner that CIVs can
readily comply with. That is, such countries should have the option in their bilaterally negotiated
treaties to adopt provisions that do not require their local CIVs to satisfy onerous treaty eligibility
tests which it can reasonably be assumed that they will satisfy but which can be costly and
administratively difficult to apply.

In contrast, contracting states whose CIVs form part of the global CIV market ought to have other
options made available to them. For instance, it would be in keeping with the principle of CIV tax
neutrality mentioned above for global CIVs to be able to qualify for treaty benefits to the extent
that interests in the CIV are owned by residents of the state in which the CIV is established or
equivalent beneficiaries. However, given the limited ability of a CIV manager to ascertain its
investors’ identity at the time treaty benefits are sought – and those investors’ residence and LOB
status – practical solutions must be implemented so that CIV managers can actually apply an
equivalent beneficiaries test. This is recognized in the proposed Commentary that contracting
states should be willing to accept practical and reliable approaches that do not require daily
tracing and that such determinations be made periodically (such as annually) with any such
determination applying to payments received thereafter until the next determination must be
made. As investments in a CIV are held through one or more financial intermediaries, it would be
helpful if CIV managers could rely on periodically updated, pooled information regarding CIV
investors’ treaty residence and withholding rates obtained (directly or through other
intermediaries) from those intermediaries with the direct relationship with the investor. 6 This is

6 The OECD’s Informal Consultative Group on the Taxation of Collective Investment Vehicles and
Procedures for Tax Relief for Cross-Border Investors (ICG) outlined in more detail such an approach at
paragraph 148 of its Report on “Possible Improvements to Procedures for Tax Relief for Cross-Border
Investors” (12 January 2009). This Report ultimately contributed to the Treaty Relief and Compliance
Enhancement (TRACE) Implementation Package.
similar to the approach contemplated by the TRACE project with respect to the application of withholding taxes on securities held by intermediaries. IFIC endorses implementation of the TRACE project as a practical and reliable means of making available the type of information needed to apply to CIVs the proposed LOB rule as well as the rules recommended in the CIV Report.7

In many cases, a combination of approaches within one treaty will be the most suitable, given the multiplicity of types of CIV and non-CIV funds that may exist within the two contracting states and as one state may have a domestically-oriented CIV market and the other a global CIV market.

Accordingly, given the difference in legal form of CIVs, the composition of their investor base, and their tax treatment in different jurisdictions, IFIC’s response to a question posed in the Discussion Draft is that it is neither desirable nor appropriate to have a “single preferred approach” to designing treaty provisions to address CIV treaty eligibility.

The Discussion Draft also asks for comments as to whether the recommendations of the CIV Report continue to be adequate for widely-held CIVs. We believe those recommendations remain adequate, subject to the proviso that – as discussed below – the various recommended treaty clauses for granting benefits to CIVs should not be thought of as mutually exclusive approaches and that contracting states ought to consider utilizing in their treaties combinations of such clauses to address both CIV and non-CIV funds.

**Specific Approaches – LOB**

All of the approaches to addressing CIV treaty eligibility discussed below assume that there is a comprehensive LOB clause in the treaty.

1. **No CIV-Specific Clause.** It may be reasonable in some cases for two contracting states not to expressly address CIVs anywhere in their treaty (that is, neither in an LOB nor elsewhere (such as Article 1 or 4)). This is contemplated in the Commentary, which recognizes that under general provisions of a treaty, many CIVs will be eligible for treaty benefits on the basis that they are persons that are residents of a contracting state and beneficially own the relevant income. In this case, a CIV should be a qualified person under the LOB either because its principal class of shares or units are listed and traded on a recognized stock exchange or because more than half of its investors are “qualified persons”, such that the Ownership / Base Erosion “qualified person” test in paragraph 2(e) of the proposed LOB rule would be satisfied. However, if that test is adopted in the form proposed in the Action 6 Report – whereby it is necessary that the Ownership prong of the test needs to be satisfied “on at least half the days of the taxable period”, this may be a very difficult test for CIVs to apply in practice and in that case it would be preferable for contracting states to include in the LOB clause of their treaty a specific category in the list of “qualified persons” applicable to CIVs.8

2. **CIVs specifically addressed in Treaty.** In many cases, there will be uncertainty regarding the eligibility for treaty benefits of CIVs in one or both contracting states. Such uncertainty may be legal or factual in nature. For instance, one or both contracting states may question as a substantive legal matter the other contracting state’s CIVs’ ability to satisfy Article 4 conditions for residence, or as a factual matter tax authorities may have little assurance that CIVs established in at least one of the two contracting states are predominantly held by investors

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7 IFIC would also encourage the OECD to work toward aligning the work on TRACE with the work on the common reporting standard (CRS) so as to reduce compliance costs for CIVs, financial intermediaries and CIV investors as much as possible.

8 See discussion of proposed subparagraph 2(f) of the LOB rule in the Action 6 Report.
resident in that state. In such cases of doubt – or even where there is little uncertainty but the two contracting states wish to make the treaty eligibility of CIVs clear – it would be appropriate to introduce CIV-specific provisions.

(a) **Pure definitional approach:** Where it is clear to two contracting states that CIVs are largely domestically held and not used for treaty abuse, and the two contracting states wish to clarify the treaty eligibility of CIVs they could adopt a provision like that set out in greater detail in paragraph 6.17 of the Commentary to Article 1:

> Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated, for purposes of applying the Convention to such income, as an individual that is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof). For purposes of this paragraph, the term "collective investment vehicle" means, in the case of [State A], a [ ] and, in the case of [State B], a [ ], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph.

Contracting states adopting such a clause would have regard to the legal form, tax treatment and investor base of CIVs in their respective jurisdictions when defining what types of vehicles would be deemed to be individuals resident in a contracting state. In particular, contracting states would likely take into account rules in their tax and non-tax laws/regulations that either restrict investment in domestic CIVs by non-residents or render such investment economically unattractive on an after-tax basis. The clause could be placed in Article 1 or Article 4 of a treaty. As noted in the Action 6 Report,

- if such a clause were included in a treaty with an LOB rule, there may be no need to separately clarify the treatment of CIVs in the LOB rule itself, since a "collective investment vehicle" as defined in the above clause would be a "qualified person" under the LOB rule by reason of being deemed to be an individual resident in a contracting state; and

- if such a clause were not included elsewhere in a treaty, then a version of it could be included as a stand-alone, CIV-specific category of "qualified person" (in other words, as proposed in the Action 6 Report, one listed type of qualified person could be a "collective investment vehicle", a term that the two contracting states would then seek to define in the LOB rule).

(b) **Equivalent beneficiary approach:** The Action 6 Report puts forward an alternative clause that would treat as a qualified person under the LOB rule “a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the CIV are owned by residents of the Contracting State in which the collective investment vehicle is established or by equivalent beneficiaries.” (The Commentary to Article 1 contains a similar clause, though not in the context of an LOB rule.) This type of clause is more difficult for taxpayers and tax administrators to apply/verify in practice than a clause treating all defined CIVs as fully entitled to treaty benefits – a clause that might be more fitting for treaty countries with a domestically-oriented CIV market. Including an equivalent beneficiaries clause would be a fitting approach where there is a concern that CIVs are potentially being used in a way that could result in base erosion through treaty abuse.
(c) Claiming treaty benefits on behalf of investors. Paragraph 6.28 of the Commentary to Article 1 recognizes that in some cases a CIV’s investors will be entitled to a better tax rate had they invested directly rather than through the CIV – for instance to the extent that those investors are pension funds. The Commentary suggests that contracting states could adopt a clause providing that in such cases the CIV itself would not be treated as a resident claiming benefits on its own behalf but may claim, on behalf of its investors, the tax reductions, exemptions or other benefits that would have been available under the applicable treaty to such owners had they received such income directly.

(d) A combined approach. We believe that for many treaties the most fitting way of approaching CIV and non-CIV funds (including the intermediary holding companies utilized by sovereign wealth funds, pension funds and private equity funds) will be a combined approach that is in all respects informed by the principle of tax neutrality. For instance, a particular treaty between countries with domestically-oriented CIV markets could include:

(i) a clause that grants full treaty benefits to CIVs as specifically defined in the treaty having regard to the laws and economic circumstances in each of the two contracting states,

(ii) a clause that grants treaty benefits to investment funds that are not CIVs as so defined, including holding entities used by non-CIV funds (including pension funds and sovereign wealth funds as well as alternative funds), to the extent that beneficial interests in the relevant fund/entity are owned by equivalent beneficiaries, and

(iii) a clause that grants CIVs and non-CIV funds the ability or choice to make claims for treaty benefits on behalf of investors entitled to a better treaty rate.10

We see no compelling reason to exclude non-CIV funds from the potential benefits to be secured through clauses described in subparagraphs (ii) and (iii) immediately above. For instance, with respect to subparagraph (iii), many pension funds and other sophisticated, tax-exempt institutional investors invest in investment funds that are not subject to investor-protection regulation. The fact that a privately placed investment fund with accredited investors is not subject to investor protection regulation in its home jurisdiction may mean that the fund will not be a CIV as defined in the CIV Report, but the absence of such regulation should not be a reason to deny treaty benefits. Like CIVs, non-CIV funds play an important role in matching providers of capital with companies and projects requiring capital, including across geographic borders. Along with preventing tax evasion and avoidance, tax treaties are intended to promote the movement of capital between two contracting states. Without some ability of non-CIV funds to access some of the solutions proposed in the CIV Report for CIV funds, the introduction of a LOB could lead to the impairment of cross-border investment through the inappropriate denial of treaty benefits, which is contrary to the principle of ensuring neutrality between direct and indirect investment.

9 To be clear, we are not suggesting that sovereign wealth funds and pension funds should, like alternative funds or holding entities used by a sovereign wealth fund, pension fund and/or alternative funds, be accorded partial treaty benefits in proportion to their treaty-eligible members/investors. Rather, we would expect sovereign wealth funds and pension funds generally to be entitled to full treaty benefits, unless disqualified under an LOB rule.

10 In instances where a CIV is only partially owned by investors entitled to a preferential rate, further consideration would be required whether a means could be devised to allow the CIV to claim both the preferential and general rates in proportion to the underlying investor entitlement.
The above is one suggested set of clauses that could provide a comprehensive “package” for addressing CIV and non-CIV funds alike. Others are possible. For instance, two contracting states may prefer to replace clause (ii) with a clause that grants CIVs full treaty benefits but only if ownership by equivalent beneficiaries above a certain ownership threshold is exceeded. CIVs that did not meet the ownership threshold, and non-CIV funds, should then still have the ability to obtain proportionate treaty benefits based on a further clause that would grant the fund treaty benefits to the extent that beneficial interests in the fund are owned by equivalent beneficiaries.

Specific Approaches – PPT

The Discussion Draft contemplates that the proposed principal purpose test (“PPT”) could apply notwithstanding the other provisions of the Convention i.e., even if a CIV were to satisfy the LOB rules. There is a risk that the PPT could introduce a higher level of uncertainty regarding eligibility for treaty benefits, which is particularly acute for CIVs, as they are often required to calculate their net asset value daily and therefore require certainty with respect to tax liabilities and treaty benefit entitlement. To mitigate against this risk, it is recommended that there be a rebuttable presumption that a CIV otherwise entitled to benefits under the treaty is presumed to have a bona fide purpose. Further, in recognition of the bilateral nature of a treaty, a contracting state should only be able to challenge a CIV on the basis of the PPT if the other contracting state agrees that the PPT could apply under the circumstances. These safeguards would militate against the possibility that aggressive application of the PPT by a contracting state could undermine the certainty required for the economic efficiency of CIVs.

Whether or not the foregoing suggestions are accepted, there is one important clarification that would be helpful in connection with the Action 6 Report’s discussion of the PPT. While there may be examples where the PPT could apply to a CIV that satisfied the LOB rules on the basis that its principal class of shares or units are listed and traded on a recognized stock exchange, we find it difficult to envisage a situation in which the PPT should apply to deny treaty benefits to a CIV that satisfied the LOB on the basis that more than half of its investors are “qualified persons” such that the Ownership / Base Erosion test were met. In other words, if more than 50% of the CIV’s investors are “good” investors and it is a bona fide CIV, how can it be inconsistent with the object and purpose of the relevant provisions of the Convention to afford benefits to the CIV even if a substantial portion (but less than 50%) of investors were not “good” investors? In Example D in paragraph 17 of the Action 6 Report, even if an RCo (resident company) held a majority of its investments in companies that were resident in State S, the investors in RCo that would not be entitled to relief under a treaty with State S were a substantial minority of RCo’s investors and it was known to investors that RCo would make significant investments in State S, it is submitted that this should not trigger the application of the PPT since the purpose of tax treaties is to provide benefits to encourage cross-border investment. We submit that Example D should be clarified accordingly.

To the extent that the OECD concludes as a result of follow-up work on CIV and non-CIV funds that there are certain fairly common fund structures/scenarios that are unlikely to be subject to a PPT, it would be helpful for clear statements to that effect to be made as early as possible in the process of publishing reports and adopting changes to the OECD Model and the Commentary, since the mere introduction of the PPT will cause considerable uncertainty as to how it will be applied in practice. Such clarity and guidance would be very helpful to funds and their investors.

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11 This requirement for certainty, specifically in the light of the requirements for a CIV to determine its net asset value, was recognized by the OECD in paragraph 6.15 of the Commentary to Article 1.
Conclusion

The concept of a CIV embraces a variety of vehicles that take different legal forms and serve as investment intermediaries for a wide range of investors that have elected to invest indirectly in a CIV for a variety of purposes. Due to the breadth of the CIV spectrum, and the many differences in applicable tax rules of OECD member states, IFIC does not believe that a single preferred approach to the treatment of CIVs is workable or appropriate.

IFIC is of the view that tax neutrality between direct investment and indirect investment through a CIV should be the guiding policy objective in this area, as it will prevent granting treaty benefits in abusive circumstances. Achieving neutrality and preventing treaty abuse will require that contracting states take into account the economic nature of CIVs in their respective jurisdictions and tailor their bilateral negotiations accordingly. To facilitate this process it is preferable that the contracting states have at their disposal a number of options, each focused on addressing a different category of CIV, which can be used in isolation or combination.

These comments apply equally to non-CIV funds and it is hoped that treaty benefits are not inappropriately denied as a result of the proposals in Action 6.

For both CIV and non-CIV funds, administrative issues in establishing and verifying entitlement to treaty benefits can be complex. We agree with the approach in the Action 6 Report that contracting states should be willing to accept practical and reliable approaches to establishing such eligibility. Moreover, we submit that broad implementation of the TRACE model should be considered as a means to ensure the flow of relevant information between financial intermediaries.

Should you have any questions in relation to our submission, please contact James Carman, Senior Policy Advisor, Taxation at jcarman@ific.ca or by phone at 1-(416) 309-2323.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: Ralf Hensel
General Counsel, Corporate Secretary & Director of Policy
Dear Ms. de Ruiter

The IDSA welcomes this opportunity to provide comments on the 21 November Discussion Draft “Follow-up Work on BEPS Action 6 (Prevent Treaty Abuse)” as we believe the area of securitisation and treaty access has perhaps been somewhat overlooked so far in this work stream. We would be pleased to attend the Public Consultation Meeting on the 22 January 2015 for which we have requested registration and to make some of the points mentioned in this paper.

1. **Irish Debt Securities Association (“IDSA”)**

The Irish Debt Securities Association (“IDSA”) is an industry organisation established with the aim of promoting and developing the environment and infrastructure in Ireland to support the global structured finance, debt securities and the specialist securities industries. The IDSA promotes a responsible, sustainable and effective environment within which debt securities and other specialist securities can be used to facilitate transactions, to create investment products and to raise capital funding.

The membership of the IDSA includes corporate administrators, trustees, audit firms, legal advisors, listing agents, and other parties involved in the structuring and management of special purpose vehicles in Ireland. The IDSA works to promote high standards of professional conduct among industry service providers and to lead industry activity in developing and providing a world-leading environment for structured finance transactions and for the issuance of debt securities and other specialist securities.

2. **The role and importance of Securitisation.**

2.1 **Bank Funding Gap**

Economic growth in Europe and the rest of the world is low by historical standards. Growth requires investment and investment requires funding. There is a natural limit to the availability of equity finance and, in Europe in particular, debt finance is hugely important.

A survey published by Standard & Poor’s in May 2012, estimated that Europe will require an additional €1.6 trillion to €1.9 trillion to finance any kind of growth between 2012 and 2016. This only focuses on growth and does not include any long-term or replacement investment needed to maintain competitiveness. As such the conservative estimate is a minimum €4 trillion gap in funding.
for the European economy in the next 5 years. Unless this funding gap can be bridged, Europe faces the potential of a wasted decade from an economic standpoint. European banks will struggle to fill this funding gap without raising significant capital.

Of all the ways in which it is possible to open up financing channels from capital market investors to the mid-cap, SME and consumer borrowers, securitisation seems most capable. Securitisation has the characteristics that make it a versatile and powerful funding channel and the potential to be a key component of any attempt to bridge the European funding gap. This is not to suggest securitisation is the only such channel or could even aspire to being the sole way in which these borrowers obtain non-bank funding. However as a funding tool it is acknowledged that securitisation can contribute to a well-diversified funding base in terms of maturity, investor type and currency.

2.2 Deleveraging Banks

The deleveraging of European banks will be in the order of 7% of their balance sheet according to the IMF, conservatively estimated at US$2.6 trillion at the lower end or a top range of US$3.8 trillion. In accordance with the Basel III liquidity rules a further €600 billion of cash will be required to be held by European banks. These new capital and liquidity regulations will constrain the ability of European banks to fund the real economy to the order of €2.5 trillion. The ECB stress tests have put more focus on deleveraging the European banks to boost regulatory capital. One of the principal reasons is the need for European banks to deleverage due to new regulatory rules on capital in addition to increased liquidity requirements.

Traditionally Europe has had a great reliance on banks to provide funding to the economy than for example the United States. The ratios of securitised loans and corporate bonds to total financing volumes in Europe in 2011 was 19 per cent, compared to 64 per cent in the United States. It is clear that European banks need increasingly to securitise their assets. The transfer of credit risk away from the banking sector can be beneficial to the real economy and to monetary and financial stability.

The higher the price that can be achieved for bank assets (principally loans to customers), the less regulatory capital banks will have to raise. Accordingly, a strong securitisation market, particularly in Europe, would assist in deleveraging banks, freeing up regulatory capital and enabling banks to lend to business.

2.3 Alternatives to Bank Funding

If the banks cannot fill the funding gap, it has to be filled from somewhere and there are limited realistic options.

- First, the gap can be filled by the public sector. This is not realistic due to current fiscal consolidation.

- Secondly, the missing finance can simply continue to go missing, resulting in a low growth period extending for a number of years. This should not be an acceptable outcome for policymakers.

- Thirdly, all or some of the missing finance can be channelled to the real economy from non-governmental and non-bank sources: in other words from the capital markets. In some cases, private equity can fill the gap, but it is largely debt funded so it in turn depends on banks (unlikely in this environment) and the capital markets.

The use of securitisations and bond issuances to fund either direct lending to businesses or to acquire debt already advanced to businesses will be a key component of any successful attempt at bridging the funding gap and providing funding to businesses.
3. **Basic Structure of a Securitisation**

Most securitisations have a similar legal structure. A typical securitisation structure and transaction can be explained in the following way:

3.1 A bank/financial institution wishes to raise new capital and de-risk its balance sheet and has identified a pool of loans that it has originated that can be sold to raise the capital it requires.

3.2 A new securitisation vehicle is established (for example, in Ireland). The securitisation vehicle usually has only a nominal equity share capital.

3.3 The nominal equity share capital of the securitisation vehicle is held by an independent share trustee usually on trust for charitable purposes. This equity structure is designed to ensure that the securitisation vehicle is ‘bankruptcy remote’, meaning that it is insulated from the insolvency risk of other parties to the securitisation (as it does not form part of any other party’s group of companies).

3.4 The securitisation vehicle raises debt financing by issuing bonds to investors (i.e., bondholders) in the capital markets. Most (if not all) of these bondholders will be resident in a different jurisdiction than the securitisation vehicle, as securitisations generally involve cross-border investment.

3.5 The proceeds of the bonds are used by the securitisation vehicle to acquire loans (such as a portfolio of mortgage loans) from the bank/financial institution which ‘collateralise’ the bonds issued to bondholders. The proceeds of this sale represents new capital for the bank/financial institutions that can be used for new lending business. It also represents a de-risking of the loans from the bank/financial institution’s balance sheet.

3.6 The securitisation vehicle uses the returns received on the loans it has purchased from the bank/financial institution (i.e., repayments of principal and interest from borrowers) to pay interest and to repay principal to its bondholders as these payments fall due.

3.7 The bonds are commonly listed on a recognised stock exchange and held in global form by a common depositary on behalf of a clearing system (such as Euroclear or Clearstream). The presence of a clearing system in the ownership chain means that the securitisation vehicle may not know who the beneficial owner of its bonds are from time to time. In addition, bondholders may freely trade their positions in the bonds through the clearing system. Importantly, the bonds are not typically traded on the recognised stock exchange on which they may be listed, but are traded through the clearing systems in electronic form.

3.8 A diagram of a typical securitisation structure is as follows:
3.9 Commonly, bonds do not all have the same repayment priority and may be issued in senior and junior tranches. Usually, senior bonds have first claim on the proceeds of all the loans in the securitised pool. Junior bonds have a subordinated claim, meaning they get paid after the senior bonds. In short, this means that losses are “allocated” first to the junior bondholders who therefore take the greater risk.

3.10 Senior bonds can be ‘over collateralised’ and in this way it is possible to issue bonds that appeal to the most risk averse capital market investors. The junior bonds, which generally constitute a much smaller proportion of the overall securitisation pool, can be sold to other capital market investors who have greater risk appetite.

3.11 Bonds which are often rated and listed are subject to the kind of benchmarking that can attract global investors. As bonds are freely tradable they allow an investor to sell the bond before its maturity. In this way they offer the possibility of liquidity to the capital market investor whilst allowing long term funding for the securitisation vehicle.

3.12 Finally, most loans that are securitised are originated by a bank. After the securitisation, the bank usually continues to service the loans. The securitisation process allows the capital market investors to leverage off (and effectively pay) the institutions that have already created the infrastructure to advance loans.

4. Regulation of a Securitisation

In recent years, the EU and the United States have introduced regulation relating to the holding of a “retention piece” in securitisation transactions in order that certain regulated entities may invest in such structures. As mentioned above, securitisation transactions are usually funded by a number of different tranches of bonds with increasing levels of risk and return and decreasing ratings. For example, a securitisation vehicle will often issue A, B, C, D, E etc. bonds with the potential for increasing return (and risk) as they are more deeply subordinated. In many securitisations in order to comply with risk retention requirements a specified proportion of the lowest tranche, or of each tranche, of the capital structure (the retention piece) must be held by an “originator”, “sponsor” or “original lender” (usually the bank that advanced or originated the debt in the first place) for the life of the transaction. This is to prevent banks from securitising loans which are of poor quality and passing the risk of any default entirely onto investors in the bonds. In addition, securitisation vehicles are subject to reporting to the Central Banks of the European member states and onward to the European Central Bank pursuant to Regulation (EC) No 1075/2013 of the European Central Bank of 18 October 2013 concerning statistics on the assets and liabilities of financial vehicle corporation engaged in securitisation transactions (commonly known as the “FVC Regulation”). We have set out in the appendix a brief overview of the EU law regulating many securitisations in Europe.

5. Securitisation Tax Regimes

Most of the tax systems of the countries that have securitisation regimes work in fundamentally the same way. The securitisation company is subject to corporation tax on its income but obtains a deduction for its funding leaving behind a small profit spread in the company.

From a superficial level this could be viewed as base erosion. An apparently simple “solution” to this base erosion would be to tax the securitisation company (say in Ireland at 25%) and deny a deduction for payments out to investors. The payments out would be dividends to the investors who would benefit from a participation exemption in their local jurisdiction. Accordingly, the tax on the securitisation activity would default to the location of the securitisation vehicle. Clearly, this is not the correct outcome as evidenced by the fact that many jurisdictions have securitisation transactions legislation that adopts a wholly different approach.
In reality, the correct approach is that the payments out to the securitisation vehicle would be usually deductible in the source country and would be taxed wherever the investors are liable to tax. The investors in securitisation vehicles are generally large institutions such as insurance companies, banks, pension funds and investment funds. These are all subject to regulation and to a tax system in the jurisdiction in which they are located.

6. **Action 6 Preventing Treaty Abuse**

The initial Discussion Document, the September Report and the Follow Up work on BEPS Action 6 published on 21 November last contain a number of proposals designed to prevent treaty abuse. In particular two new anti-abuse tests are suggested viz

- Limitation on Benefits (LOB) rule and
- Principal Purposes Test (PPT)

We are concerned that these proposals may have unintended adverse consequences on an industry which is slowly recovering from the financial crisis and whose wellbeing could be important to global economic recovery. In addition the implicit favouring of securitisation vehicles which are owned by residents of the vehicle’s home country would in our view be discriminatory against small countries where, by definition, the choice of investments would be smaller and the available pool of investors would be diminished.

7. **Analysis under LOB**

A securitisation company in any jurisdiction would likely fail the base erosion test contained within the LOB. Bonds issued by securitisation companies are commonly listed on a recognised stock exchange and held through a clearing system. This means that, in almost all cases, a securitisation vehicle cannot establish who its bondholders may be at any time and what their tax residence status may be.

For this reason, ‘cross-border’ securitisation vehicles will not satisfy the base erosion test included in paragraph 2(e)(ii) of the draft LOB as it simply will not be in a position to confirm who its bondholders may be. In addition, a securitisation vehicle in any jurisdiction would equally be unable to benefit from the equivalent beneficiaries provision contained in paragraph 4 of the draft LOB for the same reasons.

In any event, in most securitisations it would be anticipated that a majority of the bonds issued may be held by residents of a jurisdiction other than where the securitisation vehicle is established. In many cases, bondholders will be tax resident in OECD member states and may be institutional investors, such as pension funds. In this regard, a securitisation vehicle in any jurisdiction would likely fail the base erosion test contained within paragraph 2(e) (ii) LOB even if it could establish the identity and tax residence status of its bondholders. This may be the case even though its bondholders may be institutional investors in OECD member states.

It seems that the only option available to such securitisation vehicles under the draft LOB would be to apply for discretionary relief under paragraph 5 of the draft LOB. However, this is not a viable option, it would be time-consuming, costly and is likely to lead to inconsistent results between different jurisdictions.

The IDSA considers that a better solution, if an LOB must be included in the Model Tax Convention, would be to treat ‘cross-border’ securitisation companies that issue bonds that are held though recognised clearing systems as a separate category of qualified person on the basis that they are not generally established for treaty abuse purposes and have many broader benefits for the financial
system including more efficient allocation of capital, promoting more investment and growth, risk sharing and reducing dependence on the banking/financial sector.

Indeed, the proposed LOB includes a separate category of qualified person for publically traded entities. The commentary on this category of qualified person explains that the rationale for including this category is that ownership of such entities are generally widely held and, therefore, unlikely to be established for treaty shopping. The same rationale can be applied to securitisation companies (whether listed or held through a recognised clearing system) as effectively the various investors in securitisation companies are the holders of the economic interests in these entities (in the same manner that shareholders are in publically traded companies). While some of these interests are legally structured as debt, rather than equity, the fact that a securitisation company is securitising a pool of assets rather than operating a trading business means that such investors more closely resemble stockholders in a company (albeit some with a preferred interest) than the types of third-party financiers one might find in the case of debt-financed ‘traditional’ trading company.

Alternatively, if securitisation vehicles cannot be treated in this way, specific provisions should be included in the LOB outlining when ‘cross-border’ securitisation companies that issue bonds that are held through recognised clearing systems will be treated as satisfying the LOB. As currently drafted, it is not possible for such ‘cross-border’ securitisation vehicles to satisfy the LOB. Any proposal to separately deal with ‘cross-border’ securitisation vehicles in the LOB (other than including them as a separate category of qualified person) would require further consultation with industry.

Finally, IDSA would like to highlight that any LOB should not undermine the rights of freedom of establishment and free movement of capital between Member States of the European Union. These principles are enshrined in European law. IDSA considers that the LOB, as currently proposed, could potentially undermine these rights and be incompatible with European law. For example, under the proposed LOB, a securitisation vehicle established in a Member State of the European Union would be entitled to tax treaty access where its bondholders are all tax resident in that same Member State. However, that same securitisation vehicle would likely not be entitled to treaty access where it: (i) was established in a different Member State; or (ii) raised capital from bondholders that were tax resident in a different Member State. This approach has the effect of allowing / denying tax treaty access on a discriminatory basis by reference to which Member State the securitisation vehicle is established in and / or has raised its capital from. The IDSA considers such an LOB approach could potentially be contrary to the freedoms guaranteed by European law.

8. **Analysis under PPT**

The IDSA considers that the PPT is a better solution to tackle treaty abuse than the LOB.

Unlike the LOB, the PPT is focussed on arrangements that have as their principal purpose obtaining treaty benefits. Clearly, where the PPT applies, the LOB test can only have any material application in the cases where there is no treaty abuse. If this were not the case, the PPT would be failed and treaty benefits denied. Since BEPS action 6 is designated to prevent treaty abuse, the LOB should, by simple logic, not apply where a PPT applies.

Securitisations are generally effected for *bona fide* commercial purposes and not for the purposes of tax avoidance or treaty abuse. For this reason, the IDSA considers that securitisation vehicles should qualify for treaty benefits under any PPT. However, the PPT is subjective in nature and will require detailed commentary. Tax will always feature as a consideration in international dealings and investments. Accordingly, we would recommend that a PPT *only* is applied to securitisation vehicles in order to determine treaty access. We would also suggest that clear commentary is included to support this by the OECD. The commentary should state that securitisations that are in principle accepted as non-abusive unless there are unusual facts that would suggest otherwise. We would also suggest that the examples in the commentary be expanded to explicitly deal with the assessment of securitisation vehicles so as to demonstrate that the fact that choosing a jurisdiction for the
establishment of the securitisation which has a tax treaty with the investment jurisdictions should not, in and of itself, be considered a reason to fail the PPT as long as there are other good commercial reasons for the securitisation vehicle to be based in that jurisdiction (and notwithstanding the fact that there might be other jurisdictions which offer similar economic benefits).

Tax authorities can take appropriate action if they discover that a particular securitisation is abusive or has occurred for tax planning reasons. Tax authorities have (or will shortly have) sufficient information gathering tools, including under mutual exchange of information, FATCA and CRS to determine whether there is a greater risk of tax treaty abuse. Securitisation vehicles are generally financial institutions registered for FATCA purposes and we assume will be registered for CRS purposes. Accordingly, the payment flows from the securitisation vehicle to the bondholders will be capable of being tracked through the financial system to determine who the ultimate beneficial owner of those payments are. This information is not available to the securitisation vehicle or the banks and advisors involved. As a result, any securitisation effected for bona fide commercial purposes (as described above) should only have treaty benefits denied prospectively if the tax authorities discover information not available to the securitisation vehicle or the banks and advisors involved.

9. **Beneficial Ownership/Conduit**

Finally, the IDSA considers that a securitisation vehicle that is established for *bona fide* commercial purposes and not for the purposes of tax avoidance or treaty abuse should always be treated as being the beneficial owner of the interest it receives from underlying borrowers for treaty purposes, and should not be considered a conduit financing arrangement. The IDSA would also suggest that clear commentary is included to support this by the OECD.

10. **Conclusion**

We hope that policy-makers will recognise that securitisation has played and will continue to play a vital role in economic growth. These transactions are not abusive, so should not be adversely affected by the work on Treaty abuse. An over-reaction to the possibility of abuse would cause lasting economic damage by restricting securitisations and fragmenting the market into separate domestic securitisation markets. Such a policy would conflict with good economic policy and in particular, would cause EU law issues by restricting the single market.

Finally, and as mentioned we believe the area of securitisation and treaty access has perhaps been somewhat overlooked so far in this work stream and would be pleased to make ourselves available to meet with you in advance of any public session and/or to participate at the Public Consultation Meeting.

Yours faithfully,

**GARY PALMER**  
Chief Executive

Irish Debt Securities Association  
36 Upper Fitzwilliam St.  
Dublin 2  
Ireland
Appendix

1. The implications of a transaction being a “Securitisation”

The question is whether a transaction would be treated as a “securitisation” for purposes of Capital Requirements Regulation (Regulation 575/2013 EU) (the “CRR”). CRR and what the impact of that would be. The question is important for a number of reasons, including that, if the Transaction is a “securitisation” for CRR purposes, then:

(a) if an investor in any of the Notes (or in the case of an investment fund, its investment manager) is subject to regulation under CRR, the EU Alternative Investment Fund Managers Directive (“AIFMD”), the EU Directive on Undertakings for Collective Investment in Transferable Securities (UCITS) or the Solvency II Directive (prescribing capital requirements for insurance and reinsurance undertakings), then that investor will be subject to securitisation risk retention and due diligence requirements pursuant to Articles 405 and 406 of CRR, Article 17 of AIFMD (and related regulations), and eventually, corresponding legislation and rules for UCITS funds and for insurance and reinsurance undertakings;

(b) if the Seller is a credit institution or investment firm regulated under CRR, then that Seller will be subject to the requirements on credit granting criteria and disclosure set out in Articles 408 and 409 of CRR;

(c) if the Issuer or any related third party (defined as “the originator, arranger, sponsor, servicer or any other party that interacts with a credit rating agency on behalf of a rated entity ...”) solicits a credit rating from a credit rating agency (a “CRA”), then, under Articles 8c and 8d of the EU Credit Rating Agency Regulation as amended (the “CRA Regulation”), it must request two ratings from two independent CRAs, and must consider getting one such rating from a smaller CRA;

(d) if the Transaction is established after the effectiveness of regulatory technical standards implementing Article 8b of the CRA Regulation, then the issuer, the Seller and the sponsor of the programme will be required to post detailed information regarding the Transaction on a public website to be established by the European Securities and Markets Authority; and

(e) if the Loan is itself a securitisation, it is likely that the Transaction will be a “resecuritisation” as defined in CRR; in that case the Notes would be subject to higher capital requirements under CRR and unfavourable treatment under various other regulations.

2. Features of a “securitisation”

(a) CRR (in Article 4(1)(61)) defines “securitisation” as follows:

“securitisation” means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having both of the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.
The CRR definition is based on the definition of securitisation in the Basel II capital framework, which says in part (BCBS 128 paragraph 539):

A *traditional* securitisation is a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures.

The Basel text (cited above) adds the following to distinguish securitisation from certain other credit-tranched structures:

The stratified/tranched structures that characterise securitisations differ from ordinary senior/subordinated debt instruments in that junior securitisation tranches can absorb losses without interrupting contractual payments to more senior tranches, whereas subordination in a senior/subordinated debt structure is a matter of priority of rights to the proceeds of liquidation.

Questions often arise as to whether the CRR securitisation definition (as well as the Basel II definition and its counterparts in other jurisdictions) captures various kinds of transactions that include some element of credit risk tranching, obligations dependent on performance of underlying assets, or other elements typical of securitisation, but lack other elements or features typical of mainstream securitisation transactions.

In a securitisation, subordinated tranches “absorb losses without interrupting payments to more senior tranches”, and so enhance the credit quality of the senior tranches. To the extent that junior tranches have more credit risk of the underlying assets, senior tranches have less credit risk.
IFIA response to OECD follow up work on BEPS Action 6: preventing treaty abuse

The Irish Funds Industry Association (the “IFIA”) is the industry association for the international investment fund community in Ireland. The IFIA represents custodians, administrators, managers, transfer agents and professional advisory firms. Ireland is a leading centre for the domicile and administration of collective investment vehicles, with industry companies providing services to collective investment vehicles with assets totalling in excess of €2.7 trillion. The Schedule to this letter sets out the members of the IFIA.

The IFIA welcomes the follow up work on BEPS action 6 discussion draft published on 21 November 2014 (the “Discussion Draft”) and in particular the acknowledgement that this is an important issue for the global funds industry. We also welcome the opportunity to comment on the 2010 OECD report “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles” (the “2010 CIV Report”). We have also addressed the proposals for CIVs included in the deliverable “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances” issued in September 2014 (the “September Report”).

References to “CIVs” in this letter are to collective investment vehicles 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. Executive Summary

As a general remark, a CIV is very unlikely to be established or used for treaty abuse purposes. For this reason and recognising that the purpose of Action 6 of the BEPS project is to prevent treaty abuse, it is our view that, to the greatest extent possible, the output from Action 6 should impose no additional impediments on CIVs ability to obtain treaty reliefs.

In summary:

- we agree with the conclusions of the 2010 CIV Report and believe that it remains the best approach for CIVs. In our view, a single preferred approach to treaty entitlement for CIVs should not be mandated;

- we strongly oppose the application of a limitation on benefits (“LOB”) provision to CIVs. If an LOB must be applied to CIVs, they should be included as a separate category of qualified person without further restriction on the basis that CIVs are not used for treaty abuse purposes;

- if countries agree on a bilateral basis to restrict CIVs’ eligibility to be treated as qualified persons, they should strongly be encouraged to include only a
restriction by reference to equivalent beneficiaries and should be discouraged from including any such restriction until after TRACE is fully implemented; and

- the application of any PPT to CIVs should be expressly precluded on the basis that CIVs are not used for treaty abuse purposes.

2. Recommendations of the 2010 CIV Report

The importance for CIVs of being entitled to claim treaty relief has not changed since the publication of the 2010 CIV Report. As recognised in the 2010 CIV Report, CIVs offer small investors increased liquidity, risk diversification and economies of scale that they would not otherwise be able to achieve. It is important for those investors that the CIV should be entitled to receive income at reduced withholding tax rates that would be available to the investor on a direct investment. In addition, it is important for the CIV (which often performs daily net asset value calculations) to have certainty on when it will be granted treaty benefits. We welcome the results of the 2010 CIV Report and continue to believe that the recommendations remain the best solution in practice for CIVs.

In our view, it is not possible to adopt a single preferred approach for the treatment of CIVs under double tax treaties (and we note that the 2010 CIV Report did not propose to do so). CIVs take different legal forms in different jurisdictions. In addition, although CIVs generally offer tax neutrality to investors (ie, investors are taxed appropriately compared to if they had invested directly and are not unduly taxed by investing through a CIV), how that tax neutrality is achieved also varies from jurisdiction to jurisdiction. Given the varying legal forms of CIVs and the varying domestic tax treatments applied, mandating a single approach for CIVs’ entitlement to treaty relief is not advisable. Instead, countries should continue to be permitted to agree on a bilateral basis how CIVs should be granted treaty access (and by reference to paragraphs 6.8 to 6.34 of the Commentary on Article 1 of the OECD Model Tax Convention).

If, in some cases, countries are concerned about the potential risk of CIVs being used for treaty shopping, it should be open to countries to include appropriate restrictions in treaties on a bilateral basis to restrict the types of CIVs that may be entitled to claim treaty relief (as is currently the case).

The 2010 CIV Report considered whether treaties should permit treaty relief on a proportionate basis by reference to the location of the investors. Under such an approach, the CIV would be required to confirm who its investors are and their treaty status. As noted in the 2010 CIV Report, this is not a straightforward task given that shares in CIVs are generally held through intermediaries and that the interests held by investors frequently fluctuate. However, the Treaty Relief and Compliance Enhancement
(“TRACE”) project seeks to offer a solution to the problem of identifying investors for treaty purposes. It may be the case that in the future TRACE will provide a solution to enable CIVs and tax authorities identify the location and treaty status of investors. However, that project is not yet at a stage where it will enable CIVs or tax authorities to confirm the proportion of investors in a CIV that are entitled to claim treaty relief. In practical terms, we believe that an approach which permits CIVs to claim treaty benefit on a proportionate basis cannot be adopted until the TRACE project is fully implemented.

Therefore, in our view, the 2010 CIV Report remains the best approach for CIVs and a single preferred approach should not be mandated.

3. Application of limitation on benefits provision to CIVs

Requiring CIVs to satisfy a LOB threshold would have the principal effect of denying treaty benefit to ‘cross-border’ CIVs (see below), when no abusive activity has taken place. In other words an LOB would have the retrograde effect of impeding international investment transactions. It would consequently materially discriminate against cross-border CIVs in favour of ‘single country’ CIVs. It would therefore facilitate a protectionist approach contrary to the non-discriminatory principles encouraging the expansion of world trade espoused by the OECD.

Cross-border CIVs are CIVs where the majority of investors are not resident in the jurisdiction of residence of the CIV. Cross-border CIVs are good for the financial market and the stability and efficiency of the financial sector. As noted in the 2010 CIV Report, cross-border CIVs are much more efficient than domestically distributed CIVs (‘single-country’ CIVs). They can benefit from economies of scale to a greater extent than domestic CIVs. The benefits of larger cross-border CIVs have been recognised by regulators, particularly in Europe where the UCITS Directive and the Alternative Investment Fund Managers Directive (“AIFMD”) have been developed to encourage cross-border CIVs. It is critical that the outcomes of Action 6 do not impede the effectiveness of cross-border CIVs, when compared to single-country CIVs. The general economic and efficiency gains of cross-border CIVs far outweigh any concerns that such vehicles might be used for treaty abuse.

In addition, given CIVs are by definition widely held, it is not the case that a CIV can be manipulated by an investor or a group of investors to access treaty benefits. In that respect, a CIV is comparable to a publicly listed entity whose shares are regularly traded in the sense that neither is established for the purpose of treaty shopping. Paragraph 11 of the Draft Commentary on the LOB expressly recognises that because the shares of publicly-traded companies are generally widely-held, such companies are unlikely to be
established or used for treaty shopping. That rationale equally applies to CIVs and should be recognised in the conclusions on Action 6.

3.1 Including CIVs as a category of ‘qualified person’

If an LOB must be included in Model Tax Convention, the approach outlined in paragraph 35 of the draft commentary included in the September Report (the “Draft Commentary”) should be adopted. That approach includes CIVs as qualified persons without any further qualification. Given CIVs take very different legal forms in different countries and are subject to different tax treatments, it should be left to contracting states to decide whether the term ‘CIV’ should be defined in each treaty. We suggest that this would be in keeping with the 2010 CIV Report.

If CIVs are expressly referenced in an LOB, care would need to be taken to ensure that indirect participation by a wide pool of investors should be recognised as acceptable. Commonly, investors invest in a CIV through a chain of intermediaries so that there may be very few registered (or ‘direct’) investors in the actual CIV but ultimately a wide pool of investors holding through the chain of intermediaries (including master and feeder funds that are part of fund-of-funds structures). Additionally, the investors can themselves be institutions or pension funds and we would suggest that just because a CIV has, say, two pension fund investors, the CIV should still be viewed as ‘widely held’ (as the pension funds are each themselves holding the units on behalf of their members).

3.2 Administrative difficulties in confirming investor base

The Draft Commentary offers alternative formulations for paragraph 2(f) of Article X. However, all of these would impose undue administrative complications where we do not believe there is a problem to be addressed. Given the chain of intermediaries, and consequent intermediation in the funds industry, it would currently be administratively very difficult (if not impossible) and costly in the context of cross-border CIVs to effectively claim treaty relief if treaties were to contain a definition of qualified person that required looking through to determine the proportionate holdings of equivalent beneficiaries from time to time.

As noted above, in time the TRACE project may enable CIVs and tax authorities confirm the location and treaty status of investors. At that stage, countries who are genuinely concerned that CIVs pose a treaty shopping risk may wish to introduce on a bilateral basis LOBs that limit the ability of CIVs to claim treaty relief by reference to the investor base. In advance of the implementation of TRACE, we believe that the adoption of such an approach would be unworkable.
3.3 **LOB requiring investors to be equivalent beneficiaries**

The proposed wording contained in paragraph 36 of the Draft Commentary (granting treaty relief to CIVs to the extent that the investors are equivalent beneficiaries) reflects a concept contained in the 2010 CIV Report. In our view, the practical difficulties of tracing through to equivalent beneficiaries would impose very significant administrative challenges on a CIV. In light of the fact that CIVs are not established for treaty abuse reasons, we would not support the adoption of such an approach as a preferred approach in the context of the Action 6 conclusions.

3.4 **LOB requiring investors to be tax resident in the same jurisdiction as the CIV**

Paragraph 39 of the Draft Commentary proposes that a CIV would only be a qualified person to the extent the investors are resident in the state where the CIV is established. This would be hugely and unfairly discriminatory in favour of single state CIVs which have a significant investor base in one jurisdiction when compared with cross-border CIVs. Furthermore, if single state CIVs are favoured in this way, it would unavoidably discriminate against smaller countries where the choice of available CIVs for investors will be much smaller.

As noted above there has been a significant effort at European level over the past 20 years to encourage cross-border CIVs. They are considered to be good for investors and for financial markets. The introduction of a LOB requiring investors to be resident in the same jurisdiction as the CIV would fatally undermine the progress on UCITS and AIFMD.

More broadly, favouring single state CIVs would likely have a significant impact on the types of CIVs available to investors. Managers would be more likely to establish single state CIVs and likely would restrict non-resident investors from investing. This will limit investors’ ability to diversify their portfolios (in particular for geographical risk). In other words, if single state CIVs are preferred, promoters will naturally focus their energies on establishing such (advantaged) single state CIVs in larger economy jurisdictions, so that the choice of CIVs available in smaller economy jurisdictions will be much reduced. This is exactly the result that the European Union has sought to avoid with the UCITS regime.

The proposal in paragraph 39 must be abandoned.

3.5 **Publicly listed and traded CIVs**

The final option contained in paragraph 42, while it may apply to a limited category of exchange traded funds, would also result in the vast majority of cross-border CIVs (which are not listed and regularly traded) not being able to avail of treaty benefits. Accordingly,
we do not believe that this option should be adopted as an approach if an LOB is introduced for CIVs.

3.6 UCITS and UCITS-like funds

As noted above, the EU has from a legal and regulatory perspective sought to encourage the development of cross-border funds and, in particular, UCITS. UCITS are designed for small investors as a secure savings product. They are subject to strong regulation, and have strict risk diversification requirements. UCITS are open-ended and this enables investors to subscribe or redeem their interests on a daily basis. Given the UCITS infrastructure, there is no material risk of treaty shopping. This should be explicitly recognised in the outcomes of Action 6 for UCITS and UCITS-like funds that are established elsewhere. Countries opting to include LOBs in their treaties should be encouraged to treat UCITS and/or UCITS-like funds as qualified persons without any further restrictions.

3.7 EU concerns

EU Member States would be precluded from applying an LOB in respect of investors in other EU Member States, as it would be incompatible with the EU fundamental freedoms. It is important that the work on Action 6 takes account of the principles of EU law which bind a substantial portion of countries engaged in the BEPS process.

It has been acknowledged in the Discussion Draft that an alternative provision will be required to reflect EU law requirements. We welcome this development and consider that the importance of developing an LOB that can be implemented by EU Member States in compliance with their EU membership obligations should not be underestimated.

3.8 TRACE and other information sharing projects

We do not see CIVs as vehicles that are used for treaty abuse. Rather than introducing complex LOB hurdles, any concern that CIVs could enable treaty benefits to be obtained in inappropriate circumstances should be addressed through the much greater information sharing frameworks that are in the process of being developed such as TRACE, FATCA, and CRS.

It is critical that, if any of the Action 6 conclusions impose restrictions on the ability of CIVs to access treaty benefit by reference to their investor base, a practical system is introduced to enable CIVs and tax authorities to confirm when CIVs are eligible for treaty relief. Under TRACE, significant effort has been put into analysing the practicalities of applying LOB-like criteria to CIVs and other entities. The TRACE work takes account of the heavily intermediated nature of CIVs, their widely-held nature and the fact that interests
are regularly acquired and transferred / redeemed. If the Action 6 recommendations propose restrictions on CIVs qualifying for treaty relief by reference to their investor base, TRACE must be implemented fully.

More recently, some countries have increasingly imposed onerous administrative burdens on CIVs before granting treaty access to CIVs resident in treaty partner jurisdictions. This has imposed significant costs on CIVs (ultimately suffered by the investors). In this context, we continue to support the implementation of TRACE, independent of the proposals adopted to further regulate treaty access for CIVs.

4. Non-CIV funds: Treaty entitlement and application of LOB

4.1 Private equity and alternative funds

The 2010 CIV Report did not deal with treaty entitlement issues relating to collective investment funds which are not widely held, regulated and diversified, this may include some classes of private equity funds and alternative funds. Non-CIV funds share many of the same characteristics as CIVs. In particular, it is clear that the proposed LOB mechanism is ill-suited to such non-CIV funds. Given the nature of such non-CIV funds having numerous investors in different jurisdictions, the proposed LOB would effectively deny treaty access to non-CIV funds in many cases (as the restricted equivalent beneficiary test in the LOB would not be satisfied in many cases). This would be an unfair and unjustified result, as (like CIVs) non-CIV funds are established for bona fide commercial purposes.

We would therefore conclude that work similar to the 2010 CIV Report need to be undertaken through the OECD Informal Consultative Group to identify issues across the various types of non-CIV funds and develop practical solutions for treaty entitlement.

Until such work has been completed, we would recommend the inclusion of an appropriate derivative benefits clause or some other equivalent beneficiary mechanism in the LOB provisions to facilitate the appropriate treaty entitlements for such non-CIV funds (similar to that set out in the 2010 CIV Report).

4.2 Pension funds

Pension funds present unique issues in the context of treaty relief. It is widely accepted that they play a major role in the effective funding the retirement of workers. In recognition of this, many double tax treaties afford pension funds with zero withholding tax rates on investment income. Pension funds invest directly in the global equity and bond markets but many use CIVs as their investment platform, principally to obtain
appropriate economies of scale and exposure to global markets. It is imperative that pension funds (either investing directly or through CIVs) are not inadvertently negatively impacted by the introduction of LOB provisions. In addition, many pension funds pool their investments through CIVs which are tax transparent (ie, the pension fund is the beneficial owner of the income) and recognition of such transparency is critical in ensuring the maximum benefits which pension funds are entitled to are granted in practice.

The issues impacting pension funds cannot be underestimated. It is essential that small investors are encouraged to make appropriate provision through pension funding arrangements to obtain the necessary long term financial security for workers into their retirement years. Recently, FATCA (including Intergovernmental Agreements) and the Common Reporting Standard have afforded pension funds a “deemed compliant” status and provided practical definitions of pension funds falling within the “deemed compliant” status. The Action 6 agenda should follow that lead and recognise pension funds as qualifying residents in their home jurisdiction (country of establishment), without restriction under LOB (or indeed under a PPT).

5 Application of the principal purposes test to CIVs

In our view, the PPT discriminates against cross-border CIVs by making it more difficult for such CIVs to pass the PPT than it would be if their units were distributed in a single state.

5.1 Cross-border CIVs considerations

There will always be a number of strong commercial reasons for establishing a single state CIV. Domestic investors may be more familiar with the type of CIV. Domestic law may restrict public offerings by non-domestic CIVs.

However, there are also very good reasons for promoting cross-border CIVs as discussed above. Jurisdictions may seek to encourage promoters to establish their cross-border CIVs in their jurisdictions. In addition to factors such as regulatory environment, expertise of service providers and legal environment, the breadth of the treaty network of a jurisdiction may be taken into consideration by the promoters of a fund when deciding where to establish their CIV.

The manner in which the PPT is currently framed means that it could feasibly be interpreted in a manner that would mean that if it is not possible to justify that a cross-border CIV was established in a particular jurisdiction solely for non-tax reasons (ie, without regard to the applicable tax regimes of competing jurisdictions and available treaty networks), then it may fail the PPT on the basis that obtaining treaty benefits will
be “one of the principal purposes” of establishing the fund in that jurisdiction. We believe that this interpretation would be incorrect, but it nevertheless could be raised as an objection and, if raised, would inherently discriminate against cross-border CIVs.

5.2 RCo Example

One of the examples in the commentary describes RCo which has the choice of establishing a plant in one of three different jurisdictions all of which provide similar economic and political environments. After RCo makes a decision to locate its plant in one particular jurisdiction because that jurisdiction has a tax treaty with the jurisdiction in which RCo is resident, the commentary concludes that the principal purposes for making the investment are related to the expansion of RCo’s business and not the obtaining of treaty benefits. Our concern in the context of a CIV is that there is a focus in this example on the three alternative jurisdictions having similar economic and political environments. If RCo chose the jurisdiction which had a smaller economy but a wider and / or more attractive treaty network, the inference is that it would fail the PPT. Again, we believe that such an inference would be incorrect in the context of CIVs. However, unless there is clear guidance to the contrary, it remains a risk that could arise.

5.3 Need for clear guidelines

The PPT is an inherently subjective test. The absence of explicit guidance would allow different interpretations of the same transaction or CIV by different countries (including two countries under the same double taxation agreement). Therefore, very detailed guidance is required to ensure a consistent interpretation of this language by tax authorities.

5.4 Burden of proof too low

As currently drafted, the tax authorities only need to determine that it would be “reasonable to conclude” that obtaining treaty benefit is the principal purpose. This language imposes a burden of proof that is too low and wholly inappropriate in these circumstances, where denial of treaty access can have very serious commercial consequences.

It seems that the burden of proof “reasonable to conclude” is lower than “more likely than not”. All that seems to be required is for a tax authority to conclude that a reasonable person could decide that the rule applied (even if the better view was that the rule did not apply). In other words, a tax authority could apply the PPT to deny treaty benefits in a situation where it was less than 50% likely that a transaction had a principal purpose of obtaining an unjustified tax advantage. This cannot be the basis for the administration of
tax regimes. This burden of proof must be replaced with a clear language that indicates that it must be more likely than not that the conditions are satisfied.

5.5 Overall impact of the PPT

If the PPT is introduced into treaties as currently drafted, there is a risk that it will create significant uncertainty for CIVs in the minds of tax authorities and withholding tax agents in relation to the position of cross-border CIVs. There will be an inevitable discrimination between single state CIVs and cross-border CIVs as tax authorities and withholding tax agents will invariably take an overly prudent and cautious approach.

We recommend that a clause should be included which confirms that a CIV (i.e., widely-held and subject to regulatory supervision in an OECD jurisdiction) automatically passes the PPT. Where a CIV has been established for the purposes of facilitating collective investment by a large number of investors, there should be an automatic assumption that “treaty shopping” or “treaty abuse” is not one of the purposes for which the entity was established. If there were any specific circumstances where jurisdictions believed that there would be valid concerns about “treaty abuse” by CIVs, these should be included as specific examples in the commentary relating to the PPT.

In addition, we suggest that a further example is included in paragraph 14 of the Draft Commentary on the PPT. The example should be similar to Example D save for the investors should be primarily located in OECD and treaty partner jurisdictions and the CIV should not regularly distribute to investors. The inclusion of Example D in the absence of an example of a globally distributed CIV and / or a non-distributing CIV could be taken to imply that globally distributed CIVs and / or non-distributing CIVs in the same circumstances do not satisfy the PPT.

We further recommend that the wording of the PPT is amended so that treaty benefits are denied only where the principal purpose of the arrangement or transaction is the obtaining of treaty benefits. This would ensure that investment funds would, by and large, satisfy the PPT where they can demonstrate that the principal purpose of establishing the fund in a particular jurisdiction is for non-treaty reasons such as a leading regulatory environment and quality of service providers. CIVs should fail the PPT only in clear cases where artificial steps have been taken to access treaty benefits in “inappropriate circumstances”.

6. Conclusions

Widely distributed, regulated CIVs are not established as treaty shopping vehicles and accordingly, no restriction should be imposed on a CIVs ability to obtain treaty relief.
However, in cases where countries are genuinely concerned about CIVs being used for treaty shopping, they should be permitted to agree on a bilateral basis to include restrictions on the type of CIVs that can qualify for relief. The 2010 CIV Report should therefore continue to be the basis for determining treaty access for CIVS.

If countries insist on a bilateral basis on restricting CIVs’ eligibility for treaty relief, they should be encouraged to adopt restrictions that require investors to be equivalent beneficiaries rather than located in a CIV’s jurisdiction of establishment. This approach does not discriminate between domestically and globally distributed CIVs. Countries should be discouraged from introducing restrictions on the entitlement of CIVs to claim relief by reference to the investor base until TRACE is fully implemented.

If countries insist on including a PPT in their treaties on a bilateral basis, they should be precluded from applying the PPT to CIVs on the basis that CIVs are not established for treaty shopping.

IFIA

9 January 2015
Schedule

Members of IFIA

A & L Goodbody
Accenture
Anima Asset Management Ireland Ltd
Architas Multi-Manager Ltd
Arthur Cox Company
Artisan Partners Limited Partnership
Assenagon Asset Management SA
Bank of America Custodial Services (Ireland) Ltd
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BlackRock Asset Management Ireland Ltd
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CACEIS Bank Luxembourg - Dublin Branch
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Linedata Services
LK Shields Solicitors
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Maples Fund Services (Ireland) Ltd
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PIMCO Funds
Pinebridge Investments Ltd
Pioneer Global Investments Ltd
Principal Global Investors (Ireland) Limited
PwC
Quintillion Ltd.
RBC Investor Services Ireland Ltd
RR Donnelley UK Limited
Russell Investments c/o Concur
Sanlam Asset Management Ireland Ltd
SEI Investments Global Fund Services Ltd
SIX Financial Information
SMT Fund Services (Ireland) Ltd
Société Générale Securities Services
Source UK Services Ltd
Spectra Global Solutions Ltd
SS&C Globeop Ltd
State Street International (Ireland) Ltd
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William Fry
Irish Tax Institute

Response to OECD Discussion Draft: Follow Up Work on BEPS Action 6: Preventing Treaty Abuse

January 2015
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The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.
Introduction

Action 6 of the OECD’s Base Erosion and Profit Shifting (BEPS) project is entitled “Preventing Treaty Abuse”.

The initial Discussion Draft, the September report and the Follow Up Work published on 21 November contain a number of far reaching changes to tax treaties which are being proposed in order to achieve the objective of preventing treaty abuse. In particular, two new “anti-abuse” tests are proposed:

   a) A “Principal Purposes Test” (PPT); and
   b) A Limitation-on-Benefits (LOB) clause.

The Irish Tax Institute fully endorses the OECD’s overall objective of improving fairness in the international tax system and addressing the inappropriate use of tax treaties. However, we are concerned that the current proposals will have serious unforeseen consequences for smaller countries such as Ireland which could ultimately curtail the use of treaties by taxpayers based in smaller economies and thus impact on their ability to trade globally.

Clearly this is not what is intended by Action 6 but careful study of the consequences of the proposed tests in their current form, highlights significant difficulties for smaller economies that simply do not arise for larger economies and therefore a very concerning imbalance is created.

We believe that any proposals should not impact on location decisions where real substance and activity are envisaged.
Summary of recommendations

The particular concerns for smaller countries can be summarised as follows, with suggested changes to address these concerns.

A. Principal Purposes Test (PPT)

Businesses operating in a large country will find it much easier to conclude that they pass a PPT than businesses operating in a smaller country.

A company carrying out arrangements and transactions in a larger economy will find it easier to demonstrate the natural business advantages that arise from that economy, than a company in a smaller economy. These naturally occurring business advantages in an economy are likely to be more self-evident than any possible tax treaty benefits, if the economy is large rather than small.

In a smaller economy, greater weight is likely to attach to the specific business attributes of the taxpayer, the transaction and the taxpayer’s status as a local tax resident (when measuring the benefits from the transaction or arrangement), rather than the infrastructure and market size of the economy.

In this context, it more likely that the positive benefits of access to the tax treaty to avoid double taxation in relation to the cross border transaction or business arrangements will be more evident in the case of the taxpayer based in the smaller economy. This benefit could more easily be identified as one of the main benefits that arise to that taxpayer from the cross border transaction. Smaller country businesses face considerable uncertainty as to whether they can ever pass the PPT test and actually may find it impossible to conclude with certainty that they do so. If the test is to remain part of the Action 6 proposals, then it needs to be substantially re-drafted.

In our view, the PPT and commentary on the rule should be drafted in a manner that does not impact on the certainty of access to treaty benefits for locally resident companies with the knock on adverse impact that uncertainty creates on investment location decisions for any business activity where it is intended that real substance and managerial control over the income flows related to that activity will be located in the territory. In addition, the application of any PPT to Collective Investment Vehicles (CIVs - funds that are widely held, hold a diversified portfolio of securities and are subject to investor-protection in the country in which they are established) should be precluded as CIVs are generally not used for treaty abuse purposes.

B. LOB

The Publicly Traded test

- Companies based in smaller countries often have global “footprints” well beyond their shores, and indeed are often commercially required to have such footprints due to their smaller home markets. They will have difficulty passing a test which requires senior management to spend most of their time and exercise day to day responsibility in the smaller country. This “management time” criterion should be removed from the Publicly Traded test or examples should be included to demonstrate that the test applies to substantive group policy decisions only.
- The definition of “another recognised stock exchange” should be extended to include US exchanges and exchanges in regional groupings such as the EEA. There are valid and particular reasons why many non US companies choose to list on NASDAQ as an example.
- There is currently a requirement [although there are diverse views] that where a country resident treaty claimant is indirectly owned by a quoted parent, all companies in the intermediate chain would have to be resident in the country concerned or resident in the treaty
counterparty State. We do not agree with the inclusion of this requirement in the text as it disproportionately affects smaller countries which can naturally expect to form a smaller part of an international group.

**The Ownership/Base Erosion test**

For companies operating in a smaller economy, capital, and therefore ownership and financing, often comes from outside the country. Therefore the Ownership / Base Erosion test should be framed to take account of financing made available to the company from a local regional grouping such as the EEA and large capital markets such as the US.

**The Active Business test**

The substantiality test for dealings with connected parties impacts small countries disproportionately and should be removed. If the test remains, then an appropriately designed “safe harbour test” should be included.

**The Derivative Benefits test**

A widely cast Derivative Benefits test is essential if an LOB clause is to be included in tax treaties.

**Collective Investment Vehicles (‘CIVs’)**

The conclusions of the 2010 CIV Report are still valid. No single “preferred approach” should be adopted in dealing with the treaty entitlements of CIV and in the context of the application of a LOB provision to CIVs.

**Domestic anti-conduit rules**

Definition changes to the anti-conduit rules would render them more objective.
Detailed analysis

Principal Purposes Test (PPT)

Under the Action 6 proposals, treaty benefits could be denied if one of the business’ main purposes in locating in a particular country is to access the relevant tax treaty.

Small countries like Ireland are attractive for FDI investment for many valid and commercial reasons, including the ability to attract qualified staff, the ability to operate business processes within a flexible labour market, the competitive tax environment and the stability of non-tax business regulations.

However, businesses which locate in a large economy can point towards the availability of tangible factors such as a large population, greater availability of capital and other infrastructure as their main purpose for locating there. Businesses which choose smaller countries for equally valid reasons which can include a stable government, the regulatory and tax environment (including the existence of tax treaties) face greater uncertainty. They choose the smaller economy despite the lack of the wider benefits that arise to business based in a large market, with capital availability, infrastructure, etc. Therefore, the reason for their choice and the factors that directly or indirectly underpin cross border arrangements and transactions of the company are much more likely in practice to include certainty of access to tax treaties when conducting cross border trade than in the case of a business in a large economy. The benefits from avoiding double taxation under a tax treaty are more likely to come to the fore in the case of cross border trade flows for business based in smaller economies. (See Example 3 in the Appendix).

A company carrying out arrangements and transactions in a larger economy will find it easier to demonstrate the natural business advantages that arise from that economy, than a company in a smaller economy. These naturally occurring business advantages in an economy are likely to be more self-evident than any possible tax treaty benefits, if the economy is large rather than small.

In a smaller economy, greater weight is likely to attach to the specific business attributes of the taxpayer, the transaction and the taxpayer’s status as a local tax resident (when measuring the benefits from the transaction or arrangement), rather than the infrastructure and market size of the economy.

It is thus more likely that the positive benefits of access to the tax treaty to avoid double taxation in relation to the cross border transaction or business arrangements will be more evident in the case of the taxpayer based in the smaller economy. This benefit could more easily be identified as one of the main benefits that arise to that taxpayer from the cross border transaction.

In this context, a company resident in Ireland could find it fundamentally impossible to pass the PPT on this basis. Even if the test is aimed at a transactional level, such a fundamental difficulty makes it difficult for any individual transaction by the company based in a smaller economy to meet the test criteria.

A business operating in a large economy will find it much easier to pass the PPT than a business operating in a smaller economy, simply by virtue of the size of the economy. This is a distortionary effect and creates an un-level playing field as well as very significant uncertainty and cost for businesses in smaller countries.

The PPT rule should be redrafted to provide that treaty benefits can arise except where the main purpose of the arrangement or transaction is to obtain the treaty benefit. This we believe should achieve a balance between protection from treaty shopping and reflecting and preserving the benefits that treaties offer to taxpayers in smaller economies.
In addition, the commentary on the interpretation of the PPT should be revised to acknowledge that it is legitimate to recognise that one of the main purposes of establishing and continuing to conduct business in a jurisdiction is the existence of a tax treaty and the benefits it affords. The commentary should make explicit that this can be especially the case for smaller economies where some of the wider business related benefits on offer in the case of larger economies are not present. Any evaluation of the purpose of an arrangement or transaction should take into account the relatively larger weight of importance that the existence of a treaty benefit is likely to present in this scenario.

In relation to CIVs, the unilateral application of the PPT by a government could create substantial uncertainty for CIVs. CIVs require certainty on the amount of foreign tax incurred on income and gains arising from investments as they typically determine the value of their assets and liabilities on a daily basis. In this regard, a clause should be included in the PPT confirming that CIVs (widely held and regulated in an OECD jurisdiction) automatically pass the PPT. Where a CIV has been established for the purposes of facilitating collective investment by a large number of investors, there should be an automatic assumption that treaty abuse is not one of the purposes for which the CIV was established. If there any concerns about potential abusive arrangements in relation to CIVs these specific concerns could be included as examples in the Commentary to the PPT.

**Limitation of Benefits (LOB) Clause**

In essence, the LOB clause contained in the Action 6 proposals is designed to prevent access to tax treaties where an entity is owned or financed from abroad or where its shares are traded on a foreign stock exchange.

Businesses in smaller countries often have very little capital available locally for investment and a small, if any, Stock Exchange. They are much more likely than companies based in large economies to be owned and financed from abroad and to be listed on a foreign stock exchange. (See example 2 in the Appendix).

There are a number of tests contained in the LOB clause proposed in Action 6 and difficulties arise at a number of levels with these tests.

**a) The Publicly Traded test**

Companies in small countries can qualify for treaty benefits if their shares, or those of their ultimate parent, are:

(a) quoted and primarily traded on a stock exchange in the country concerned, or

(b) quoted and regularly traded on another recognised stock exchange and the company’s executive officers and senior management employees exercise day to day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in the country concerned than in any other State and the staff conduct more of the day to day activities necessary for preparing and making those decisions in the country concerned than in any other State.

This Publicly Traded test will, in practice, be very difficult for many companies based in smaller economies. A feature of these companies is that they have outgrown their domestic market and collectively management spend more time outside the base country, than would the management of a company and its subsidiaries based in a large economy.

(i) Stock exchanges in smaller countries will often not have large pools of capital and so companies operating in that country will choose to list on a foreign stock exchange. This is for purely commercial non-tax reasons.
(ii) Businesses in small countries are much more likely to be a relatively small part of the global operation and therefore a material portion of senior personnel will often be working overseas or spending material time overseas. Common examples would be where the Chief Marketing Officer is located in the territory where the final goods are sold e.g. the US or where the group’s back office is centralised in a specific location and a Chief Technology Officer is located there e.g. the UK.

Successful listed businesses from a small country which have grown internationally will therefore struggle to pass this Publicly Traded LOB test.

To prevent distortions between small countries and larger countries, the Irish Tax Institute recommends that the management time test be removed from the OECD’s proposed LOB. If this cannot be agreed, then examples in the text should make it expressly clear that operational day to day decision making can be devolved to local subsidiaries (which is normally the case) but that the key factor for management and control relates to substantive policy decisions, which are normally determined at head office.

The OECD commentary on the proposed LOB states that some countries may be willing to agree to include stock exchanges within a regional grouping such as the EEA in (a) above. This extension would be helpful. However, the extension will not cover all smaller country situations as some entities within the EEA as an example will be quoted outside the EEA. It would be helpful if (a) above could be extended to include groupings such as the EEA but also to include stock exchanges in major international markets such as the US, in particular, where many companies from smaller countries outside the US will seek to list and raise capital. This is particularly the case for certain industries – such as technology sector companies listing on the NASDAQ exchange.

The proposed Publicly Traded test includes [in square brackets] a requirement such that, where a treaty claimant is indirectly owned by a quoted parent, all companies in the intermediate ownership chain would have to be resident in the country concerned or resident in the counterparty treaty State. Different countries have expressed different views on whether or not this is necessary. In our view, the narrow version creates problems for companies based in smaller economies:

(i) the publicly traded test is likely to be the more relevant for treaty access (because of the reasons outlined below the other test are more inherently difficult to meet); and

(ii) because that country subsidiary will often not be the main driver of the overall group structure (as, by definition, it is likely to be relatively smaller than a large country subsidiary).

b) Ownership/base erosion test

Under the ownership/base erosion test, an entity qualifies for treaty benefits if it meets both a detailed ownership and a “base erosion” test. These tests are designed to check whether the treaty claimant is ultimately owned and financed from its country of residence.

For non publicly listed companies, the ownership/base erosion tests set out in the LOB are reasonably straightforward to meet in the case of most companies operating in large economies. They are generally owned and financed domestically due to the availability of significant domestic capital. It would be particularly difficult and, in many cases, impossible for companies operating in a smaller economy to satisfy this test because capital, and therefore ownership and financing will often come from outside the country.

As with the Publicly Traded test above, we suggest that the base erosion test should be framed to take account of financing made available to the company from a local regional grouping such as the EEA and large capital markets such as the US.
c) **Active Business test**

A smaller economy company would qualify for treaty benefits if it is engaged in “the active conduct of a business” in the country concerned. This is an important test.

However the proposed LOB states that where income is derived from a related party, the Active Business test will only be considered to be satisfied if the business activity carried on in the smaller economy is substantial in relation to the business activity carried on by the associated enterprise in the other state.

This substantiality requirement will often be difficult for a small country entity to meet and we are unclear as to why it is necessary if there is operational substance in the small country.

The OECD commentary does helpfully note that due regard will be given to the relative sizes of the economies and markets in the two Contracting States. However, the text of the OECD active business test is based largely on the existing US treaty language and in practice, it has been found that US domestic rules can mean the test is often failed by legitimate businesses. This means that the application of the test could well be different in many countries if they interpret certain key provisions differently e.g. as to the meaning of active or passive income, the local definition of income source and whether or not that income source (reasonably considered to form part of the business of the company in the small country) has a source in that country from the perspective of sourcing rules in the counterparty jurisdiction.

For example, there could be large manufacturing facilities in the treaty partner location (because there may be a large market of consumers there) with substantial management oversight and support functions (R&D etc.) in the small country concerned – it is not at all clear that payments from the manufacturing facilities for the small country management / support functions would meet the substantiality test. This would depend on how the large country defines the key terms in the active trade or business test.

Many small country operations that a reasonable person would have thought would easily have met an Active Business test have, in practice, found it difficult to meet the Active Business test in US tax treaties which simply illustrates the challenges that meeting this test presents and which will be magnified if adopted across multiple jurisdictions.

In our view, it is critical the final ‘active trade or business’ test reflects changes in group supply chain practices since the original version of the US LOB was adopted.

We suggest that the OECD proposals are amended so that it is clear that business support activities (where the workforce in the smaller economy conducts substantial managerial and operational activities over those support services) can qualify as an active business even where those activities are provided for the benefit of related group parties and where there are no or limited sales of the relevant Group’s products / services in the small country concerned.

In addition, the inclusion of a “safe harbour” with accepted definitions might address these concerns. Some US treaties contain a “safe harbour” whereby substantiality is assumed if, in prior years, the asset value, gross income and payroll of the small country activity are, for example, at least 7.5% of the equivalent numbers in the US, and the average of the three ratios exceeds 10%. In practice the US safe harbour can be difficult to meet because of the US source of income rules outlined above.

Options for a fair safe harbour might include a mathematical safe harbour which is similar to the ones in some US treaties but:
(i) with clarification that the resident country activity includes all sales / services from the resident country entity to counterparties outside the country concerned. This clarification would be required for the purposes of the general substantiality test and any mathematical safe harbour; and

(ii) with adjustment for the relative size of the economies concerned.

d) Derivative Benefits test

A company might qualify for treaty benefits if it meets the terms of a “Derivative Benefits” test. This is designed to allow treaty access where the company is owned and financed by “equivalent beneficiaries” i.e. certain defined persons from jurisdictions having a treaty with the other country which offers equivalent benefits as compared with the taxpayer country’s treaty with that other country.

The availability of a broad based derivative benefits test is essential if the LOB is to operate effectively for business based in small economies. It should serve to mitigate the greater likelihood that companies in smaller economies will have shareholders who are not locally resident. However, there are some difficulties with the proposed test from a smaller country viewpoint:

- Some countries do not agree to include a Derivatives Benefit test (other than for dividends). The text is thus in [square brackets].

- Every entity in the chain of ownership must be “an equivalent beneficiary”. This significantly limits the potential applicability of the test and will most adversely affect smaller country entities which are most likely to rely on the test (as they will have more difficulty passing other tests).

- The definition of an equivalent beneficiary is relatively narrow e.g. private companies are excluded. It is not clear why this is the case and, as with other restrictions, it is most likely to adversely affect smaller country entities where access to publicly held capital is less available.

To prevent significant disadvantage to smaller economies as compared with larger economies a widely cast Derivative Benefits test is essential if treaties are to include an LOB clause. The test must:

- Reflect a more diverse mix of non-locally resident ownership and financing because much of the financing for entities in those countries will naturally come from abroad (for reasons totally unrelated to tax). At a minimum, the Derivative Benefits test should include residents within a local regional grouping such as the EEA for both the ownership and base erosion tests.

- There should be no limit to the number of equivalent beneficiaries (seven is suggested in the draft) to satisfy the test once, for example, substantially all shareholders are equivalent beneficiaries.

- Take account of the greater incidence of privately held family business, by including the possibility to attribute to, and treat as held by, one person interests held by members of a family so that companies which are held by generations of one family will not fail the test simply because ownership is split amongst individual family members.

- Treat as held by one person, those share interests held under employee share schemes by executives of non-publicly listed groups.

e) Discretionary relief

If a company cannot satisfy any of the other LOB tests, it may be granted treaty access if, on foot of an application to the authorities in the treaty partner country, it persuades them that the
“establishment, acquisition or maintenance” of the company “and the conduct of its operations” did not have, as one of its principal purposes, the obtaining of treaty benefits.

If we draw on US experience as an illustration of the likely operation of this test in practice, in our members’ experience, it has proved exceptionally difficult to persuade the US tax authorities that the principal purpose test is met, even where the fact pattern is very clearly in the company’s favour (in the view of the small country resident).

It is problematic to place relief solely at the discretion of a tax authority in this type of situation. A more valid test would be one which:

a) does not require application to the foreign tax authority; and

b) has a clear right of appeal to the courts of the country concerned and ideally to an independent international arbitrator.

It should also be clear that any principal purpose clearance would apply retroactively because, in many cases, companies may be of the view that they meet the Active Business test and therefore may only wish to assert reliance on discretionary relief as a last resort.

f) Collective Investment Vehicles; Application of LOB Provisions

The conclusion of the 2010 CIV Report (The Granting of Treaty Benefits with Respect to Income of Collective Investment Vehicles) remains valid and is the best approach for dealing with granting treaty benefits to CIVs. The 2010 CIV Report recognises that CIVs can take different legal forms in different countries and are subject to different tax treatments (both in respect of the CIV and the investors in the CIV). As a result, the 2010 CIV report provides alternative approaches for providing treaty relief for CIVs. In this regard, no single “preferred approach” should be adopted in dealing with the treaty entitlements of CIVs and in the context of the application of a LOB provision to CIVs. Furthermore, CIVs should be treated as “qualified persons” in the LOB without any further qualifications and countries should continue to be permitted to agree on a bi-lateral basis how CIVs should be treated based on the facts and circumstances of the CIVs resident in the two contracting states and by reference to paragraph’s 6.8 to 6.34 of the commentary on Article 1 in the Model Tax Convention.

g) Non-CIV Funds; Application of LOB Provisions and Treaty Entitlements

Non-CIV Funds

The 2010 CIV Report did not deal with treaty entitlement issues relating to non-CIV funds such as sovereign wealth funds, pension funds and private equity funds and alternative funds. As a result, there is a real concern that the application of LOB provisions will have a detrimental impact on the ability of such non-CIV funds to claim treaty benefits. We would recommend that work similar to the 2010 CIV Report be undertaken through the OECD Informal Consultative Group to identify issues across the various types of non-CIV funds and develop practical solutions for treaty entitlement. In the absence of such work be completed in advance of the conclusion of the BEPS project, we would recommend the inclusion of an appropriate derivative benefits clause or some other equivalent beneficiary mechanism in the LOB provisions to facilitate the appropriate treaty entitlements for such non-CIV funds.

Pension Funds

Pension funds present unique issues in the context of treaty relief. It is widely accepted that they play a major role in the effective funding of the retirement of workers. In recognition of this, many double tax treaties, afford pension funds with zero withholding tax rates on investment income. Pension
funds invest directly in the global equity and bond markets but many use CIVs as their investment platform, principally to obtain appropriate economies of scale and exposure to global markets. It is imperative that pension funds (either investing directly or through CIVs) are not inadvertently negatively impacted by the introduction of LOB provisions. In addition, many pension funds pool their investments though CIVs which are tax transparent (i.e. the pension fund is the beneficial owner of the income) and recognition of such transparency is critical in ensuring the maximum benefits which pension funds are entitled to be granted in practice.

The issues impacting pension funds cannot be underestimated. It is essential that small investors are encouraged to make appropriate provision through pension funding arrangements to obtain the necessary long term financial security for workers into their retirement years. Recently FATCA (including Intergovernmental Agreements) and the Common Reporting Standard have afforded pension funds a “deemed compliant” status and provided practical definitions of pension funds falling within the “deemed compliant” status. The Action 6 agenda should follow that lead and recognise pension funds as qualifying residents in their home jurisdiction (country of establishment), without restriction under LOB (or indeed under a PPT).

**Domestic anti-conduit rules**

The OECD has recommended three options to countries, as regards the application of the PPT and LOB rules.

1. Include both the PPT and an LOB in treaties.
2. Include a PPT only, in treaties.
3. Include an LOB but no PPT in treaties – in this case, the suggestion is that this be supplemented by the introduction of domestic “anti-conduit” rules which is apparently designed to prevent transactions being artificially routed through an active business.

The anti-conduit rules suggested are very broad. They would apply where a company which “receives an item of income… pays, directly or indirectly all or substantially all of that income (at any time or in any form) to one or more persons who are not resident” and “who, if they received that item of income direct.... would not be entitled under a convention for the avoidance of double taxation...to benefits which are equivalent” (emphasis added).

There are at least three respects in which a provision along these lines is particularly difficult for taxpayers based in smaller economies and problematic generally:

1. A company operating in a small economy is naturally more likely to be foreign owned. Ultimately, a foreign owned company will usually pay all of its income to non-residents because it will ultimately pay dividends to overseas shareholders. However, it is not classically understood that conduit arrangements include situations where profits are retained within a country and then eventually paid out by way of dividend. Such a definition should be confined to payments which are deductible from taxable income.

2. A company in a small country is also more likely to be foreign financed. Therefore, it is more likely to make financing payments to non-residents. It is suggested that the scope of exclusions for an ‘equivalent beneficiary’ is extended to financing raised from lenders in regional economic groupings such as the EEA. Although it is noted that companies in particular sectors may normally raise finance outside of the EEA (e.g. technology sector companies).

3. The words “substantially all” are not defined, which will give rise to uncertainty and probably give rise to multiple different interpretations in different jurisdictions.

A more objective anti-conduit rule would:
(i) define “substantially all” (e.g. greater than 95%) and
(ii) replace the words “in any form” with “in any tax deductible form” - this would exclude dividends and is consistent with the base erosion test in the LOB which is based on a tax deductible payment.

Resolving treaty disputes

From time to time, disputes will arise as to the interpretation and / or application of tax treaties. This raises the question as to how such disputes ought to be resolved. Currently treaty disputes are typically resolved in accordance with the domestic procedures applicable in the country seeking to levy taxation. This process has a number of risks including:

(i) the risk of multiple different approaches and interpretations being taken in different countries.
(ii) varying quality as to the independence and rigour of procedures in different jurisdictions, and
(iii) a risk of bias, whether conscious or unconscious, in favour of the domestic tax collector and against the foreign taxpayer.

These risks will be exacerbated by the Action 6 proposals because the proposed new provisions are relatively complex and in many cases require a relatively high level of subjective judgement. Smaller countries are likely to have less power to redress any injustices arising from treaty disputes as they will have less resources and less diplomatic influence in seeking redress.

An independent, international, speedy and binding arbitration tribunal to resolve disputes over treaty access would substantially reduce the risk of unjust treatment of taxpayers generally and of those based in small countries in particular. In any event, a right of appeal to a qualified and genuinely independent body is a basic principle of justice.

Confidence in such a dispute resolution body would be best served by appointing to it respected, qualified and experienced jurists from countries with a strong reputation for an independent and fair judiciary.
### If Proposals Implemented as per September 2014 Report

#### Example 1 Listed Companies

<table>
<thead>
<tr>
<th>Various Tests under new Proposal</th>
<th>Listed company from a small country</th>
<th>Listed company from a large country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tech company grows and lists on NASDAQ.</td>
<td>Strategic management and control/board meetings held in home country (Ireland) but &quot;day-to-day&quot; management carried out all over the world.</td>
<td>Same fact pattern but company is from the US.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Publicly Traded Test (1) - Listed on local exchange</th>
<th><strong>FAIL</strong></th>
<th><strong>PASS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Not listed on home Stock Exchange.</td>
<td>Not required to be proven.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Publicly Traded Test (2) - Listed on recognised stock exchange &amp; management test</th>
<th><strong>FAIL</strong></th>
<th><strong>PASS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Not clear. In practice, substantial &quot;day-to-day&quot; management outside of home territory.</td>
<td>Not required to be proven.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Ownership/ Base Erosion Test</th>
<th><strong>FAIL</strong></th>
<th><strong>PASS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Majority ownership and finance from outside home territory.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Active Business Test</th>
<th><strong>MATERIAL UNCERTAINTY</strong></th>
<th><strong>PASS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to uncertainty over definitions.</td>
<td>Not required to be proven.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Derivative Benefits Test</th>
<th><strong>MATERIAL UNCERTAINTY</strong></th>
<th><strong>PASS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Who are owners and can they qualify as equivalent beneficiaries?</td>
<td>Not required to be proven.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Discretionary Relief</th>
<th><strong>MATERIAL UNCERTAINTY</strong></th>
<th><strong>PASS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Not required to be proven.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Principal Purpose Test</th>
<th><strong>MATERIAL UNCERTAINTY</strong></th>
<th><strong>PASS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Justification for access to local (Irish) treaty network.</td>
<td>Justification for access to local (US) treaty network.</td>
<td></td>
</tr>
</tbody>
</table>
# If Proposals Implemented as per September 2014 Report

## Example 2 Non-Listed Companies

<table>
<thead>
<tr>
<th>Various Tests under new Proposal</th>
<th>Private company from a small country</th>
<th>Private company from a large country</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>a) Ownership/Base Erosion test</td>
<td>German based private company expands + seeks capital and finance (large home capital and consumer market). Investors and finance sourced from inside Germany.</td>
</tr>
<tr>
<td></td>
<td>Small country based private export focused company (small home capital and consumer market). Investors and finance sourced from outside of home country (&gt;50%).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b) Active Business test</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Substantial management oversight and support functions (R&amp;D) in small country but markets largely outside Ireland and therefore majority of manufacturing and distribution located worldwide.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Publicly Traded Test (1) - Listed on local exchange</th>
<th>Limitation-on-Benefits</th>
<th>Limitation-on-Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Publicly Traded Test (2) - Listed on recognised stock exchange &amp; management test</th>
<th>Limitation-on-Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N/A</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Ownership/Base Erosion Test</th>
<th>Limitation-on-Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership and finance sourced outside of home territory.</td>
<td>Company was able to source sufficient local capital and finance.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Active Business Test</th>
<th>Limitation-on-Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to uncertainty over definitions.</td>
<td>Not required to be proven.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Derivative Benefits Test</th>
<th>Limitation-on-Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Can owners qualify as equivalent beneficiaries?</td>
<td>Not required to be proven.</td>
</tr>
</tbody>
</table>

<table>
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<tr>
<th>Discretionary Relief</th>
<th>Limitation-on-Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not required to be proven.</td>
<td>Not required to be proven.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Principal Purposes Test</th>
<th>Limitation-on-Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Justification for access to local treaty network.</td>
<td>Justification for access to local treaty network.</td>
</tr>
</tbody>
</table>
## Example 3 FDI

### Various Tests under new Proposal

<table>
<thead>
<tr>
<th>Investing in a small country</th>
<th>Limitation-on-Benefits</th>
</tr>
</thead>
</table>

**Publicly Traded Test (1)**
- Listed on local exchange

| N/A |

**Publicly Traded Test (2)**
- Listed on recognised stock exchange & management test

| N/A |

**Ownership/ Base Erosion Test**

| FAIL |

- Company is owned and financed outside of Ireland.

**Active Business Test**

| MATERIAL UNCERTAINTY |

- Can owners qualify as equivalent beneficiaries?

**Derivative Benefits Test**

| MATERIAL UNCERTAINTY |

**Discretionary Relief**

| MATERIAL UNCERTAINTY |

- Company is owned and financed outside of Ireland.

**Principal Purposes Test**

| FAIL |

- Treaty network a part of business decision to locate in Ireland.
Ms. Marlies de Ruiter  
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division  
Centre for Tax Policy and Administration  
Organisation for Economic Cooperation and Development  

Accounting & Tax Committee  
Japan Foreign Trade Council, Inc.

Comments on Discussion draft on  
Action 6 (Preventing treaty abuse (Follow-Up Work)) of the BEPS Action Plan

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the “Follow Up Work on BEPS Action 6: Preventing Treaty Abuse”.

The JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of JFTC’s Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

General Comments

1. One of the principal roles of tax treaties is to eliminate international double taxation in order to promote economic interchange between Contracting States. In view of this, we reaffirm our support for OECD’s existing efforts to limit the granting of the treaty benefits to artificial transactions and arrangements aimed solely at enjoying the treaty benefits and to make it clear that treaties should not be used for obtaining double non-taxation.

2. Nevertheless, it should be noted that excessive anti-avoidance rules in tax treaties and domestic tax laws may make adverse effect on genuine business transactions and investments with economic substance and thereby may impede the objectives of tax treaties to eliminate double taxation and
encourage cross-border trade and investment. In addition, consideration should be given to achieving a balance between the administrative burden on taxpayers of ascertaining and interpreting anti-avoidance rules and the effectiveness of those provisions.

3. The objective of BEPS Action 6 is to prevent double non-taxation by abusing tax treaties, but the current Report lay down excessively strict conditions for becoming qualified persons under tax treaties, which may deny the treaty application even to investment activity with business reason and which may lead to international double taxation. As regards whether or not there is abusive application of tax treaties, judgment should be made after close examination of all the relevant facts, and there should be no simplistic and injudicious speculation that “most investments via third States should be essentially for the purpose of treaty abuse”. In particular, in order to enhance fairness and transparency in the application of tax treaties, we request very strongly that the actions set out below be implemented and that it be reflected explicitly in the OECD Model Tax Convention text or the Commentary. Even if all the facts are closely examined and reasonable interpretation of the tax treaty is made, judgment by relevant authorities may differ in relation to whether there is abusive treaty application. In such cases, source States should not treat such transactions as treaty abuse unilaterally, instead should discuss between the competent authorities fully taking into account business reasons and the other facts. We request that the above should be reflected in the OECD Model Tax Convention or in the Commentary.

- Placing of importance on economic substance
- Determination of treaty entitlement based on the activities of entire corporate groups
- Impartial application to all companies
- Assurance of the effectiveness of the administration and judicature of all participating states.

Not to lay down express provisions and thus to entrust such matters to the discretion of jurisdictional authorities would impair predictability for taxpayers, and should be strictly avoided.

4. It is important to consider the consistency of tax treaties and domestic laws, but the recommendations of Action 6 should be reflected into each tax treaty
after the necessary revisions in each state's domestic law. In addition, as regards the relationship between anti-abuse provisions in tax treaties and in domestic laws, if the provisions are inconsistent with each other, it should be stated expressly that the treaty's provisions take precedence over domestic law and that the conditions for applicability of tax treaties should be stipulated only within the treaties, and also that if one Contracting State were, without consulting the other party, to unilaterally limit application of the treaty according to domestic law, that would constitute a treaty violation.

Specific Comments

A. Issues Related to the LOB Provision

3. Commentary on the discretionary relief provision of the LOB rule

Even if a company resident in a Contracting State does not satisfy the conditions for being a qualified resident by itself, the fact that the entire multinational enterprise (MNE) group to which the said company belongs (i.e., comprising the said company together with all other member companies engaging in business activity in the said Contracting State) has sufficient economic substance or satisfy the active-conduct test, should be an important evidence that the said resident's principal purpose is not to obtain tax benefits.

In the course of corporate activity, there are many cases where a legally segmented business entities must be incorporated, or such incorporation should be economically rational. Since it is unreasonable for disparities in the determination of treaty entitlement to arise between cases in which business is segmented among legally segmented business entities, and cases in which business is fragmented within a single legal business entity, the treaty application should be determined based on an entire corporate groups. The specific reason for this view is set out in the comment in no. 10 (Clarification of "active conduct of a business" provision) below.

In addition, in order to make the determination of treaty entitlement more objective, importance should be given to economic substance. As regards the various factors that affect judgment as to whether or not a company has the prescribed
degree of economic substance, in order to avoid unnecessary disputes and the concomitant administrative burden for both tax authorities and taxpayers, consensus should be reached between and among all State tax authorities based on the examination of examples of cases.

We endorse the inserted sentence "The competent authority of the Contracting State to which the request has been made will consult with the competent authority of the other State before rejecting a request made under this paragraph by a resident of that other State," however we believe it is essential to make this provision more effective in practice by stipulating the consultation mechanism. Additionally, in order to avoid the burden of consultations between authorities and impairing predictability for taxpayers, when the authorities in the State of residence attest that a taxpayer is a qualified person for treaty benefits through an advance tax ruling or tax residence certifications, such attestation should be accepted. Rejection without rational reasons should not be permitted, and in case a rejection is made for some unavoidable reason, the reasons therefor should be explained to the authorities of the Other State and to the taxpayer.

While addressing increases in requests for relief to competent authorities pursuant to this provision, we would expect parallel discussions to be conducted at the same time to deal properly with such increases.

This discretionary relief provision was introduced as a kind of safe-harbor, however we are concerned that predictability for taxpayers may become low unless the approval criteria are identified specifically, and that the bloating of the administrative burden for the authorities concerned may make this provision unworkable. In view of this, it is essential that adequate guidelines and examples of concrete judgment criteria with regard to the criteria for determination by competent authorities be given by inclusion in the Commentary, etc.

6. Issues related to the derivative benefit provision

We believe that the “at least 95 per cent” ownership ratio by “equivalent beneficiaries” to be extremely and excessively high. It is difficult for minor shareholders to be involved in the determination the transaction and there are existing tax treaties adopting ownership ratio of “at least 75 per cent”,
therefore it is desirable to lower this ratio to no more than “at least 75 per cent.”

Furthermore, it is stated that the maximum tax rate applied to payments between the source State and a third State must be equal to or higher than the maximum tax rate under the relevant treaty in order to be deemed equivalent beneficiaries. If this condition is not met, the said beneficiary is not deemed a derivative beneficiary, and this would yield an unreasonable outcome, given that the equivalent beneficiary provision is a type of bona fide provision. Therefore, in such instances, the tax rate of the tax treaty applied in case the ultimate beneficial owner directly made investment should be applied. As an example of this approach, this treatment is accepted in the technical explanations of the US-UK Tax Treaty or in court cases in certain states, and should be appended to the OECD Model Tax Convention.

To take an example, an investment is made from the resident company A of State A in the resident company C in State C and an intermediate holding company B is established in State B, the treaty-based rate of withholding tax on dividends is 10% between State A and State C, and the treaty-based tax rate of 0% between State A and State B and between State B and State C, and the domestic tax rate in State C is 20%. In these circumstances, if, owing to proposed LOB, it is deemed that company B is established for the purpose of avoiding tax, it is possible that withholding tax of 20% will be applied to dividends from company C to company B under State C’s domestic law, but for cases such this, a relief provision should be included that applies a tax relationship that is equal to the one that exists pursuant to the tax treaty between State A and State C (10% withholding tax rate), where State B is not an intermediary.

10. Clarification of the "active conduct of a business" provision

We are concerned that under the LOB provision there can be judgments solely based on the form as to whether a person is eligible to be granted treaty benefits without considering the bona fide business purposes. It is our view that, when determining whether or not a person is a qualified person, the approach should place emphasis on substance rather than form. In particular, although it is stated that the active-conduct test applies only to business "other than the business of making or managing investments," active-conduct
test irrespective of the industrial category to which a taxpayer belongs, judgment should ultimately be made on the basis of the actual nature of its business, and a person engaged in the activity of making or managing investments should be also treated as a qualified person.

In addition, determination through the active-conduct test should be made on the basis of a corporate group rather than on the stand-alone basis of an individual member company. For the purpose of quarantining diverse types of business risk or of strengthening resistance to the economic fluctuations through the dispersal of business risk, MNE groups split up business activity within the same state, conducting business in business entities in which individual business activities are legally segmented. This may give the impression, when considered on a stand-alone basis, that the individual companies do not have sufficient economic substance, but even if each business entity is conducting trade or investment activities separately, as long as they are engaged in active conduct of a business as an entire MNE group in the same state, they should be treated as satisfying the eligibility criteria. Please refer to Examples 1 and 2 in the annex hereto, and we strongly request that the tax treatment under the Examples 1 and 2 should be consistent.

With regard to paragraph 48 of the proposed Commentary in the “Action 6: 2014 Deliverable issued in September 2014, namely “Since a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in the active conduct of a business for purposes of paragraph 3”, judgment should be made after giving full consideration to the actual state of business activity as described above. If a headquarters has adequate economic substance and it provides with various important functions to its group companies, it should be regarded as engaging in the active conduct of a business. Moreover, as stated above, any such judgment should be made for the corporate group as a whole.

With regard to companies that engage concurrently in trading and other ordinary business activities together with activities that do not satisfy the active-conduct test, such company should be granted the full benefit of the treaty with the State of the invested entity in case that its trading business is closely connected with the business operations of the invested entity.
B. Issues Related to the PPT Rule

In the Report, the definition under the principal purposes test (PPT) provision is too broad, causing us the concern that tax authorities will make various interpretations and there will be differences in the way it is performed. In order to promote international transactions and arrangements and ensure business stability, we consider it desirable to give detailed examples and supplement the Commentary, and also add postscripts for, among other things, the building of a system for advance confirmation of whether or not the test is applicable, and for addressing disputes arising from inconsistencies in the recognition of facts on the part of companies and of the tax authorities.

In actual business practice, important factors to be considered include not only business-related factors but also the application of tax treaties. It is difficult to judge between non-tax purposes and tax-related purposes as to which are the most important, but if taxpayers prove that their principal or one of their principal purposes is a non-tax purpose, we request that, unless otherwise stipulated by treaty or law, their claim be respected, and that this be stated explicitly in the PPT rule. With regard to the phrase "arrangements one of the principal purposes of which is to obtain treaty benefits," the burden of proof should rest with the tax authorities.

From the perspective of fairness of the rule, if it is deemed that “there were clear reasons, unrelated to the obtaining of treaty benefits, for its formation, acquisition, or maintenance...” under the discretionary relief provision of the LOB rule, it should be also deemed for the PPT rule purposes that the principal purpose of the transaction is not obtaining of treaty benefits.

14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

It is suggested that either the LOB provision or the PPT rule is to be used as a condition for the applicability of tax treaties, but from the perspective of equality of opportunity with respect to treaties and also of preventing BEPS through the intentional use of the more favorable test, it is essential that the substance of both tests be made essentially the same.
The PPT rule is a condition that directly questions the purposes of treaty application, adapted faithfully for the purpose of preventing the abusive application of tax treaties, whereas although the conditions of applicability of the LOB provision are objective, it is flawed by the fact that it draws formal conclusions without questioning the purposes of treaty use. Approval by competent authorities should be conducted based on the purpose of treaty use not solely based on the form of the transaction.

In addition, if authorities wish to disprove explicit statements by taxpayers that they do not have as one of their principal purposes the obtaining of treaty benefits, the burden of proof should rest with the tax authorities, and wording to that effect should be included in the treaty text or Commentary.

15. Whether some form of discretionary relief should be provided under the PPT rule

Even under the PPT rule, in order to ensure fairness for taxpayers and also on the basis of the fundamental intent of tax treaties to avoid double taxation, it should not be permissible for improper denial of the application of a treaty to be made at the discretion solely of the competent authorities of the other Contracting State. Accordingly, in case the application of a treaty is to be denied, it should be made essential for advance consultation to be conducted between the competent authorities of both Contracting States. In addition, in order to avoid the burden of consultations between the authorities and impairing predictability for taxpayers, if the authorities in the State of residence make advance rulings and take steps such as procedures for issuing verification of residential status, and through these means attest that the taxpayer is a qualified person for treaty benefits purposes, that attestation should be accepted.

17. List of examples in the Commentary on the PPT rule

In the PPT rule also, determination of entitlement should be conducted on the basis of entire corporate groups, and in the examples attached the eligibility criteria under the PPT rule should be satisfied. (Examples 1 and 2 in the annex hereto.)

C. Other Issues

19. The design and drafting of the rule applicable to permanent establishments
Located in third States issue

We are concerned that Paragraph 42 of the “Action 6: 2014 Deliverables” issued in September 2014, pays attention only to effective tax rates, and that even in cases in which there is no tax avoidance or double non-taxation it is possible that this provision will apply, and that this will impede the encouragement of investment that is expected to result from the favorable treatment offered by tax treaties. Exceptions are made in subparagraphs e) and f), of this Paragraph but especially with regard to e), the exceptions are dependent upon the determination of facts by tax authorities whether the transaction is “in connection with or in incidental to the active conduct of a business”, which may be a cause of disputes if their interpretations differ from those of the relevant taxpayers, possibly leading to a greater administrative burden for both taxpayers and tax authorities. In view of this, we request that the scope of this provision restricted to only transactions and arrangements for the purpose of tax avoidance or evasion.

20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules issue

In the Report there is no mention of cases in which there are conflicts between anti-abuse provisions in tax treaties and domestic anti-abuse rules, but it should be stated expressly that in the event of inconsistency a treaty’s provisions take precedence over domestic rules. It should also be stated expressly that tax treaty applicability conditions should be stipulated only in the treaties, and should not be stipulated in domestic rules (and be invalid even if they are prescribed subsequently). Prescribing domestic rules that limits treaty applicability conditions unilaterally, without consulting the other Contracting State, impairs the intrinsic objectives of treaties and gives rise to international double taxation, and thus is unacceptable.

In view of the above, in order for Action 6 to ensure predictability for taxpayers, efforts to build a consensus with regard to more specific approval criteria should be made, and States' tax authorities should be proactive in issuing public rulings in conformity with those. We also believe that the existence of reliable administrative procedures and of a strong and independent judicial system is indispensable for preventing subjective interpretations of anti-abuse provisions.
Annex

Example 1: Case in which multiple business activities are conducted within the same business entity (The nature of business activity is identical to that in Example 2)

Assumptions

1. T Co, a company resident of State T listed on the stock exchange of State T, is an MNE conducting a variety of business activities (wholesaling, retailing, manufacturing, investment, finance, etc.) globally.

2. It is effectively impossible for T Co to conduct the management of its overseas business in State T, for reasons such as their long physical distances from State T, problems relating to transportation and time differences, limited numbers of personnel able to speak foreign languages, and the overseas locations of business partners. In consequence, T Co adopts a strategy that entails establishing R Co, a subsidiary in State R, where there are highly liquid markets for international goods and financial markets and an abundance of high-quality human resources, and using R Co as a base for developing overseas business activity.

3. R Co is a resident of State R, and its business activities in State R are diverse: wholesaling, retailing, manufacturing, investment (domestically and internationally), and finance. It also possesses the capabilities (legal, financial, accounting, taxation, risk management, auditing, internal control) to manage
these diverse business activities. It has certain amount of sales and number of personnel, and it is plain that it engages in the active conduct of a business in State R.

Part of R Co's business strategy is to launch business activity in State S, either by itself or together with partners. When doing so, it contributes capital and extends loans to S Co, a subsidiary in State S that it has newly established or acquired, and for withholding tax on dividends and interest it applies the limited tax rate pursuant to the tax treaty concluded between States R and S.

Consideration

In the above example, since R Co established in State R is neither a listed company in State R or a subsidiary of one, it does not satisfy the provisions of paragraphs 1 or 2 of the LOB rule, but since it is engaged in active conduct of a business it satisfies the requirements of paragraph 3, and thus should be accorded the benefits of the tax treaty concluded between States R and S.

Under the PPT rule also, R Co's contributions of capital and extension of loans to S Co are conducted as part of T Co's and R Co's business strategy and thus qualify sufficiently as being for business reasons, and in consequence should be accorded the benefits of the tax treaty concluded between States R and S.

Example 2: Case in which multiple business activities are conducted through segmented business entities (The nature of business activity is identical to that in Example 1)
Assumptions

1. There is no substantive difference with the activities of T Co's entire corporate group in Example 1.
2. However, in accordance with T Co's business strategy and risk management, it judges that it is undesirable to concentrate diverse business activities in State R on R Co alone, as in Example 1, and thus splits R Co's business, establishing multiple subsidiaries to engage in each separate business in State R.
3. R1 Co has supervisory functions, providing its associated companies with management services and shared services, while R2 Co engages in wholesaling business, R3 Co in retailing business, R4 Co in manufacturing business, R5 Co in investment business (domestically and internationally), and R6 Co in financial business, and T Co also has numerous other subsidiaries in State R. (These are referred to collectively as the "R Co Group.")
4. This establishment of subsidiaries to engage in separate business activities is not only for T Co's business strategy purposes, but is also required by third-party financial institutions as a means of quarantining the legal risk to which each business line is exposed (including bankruptcy remoteness), and is necessary for conducting low-interest-rate, stable funding. Also, when operating jointly with business partners it is customary to establish individual business entities to help ensure joint business activity is conducted smoothly.
5. The scale (sales, number of employees) of the R Co Group is the same as in Example 1.
6. Part of the R Co Group's business strategy is to launch business activity in State S, either by itself or together with partners. When doing so, R5 Co contributes capital and extends loans to S Co, a subsidiary in State S that it has newly established or acquired, and for withholding tax on dividends and interest it applies the limited tax rate pursuant to the tax treaty concluded between States R and S.

Consideration

1. In the above example, since R5 Co established in State R is neither a listed company in State R or a subsidiary of one, it does not satisfy the provisions of paragraphs 1 or 2 of the LOB provision. Also, since R5 Co engages in investment activity on a stand-alone basis and moreover (although
competitors are financial institutions, R5 Co itself) is not a financial institution, based on the current treaty draft it is unable to satisfy the active-conduct test prescribed in paragraph 3.

However, the only difference with Example 1 is that the companies are legally segmented within the same corporate group. In addition, the formation of these legally segmented business entities is not any way connected with a tax purpose.

It would be inconsistent if, despite there being no substantive difference with regard to the state of activity of the entire corporate group as just described, there is a difference between the treatment in Example 1 and Example 2 under the tax treaty. In view of this, whether or not the LOB provision's active-conduct test is satisfied should be judged by the activities of the entire corporate group in State R, the result of which would be that R5 Co satisfies the criteria and should be accorded the benefits of the tax treaty concluded between States R and S.

Under the PPT rule also, R5 Co's the contributions of capital and extension of loans to S Co are conducted as part of T Co's and the R Co Group's business strategy, and accordingly they qualify sufficiently as being for business reasons, and in consequence should be accorded the benefits of the tax treaty concluded between States R and S.

With regard to the LOB provision, in the example above the competent authorities in State S would have scope, pursuant to paragraph 5, to permit tax treaty benefits to be granted, but reliance on the discretion of competent authorities gives rise to considerable uncertainty, so in our view paragraph 5 should be treated very much as a last resort only after it is deemed that the provisions of paragraphs 1 to 4 do not apply. Accordingly, in order to make certain that the tax treaty treatment in Example 1 and Example 2 is consistent, we believe that it should be expressly stipulated in paragraph 3 that the active-conduct test shall be judged on the basis of the activities of the corporate group as a whole in State R.
Japan Foreign Trade Council, Inc.

World Trade Center Bldg. 6th Floor,
4-1, Hamamatsu-cho 2-chome,
Minato-ku, Tokyo 105-6106, Japan
URL. http://www.jftc.or.jp/

Members of the Accounting & Tax Committee of J FTC

CBC Co., Ltd.
Chori Co., Ltd.
Hanwa Co., Ltd.
Hitachi High-Technologies Corporation
Inabata & Co., Ltd.
ITOCHU Corporation
Iwatani Corporation
JFE Shoji Trade Corporation
Kanematsu Corporation
Kowa Company, Ltd.
Marubeni Corporation
Mitsubishi Corporation
Mitsui & Co., Ltd.
Nagase & Co., Ltd.
Nippon Steel & Sumikin Bussan Corporation
Nomura Trading Co., Ltd.
Shinyei Kaisha
Sojitz Corporation
Sumitomo Corporation
Toyota Tsusho Corporation
Yuasa Trading Co., Ltd.
Marlies de Ruiter  
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division  
OECD/CTPA

12 January 2015

Dear Marlies

Re: Comments on BEPS Action 6 Public Discussion Draft – Impact on Institutional Investors

Thank you for the opportunity to provide comments on the Public Discussion Draft entitled “Follow up work on BEPS Action 6: Preventing treaty abuse”, which was released for comment on 21 November 2014.

We act on behalf of the following Australian and New Zealand Institutional Investors:

- Queensland Investment Corporation (“QIC”); and
- New Zealand Superannuation (“NZ Super”).

Please refer to Appendix B for further information in respect of each of our clients participating in this joint submission.

For the purposes of this submission the following abbreviations are used:

- The OECD Report (2014 Deliverable) titled, “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances”, by the OECD/G20, Base Erosion and Profit Shifting Project, will be referred to as “Action Plan 6”.
- The OECD Report titled “The Granting of Treaty Benefits with respect to the income of Collective Investment Vehicles”, adopted by the OECD Committee on Fiscal Affairs on 23 April 2010, will be referred to as the “CIV Report”.
- The OECD Public Discussion Draft titled “Follow up work on BEPS Action 6: Preventing Treaty Abuse”, dated 21 November 2014 will be referred to as the “Discussion Draft”.
- The expression Government when used in this submission means either a Nation State or a political sub division of that Nation State. For example in the context of Australia the term Government will cover the Commonwealth of Australia and each State and Territory Government within Australia individually.
- Sovereign Wealth Funds are defined in this submission to cover globally recognised Government sponsored investment entities which invest funds for the benefit of the citizens of that Government as a whole rather than any individual or group within the population.
managed by that Government. The term “SWF” is used as an abbreviation of Sovereign Wealth Fund. The definition of a SWF will exclude Government owned trading entities. A Government owned trading entity includes companies such as Government owned broadcasters, electricity suppliers and telecommunications companies. Investment entities are entities set up for either the purpose of meeting a future Government liability (e.g., pensions) or as a mechanism for intergenerational funds transfer. A broader definition is beyond the scope of this submission however reference is made to the Institutional Investor’s Sovereign Wealth Centre (www.sovereignwealthcentre.com) which publishes data on all globally recognised SWFs.

- Pension Funds are defined in this submission to mean either defined benefit or defined contribution funds which are organised to provide pension benefits to either employees or contributors. However, we have excluded from the definition of Pension Funds any privately sponsored fund for the benefit of a family group or that has less than 1,000 contributors who contribute on a regular basis. A broader definition is beyond the scope of this submission however reference is made to the Pensions & Investments web page, (www.pionline.com).

- Institutional Investors are defined to be either or both SWFs and Pension Funds.

1 Executive Summary

We have set out two recommended alternate approaches to appropriately deal with the position of Institutional Investors.

1.1 Preferred Position

The preferred position is to align the position of Institutional Investors to “not for profit organisations” who are “qualified persons” pursuant to sub paragraph 2(d)(i). This could be achieved by amending the definition of “qualified person” in subparagraph 2(d)(ii) by removing all the words in that subparagraph starting with the words “provided that…” and substituting the following words “or is an investment entity owned by an entity set out in sub paragraph 2(b)”.

Given the nature and functions of Institutional Investors this recommendation is as much a social and political decision as it is a matter of tax policy.

1.2 Alternate Position

Alternatively, we propose to align the position of Institutional Investors to banks and other financial institutions.

As set out in this submission some Institutional Investors are larger than the world’s largest banks and by nature we consider that an Institutional Investor is more aligned with financial institutions than manufacturing or trading companies. This change requires some changes to both the wording of sub paragraph 3(a) and the commentary as to what constitutes an active business.
As a consequence of the diversity of Institutional Investors’ activities this alignment will also need to deal with the current treatment of CIVs and the commentary to sub paragraph 6.

In brief, an Institutional Investor which sets up an ownership vehicle in and manages an asset from State A should be entitled to the benefits of all Treaties with State A. Management of an asset can occur either as direct management by the Institutional Investor by an entity resident in State A or management via an external manager (also resident in State A) who acts on behalf of the Institutional Investor.

It follows from this that a CIV comprised of Institutional Investors should be treated in the same manner as an Institutional Investor.

Article 10(7) (PPT rule) would remain to cover the position of a potential abuse.

2 Introduction

By way of context, we recognise that, at the highest level the Organisation for Economic Co-operation and Development ("OECD") Base Erosion and Profit Shifting ("BEPS") initiative seeks to ensure that the Governments of each Member State receive their fair share of revenue so they can discharge their respective social obligations.

The proposed OECD Model Tax Convention and Commentary in respect of the Limitation on Benefits ("LOB") and Principal Purpose Test ("PPT") rules seek to ensure that taxpayers do not avail themselves of treaty relief in circumstances where it would be inappropriate for them to do so. These provisions also seek to prevent double non-taxation (i.e. where a prima facie taxable entity is exempt from tax both in the country of source and in the country of residence).

2.1 The role of Institutional Investors

In this context, it is important to consider the broader role of Institutional Investors (being SWFs, public pension reserve funds and pension funds) in society as a whole. For further information on SWFs and public pension reserve funds as considered by the OECD\(^1\), please refer to Appendix C.

Institutional Investors are not established to generate wealth or profit for a small group of individuals as in the case of a corporate, rather they are established as a matter of Government policy of each member state to meet intergenerational (i.e transfer wealth from the generation which benefits from high commodity prices to spend when the commodity no longer is valuable) or contractual commitments relating to the ongoing retirement obligations for its citizens (e.g. doctors, nurses, police officers, military personnel, etc), or in some countries the entire population.

\(^1\) Adrian Blundell-Wignall, Yu-Wei Hu and Juan Yermo, *Sovereign Wealth and Pension Fund Issues*, 2008
Institutional Investors differ from corporate investors in six material aspects, which are discussed in further detail below:

1. They are generally exempt from tax in their home market, albeit taxable in foreign jurisdictions;
2. They seek to match income flows with contractual or intergenerational commitments;
3. The use of external managers and regional offices to manage their investments;
4. Their predominant “liabilities” (whether they are future pension payments or intergenerational social welfare obligations) are in their home currency;
5. Asset allocation; and
6. Risk profile and fiduciary obligations.

1. **Exemption from income tax in home market**

   Institutional Investors are generally exempt from income tax in their home country on public policy ground due to their stated social purpose, which is to meet intergenerational or contractual commitments relating to pension obligations.

   This is recognised in most jurisdictions as distinct from the purpose of corporations, which seek to benefit individuals through their profit making endeavours.

   Tax exemption means Institutional Investors are not driven to locate entities in foreign jurisdictions to avoid home country tax. It should also be borne in mind that Institutional Investors have fiduciary obligations in managing their assets and the choice of a regional office or external manager will turn on numerous factors dealing with reciprocity of law especially when common law countries invest in civil law jurisdictions.

   As set out later in this submission, many countries have sought to create incentives to attract foreign based Institutional Investors to invest in their host markets as they represent a long term, stable source of capital for investments that pay stable cash flows.

2. **They seek to match income flows with contractual or intergenerational commitments**

   Institutional Investors can be most easily distinguished from corporate investors in that they do not operate to maximise profits for their shareholders, rather they operate with a view to meeting contractual (e.g. defined benefit or defined contribution pension plans) or intergenerational commitments (future income flows to ensure continued prosperity for States with economies tied to finite exhaustible resources – e.g. Saudi Arabia). This significantly impacts the risk profiles and asset mix of each Institutional Investor and is often further controlled through legislation.

3. **The use of external managers and regional offices to manage the investment**

   Institutional Investors are generally likely to employ both regional offices and external managers to administer and manage their investments. This is due to a number of reasons, predominantly related to the fact that they invest across a wide portfolio of assets in various
global markets. We have set out in section 5 below the asset classes and geographies in which investments are made.

In the case of a very large investment, (eg infrastructure and large real estate investments) these are generally made in consortia. By way of an example, Institutional Investors will typically invest in infrastructure and large real estate assets as part of a consortium, usually comprising three to five investors, which allows these investors to better manage their risk profile and exposure to any one asset. In these cases, it is often beneficial to appoint an external manager or establish a regional office in a central third country to manage the investments being made, especially where the investors are situated in many different countries. This type of structure allows for governance rights to be exercised in an efficient manner (especially where time zones are an issue) while also allowing investors the flexibility to appoint an expert manager to efficiently manage the asset. Institutional Investors will generally not have the in-house expertise themselves to manage for example a toll-road or an airport.

In our view, the structure of the CIV industry described in the CIV Report\(^2\) focussed exclusively on portfolio equity and debt funds. In these funds the underlying investors have no direct rights over the assets in the fund and rely entirely upon the manager to make all decisions regarding the operation of the fund. This should be contrasted with a consortium of Institutional Investors purchasing an infrastructure asset through a CIV created for the particular acquisition\(^3\). The Institutional Investors will each individually have governance rights that will give the particular investor proportionate control over the asset. In respect to a number of matters it is common for investors to have “negative control” over important decisions. Negative control is the ability of an Institutional Investor on protective grounds to block a decision made by the majority of the investors.

A comparison of the world’s largest companies\(^4\) with the world’s largest Institutional Investors\(^5\) shows the following statistics:

1. Almost 25% of the world’s largest 100 companies by market capitalisation would be displaced by Institutional Investors if Institutional Investors’ net worth was defined as market capital;
2. The world’s largest companies are geographically represented by subsidiaries throughout the world whereas Institutional Investors have regional offices to manage foreign investments; and
3. The world’s largest companies employ by factors of between 100 and many thousands more employees.

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\(^2\) Section 2.2ff

\(^3\) http://www.sovereignwealthcenter.com/Article/3205798/real-estate-and-infrastructure/Powering-Up-Sovereign-Fund-Investment-in-Infrastructure.html#VKnLdgcR3Y

\(^4\) www.corporateinformation.com

\(^5\) www.towerswatson.com; www.sovereignwealthcentre.com
The differences largely turn on the fact that Institutional Investors do not deal directly with individuals in foreign markets and that their direct investments in foreign markets tend to be real estate and infrastructure.

4. **Their predominant liabilities are in their home currency**

As Institutional Investors are established to meet future contractual or intergenerational obligations, the relevant liabilities they are seeking to manage are also in the home currency. It should be noted the even where a pension fund is managed by an employer or a third party not controlled by Government, pension funds are all regulated by Government. The reason for the regulation is primarily on public policy grounds to ensure that retirees are self-funded. The alternative to adequate self-funding for retirees means that greater costs would be placed on future public spending through additional social welfare payments.

This means that Institutional Investors will seek to invest in assets that generate stable cash flows and are either not subject to significant foreign exchange rate fluctuations or the investment is hedged against this. This also means that Institutional Investors are also likely to retain significant cash reserves or liquid assets in their home currency to ensure they can meet these obligations as they fall due.

This is not consistent with the general investment patterns of multinational corporates, which would have liabilities in a number of currencies and would also seek to maximise returns through leveraging their operations.

5. **Asset allocation**

In line with the stated purpose of Institutional Investors, which is to meet future contractual or intergenerational obligations, asset allocations for these investor types are generally weighted towards low-risk cash and equity type investments (e.g. Government bonds).

A sample asset allocation for an Institutional Investor may be:

- Portfolio dividends, cash and low-risk debt interests (55-85%); and
- Real estate, infrastructure and private equity type investments (15-45%).

Whilst alternative investments (e.g. real estate, infrastructure, agricultural and private equity) are by percentage terms smaller than portfolio investments in absolute terms, they are still material in a global sense.

These asset investments can be either direct investments (with governance rights and obligations) or fund investments (where there are no governance rights or obligations or those rights and obligations are more limited). The mix of direct and fund investments varies depending on the Institutional Investor and their desired asset mix.

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6 A direct invest is an investment where the Institutional Investor has governance obligations which will be exercised either directly or indirectly.
A complicating factor is the fact that the rate of return on asset classes, especially infrastructure is relatively low given its very long term nature. Where rates of return are low consortiums between likeminded Institutional Investors can be distorted when each investor has a different tax outcome.

In recent years, Institutional Investors have been demonstrating an increased appetite for direct infrastructure and real estate investments, which has been largely explained due to the low-risk and long term cash flow characteristics of these investment types. It is important to note that these investments are largely passive, with Institutional Investors generally being more interested in matching cash flows to obligations as opposed to generating growth and profits through active involvement in businesses.

The principal concerns we have with Action Plan 6 is its potential impact on global infrastructure and real estate investment. The concern arises if;

1. an “equivalent beneficiary” approach is taken;
2. the OECD determines that managing real estate and infrastructure assets is not an active business; and
3. Institutional Investors managing their own assets is not an active business.

6. Risk profile and fiduciary obligation

In line with their stated purpose, Institutional Investors are operating to meet certain obligations for the benefit of their beneficiaries, whether these be future generations, the recipients of pensions or the relevant Government. This purpose means that Institutional Investors are highly conservative and are likely to invest in a wide variety of assets to diversify their portfolio and manage risk through traditional hedging and portfolio management theory. Institutional Investors are also likely to invest as part of consortia to limit exposure to large, illiquid assets while still accessing desirable cash flows from real estate and infrastructure investments. The investment behaviour of Institutional Investors is also influenced by their fiduciary obligations to their beneficiaries. These beneficiaries vary depending on the type of obligation being met by the investor, with pensioners being the fiduciary for defined contribution plans as they have invested directly in the fund, the Government being the fiduciary for defined benefit plans as the fund is meeting a Government obligation and the future generations of beneficiaries being the beneficiaries for sovereign wealth funds that augment Government revenues.

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2.2 The importance of Institutional Investors in global capital flows

Institutional Investors, in particular pension funds and sovereign wealth funds, are an increasingly important source of global investment capital. Sovereign wealth funds spent a total of $43.5 billion on 184 direct investments in 2013\(^\text{10}\) and had a total of US$7.057 trillion of assets under management as at December 2014\(^\text{11}\). Similarly, the top 300 pension funds (including sovereign funds) had an estimated US$15 trillion of assets under management to December 2013\(^\text{12}\).

Traditionally, Institutional Investors have been seen as sources of long-term capital with investment portfolios built around the two main asset classes (bonds and equities) and an investment horizon tied to the often long-term nature of their liabilities. In recent years Institutional Investors have diversified portfolios by adding allocations to alternative investments such as private equity, real estate, infrastructure, agricultural and hedge funds in OECD markets. They generally seek to operate in long-term, relatively illiquid investments which pay a steady rate of return.

The OECD itself has studied the unique attributes that Institutional Investors can provide to stimulate the global economy and has been a thought leader in presenting this opportunity to the G20 and APEC\(^\text{13}\).

“\text{The fallout from financial crisis has exposed the limitations of relying on traditional sources of long-term investment finance such as banks. Governments are looking for other sources of funds to support the long-term projects that are essential to sustaining a dynamic economy. There is huge potential among Institutional Investors to support development in a range of areas such as infrastructure, new technology and small businesses.}\"

Angel Gurria, OECD Secretary-General

G20 Leaders' Summit, St. Petersburg, September 2013

Further, at the recent G20 Leaders Summit held in November 2014, in Brisbane, Australia, the issue of long-term financing for sustainable and durable growth was an important theme in charting the economic future of member countries. G20 leaders identified structural reforms and quality investments, particularly in infrastructure, as important conditions to foster job creation and to support long-term growth targets. Promoting institutional investment in infrastructure is increasingly becoming a topic of interest at the G20 as part of this multi-year plan for growth.


\(^{11}\) http://www.swfinstitute.org/fund-rankings/ - accessed 29 December 2014


\(^{13}\) Years of work undertaken by the OECD was recently summarized in its May 2014 project report "Institutional Investors and Long-Term Investment. http://www.oecd.org/finance/private-pensions/ECD-LTI-project.pdf"
It is generally recognised that a common factor for this investor type is the long-term investment timeline and significant capital commitment required for them to meet their future obligations. Accordingly, these investors seek global efficiency from a taxation perspective as they are generally exempt from income taxes in their home market.

Institutional Investors are not seeking an exemption from BEPS or exclusion from the treaty shopping and other such integrity provisions, rather they are seeking to ensure that these provisions operate in a uniform way that will not distort their ultimate economic outcomes on the basis of investment structure into their target jurisdiction.

2.3 Concessionary treatment for Institutional Investors

We note that the unique investment profile and character of Institutional Investors and their increasingly prevalent role in providing stable long-term capital in infrastructure and real estate investments has been recognised by a number of States which have passed legislation providing concessionary tax treatment for pension and sovereign wealth funds and their subsidiaries, usually in the form of an exemption from withholding taxes. These measures reflect the importance afforded by many Governments to attracting long term capital inflows to advance broader national economic policy initiatives, in the context of a highly competitive global capital market.

There are some jurisdictions at present which provide some form of exemption (a form of sovereign immunity) from income taxes to foreign governments and Institutional Investors include Australia, Germany, Canada, USA, UK, France and Korea. It is expected that given the increasingly competitive environment to attract global capital as well as pressing domestic requirements to expand and/or upgrade infrastructure and other assets these countries may seek to offer some tax preferences to Institutional Investors.

Currently many countries offer alternative incentives to sovereign immunity for Institutional Investors. For instance, Australia:

- exempts certain Institutional Investors from some income tax in Australia;
- has a Managed Investment Trust (“MIT”) regime (which provides a concessional 15% withholding rate for distributions made by widely held funds – Institutional Investors being regarded as widely held - investing either directly or indirectly in assets generating passive income – discussed at Appendix D);
- exempts certain foreign pension funds from interest and dividend withholding tax; and
- provides certain domestic pension funds with an effective exemption from income tax through the use of refundable franking credits through the dividend imputation system.

Another example of concessionary legislation is the United States’ (“US”) Foreign Account Tax Compliance Act (“FATCA”) regulations (also discussed at Appendix D), which have identified

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14 For a more detailed listing see [www.law.wisc.edu/m/y2njd/swfs_taxation_arial_717_08.doc](http://www.law.wisc.edu/m/y2njd/swfs_taxation_arial_717_08.doc) - accessed 29 December 2014
foreign governments and foreign superannuation funds and retirement plans (as well as certain wholly owned entities) as low risk entities for US tax evasion purposes and have thus excluded them from the requirements to trace their ownership to identify US members or potential US members.

Additionally, in the US there has been recent discussion on exempting foreign pension funds from paying capital gains taxes on the disposal of real property and infrastructure interests in the US. The US treasury excerpt below highlights the unique role pension funds play in long-term infrastructure investments both in the US and globally, and highlights the US’s recognition of the impact that tax imposts have on distorting choice of investment destination:

“Infrastructure assets can be attractive investments for long-term investors such as pension funds that value the long-term, predictable, and stable nature of the cash flows associated with infrastructure. With U.S. pension funds generally exempt from U.S. tax upon the disposition of U.S. real property investments, the Administration proposes to put foreign pension funds on an approximately equal footing: exempting their gains from the disposition of U.S. real property interests, including infrastructure and real estate assets, from U.S. tax under FIRPTA.” 15

The various unilateral tax concessions granted by Governments worldwide to Institutional Investors to advance broader domestic economic policy initiatives recognise their unique status and operations and further distinguish them from those of multinational corporates.

2.4 Public Policy Considerations

The OECD recognises the role of non-profit organisations in the current draft of Article 10. As has been set out pension funds are globally active in seeking to provide retirement income for contributors. As set out in the numerous footnotes the largest pension funds are those devoted to government employees. Any additional costs imposed upon pension funds (including administration) are in the long term additional social welfare costs imposed upon governments. It should be noted that China, Malaysia and Singapore have amongst the world’s largest pension funds and sovereign wealth funds.

Both pension funds and sovereign wealth funds serve the same social function of providing future earnings for the citizens of a particular country.

2.5 Impact of proposed LOB and PPT articles on Collective Investment Vehicles (“CIV’s”)

The Public Discussion Draft refers to the proposed wording of the LOB and PPT articles in the Action Plan 6, and recognises that a number of funds use interposed entities to manage and / or structure their investments.

We are confident that no Government globally is seeking to disadvantage or dissuade Institutional Investors from investing in their markets. Accordingly, it is submitted that specific

Comments on BEPS Action 6 Public Discussion Draft – Impact on Institutional Investors

ABCD

consideration should be afforded to the practices of Institutional Investors as part of the BEPS project. It should also be acknowledged that the Institutional Investors themselves are predominantly government owned or regulated and they operate in a different manner to multinational corporates.

As previously noted, unlike multinational corporates which often operate with branches in multiple countries, Institutional Investors are likely to use specialist external managers or regional offices to manage their investments and exercise their governance rights and obligations. This is often necessitated as a matter of practicality when pooling capital for investment in a large infrastructure asset as part of a consortium, or where time zones or geographical distances make the exercise of these rights and obligations impractical from the home country.

Often the external managers and regional offices are resident in a jurisdiction other than where the Institutional Investor is resident. This is the principal situation where adverse and inequitable taxation outcomes could arise if the present BEPS Action Item 6 rules are not modified.

Work is required to ensure that whatever the final form of Action Plan 6, that it:

- does not dissuade global capital flows arising from Institutional Investors;
- does not change the ability of host jurisdictions to attract global capital; and
- allows Institutional Investors to diversify asset allocation into foreign markets to manage their risk.

The proposed amendments to the LOB and PPT provisions, as currently drafted, may lead to a number of unintended adverse outcomes from a taxation perspective for Institutional Investors which are presently investing through a CIV or manager in a third State (i.e. a State that is neither the investment destination, nor the country of residence for the investor).

The use of a CIV or manager in a third state is one of the most common structuring options used by Institutional Investors for their investments and may have a number of advantages over direct investment:

- Economies of scale through pooling of capital - investment exposure to larger assets;
- Geographical proximity to the underlying asset’s jurisdiction, which may assist in exercising governance rights over the asset;
- Better investment risk management through portfolio diversification; and
- Access to specialist manager expertise.

In most cases, investment through an intermediary is a case of economic and practical necessity such that the investment can be managed in an effective way and governance rights and obligations can be exercised and fulfilled.

Institutional Investors are generally experienced in selecting and administering their investment portfolio, but are unlikely to be directly involved in the day-to-day operation of the assets they
acquire as, in the case of smaller funds, they may lack the necessary expertise to extract the maximum return. Similarly, as funds generally invest in a number of assets (and are an increasingly important source of global investment capital), it is inefficient to maintain large numbers of personnel to manage investments all over the world. In the case of some Institutional Investors, their constituent documents may even prohibit direct investment in non-financial assets. Accordingly, for assets like infrastructure and real estate, minority stakes in CIVs may be the only permissible way to.

To overcome this capability gap, it is common practice for Institutional Investors to appoint a sophisticated manager, who has experience in operating the assets which they have acquired. This has resulted in the rise in popularity of CIV’s situated in the jurisdiction where the fund manager is based as opposed to investment vehicles situated in the State in which the asset is located.

3 Case Studies

Three case studies are provided below which illustrate common investment scenarios for Institutional Investors.

Our case studies have not included investments in portfolio equity and debt. Generally these investments are the largest allocation of all Institutional Investors’ capital investment. These investments are generally held directly from the home market as there is no requirement for any level of governance over portfolio investments.

Case Studies 1 and 2 require a significant level of governance and oversight. Accordingly for the reasons set out below it is not feasible to manage the investments from the home market. It is in these circumstances that it is critical to understand the differences between a corporate investor and Institutional Investors.

If you compare the world’s largest companies16 with the largest pension funds17 and the largest sovereign wealth funds18 a significant number of Institutional Investors would be included within the Top 100 companies by market capitalisation (9 sovereign wealth funds and 26 pension funds). However if we compared total number of employees no sovereign wealth fund or pension fund would be close to the range and number of employees of a major corporate investor.

The major factors leading to this are as follows:

1. Institutional Investors generally own assets such as infrastructure and real estate in consortiums where each investor has governance rights. Those governance rights can be exercised by a manager;

16 www.corporateinformation.com
17 www.towerswatson.com
18 www.sovereignwealthcentre.com
2. Generally individual assets are held in discrete locations rather global operating businesses (see below the Frankfurt Airport example);

3. Where assets are pooled they are generally managed by an external manager and governance rights of the Institutional Investor are exercised by a regional office or another external manager (see French real estate example below);

4. Where assets are pooled by an external manager and there are no governance rights in the hands of Institutional Investors (ie the investors to the PE Fund), the investment into the PE Fund by the Australian or NZ Institutional Investor is made generally directly from Australia or New Zealand (see private equity example below).

**Case Study 1**

There are four global Institutional Investors which comprise a consortium that is seeking to invest in the Frankfurt Airport. These investors are headquartered in Australia, Canada, the UK and Dubai.

To pool their capital, these entities set up an investment vehicle in a jurisdiction with clear rules on CIV’s and which provides recognition of both Civil and Common law jurisdictions (e.g. Luxembourg or Ireland).

The Consortium either appoints an external manager based in the location of the fund or directly employs experts in either Luxembourg or Ireland to manage the investment.

**Case Study 2**

An unlisted wholesale Real Estate Fund is set up to invest in real estate in France by an International Bank. A New Zealand Institutional Investor will hold 15% of the fund and will have certain governance rights regarding the fund. Rather than holding the asset directly from New Zealand it will hold the asset either through a regional office of the Institutional Investor resident in Europe or gives powers of management to an external manager who will act as nominee for the Institutional Investor in the country in which the manager is based. The use of either the regional office or the external manager is to allow the Institutional Investor to manage its governance rights in an efficient manner taking into account geography and time zones. Depending on the type of Institutional Investor or the purpose of the investment the asset may be held in a single asset holding structure or as part of a wider holding vehicle.

Due to the geographical and time zones differences between New Zealand and France, it is difficult for the Institutional Investor to exercise governance rights directly from New Zealand.

**Case Study 3**

A global private equity manager sets up a fund in Ireland or Luxembourg. Contracts relating to the fund impose restrictions such that the only way an Australian or NZ Institutional Investor can invest is through the intermediate fund entity and has no way of investing in the underlying assets directly. Typically this type of fund is unlisted and attracts investors from all over the world.
3.1 **Comments in relation to the case studies**

Case Study 1 is a common fact pattern. A group of Institutional Investors will bid for a large infrastructure asset either as a Greenfield (ie construction of a new asset) or Brownfield (ie a secondary market transaction) project. The joint venture vehicle is required to be in a jurisdiction in which each of the following characteristics can be satisfied:

1. It is resident in jurisdiction that allows both civil and common law investors to participate without prejudice.
2. It is resident where the majority of Institutional Investors have employees or external managers who will be responsible for exercising the governance rights attached to the ownership interests and
3. Most importantly it is located in a jurisdiction which has clear and regulated collective investment rules.

Consistent with the Approach in Article 10(3)(a) if the German asset is held say in an Irish fund vehicle and is managed and controlled in Ireland by an Irish fund manager for each of the investors or alternatively the asset was managed by regional offices for each of the Institutional Investors based in Ireland it is our view that the appropriate treaty to consider is the Irish/German treaty. This is because Ireland is where the active business decisions of managing the asset are made from.

In respect of Case Study 2, an International Bank has set up a Real Estate Fund in France and will seek say 5-6 investors. Due to the nature of the Real Estate Fund each investor will have governance rights over a number of issues.

The New Zealand investor has decided that due to the geographical and time zone differences it is difficult to manage the investment from New Zealand and has decided to allow an external manager to control its governance rights. The investment is undertaken through an entity in a third State, which is generally where the external manager is resident. Alternatively if a Regional Office of the Institutional Investor had the expertise and was in the appropriate time zone the investment entity would be created in the jurisdiction where the regional office is resident.

The Institutional Investor is using either the external manager or its Regional Office to provide greater proximity between the asset and the co-investors and thus serves to maximise returns for investors while assisting the investors in managing their governance obligations through reducing the ‘lag’ time for operational decisions to be made.

Accordingly it is our view that the business of the New Zealand investor is actively carried on where the manager or the Regional office is based.
Case Study 3 is an example of where funds invest with an established manager and is an example of a private equity type investment model. The Institutional Investor in this case has limited governance rights and is likely entirely passive.

At a technical level, for Case Studies 1 and 2, the physical asset is situated in one country, the investor is in a second country, and the investment is made through a third country. Because of their geographical spread of investments and the fact that Institutional Investors have governance rights the use of a third country is to allow geographically distant assets to effectively and efficiently be managed by allowing each investor to exercise its governance rights and satisfy its governance obligations on a timely and efficient basis.

If the differences between the business of a corporate and an Institutional Investor were taken into account we consider that the governance rights constitute an active trade or business as set out in Article 10(3)(a).

Case Study 3 is structured in a similar way, but necessitates investment through an intermediate entity and requires that the investors ultimately surrender full control of administration of investment to the manager which has established the fund.

We would submit that the PE Fund is resident in the country in which the manager is based. Due to the absence of governance rights the investment by the Institutional Investor to the PE Fund would be made direct from the home country. Therefore if the PE Fund Manager manages the Fund from Ireland it would be our view that the Manager should be treated as having an active business of fund management based in Ireland. Therefore the CIV should be entitled to the Irish treaty network.

Whilst the CIV Report at paragraphs 52-59 expresses concern about treaty shopping we consider that the modified sub paragraph (3)(a) of proposed Article 10 can adequately deal with concerns on treaty shopping. The CIV Report continually refers to concerns about investors participating into a CIV for the purpose of obtaining a particular treaty outcome better than they could have if they invested directly. If we examine a PE Fund, the Manager has an active role in managing and dealing with assets. The active role of a Manager can be seen in the fact that Institutional Investors select private equity firms on the basis of the personnel within a region and indeed frequently negotiate protective rights to either terminate the fund or have the fund cease making new investments in the event of “key person” exits from the Manager. Accordingly if an Institutional Investor was prepared to be as active a Manager as a Fund Manager that Investor would also get the benefits of Article 10 (3)(a).

It is important to acknowledge that due to the scale and size of Institutional Investors, there are a number of Australian funds with personnel in the UK, Ireland and Luxembourg as these are destinations that have been popular for pooling capital prior to investment. These intermediary destinations are also host to a number of managers which are engaged to manage the investments made by funds and other Institutional Investors and which provide significant expertise in the management of specific types of assets (e.g. real estate, infrastructure, etc). The
use of managers is considered to be a key driver of efficiency for funds as, due to the significant number of investments undertaken and the number of assets under management, it is not practical for a fund to open an office in each investment destination. Greater commercial efficiency can also be obtained through centralisation and contracting to professional asset managers who have experience running the assets in which the fund is investing.

Accordingly, as many Institutional Investors have existing operations in the UK, Ireland and Luxembourg, it is likely the investment entry point will occur through such a jurisdiction, or alternatively through a jurisdiction where there is sufficient and available expertise that can be engaged to manage the asset (i.e. an asset manager).

4  
**Tax treaties**

As Institutional Investors have mandates to invest prudently such that they can meet future obligations, their investment decisions take into account any tax burden. As these classes of investors are likely exempt from tax in their home jurisdiction, they are highly sensitive to the taxation of investment returns on international investments and rely on tax treaties to help limit the impact on investment yields.

Unfortunately, many tax treaties were written before the advent of Institutional Investors and do not provide efficient outcomes where Institutional Investors invest through CIV’s. This can result in anomalous and oftentimes inappropriate taxation outcomes for investors, which mean that investors in the same CIV can face very different tax outcomes.

4.1  
**LOB provision**

As presently drafted, the LOB provision in proposed Article X would not extend treaty protection to any of the funds involved in the three common investment scenarios contemplated in the case studies above. This is due to the current definition of “qualified person” in Paragraph 2, and in particular subparagraph 2(d) of the proposed Article not extending to funds investing through intermediate entities. Further as mentioned in the Discussion Draft the concept of what constitutes an active business will vary between Institutional Investors and Corporate Investors.

This results in an anomalous outcome whereby Institutional Investors investing directly into another member State can access treaty benefits, but those which choose to use an intermediate entity, whether for the purpose of pooling funds or to facilitate the use of an experienced investment manager that is engaged directly to manage the assets being acquired, cannot.

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19 Published in Para 10 of the OECD BEPS Action 2014 Deliverable: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
Accordingly, the introduction of a rule such as the proposed LOB article, as currently drafted, would represent an artificial cost of doing business, penalising funds for not investing directly or through listed widely held entities (where they can obtain treaty relief) and resulting in a situation where a pension fund or a sovereign wealth fund obtains two different tax outcomes depending on whether it invests through a listed widely held entity or undertakes a strategy involving an unlisted intermediate vehicle. This would arguably result in disadvantage to the national economies of states that do not provide flow through treatment for intermediate holding vehicles as it would result in funds shifting capital to more favourable investment destinations.

Additionally, we note that where Institutional Investors from different jurisdictions invest through a single pooling entity, the logical outcome should be that they are taxed in a uniform manner. The presently draft of the Article could potentially result in outcomes whereby two Institutional Investors investing in the same asset, through the same CIV could be taxed differently.

It is submitted that the most efficient way in which the objectives of OECD BEPS can be achieved without distorting the taxation outcomes for Institutional Investors is to extend treaty benefits to the investment vehicle or manager in the intermediate jurisdiction provided the Institutional Investor has either a regional office or uses an external manager resident in the intermediate jurisdiction. That is, the relevant treaty would be the one between the intermediate jurisdiction and the investment destination and not the investment destination and the jurisdiction in which the Institutional Investor is resident. In our view this is consistent with Article 10(3)(a).

We note that a ‘derivative benefits’ test has been proposed, in Article 10(4) as a means of providing relief to entities investing through CIV’s. It is submitted that the use of a derivative benefits type test would be very complicated, especially in a scenario where four or five investors in a pooled vehicle would then invest in an asset.

This scenario would require tracing through each individual investor in the pooled vehicle to ascertain whether treaty relief could be obtained for each individual investor having regard to the character of each party’s investment. This would be both cumbersome and onerous from a compliance perspective and could result in anomalies where there are variances in the drafting and interpretation of the derivative benefits articles being relied on under each respective treaty.

In a case where the application of the derivative benefits test is not uniform, this may serve to discourage investment through CIV’s as it would make pooling capital more difficult and introduce uncertainty as to tax outcome for individual investors.

Provided that all entities investing in the CIV are Institutional Investors, they should generally be exempt from tax in their home jurisdiction. Accordingly, it is submitted that there is no real mischief to be averted that would make the derivative benefits provision appropriate as any asymmetrical outcome between individual investors in a CIV would be anomalous.
Conclusion

As set out in this submission Institutional Investors play an important role in the social welfare fabric of their home country. Institutional Investors are also the major investor class to refinance and construct much of the world’s infrastructure\(^{20}\). The CIV Report focusses mainly on portfolio equity and debt investment by regulated CIVs. A significant proportion of infrastructure and real estate investments made by Institutional Investors is in unregulated funds where the investors have material governance rights.

Without significant changes to Action Plan 6 there will be market distortions in the area of infrastructure and real estate investment. This distortion will arise if an “equivalent beneficiary” approach is adopted by the OECD. As has been set out earlier both real estate and infrastructure have relatively low yields when compared to corporate rates of return. This is the very reason why corporates do not hold infrastructure and do not want real estate on their balance sheets.

When forming consortiums it is critical for investors to value the assets on the same basis. If the test was based on where the asset is managed from then all investors would be treated equally. If the test is a tracing test then some investors will be excluded from some markets due to their home country treaty. This outcome is to no nation’s advantage.

Please refer to Appendix A for suggested amendments to the OECD Model Tax Convention and Commentary.

Thankyou for the opportunity to provide comments on the Discussion Draft. If you have any questions in relation to our comments in this letter, please feel free to contact us.

Yours sincerely

Steven Economides
Partner

Minh Dao
Director

Appendix A - Entitlement to benefits

Legend to Amendments

1. Article 10 as drafted by the OECD is set out in Dark Blue
2. The commentary as drafted by the OECD is set out in Black
3. Proposed changes and comments are set out in Red
4. Where words have been struck out of the Article or Commentary double strike out is used.
5. Where no change is made the words “No change proposed.” are made.
6. Where a provision is irrelevant to Institutional Investors the comment “Not quoted as not relevant” is made.
7. Where we have added a new paragraph to the commentary we have used in a letter in the paragraph number as to not disturb the existing numbering system.

Article X together with the Commentary

Paragraph 1

1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a “qualified person”, as defined in paragraph 2, at the time that the benefit would be accorded.

4. No change proposed.

5. No change proposed.

6. No change proposed.

Paragraph 2

2. A resident of a Contracting State shall be a qualified person at a time when a benefit would otherwise be accorded by the Convention if, at that time, the resident is:

7. No change proposed.

8. No change proposed.

Individuals – subparagraph 2 a)

a) an individual;

9. Not quoted as not relevant

Governments – subparagraph 2 b)
b) a Contracting State, or a political subdivision or local authority thereof, or a person that is wholly-owned by such State, political subdivision or local authority. Wholly owned shall be deemed to include bodies created under statute without share capital or membership interests provided all of the income and capital inures only to the benefit of the Contracting State or political subdivision thereof;

10. No change proposed.

Publicly-traded companies and entities – subparagraph 2 c)

11-20. Not quoted as not relevant

Charitable organisations and pension funds – subparagraph 2 d)

d) a person, other than an individual, that
i) is a [list of the relevant non-profit organisations found in each Contracting State],
ii) was constituted and is operated exclusively to administer or provide pension or other similar benefits, or is an investment entity owned by an entity or entities defined in subparagraph 2(b) provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State, or
iii) was constituted and is operated to invest funds for the benefit of persons referred to in subdivision ii), provided that substantially all the income of that person is derived from investments made for the benefit of these persons

Note

By eliminating the 50% requirement for pension benefits to be provided to residents of a particular jurisdiction very minor drafting changes are required. We have also added to SWFs to subparagraph (ii). If this change is accepted the majority of the other drafting changes will not be required.

21. No change proposed.

22. No change proposed.

Note

On the basis that charities automatically qualify for treaty benefits it is equally relevant to qualify pension funds and SWFs. The majority of pension funds are created for the benefit of employees and public servants\(^{21}\) whilst SWFs are committed to maintain living standards for their civil population, and each is typically tax exempt in its home country on public policy grounds. Therefore why is there a distinction made?

\(^{21}\) www.sovereignwealthcentre.com
23. Under subdivision ii), a resident pension fund will qualify for treaty benefits if more than 50 per cent of the beneficial interests in that person are owned by individuals resident of either Contracting State. For purposes of this provision, the term “beneficial interests in that person” should be understood to refer to the interests held by persons entitled to receive pension benefits from the fund. Some States, however, may wish to relax the 50 per cent beneficial interest requirement in subdivision ii) (e.g., where a State is part of a regional grouping of States, such as the European Union, which permits pension funds to be constituted in any State which is a member of that regional grouping).

23A An investment entity must be distinguished from a trading entity. A trading entity will carry on an active business and other than its shareholding cannot be distinguished from a privately owned entity. Examples of trading entity are government owned electricity companies, telecommunication companies and broadcasters. An investment entity invests across separate asset classes and is used for the purposes of meeting Government liabilities (e.g., pension liabilities) or is used for the purposes of intergenerational funds transfer.

24. No change proposed.

Ownership / Base Erosion – subparagraph 2 e)

e) a person other than an individual or an entity covered by 2(d), if
   i) on at least half the days of the taxable period, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), b) or d), or subdivision i) of subparagraph c), of this paragraph own, directly or indirectly, shares representing at least 50 per cent of the aggregate voting power and value (and at least 50 per cent of any disproportionate class of shares) of the person, [provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State], and
   ii) less than 50 per cent of the person’s gross income for the taxable period, as determined in the person’s Contracting State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b) or d), or subdivision i) of subparagraph c), of this paragraph in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person’s Contracting State of residence (but not including arm’s length payments in the ordinary course of business for services or tangible property);

Note

Neither a charity, pension fund nor Government investor will qualify under this test given their unique investment criteria and size therefore we have amended the sub paragraph.

25. No change proposed.

26. No change proposed.

27. No change proposed.

28. No change proposed.

29. No change proposed.
30. No change proposed.

**Collective investment vehicles – subparagraph 2 f)**

f) [possible provision on collective investment vehicles]1 [Footnote 1] This subparagraph should be drafted (or omitted) based on how collective investment vehicles are treated in the Convention and are used and treated in each Contracting State: see the Commentary on the subparagraph and paragraphs 6.4 to 6.38 of the Commentary on Article 1.

**Note**

Provided the definition of active business is amended to include a fund business the issue is largely academic. Nevertheless we should point out that the significant majority of CIVs are not publicly listed. The test should be where the fund is actually administered and managed.

31. As indicated in the footnote to subparagraph f), whether a specific rule concerning collective investment vehicles (CIVs) should be included in paragraph 2, and, if so, how that rule should be drafted, will depend on how the Convention applies to CIVs and on the treatment and use of CIVs in each Contracting State. Such a specific rule will frequently be needed since a CIV may not be a qualified person under either the other provisions of paragraph 2 or 3, because, in many cases

- the interests in the CIV are not publicly-traded (even though these interests are widely distributed);
- these interests are held by residents of third States; and
- the distributions made by the CIV are deductible payments, and
- the CIV is used for investment purposes rather than for the “active conduct of a business” within the meaning of paragraph 3.

**Note**

The CIV Report covers only portfolio asset funds. An infrastructure or real estate fund is actively managed as reinvestment decisions need to be made on a regular basis. The entire commentary flows from an analysis of the CIV Report. As we have submitted the report ignores the operations of infrastructure and real estate unregulated wholesale funds. The underlying management of the assets which are set out in our submission should constitute an active business. Accordingly we are not comfortable with any of the drafting as it proceeds on an assumption that investors have no governance obligations. Whilst this may be the case for the very large funds on the wholesale funds each investor generally has governance obligations. Whilst we have not struck out paragraphs 32-43 we do not think those paragraphs apply to all CIVs.

32. Paragraphs 6.8 to 6.34 of the Commentary on Article 1 discuss various factors that should be considered for the purpose of determining the treaty entitlement of CIVs and these paragraphs are therefore relevant when determining whether a provision on CIVs should be included in paragraph 2 and how it should be drafted. These paragraphs include alternative provisions that may be used to deal adequately with the CIVs that are found in each Contracting State. As explained below, the use of these provisions may make it unnecessary to include a specific rule on CIVs in paragraph 2, although it will be important to make sure that, in such a case, the definition of “equivalent beneficiary”, if the term is used for the purposes of one of these alternative provisions, is adapted to reflect the definition included in paragraph 6.
Note
Please refer to the Note to paragraph 31

33. If it is included, subparagraph f) will address cases where a Contracting State agrees that CIVs established in the other Contracting State constitute residents of that other State under the analysis in paragraphs 6.9 to 6.12 of the Commentary on Article 1 (such agreement may be evidenced by a mutual agreement as envisaged in paragraph 6.16 of the Commentary on Article 1 or may result from judicial or administrative pronouncements). The provisions of the Article, including subparagraph f), are not relevant with respect to a CIV that does not qualify as a resident of a Contracting State under the analysis in paragraphs 6.9 to 6.12 of the Commentary on Article 1. Also, the provisions of subparagraph f) are not relevant where the treaty entitlement of a CIV is dealt with under a treaty provision similar to one of the alternative provisions in paragraphs 6.17, 6.21, 6.26, 6.27 and 6.32 of the Commentary on Article 1.

Note
Please refer to the Note to paragraph 31

34. As explained in paragraphs 6.19 and 6.20 of the Commentary on Article 1, Contracting States wishing to address the issue of CIVs’ entitlement to treaty benefits may want to consider the economic characteristics, including the potential for treaty shopping, of the different types of CIVs that are used in each Contracting State.

Note
Please refer to the Note to paragraph 31

35. As a result of that analysis, they may conclude that the tax treatment of CIVs established in the two States does not give rise to treaty-shopping concerns and decide to include in their bilateral treaty the alternative provision in paragraph 6.17 of the Commentary on Article 1, which would expressly provide for the treaty entitlement of CIVs established in each State and, at the same time, would ensure that they constitute qualified persons under subparagraph a) of paragraph 2 of the Article (because a CIV to which that alternative provision would apply would be treated as an individual). In such a case, subparagraph f) should be omitted. States that share the view that CIVs established in the two States do not give rise to treaty shopping concerns but that do not include in their treaty the alternative provision in paragraph 6.17 of the Commentary on Article 1 should ensure that any CIV that is a resident of a Contracting State should constitute a qualified person. In that case, subparagraph f) should be drafted as follows: f) a CIV [a definition of CIV would be included in subparagraph f) of paragraph 6];

Note
Please refer to the Note to paragraph 31

36. The Contracting States could, however, conclude that CIVs present the opportunity for residents of third States to receive treaty benefits that would not have been available if these residents had invested directly and, for that reason, might prefer to draft subparagraph f) in a way that will ensure that a CIV that is a resident of a Contracting State will constitute a qualified person but only to the extent that the beneficial interests in the CIV are owned by equivalent beneficiaries. In that case, subparagraph f) should
be drafted as follows: f) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the CIV are owned by residents of the Contracting State in which the collective investment vehicle is established or by equivalent beneficiaries.

**Note**

Please refer to the Note to paragraph 31

37. That treatment corresponds to the treatment that would result from the inclusion in a tax treaty of a provision similar to the alternative provision in paragraph 6.21 of the Commentary on Article 1. As explained in paragraphs 6.18 to 6.24 of the Commentary on Article 1, the inclusion of such an alternative provision would provide a more comprehensive solution to treaty issues arising in connection with CIVs because it would address treaty-shopping concerns whilst, at the same time, clarifying the tax treaty treatment of CIVs in both Contracting States. If that alternative provision is included in a tax treaty, subparagraph f) would not be necessary as regards the CIVs to which that alternative provision would apply: since that alternative provision provides that a CIV to which it applies shall be treated as an individual (to the extent that the beneficial interests in that CIV are owned by equivalent beneficiaries), that CIV will constitute a qualified person under subparagraph a) of paragraph 2 of the Article.

**Note**

Please refer to the Note to paragraph 31

38. The approach described in the preceding two paragraphs, like the approach in paragraphs 6.21, 6.26 and 6.28 of the Commentary on Article 1, makes it necessary for the CIV to make a determination, when a benefit is claimed as regards a specific item of income, regarding the proportion of holders of interests who would have been entitled to benefits had they invested directly. As indicated in paragraph 6.29 of the Commentary on Article 1, however, the ownership of interests in CIVs changes regularly, and such interests frequently are held through intermediaries. For that reason, the CIV and its managers often do not themselves know the names and treaty status of the beneficial owners of interests. It would therefore be impractical for the CIV to collect such information from the relevant intermediaries each time the CIV receives income. Accordingly, Contracting States should be willing to accept practical and reliable approaches that do not require such daily tracing. As indicated in paragraph 6.31 of the Commentary on Article 1, the proportion of investors in the CIV is likely to change relatively slowly even though the identity of individual investors will change daily. For that reason, the determination of the extent to which the beneficial interests in a CIV are owned by equivalent beneficiaries should be made at regular intervals, the determination made at a given time being applicable to payments received until the following determination. This corresponds to the approach described in paragraph 6.31 of the Commentary on Article 1, according to which:

… it would be a reasonable approach to require the CIV to collect from other intermediaries, on specified dates, information enabling the CIV to determine the proportion of investors that are treaty-entitled. This information could be required at the end of a calendar or fiscal year or, if market conditions suggest that turnover in ownership is high, it could be required more frequently, although no more often than the end of each calendar quarter. The CIV could then make a claim on the basis of an average of those amounts over an agreed-upon time period. In adopting such procedures, care would have to be taken in choosing the measurement dates to ensure that the CIV would have enough time to update the information that it provides to other payers so that the correct amount is withheld at the beginning of each relevant period.
Note

Please refer to the Note to paragraph 31

39. Another view that Contracting States may adopt regarding CIVs is that expressed in paragraph 6.26 of the Commentary on Article 1. Contracting States that adopt that view may wish to draft subparagraph f) so that a CIV that is a resident of a Contracting State would only constitute a qualified person to the extent that the beneficial interests in that CIV are owned by residents of the Contracting State in which the CIV is established. In that case, subparagraph f) should be drafted as follows:

f) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established. Since the inclusion of the alternative provision in paragraph 6.26 of the Commentary on Article 1 would achieve the same result with respect to the CIVs to which it would apply, subparagraph f) would not be necessary, if that alternative provision is included in a treaty, as regards the CIVs to which that provision would apply.

Note

Please refer to the Note to paragraph 31

40. A variation on the preceding approach would be to consider that a CIV that is a resident of a Contracting State should constitute a qualified person if the majority of the beneficial interests in that CIV are owned by individuals who are residents of the Contracting State in which the CIV is established. This result could be achieved by omitting subparagraph f) and simply relying on the application of subparagraph 2) e) (the so-called ownership and base erosion test).

Note

Please refer to the Note to paragraph 31

41. Another possible view that the Contracting States could adopt would be to conclude that the fact that a substantial proportion of the CIV’s investors are treaty-eligible is adequate protection against treaty shopping, and thus that it is appropriate to provide an ownership threshold above which benefits would be provided with respect to all income received by a CIV. An alternative provision that would ensure that result is included in paragraph 6.27 of the Commentary on Article 1 and subparagraph f) would not be necessary, if the Contracting States include that provision in their bilateral treaty, with respect to the CIVs to which the provision would apply. If that provision is not included in the treaty, the scope of subparagraph f) could be broadened in order to achieve a similar result by referring to “a collective investment vehicle, but only if [ ] per cent of the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established and equivalent beneficiaries”.

Note

Please refer to the Note to paragraph 31

42. Similarly, the Contracting States may use the alternative provision in paragraph 6.32 of the Commentary on Article 1 where they consider “that a publicly-traded collective investment vehicle cannot be used effectively for treaty shopping because the shareholders or unit holders of such a collective investment vehicle cannot individually exercise control over it”. In such case, subparagraph f)
would not be necessary with respect to the CIVs to which the alternative provision would apply. States that share that view but that have not included the alternative provision in their treaty could draft subparagraph f) to read: f) a collective investment vehicle if the principal class of shares in the collective investment vehicle is listed and regularly traded on a recognised stock exchange.

Note

Please refer to the Note to paragraph 31

43. Finally, as explained in paragraph 6.25 of the Commentary on Article 1, States that share the concern described in that paragraph about the potential deferral of taxation that could arise with respect to a CIV that is subject to no or low taxation and that may accumulate its income rather than distributing it on a current basis may wish to negotiate provisions that extend benefits only to those CIVs that are required to distribute earnings currently. Depending on their drafting, such provisions may render subparagraph f) unnecessary.

Note

Please refer to the Note to paragraph 31

**Paragraph 3 – Active conduct of a business 3.**

a) A resident of a Contracting State will be entitled to benefits of this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in the first-mentioned Contracting State (other than the business of making or managing investments for the resident’s own account, unless these activities are banking, insurance or securities activities carried on by a bank or [list financial institutions similar to banks that the Contracting States agree to treat as such] or these activities are investment activities carried on by an entity covered by clause 2(d) or a collection of investors comprising exclusively entities covered by clause 2(b) or, insurance enterprise or registered securities dealer respectively), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that business.

b) If a resident of a Contracting State derives an item of income from a business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from an associated enterprise, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item only if the business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the business activity carried on by the resident or associated enterprise in the other Contracting State. Whether a business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances.

c) For purposes of applying this paragraph, activities conducted by persons connected to a person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) or another person possesses at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate voting power and value of the company’s shares or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be
connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

44. No change proposed.

45. A resident of a Contracting State may qualify for benefits under paragraph 3 whether or not it also qualifies under paragraph 2. Under the active-conduct test of paragraph 3, a person (typically a company) will be eligible for treaty benefits if it satisfies two conditions: (1) it is engaged in the active conduct of a business in its State of residence; and (2) the payment for which benefits are sought is related to the business. In certain cases, an additional requirement that the business be substantial in size relative to the activity in the source State generating the income must be met.

Note

As set out in our submission a consortium of Institutional Investors managing real estate assets or infrastructure assets have governance obligations along the lines of a partner rather than a shareholder. The comment dealing with companies is unduly prejudicial. As already set out many Institutional Investors’ assets under management exceed the market capitalisation of any of the world’s banks.

46. No change proposed.

47. The term “business” is not defined and, under the general rule of paragraph 2 of Article 3, must therefore be given the meaning that it has under domestic law. An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting (such as officers or employees of a company or an investment manager in the case of a pension fund or SWF) conduct substantial managerial and operational activities.

48. The business of making or managing investments for the resident’s own account will be considered to be a business only when the relevant activities are part of banking, insurance or securities activities conducted by a bank or financial institution that the Contracting States would consider to be similar to a bank (such as a credit union or building society), an insurance enterprise or a registered securities dealer respectively or investment activities carried on by an entity covered by clause 2(d) or a collection of investors comprising exclusively of entities covered by clause 2(d). Such activities conducted by a person other than a an entity covered by clause 2(d) or a collection of investors comprising exclusively of entities covered by clause 2(b), bank (or financial institution agreed to by the Contracting States), insurance enterprise or registered securities dealer will not be considered to be the active conduct of a business, nor would they be considered to be the active conduct of a business if conducted by a bank (or financial institution agreed to by the Contracting States), insurance enterprise or registered securities dealer but not as part of the enterprise’s banking, insurance or dealer business. Since a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in the active conduct of a business for purposes of paragraph 3.

Note

There is a significant difference in the way a company manages its subsidiaries and the way Institutional Investors manage their assets. In the case of infrastructure and real estate there is no difference between the ways Institutional Investors carry out their activities and the way banks do.
49. No change proposed.

50. A business activity generally will be considered to form part of a business activity conducted in the State of source if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The line of business in the State of residence may be upstream, downstream, or parallel to the activity conducted in the State of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the State of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the business carried on in the State of source. The following examples illustrate these principles:

Example 1: ACO is a company resident of State A and is engaged in an active manufacturing business in that State. ACO owns 100 per cent of the shares of BCO, a company resident of State B. BCO distributes ACO’s products in State B. Since the business activities conducted by the two companies involve the same products, BCO’s distribution business is considered to form a part of ACO’s manufacturing business.

Example 2: The facts are the same as in Example 1, except that ACO does not manufacture products. Rather, ACO operates a large research and development facility in State A that licenses intellectual property to affiliates worldwide, including BCO. BCO and other affiliates then manufacture and market the ACO designed products in their respective markets. Since the activities conducted by ACO and BCO involve the same product lines, these activities are considered to form a part of the same business.

Example 3: An unlisted wholesale Real Estate Fund is set up to invest in real estate in France by an International Bank. All of its investors are either widely held pension funds or sovereign wealth funds. Each investor will have certain governance rights regarding the fund. A pension fund rather than holding the asset from outside of Europe will hold the interest in the Real Estate Fund either through a regional office of the pension fund in Europe or gives powers of management to an external manager who will act as a nominee for the Institutional Investor in the country in which the manager is based. The use of either the regional office or the external manager is to allow the pension fund to manage its governance rights in an efficient manner taking into account geography and time zones.

On the assumption that the governance rights are material to the operation of the asset the activities of either the regional office or the manager will constitute an active business for the pension fund.

51. No change proposed.

Example 4. CCO is a company resident of State C that operates an international airline. DCO is a wholly-owned subsidiary of CCO resident of State D. DCO operates a chain of hotels in State D that are located near airports served by flights operated by CCO. CCO frequently sells tour packages that include air travel to State D and lodging at DCO’s hotels. Although both companies are engaged in the active conduct of a business, the businesses of operating a chain of hotels and operating an airline are distinct businesses. Therefore DCO’s business does not form a part of CCO’s business. DCO’s business, however, is considered to be complementary to CCO’s business because these two businesses are part of the same overall industry (travel) and the links between these activities tend to make them interdependent.
Example 5. The facts are the same as in Example 3, except that DCO owns an office building in the other Contracting State instead of a hotel chain. No part of CCO’s business is conducted through the office building. DCO’s business is not considered to form a part of or to be complementary to CCO’s business. They are engaged in distinct businesses in separate industries, and there is no economic dependence between the two operations.

Example 6. ECO is a company resident of State E. ECO produces and sells flowers in State E and other countries. ECO owns all the shares of FCO, a company resident of State F. FCO is a holding company that is not engaged in a business. FCO owns all the shares of three companies that are resident of State F: GCO, HCO and ICO. GCO distributes ECO’s flowers under the ECO trademark in State F. HCO markets a line of lawn care products in State F under the ECO trademark. In addition to being sold under the same trademark, GCO’s and HCO’s products are sold in the same stores and sales of each company’s products tend to generate increased sales of the other’s products. ICO imports fish from State E and distributes it to fish wholesalers in State F. For purposes of paragraph 3, the business of GCO forms a part of the business of ECO, the business of HCO is complementary to the business of ECO, and the business of ICO is neither part of nor complementary to that of ECO.

Example 7. JCO is a company resident of State J. JCO produces and sells baby food in State J and other countries. JCO acquires all the shares of KCO, a company resident of State K that produces and distributes jam and similar food products. JCO and KCO are both involved in the food industry, the products resulting from the businesses activities carried on by these companies are sold in the same stores and sales of each company’s products would be affected by any incident related to the quality of any of their products. For purposes of paragraph 3, the business of KCO is complementary to the business of JCO.

Example 8. In the case of widely pension funds and sovereign wealth funds due to their size and range of investments sub paragraph (3)(b) is difficult to apply. If a pension fund resident in State E is using a regional office in State K to manage investments throughout an applicable region the fact the income of the regional office may be significantly less than the investment in State L (the investee market) should not prevent State L giving the pension fund the benefits of the DTA between State K and State L. Further if a pension fund or sovereign wealth fund resident in State E uses an external manager in State K to manage a holding vehicle established in State K to hold an investment in State L treaty benefits should not be denied. Pension funds and sovereign wealth funds manage their assets like banks and need to create holding entities which can exercise governance rights on a timely basis.

52. No change proposed.

53. No change proposed.

54. The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the businesses in each Contracting State, the nature of the activities performed in each Contracting State, and the relative contributions made to that business in each Contracting State. In any case, in making each determination or comparison, due regard will be given to the relative sizes of the economies and the markets in the two Contracting States.
Example 9. LCO is a pharmaceutical company resident of State L. LCO is engaged in an active manufacturing business in State L and also conducts research and development in State L. All the shares of LCO are owned by OCO, a company resident of State O. LCO has developed different anti-malaria drugs which are produced, under LCO’s patents and trademarks, by MCO, a subsidiary of LCO which is a resident of State M. LCO sells these drugs, along with the other drugs that it manufactures, in State L and other States where malaria is almost non-existent. MCO pays a royalty to LCO for the use of the IP. Taking into account the nature of the business activities performed in State L and State M and the relative contribution made to the trade or business in each state, the royalty payment is entitled to treaty benefits. Due regard is also given to the relative small size of the market of anti-malaria drugs in State L (where the drugs are primarily sold to people who travel to parts of the world where malaria is widespread) compared to the market for such products in State M. Given the nature of the market for the drug in each country as well as all the other facts and circumstances, the business activity carried on by LCO in State L may be considered substantial in relation to the business activity carried on by MCO in State M.

Example 10: PCO, a company resident of State P, a developing country, has developed a line of luxury cosmetics that incorporate ingredients from plants that are primarily found in State P. PCO is the owner of patents, trade names and trademarks for these cosmetics. PCO’s shares are held in equal proportion by three shareholders: a company that is a resident of State P, another company that is a resident of State Q and a third company that is a resident of State R. PCO harvests and conditions the plants in State P. The plants are then shipped to State S (a large affluent country where there is an important demand for luxury cosmetics) where they are transformed into cosmetics by SCO, a subsidiary of PCO that is a resident of State S. The cosmetics are distributed in State S by another subsidiary, TCO, which is also a resident of State S, under trade names and trademarks licensed to TCO by PCO. The cosmetics are labelled “made in State S”. Due to the relatively small size of the economy of State P compared to the size of the economy of State S, the business activity carried on by PCO in State P is substantial in relation to the business activity carried on by SCO and TCO in State S.

Example 11: A is a sovereign wealth fund resident in State S. State Y is on the other side of the world and has decided to privatise certain infrastructure assets. A has no regional office or asset manager based in State Y however ownership of infrastructure assets is subject to a number of government regulatory rules and A has governance rights over the assets dealing with maintenance, pricing and expansion of the facility. State X is where A manages all of its investments in State Y’s part of the world. Therefore the investment in State Y will be made through State X. In examining the income of both States it is important to understand that the entity in State X will only have modest income as the capital for the investment will come from State A. Nevertheless provided that State X is where assets are managed from for that geographical region it is appropriate for State Y to grant the benefits of the DTA with State X to the investment entity resident in State X.

55. No change proposed.

56. No change proposed.

57. No change proposed.
**Paragraph 4 – Derivative benefits**

**[4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if, at the time when that benefit would be accorded:**

a) at least 95 per cent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary, and

b) less than 50 per cent of the company’s gross income, as determined in the company’s State of residence, for the taxable period that includes that time, is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm’s length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the company’s State of residence.]

58-61. *Not quoted as not relevant*

**Paragraph 5 – Discretionary relief**

5. If a resident of a Contracting State is not entitled, under the preceding provisions of this Article, to all benefits provided under this Convention, the competent authority of the Contracting State that would otherwise have granted benefits to which that resident is not entitled shall nevertheless treat that resident as being entitled to these benefits, or benefits with respect to a specific item of income or capital, if such competent authority, upon request from that resident and after consideration of the relevant facts and circumstances, determines that the establishment, acquisition or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the Contracting State to which the request has been made will consult with the competent authority of the other State before rejecting a request made under this paragraph by a resident of that other State.

62. No change proposed.

64. No change proposed.

65. No change proposed.

66. No change proposed.

67. No change proposed.

68. No change proposed.

**Paragraph 6 – Definitions 6.**

For purposes of the preceding provisions of this Article:
69. No change proposed.

The terms “recognised stock exchange”, “principal class of shares”, “disproportionate class of shares” and “primary place of management and control” – Not quoted as not relevant

70-76. Not quoted as not relevant

The term “collective investment vehicle” Not quoted as not relevant

77. No change proposed.

78. No change proposed.

The term “equivalent beneficiary” – subparagraph f)1 [f) the term “equivalent beneficiary” means a resident of any other State, but only if that resident i) A) would be entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed under provisions analogous to subparagraph a), b) or d), or subdivision i) of subparagraph c), of paragraph 2 of this Article, provided that if such convention does not contain a comprehensive limitation on benefits article, the person would be entitled to the benefits of this Convention by reason of subparagraph a), b), subdivision i) of subparagraph c), or subparagraph d) of paragraph 2 of this Article if such person were a resident of one of the Contracting States under Article 4 of this Convention; and B) with respect to income referred to in Articles 10, 11 and 12 of this Convention, would be entitled under such convention to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention; or ii) is a resident of a Contracting State that is entitled to the benefits of this Convention by reason of subparagraph a), b) or d), or subdivision i) of subparagraph c), of paragraph 2 of this Article.] [Footnote 1: The inclusion of a definition of “equivalent beneficiary” will depend on whether paragraph 4 is included and whether that phrase is used in subparagraph f) of paragraph 2 dealing with collective investment vehicles.]

79. The definition of “equivalent beneficiary” is relevant for the purposes of the derivative benefits test in paragraph 4 but may also be relevant for the purposes of subparagraph f) of paragraph 2 depending on how that rule is drafted.

Note

This is highly complex and in our view will involve a distortion to collective investment. In example 3 we had a consortium of global Institutional Investors. If each of the investors had to fall within the definition of equivalent beneficiary then an investor who fell outside of that definition would be unable to bid for infrastructure assets or real estate assets on the same basis as other investors. Provided that the investment is actually managed from the relevant state it is difficult to understand why there would be concern on treaty shopping.

80. Under the definition, a person may qualify as an “equivalent beneficiary” in three alternative ways.

81. No change proposed.

82. No change proposed.
82A. The third alternative would be relevant to pension funds and sovereign wealth funds. Provided that the investment vehicle is managed from the jurisdiction claiming the treaty benefits all pension fund and SWFs would qualify as “equivalent beneficiaries”. This will need to be drafted after consultation.

83. No change proposed.

84. No change proposed.

85. *Not quoted as not relevant*

**Paragraph 7 – Entitlements to Benefits**

7. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

**Commentary on the PPT rule**

1. No change proposed.

2. No change proposed.

3. No change proposed.

4. No change proposed.

5. No change proposed.

6. No change proposed.

7. No change proposed.

8. No change proposed.

9. No change proposed.

10. No change proposed.

11. No change proposed.

12. No change proposed.

13. No change proposed.

14. The following examples illustrate the application of the paragraph:
− Example A: T No change proposed.

− Example B: No change proposed.

− Example C: No change proposed.

− Example D: No change proposed.

− Example E: No change proposed.

-- Example F: A is a sovereign wealth fund resident in State S. State Y is on the other side of the world and has decided to privatisate certain infrastructure assets. A has no regional office or asset manager based in State Y however ownership of infrastructure assets is subject to a number of government regulatory rules and A has governance rights over the assets dealing with maintenance, pricing and expansion of the facility. State X is where A manages all of its investments in State Y’s part of the world. Therefore the investment in State Y will be made through State X. In examining the income of both States it is important to understand that the entity in State X will only have modest income as the capital for the investment will come from State A. Nevertheless provided that State X is where assets are managed from for that geographical region it is appropriate for State Y to grant the benefits of the DTA with State X to the investment entity resident in State X. As the decision to use a regional investment centre was based on geography and personnel paragraph 7 should not apply.

15. No change proposed.

18. No change proposed.

19 and ff. *Not quoted as not relevant.*
Appendix B – Our Clients

7.1 Queensland Investment Corporation (“QIC”)
QIC was established in 1991 by the Queensland Government to serve its long term investment responsibilities.

QIC’s enabling legislation is the Queensland Investment Corporation Act 1991 (Qld). QIC is also regulated by the Queensland State Government legislation pertaining to Government owned corporations, the Government Owned Corporations Act 1993, in addition to the Corporations Act 2001.

7.2 New Zealand Superannuation Fund (“NZ Super”)
NZ Super is New Zealand’s sovereign wealth fund. The NZ Super Fund is a New Zealand Government savings vehicle to help pre-fund the future cost of universal superannuation.

All New Zealanders aged 65 and over receive New Zealand Superannuation payments. These payments are paid by today’s Taxpayers. Over the next few decades, however, the New Zealand population will age significantly.

To take the pressure off future New Zealand Taxpayers and in response to the challenge of New Zealand’s ageing population, the NZ Superannuation and Retirement Income Act 2001 established:

- the New Zealand Superannuation Fund (“Fund”), a pool of assets on the Crown’s balance sheet; and
- the Guardians of New Zealand Superannuation, a Crown entity charged with managing the Fund.

The Guardians of New Zealand Superannuation is the Crown entity charged with managing and administering the Fund. It operates by investing initial Government contributions – and returns generated from these investments – in New Zealand and internationally, in order to grow the size of the Fund over the long term.
Appendix C

8.1 Sovereign Wealth Funds and Public Pension Reserve Funds

Sovereign Wealth Funds (SWFs) are pools of assets owned and managed directly or indirectly by governments to achieve national or State objectives. They may be funded by:

i) foreign exchange reserves;

ii) the sale of scarce resources such as oil; or

iii) general tax and other revenue.

There are a number of potential objectives of SWFs, which are not always easy to attribute to a particular fund; and some funds may have more than one of the distinguishable objectives. Some of these are:

i) to diversify assets;

ii) to get a better return on reserves;

iii) to provide for pensions in the future;

iv) to provide for future generations when natural resources run out;

v) price stabilisation schemes;

vi) to promote industrialisation; and

vii) to promote strategic and political objectives.

Public Pension Reserve Funds (PPRFs) could be defined as funds set up by governments or social security institutions with the objective of contributing to financing the relevant pay-as-you-go pension plans.

i. The first type, Social Security Reserve Funds (SSRFs), is set up as part of the overall social security system, where the inflows are mainly surpluses of employee and/or employer contributions over current payouts, as well as, in some cases, top-up contributions from the government via fiscal transfers and other sources. Among others, Denmark’s Social Security Fund, Japan’s Government Pension Investment Fund, and USA’s Social Security Trust Fund fall within this category.

ii. The second type, Sovereign Pension Reserve Funds (SPRFs), refers to those funds which are established directly by the government (completely separated from the social security system), and its financial inflows are mainly from direct fiscal transfers from the government. Unlike the first type of reserve fund, those within this category have been set up by governments to finance public pension expenditures at specific future date. Some are not allowed to make any payouts for decades. Examples include, the New Zealand Superannuation Fund, the Irish National Pension Reserve Fund, the Norwegian Government Pension Fund, and the French Fonds de réserve pour les retraites. Some of these funds are sometimes treated as SWFs and indeed a few fit both definitions.
9 Appendix D – Australian MIT rules and FATCA

9.1 Australian Managed Investment Trust ("MIT") rules - overview

Australia’s MIT rules offer significant tax concessions for entities which qualify as a MIT. Concessions are available for both foreign residents and Australian residents and allow:

- foreign residents to access a reduced rate of withholding tax on most distributions (currently 15% and in some limited cases 10% - the general rate is 30%); and
- Australian residents to access the capital gains tax discount on capital gain distributions.

The types of trusts which qualify as MITs are widely held Australian resident and managed trusts which carry on passive investment activities (e.g., investing in Australian rental property).

A key requirement for a trust to qualify as an MIT is that it must be ‘widely held’. Institutional Investors are, in many cases, able to satisfy this requirement as they are deemed to be widely held. Recent amendments to the MIT rules seek to include the following as entities that can satisfy the requirements for MIT status:

- a Managed Investment Scheme ("MIS") that is not required to be registered under the Corporations Act because it provides financial services to wholesale clients;
- a MIS that is unable to register under the Corporations Act because it is operated by a government-owned entity or a wholly-owned subsidiary of government-owned entity; and
- a MIS that is operated or managed by an entity that is not required to be a financial services licensee because it is government-owned.

These changes are being introduced to recognise current practices by Institutional Investors, which often use collective investment vehicles to invest into assets in Australia.

“These conditions were designed to ensure that the trust was a genuine collective investment vehicle and to limit the ability of foreign residents to adopt trust structures to access the reduced withholding tax rates.

However, genuine collective vehicles that were not registered under the Corporations Act, and were not required to be registered (certain wholesale MISs and government-owned MISs), could not satisfy that MIT definition.

The amendments extend the definition of MIT to enable certain wholesale MISs and government-owned MISs to qualify as MITs. This is to ensure that the MIT withholding..."
tax rules apply consistently to all widely held collective investment vehicles undertaking passive investments."

9.2 United States (“US”) Foreign Account Tax Compliance Act (“FATCA”) - overview

FATCA is legislation enacted by US Congress to prevent offshore tax abuses by US persons. These rules are intended to be wide-ranging and force global financial institutions, investment entities, as well as national banks and other financial organizations to report details on their US clients directly to the US Internal Revenue Service ("IRS").

"The fundamental premise of FATCA is that a Foreign Financial Institution (FFI) will be subjected to a 30 percent rate of withholding on all withholdable payments (generally US fixed, determinable, annual or periodical income (FDAP) as well as the gross sales proceeds on sales of assets that generate US source interest or dividends) unless the FFI enters into an agreement with the IRS and agrees to identify certain US persons and to report them annually to the IRS. Non-US pension funds will generally be FFIs for these purposes because of their investment activities."24

The FATCA regulations recognise the unique role of pension and sovereign wealth funds and have provided broad based exemptions for these classes of investors on the basis that they present a low risk of tax evasion.25 These Institutional Investors would have otherwise been caught by FATCA and classified as FFIs due to their investment activities.

The specific classes of entities that are exempt from registering and reporting are:

- most governmental entities;
- most non-profit entities; and
- certain retirement entities, such as pension funds.

Retirement funds which qualify for the exemption include those established in a country with which the U.S. has an income tax treaty in force and which are generally exempt from income taxation in that country. Pension plans or other retirement arrangements that are established in the U.K. or Australia, for example, are excluded as FFIs and are thus not required to trace their ownership to identify US members or potential US members.

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Private and confidential
Ms. Marlies de Ruiter
Head, Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA

By email: taxtreaties@oecd.org

9 January 2015

Dear Madam

OECD/G20 BEPS Project
Follow up work on BEPS Action 6: Preventing Treaty Abuse
Fairness for Smaller Economies

KPMG Ireland welcomes the opportunity to make a submission in response to the above discussion draft on follow up work on BEPS Action 6: Preventing Treaty Abuse.

We consider that it is critical that measures to counteract base erosion and profit shifting activity do not undermine the important role that tax treaties play in supporting the expansion of international trade and in providing certainty of outcomes for business engaging in cross border trade. We are concerned that, if the proposed Limitation-on-benefits (LOB) and Principal Purposes Test (PPT) provisions are implemented in the manner drafted, they pose significant threats to the effectiveness of tax treaties in the conduct of day to day cross border trade.

This impact is most severe on business based in smaller economies without the natural advantages of larger economies to add weight to the impetus to engage in cross border trade.

The proposed PPT and LOB present acute concerns for smaller economies. As presently drafted, they operate unfairly to create a disproportionately higher threshold for business based in smaller economies to meet because of the fundamental differences in the infrastructure of these economies.

The complexity and detail of a LOB which was crafted for the US, a large economy with a large consumer market and deep capital base, is simply not fit for purpose when applied to business based in smaller economies. These economies are characterised by smaller local capital markets and a relatively heavier reliance on the presence of an effective tax treaty network to support cross border trade.
In Appendix 1 to this letter we have set out detailed comments on issues related to the LOB provision. These respond to a number of questions raised in the discussion draft on points 3 to 10 of Section A. They identify a number of instances in which the manner of operation of the ownership and base erosion tests discriminate against business based in smaller economies.

We have also included comments on the PPT rule and have made suggestions to refine the wording of the draft PPT rule and to expand the commentary on the rule so as to present a better balance to the manner in which the PPT rule could apply to residents of smaller economies.

Finally, we have made comments on the domestic anti-conduit rules and the effect which we consider the LOB or PPT will have on instances of treaty disputes and their effective resolution.

Should you wish to discuss any of the matters raised in this submission in further detail, please do not hesitate to contact Conor O’Brien on conor.obrien@kpmg.ie.

Yours sincerely

Conor O’Brien
Head of Tax and Legal Services
Appendix 1

Opening remarks

Under Action 6 of the OECD BEPS proposal, significant changes to tax treaties are proposed. To the extent that these, and other BEPS proposals, act to improve fairness in the international tax system they ought to be supported. However some of the current treaty proposals are heavily biased against smaller economies and potentially will damage legitimate economic activity in those economies. They could impact on many situations well beyond the stated target of Action 6 i.e. the granting of treaty benefits in “inappropriate circumstances”.

There is a moral responsibility on the more powerful to deal fairly with the less powerful. Unfortunately, history is replete with examples of large economies dealing unfairly with smaller economies. In the interests of fairness, trade and balanced global development, it is critical that the BEPS treaty proposals are carefully targeted at artificial arrangements and do not discriminate against genuine and substantial activity in small economies. It is important that a project billed as advancing the cause of fairness does not become a vehicle for large economies to advance their self interests at the expense of the legitimate rights of smaller economies.

Some of the proposed amendments to tax treaties are not particularly discriminatory – we have therefore not addressed these proposals in this submission1.

The proposals which are discriminatory against smaller economies are those that would require treaties to include at least one of the LOB or PPT rules which would need to be met in order for treaty benefits to be granted. We have set out below a detailed analysis of the impact of these proposals on smaller economies. A lot of the discrimination is buried in the detail. When one examines the detail it is clear, in our view, that the proposals are, whether intentionally or not, very biased against smaller economies.

Section 1 - Limitation-on-benefits ("LOB")

The second leg of the OECD proposals are aimed at denying treaty access where one is owned or financed from abroad or where one’s shares are traded on a foreign stock exchange. Obviously, companies in smaller economies are far more likely to be owned or financed from abroad given relatively smaller local available capital. Also, they are far more likely to list their shares on an overseas stock market.

Take the example of two medium sized businesses which are identical in all relevant respects other than the fact that one is based in Stockholm and one is based in London. Assume both

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1 These proposals include proposals on (i) splitting up of contracts to avoid a PE, (ii) certain dividend transfer transactions, (iii) tightening of the provisions dealing with capital gains on immovable property, and (iv) PE’s situated in third states.
have their shares listed on the London Stock Exchange because the London Stock Exchange attracts a much deeper pool of capital. What fair or rational basis is there for providing that the London based company ought to be granted treaty access but the Stockholm based company ought not?

LOB clauses were pioneered by the United States of America (US) and have been a feature of US tax treaties for many years. The details of the clauses have been crafted to reflect the realities of a large economy and the policy interests of such an economy. The discussion draft raises a number of issues in relation to the operation of the proposed LOB. Matters which we consider raise particular concerns for companies based in smaller economies include:

(i) **Publicly Traded test (conditions in 2(c)(i)(A) and (B))**

Companies in smaller economies can qualify for treaty benefits if their shares, or those of their ultimate parent, are:

(a) quoted and primarily traded on a stock exchange in the country concerned, or

(b) quoted and regularly traded on another recognised stock exchange and the company’s executive officers and senior management employees exercise day to day responsibility for more of the strategic financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in the country concerned than in any other State and the staff of such persons conduct more of the day to day activities necessary for preparing and making those decisions in the country concerned than in any other State.

This Publicly Traded test will, in practice, be very difficult for many companies in smaller economies to meet because (i) often they will naturally (i.e. without tax motivation) be listed on stock exchanges outside their home jurisdiction because stock exchanges in larger economies have larger pools of capital and (ii) often their senior personnel will be working overseas as the smaller country is, by definition, much more likely to be a relatively small part of the global operation. It can be seen therefore that the manner in which this provision is drafted confers an unfair advantage on large economies. It may well be the case that even household names that would be universally regarded as longstanding domestic businesses in the country concerned would be unable to meet this test because they have grown internationally and whilst the country concerned remains significant to the group it is not where management spend most of their time. Indeed, it is likely that any successful business from a smaller economy which grows internationally will run into difficulties with this test.

There is a Publicly Traded test in the LOB in some older US tax treaties which is drafted differently and which is much fairer to smaller economies – because it excludes the requirement that group senior management spend most of their time in the smaller country concerned (more
recent US treaties include the management time test). In order to be fair to smaller economies the OECD’s proposed LOB ought to be amended along the lines of the older US model.

The OECD commentary on the proposed LOB states that some countries may be willing to agree to include stock exchanges within a regional grouping such as the EEA in the first leg of the test (i.e. condition 2(c)(i)(A), the leg that does not include the management time test). This extension would be helpful. However, the extension will not cover all smaller country situations within the EEA as some entities will be quoted outside the EEA – the EEA plus the US would cover most situations in this scenario. We believe that no legitimate policy objective is served by refusing to amend the LOB along these lines – in reality, the only policy objective which would be served by not amending would be to discriminate against smaller economies.

The proposed Publicly Traded test includes in square brackets a requirement such that where a smaller country resident treaty claimant is indirectly owned by a quoted parent that all companies in the intermediate chain would have to be resident in the country concerned or resident in the particular treaty partner State. It is in square brackets because different countries have expressed different views on whether or not this is necessary. In our view, the narrow version again acts to discriminate against companies based in smaller economies who (i) are more likely to be reliant on the publicly traded test to gain treaty access (because they will, by definition, have more difficulty passing the other tests - see below) and (ii) because the smaller country subsidiary will often not be the main driver of the overall group structure (as, by definition, it is likely to be relatively smaller than a large country subsidiary).

(ii) Ownership / Base Erosion test

One would qualify for treaty benefits if one meets both a detailed ownership and “base erosion” test. These tests are designed to check if the treaty claimant is ultimately owned and financed from its country of residence. This test would be relatively easy for most companies operating in large economies to meet (because they are often owned and financed domestically due to deep pools of available domestic capital). It would be particularly difficult and, in many cases, impossible for companies operating in a smaller economy to satisfy this test i.e. because capital, and therefore ownership, and financing will often come from outside the jurisdiction.

(iii) Active Business test

A smaller economy company would qualify for treaty benefits if it is engaged in “the active conduct of a business” in the country concerned. This is a potentially significant test. However, the proposed LOB states that where income is derived from a related party, the Active Business test will only be considered to be satisfied if the business activity carried on in the smaller economy is substantial in relation to the business activity carried on by the associated enterprise in the other state. Ideally, the substantiality requirement would be dropped because it will often be difficult for an entity based in a smaller economy to be able to meet this test.
The OECD commentary does helpfully note that due regard will be given to the relative sizes of the economies and markets in the two Contracting States. However, the text of the OECD Active Business test borrows heavily from the existing US type treaty language and in practice, it has been found that US domestic rules can mean that the test is often failed by legitimate businesses. Examples of the difficulties experienced with the US rules include:

- Rules on whether the activity is active. It is quite possible that there is a substantial presence in the smaller country concerned which carries out substantial activity, but which is not “active” as defined for US tax purposes.

- Furthermore, under US rules for determining the source of income, the US may view the smaller country activity (the scale of which is compared to the US activity) as excluding certain income from counterparties outside the smaller country which one might have expected to have been obviously regarded as part of the smaller country activity.

For example, there could be large manufacturing facilities in the treaty partner location (because there may be a large market of consumers there) with substantial management oversight and support functions (R&D etc.) in the smaller economy – it is not at all clear that payments from the manufacturing facilities for the smaller country management / support functions would meet the substantiality test. For reasons such as the foregoing, many smaller economy operations that a reasonable person would have thought would easily have met an Active Business test have, in practice, found it difficult to meet the Active Business test in US tax treaties – but at least some of them could fall back on the relatively reasonable Publicly Traded test in some US treaties.

We suggest that the OECD proposals are amended so that it is clear that business support activities (where the workforce in the smaller country concerned conduct substantial managerial and operational activities over those support services) can qualify as an active business even where those activities are provided for the benefit of related group parties and where there are no or limited sales of the relevant Group’s products / services in the smaller country concerned.

In this regard, one might consider whether a “safe harbour” might be included. Some US treaties contain a “safe harbour” such that substantiality is assumed if, in prior years, the asset value, gross income and payroll of the small country activity are, for example, at least 7.5% of the equivalent numbers in the US, and the average of the three ratios exceeds 10%. In practice, the US safe harbour can be difficult to meet because of the aforementioned US source of income rules. Options for a fair safe harbour might include:

(a) A mathematical safe harbour which is similar to the ones in some US treaties but (i) with clarification that the smaller country activity includes all sales / services from the smaller country entity to counterparties outside the country concerned (this clarification would be required for the purposes of the general substantiality test and any mathematical safe harbour) and (ii) with adjustment for the relative size of the economies concerned.
(b) A purpose test e.g. the substantiality requirement would not apply where the main purpose of the activity was not access to treaty benefits.

(iv) **Derivative Benefits test**

One might qualify for treaty benefits if one meets the terms of a “Derivative Benefits” test. This is designed to allow treaty access where one is owned and financed by “equivalent beneficiaries” i.e. certain defined persons from jurisdictions having a treaty with the other country which offers equivalent benefits as compared to the taxpayer country’s treaty with that other country. Ownership and base erosion tests are set out to determine if the test is met. This is a potentially significant test. However, there are a number of difficulties with the OECD’s proposed test from a smaller economy viewpoint including:

(a) The test is included in the OECD’s proposed LOB clause in square brackets because some States have indicated that they do not want to agree to include a derivative benefits test other than for dividends.

(b) It is provided that every entity in the chain of ownership must be “an equivalent beneficiary”. This significantly limits the potential applicability of the test and this will most adversely affect smaller economy entities which are most likely to be reliant on this test as they will have more difficulty passing other tests.

(c) A relatively narrow group of persons can be an equivalent beneficiary. For example, private companies are excluded. It is not clear why this is the case and, as with other restrictions, it is most likely to adversely affect smaller country entities.

If treaties are to include an LOB clause, it is essential, in order to be fair to smaller economies, that there be a properly worded Derivative Benefits test as much of the financing for entities in those economies will naturally (i.e. without tax motivation) come from abroad.

(v) **Discretionary relief**

If a company cannot satisfy any of the other LOB tests, it may be granted treaty access if, on foot of an application to the authorities in the treaty partner country, it persuades them that the “establishment, acquisition or maintenance” of the company “and the conduct of its operations” did not have as one of its principal purposes the obtaining of treaty benefits.

Experience with the US is that it has proved exceptionally difficult to persuade the US tax authorities that the principal purposes test is met despite the facts being, in the smaller country resident’s view, very clearly in the company’s favour. It is generally a bad principle that relief ought to be solely at the discretion of a tax authority (which clearly has a conflict of interest) without any right of appeal to an independent body – in fact such independent review of government officials’ decisions is a basic human right².

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² recognised as such in Magna Carta and before.
This test would be fairer and more efficient if:

(a) it was not subject to having to apply to the foreign tax authority,

(b) there was a clear right of appeal to the courts of the country concerned and ideally to an independent international arbitrator.

It should also be made clear that any principal purpose clearance would apply retroactively because, in many cases, companies may be of the view that they meet the Active Business test and therefore may only wish to go down the principal purpose route as a last resort.

**Section 2 – Principal Purposes Test (“PPT”)**

**Analysis of the impact of size of economy**

The first leg of the Action 6 proposals is aimed at denying treaty benefits where **one of** the main purposes of being located in a particular country is access to tax treaties.

Clearly, there will always be stronger non tax commercial reasons for locating in a large economy with a large domestic market. By definition if an economy is larger it has:

i. more customers

ii. a larger available pool of labour

iii. a larger network of providers of capital

iv. a larger availability of support services

v. a greater choice of and competition between suppliers

vi. lower transportation costs given that one is nearer to customers

vii. more universities etc., etc.

These factors have been described as ‘positive externalities’ which exert a very strong pull in attracting populations and investment generally to larger economies. In contrast, the relative ‘negative externalities’ suffered by smaller economies are enormous. The comparatively few positive externalities enjoyed by them, such as the attractiveness of a quieter and less densely populated environment, will come nowhere close to compensating for the positive externalities enjoyed by the larger economy.

Smaller economies are at a greater economic disadvantage the further they are from densely populated centres. In particular, transportation costs, both of goods and people – including the direct costs of travel and the time cost of travel – increase as distance increases.
In Appendix 2, we have explored the above economic analysis in greater detail, drawing upon the findings of leading economists.

A smaller economy is likely to have to offer some form of reduced costs in order to attract and retain industry in order to compensate for these relative disadvantages. For the purpose of this analysis, we can categorise small economies into two categories:

(i) Smaller economies without tax treaties. In most cases the reason for the absence of tax treaties will be that such economies have attempted to compensate for their negative externalities by having nil or nominal tax rates. We therefore refer to these economies as “Tax Havens” hereinafter.

(ii) Smaller economies with tax treaties (hereinafter referred to as "SETTs") and which have otherwise reduced costs to compensate for negative externalities. A SETT will usually have tax costs greater than those applicable in a Tax Haven. In this regard, it will be at a disadvantage in comparison to a Tax Haven due to its higher domestic tax costs. It will share with a Tax Haven many of the wider negative externalities common to small economies when compared to a larger economy. It may be that a significant positive externality of a SETT versus a Tax Haven, or at least one of the main positive externalities versus a Tax Haven, will be access to tax treaties.

Therefore, while a larger economy will be able to point to numerous positive externalities versus a Tax Haven other than access to tax treaties, it will be very difficult, and perhaps impossible, for a SETT to conclusively demonstrate that access to tax treaties is not one of the main positive benefits that it has relative to a Tax Haven.

This is the economic reality which gives rise to our concerns that the manner in which the PPT rule is currently drafted and the manner in which the commentary on the PPT is framed are inherently discriminatory against residents of smaller economies.

(b) Applying the PPT rule to the position of residents in smaller economies

The PPT rule applies where, inter alia, obtaining treaty benefits was one of the principal purposes of any "arrangement or transaction" that resulted "directly or indirectly" in the treaty benefit.

Paragraph 9 of the commentary states that "arrangement or transaction" should be interpreted broadly. The meaning encompasses arrangements concerning "the establishment, acquisition and maintenance of a person who derives the income". The broad scope of interpretation that this implies fundamentally undermines the certainty of application of treaties for residents of SETTs.

A resident of a larger economy, starting with such a large balance of positive externalities in its favour, should be able to relatively easily demonstrate that access to a tax treaty is not one of the
main purposes for establishing a business in that larger economy. Indeed, the resident of the larger economy will be able to make the very persuasive argument that if larger economies, with the greatest number of positive externalities of any economies in the world cannot pass a PPT, then nobody can!

In contrast, residents of a SETT will, due to the inherent nature of that economy, find it much more difficult to point to positive externalities which the SETT enjoys relative to a Tax Haven other than access to tax treaties. The weight of importance of access to a tax treaty is likely to be seen to be greater in assessing its relative importance amongst the range of purposes related to the ‘establishment, acquisition or maintenance’ of the SETT resident.

In making the judgment required to apply the PPT, residents of a SETT will find it much harder to refute the argument that access to tax treaties was one of the main motivations for establishing a business and continuing business in that jurisdiction. This difficulty overshadows both the ‘arrangement’ by which the company is established or acquired and every ‘transaction’ subsequently conducted by it for which it claims treaty benefits. It is almost axiomatic that a SETT resident will find it far more difficult to satisfy a PPT than will a resident of a larger economy simply by reason of the externalities inherent in economies of different sizes.

The position of the SETT is made more precarious by the fact that mere doubt over access to tax treaties may be sufficient to scare off investment. In the case of this very broadly drafted PPT rule, the doubt on access to a tax treaty is multiplied by multiple possible interpretations that may be taken across multiple treaty partner jurisdictions. It is easy to see businesses choosing to forego the uncertainty surrounding treaty access for SETT’s and simply locating in a larger economy where the large amount of positive externalities puts passing a PPT beyond any significant doubt.

It is clear therefore that companies will have far more certainty over passing a PPT if they locate in a larger economy than in a SETT solely due to the larger positive externalities enjoyed by a larger economy.

This is clearly discriminatory against residents of the SETT and adds a further economic disadvantage to economies already disadvantaged in relative terms. It is particularly discriminatory against a SETT in a peripheral location which has a starting position of even greater relative economic disadvantage.

(c) Suggested changes to the PPT rule and commentary

In our view, to counteract the bias inherent in the current PPT rule and so that it should not operate to the disadvantage of SETT residents, it would be more appropriate for the PPT rule to be drafted in a manner where it would either say:
• A benefit shall not be granted… if it is reasonable to conclude, having regard to all of the relevant facts and circumstances, that obtaining that benefit was the main purpose of any arrangement or transaction that resulted directly or indirectly in that benefit, unless…..or

• The benefit shall not be granted…. if it is reasonable to conclude, having regard to all of the relevant facts and circumstances, that the transaction or arrangement was not undertaken or arranged primarily for purposes other than to give rise to that benefit, unless…..

By redrafting the rule in this manner, the legitimate expectation of access to a treaty and its benefits is not undermined for a resident of a SETT. Instead, the redrafted rule removes the inherent bias faced by a resident of a jurisdiction where it can be reasonably expected that access to a tax treaty is one of the main benefits that local residents engaged in cross border trade seek to gain from conduct of business in that economy. The rule seeks to balance the preservation of access to tax treaties for SETTs and to address treaty shopping arrangements or transactions in a manner which lessens the risk of the rule being applied in a manner which is discriminatory for residents of SETTs.

In addition to redrafting the PPT, in our view, the current commentary could be usefully expanded to underscore that the existence of a tax treaty network is legitimately one of the main benefits which might expect to arise to residents of a SETT. The assessment of the relative weight of importance of a treaty benefit in determining its relative size amongst the range of purposes for a transaction or arrangement should take into account the likely greater weight of importance that treaties and their benefits can play in the establishment, acquisition and day to day conduct of business of a person in a SETT. The commentary should note that the very existence of a tax treaty (especially in the context of a smaller economy) should not be given undue weight as a factor in applying the PPT.

The inclusion of a LOB provision as an alternative test does not redress the unfair advantage granted to large economies by the PPT. Firstly, as outlined at Section 1 above, the LOB itself is heavily biased against smaller economies. Secondly, even if the LOB proposal is redrafted to remove the anti smaller country bias there will, no doubt, always be some cases where taxpayers cannot pass the LOB test. A large country can avoid this difficulty by implementing the PPT only option confident in the knowledge that the natural commercial advantages of its economy make it relatively easy for locally resident companies to pass the PPT – this strategy is not available to smaller economies.

**Section 3- Domestic anti conduit rules**

The OECD has recommended three options to countries:

1) Put both the PPT and an LOB in treaties.

2) Put a PPT only in treaties.
3) Put an LOB but no PPT in treaties – in this case, the OECD suggests that this be supplemented by the introduction of domestic “anti-conduit” rules it says would be designed to prevent transactions being artificially routed through an active business.

The anti-conduit rules suggested by the OECD are, in our view, very broad. They would apply where a company which “receives an item of income…pays, directly or indirectly all or substantially all of that income (at any time or in any form) to one or more persons who are not resident” and “who, if they received that item of income direct…. would not be entitled under a convention for the avoidance of double taxation...to benefits which are equivalent” (emphasis added).

There are at least three respects in which a provision along these lines is discriminatory against smaller economies and / or otherwise flawed i.e.:

- A company operating in a smaller economy is naturally more likely to be foreign owned. Ultimately, a foreign owned company will usually pay all of its income away to non residents i.e. because it will ultimately pay dividends to overseas shareholders. However, we do not believe that conduit arrangements are classically understood as including situations where profits are retained within a country and then eventually paid out by way of dividend.

- A company in a smaller economy is also more likely to be foreign financed. Therefore, it is more likely to make financing payments to non residents.

- The words “substantially all” are not defined which will give rise to uncertainty and likely multiple different interpretations in different jurisdictions.

We suggest therefore that a more fair and more objective anti-conduit rule would (i) define “substantially all” (e.g. greater 95%) and (ii) replace the words “in any form” with “in any tax deductible form” - this would exclude dividends and is consistent with the base erosion test in the LOB which is based on tax deductible payments.

Section 4 – Resolving treaty disputes

From time to time, disputes will arise as to the interpretation and / or application of tax treaties. This raises the question as to how such disputes ought to be resolved. Currently, treaty disputes are typically resolved in accordance with the domestic procedures applicable in the country seeking to levy taxation. This process has a number of risks including:

- the risk of multiple different approaches and interpretations being taken in different economies,
(ii) varying quality of the independence and rigour of procedures in different jurisdictions, and

(iii) a risk of bias, whether conscious or unconscious, in favour of the domestic tax collector and against the foreign taxpayer.

These risks will be exacerbated by the Action 6 proposals because the proposed new provisions are relatively complex and in many cases require a relatively high level of subjective judgment. Smaller economies are likely to have less power to redress any injustices arising from treaty disputes as they will have less resources and less diplomatic influence in seeking redress.

An independent, international, speedy and binding arbitration tribunal to resolve disputes over treaty access would substantially reduce the risk of unjust treatment of taxpayers generally and of those based in small economies in particular. In any event, a right of appeal to a qualified and genuinely independent body is a basic principle of justice.

Confidence in such a dispute resolution body would be best served by appointing to it respected, qualified and experienced jurists from economies with a strong reputation for an independent and fair judiciary.

Section 5 – In conclusion

Most of the broad thrust of the OECD’s BEPS proposals advance the legitimate causes of fairness, trade and alignment of taxation rights with substance and genuine economic activity. However, some of the proposals as drafted would lead to unfair advantages being granted to large economies at the expense of smaller economies. It is a reality that large, and particularly large Western economies, have had a disproportionate influence on the construction of global taxation rules. It is critical, as a matter of justice, that this influence is used to create a level playing pitch for all and not to serve the selfish interests of those large economies.

The greatest manifestation of a bias against smaller countries is the current draft proposals on taxation treaties which, in their detailed provisions, go far beyond the stated goal of denying treaty benefits in “inappropriate circumstances”. In a whole host of circumstances they would deny or cast doubt over treaty access to genuine and substantial businesses operating in smaller economies without causing any equivalent difficulty for similar businesses operating in large economies.

Specifically:

(i) As outlined at Section 1 above, the proposed LOB is very unfair to smaller economies in a number of respects. To eliminate the many anti small country biases in the LOB clause it should be redrafted as follows:

(a) The Publicly Traded test in the LOB (condition 2(c)) should provide (1) where the primary quotation is on a recognised stock exchange outside the country concerned
there should be no requirement that senior management spend most of their time in that country (2) the test should take into account trading on recognized stock exchanges within and outside a region including exchanges located in states where local residents commonly list (for many in the EEA, the most important exchanges are in the EU, especially London, and in the US) and (3) there should be no requirement for intermediate entities in a chain to be resident in the taxpayer’s country.

(b) Ideally, the substantiality test for dealings with connected parties would be dropped from the Active Business test. If it is not dropped then options for a safe harbour might include:

- A mathematical safe harbour test but with clarification that the taxpayer activity includes all sales / services from the taxpayer to counterparties outside its home country (this clarification would be required for the purposes of the general substantiality test and any mathematical safe harbour), and
- A purpose test e.g. the substantiality requirement would not apply where the main purpose of the business was not access to treaty benefits.

(c) We suggest that there is an express acknowledgement in the Active Business test that business support activities (where the taxpayer workforce conduct substantial managerial and operational activities over those support services) can qualify as an active business even where those activities are provided for the benefit of related group parties and where there are no or limited sales of the relevant group’s products / services in the country concerned.

(d) There should be a Derivative Benefits test and (1) it should not be necessary for all entities in the chain of ownership to be “equivalent beneficiaries”, and (2) the full range of persons including private companies should be capable of being equivalent beneficiaries.

(e) It would be preferable if the principal purposes test embedded in the Discretionary Relief clause in the LOB was not subject to an application to the competent authority in the other jurisdiction. In any event there should be a right of appeal to the courts of the country concerned and ideally to an independent international arbitrator. It should also be made clear that any principal purpose clearance would apply retroactively.

(ii) For the reasons outlined at Section 2 above, it is almost axiomatic that it will be much easier to conclude that a business operating in a large economy passes a PPT than it will be for a business operating in a smaller economy. The gap in the level of certainty creates an immediate, and unfair, advantage for large economies.
The advantage given to large economies by the PPT is not eliminated by the LOB only option – even if it is redrafted in the manner we suggest above.

Without redrafting the PPT (in a manner suggested above), it is in our view completely inappropriate for any smaller country tax treaty.

Commentary on the interpretation of the PPT should be expanded to recognize that benefits arising from a tax treaty network are a legitimate expectation of residents of smaller economies. This should acknowledge that those benefits can be expected to play a greater weight in decisions made to locate and conduct business day to day in that smaller economy as compared to the relative weight of importance that might attach to expected treaty benefits when making location decisions for a larger economy which offers a wider range of positive business benefits.

(iii) For the reasons outlined at Section 3 above, the proposed anti-conduit rule should be amended to that (1) “substantially all” is defined (e.g. greater 95%) and (2) so that only tax deductible payments are counted.

(iv) Where there is a dispute as to the interpretation and / or application of tax treaties there ought to be a right of appeal to an independent international tribunal staffed by respected, qualified and experienced jurists from economies with a strong reputation for an independent and fair judiciary.

It would be a sad irony if the BEPS project which is billed as advancing the cause of fairness became a vehicle for large economies to discriminate unfairly against smaller economies. To date, far too little attention has been paid to this issue in the drafting of the BEPS treaty proposals. It is critical, in the interests of justice, fairness and balanced global development that this is resolved in future drafts.
Appendix 2

In this Appendix, we explore in more detail some of the characteristics of economies of different sizes that underlie our concerns that the PPT rule is inherently biased against residents of smaller economies.

As discussed in Section 1 of Appendix 1, there will always be stronger non tax commercial reasons for locating in a large economy with a large domestic market. By definition if an economy is larger it has:

i. more customers
ii. a larger available pool of labour
iii. a larger network of providers of capital
iv. a larger availability of support services
v. a greater choice of and competition between suppliers
vi. lower transportation costs given that one is nearer to customers
vii. more universities etc., etc.

Over 100 years ago Alfred Marshall identified the "positive externalities" (i.e. competitive advantages arising from a firm's external environment as distinct from factors internal to the firm itself) which benefit industries clustered in large numbers in a particular location. As listed above, these include a large available pool of skilled labour, a large available pool of specialised suppliers and the benefits of informational spillovers.

More recent advances in economic research in the fields of New Trade Theory and the New Economic Geography have demonstrated that this effect applies to the manufacturing industry as a whole, and not just to specific industries i.e. a positive feedback loop causes industry to locate close to other industries thereby increasing the size of industrial concentrations and thereby further attracting additional business, workers and consumers\(^3\). As a result of this positive feedback loop, in the absence of any force to the contrary, populations will become concentrated in a small number of densely populated mega conurbations. Over time the positive externalities enjoyed by such mega conurbations are enormous - even the apparently negative economic effect of higher labour costs in densely populated centres will create a positive externality by increasing consumer demand in that centre. The greater range of cultural, social

and entertainment choices that such centres offer will also create further positive externalities.

By contrast, the relative negative externalities suffered by smaller economies are enormous and the comparatively few positive externalities enjoyed by them, such as the attractiveness of a quieter and less dense populated environment, will come nowhere close to compensating for the positive externalities enjoyed by the more densely populated centre.

Smaller economies are at a greater economic disadvantage the further they are from densely populated centres. In particular transportation costs, both of goods and people – including the direct costs of travel and the time cost of travel – increase as distance increases. This is supported by the Gravity Model of Trade which predicts that the amount of trade between two economic centres will be proportional to their sizes divided by the distance between them. This model has proven to be strongly supported by empirical data.

A smaller economy is likely to have to offer some form of reduced costs in order to attract and retain industry in order to compensate for its relative negative externalities. There are many ways in which this might occur. For the purpose of this analysis we can categorise small economies into two categories:

(i) Smaller economies without tax treaties. In most cases the reason for the absence of tax treaties will be that such economies have attempted to compensate for their negative externalities by having nil or nominal tax rates. We have referred to these economies as "Tax Havens".

(ii) Smaller economies with tax treaties (hereinafter referred to as "SETTs") and which have otherwise reduced costs to compensate for negative externalities. A SETT will usually have tax costs greater than those applicable in a Tax Haven. Therefore it will suffer a negative externality versus the Tax Haven (due to its higher domestic tax costs) and will share with a Tax Haven other negative externalities versus the larger economy. It may be that a significant positive externality versus the Tax Haven, or at least one of the main positive externalities versus the Tax Haven, will be access to tax treaties.

Therefore while a larger economy will be able to point to numerous positive externalities versus a Tax Haven other than access to tax treaties, it will be very difficult, and perhaps impossible, for a SETT to conclusively demonstrate that access to tax treaties is not one of the main positive externalities that it has relative to a Tax Haven.

Indeed it might be argued, in many cases, that it is axiomatic that access to tax treaties is one of the main positive externalities offered by a SETT relative to a Tax Haven bearing in mind that the positive externalities have to be sufficient to compensate for the negative externality suffered by the SETT from having higher domestic tax rates than the Tax Haven.

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To Marlies de Ruiter, Head, Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

Date January 9, 2015

From Jason R. Connery, Principal KPMG LLP

Re Follow Up Work on BEPS Action 6: Preventing Treaty Abuse

Dear Ms. de Ruiter,

KPMG LLP, the U.S. member firm of KPMG International Cooperative, welcomes the opportunity to comment on the OECD’s Public Discussion Draft Follow Up Work on BEPS Action 6: Preventing Treaty Abuse (the “Follow Up Report”). The Follow Up Report requests specific comments on certain recommendations made and issues raised in the Action 6 2014 Deliverable entitled OECD (2014), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, OECD/G20 Base Erosion and Profit Shifting Project (the “Action 6 Deliverable”). U.S. tax professionals have substantial familiarity with anti-treaty shopping provisions given that today most U.S. income tax treaties include a comprehensive Limitation on Benefits ("LOB") article designed to limit the ability of taxpayers to treaty shop. In comparison, to date, the United States has not favored the inclusion of a principal purpose test ("PPT") in lieu of an LOB article in U.S. income tax treaties. Because of our experience with interpreting and applying the tests included in a comprehensive LOB article, which are similar to those tests included in proposed Article X (Entitlement to Benefits), we have chosen to limit our comments to address specific issues surrounding the proposed addition of Article X (Entitlement to Benefits) to the OECD Model Tax Convention. Although we do not specifically comment on the PPT, we would welcome the opportunity to assist the OECD with its effort to ensure the PPT is implemented in a manner resulting in consistent application by all states and that its application creates certainty as to the ability of a resident to claim the benefits of an applicable income tax treaty, regardless of whether the person is a resident of a state with a small or large economy.

Also, while our comments and recommendations are influenced by our experience in dealing specifically with an LOB article included in most U.S. income tax treaties, we note that many of our comments and recommendations in respect of the Entitlement to Benefits provision are equally relevant to residents of states with smaller economies. As presently drafted, these provisions may operate to create a disproportionately higher threshold for business based in smaller economies to meet because of the fundamental differences in the infrastructure of these economies. For example, in our experience, resident companies of states with smaller economies tend to list their shares on
non-local stock exchanges, raise capital from outside their country of residence, and their management tends to spend significant time in major markets located outside of their state of residence. These realities for residents of states with smaller economies may make the proposed implementation of the Entitlement to Benefits provision, or the implementation of a PPT, more challenging and, therefore, may require further consideration.

Our comments fall into two categories: (1) proposing amendments to the Entitlement to Benefits’ definition of a “qualified person” in paragraph 2 and application of the Derivative Benefits Test in paragraph 4 to account for common commercial transactions; and (2) providing potential examples to be included in the Commentary in respect to discretionary determinations provided for under paragraph 5. We first summarize our recommendations and then address each recommendation in turn below.

I. Summary of Recommendations

Our recommendations are as follows:

- The Commentary to subdivision i) of subparagraph c) of paragraph 2 of Article X (the “Publicly Traded Entity Test”) should provide the Contracting States with the flexibility to omit the requirement that (1) the company’s or entity’s principal class of shares be primarily traded on a stock exchange in the Contracting State where the company or entity is a resident or (2) the company’s or entity’s primary place of management and control be in the Contracting State of which it is a resident;

- For purposes of subdivision ii) of subparagraph c) of paragraph 2 of Article X (the “Subsidiary of a Publicly Traded Entity Test”), the requirement that five or fewer residents that satisfy the Publicly Traded Entity Test must own at least 50 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company or entity should be eliminated such that any number of residents that satisfy the Publicly Traded Entity Test must own at least 50 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company or entity;

- For purposes of applying the base erosion prong of the Ownership and Base Erosion Test in subparagraph e) of paragraph 2 of Article X, the list of qualifying payees should be expanded to include a resident of one of the Contracting States that satisfies the Subsidiary of a Publicly Traded Entity Test;

- For purposes of the Derivative Benefits Test in paragraph 4 of Article X, the requirement that seven or fewer equivalent beneficiaries own at least 95 percent of the
aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company should be eliminated such that any number of equivalent beneficiaries must own at least 95 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company;

- For purposes of the ownership prong of the Derivative Benefits Test, in the case of indirect ownership, the requirement that all indirect owners in the ownership chain be equivalent beneficiaries should be eliminated;

- The definition of an “equivalent beneficiary” in subparagraph f) of paragraph 6 of Article X should be expanded to include a resident that satisfies the Subsidiary of a Publicly Traded Entity Test; and

- In respect of a discretionary determination provided in paragraph 5 of Article X, the Competent Authorities should publish facts and circumstances that have lead them to grant discretionary relief.

II. Publicly Traded Entity Test

The definition of a “qualified person” in paragraph 2 of Article X includes a resident that satisfies the Publicly Traded Entity Test in subdivision i) of subparagraph c). The Publicly Traded Entity Test in Article X is similar to that found in subdivision i) of subparagraph c) of paragraph 2 of Article 22 (LOB) in the 2006 U.S. Model Income Tax Treaty and, thus, reflects certain requirements that were included to address certain U.S. tax policy concerns. For example, as currently drafted, the Publicly Traded Entity Test in the Entitlement to Benefits provision requires, inter alia, that (1) the company’s or entity’s principal class of shares be primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company or entity is a resident; or (2) the company’s or entity’s primary place of management and control be in the Contracting State of which it is a resident.

In the case of United States treaty development, we understand that these alternative requirements were added to the 2006 U.S. Model Income Tax Treaty to limit the ability of an expatriated entity to satisfy the Publicly Traded Entity Test post expatriation if the company’s management did not move offshore as part of the transaction. It is not clear whether all countries share this same policy concern. In particular, countries within the European Union, where the free-flow of capital is permitted, may not share the same policy concern as the United States. Therefore, we recommend that the Commentary to the Publicly Traded Entity Test provide the Contracting States with the flexibility to omit the requirement that (1) the company’s or entity’s principal class of shares be primarily traded on a stock exchange in the Contracting State where the company or entity is a
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III. Subsidiary of a Publicly Traded Entity Test

A company or entity resident in a Contracting State is a “qualified person” under the Subsidiary of a Publicly Traded Entity Test if at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) in the company or entity is owned directly or indirectly by five or fewer companies or entities entitled to benefits under the Publicly Traded Company Test (the “Five or Fewer Requirement”) [provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State].

We are not aware of any policy reason for this Five or Fewer Requirement and, thus, we recommend eliminating it such that a resident of a Contracting State may satisfy the Subsidiary of a Publicly Traded Company Test if, e.g., any number of residents of a Contracting State that satisfy the Publicly Traded Entity Test own directly shares carrying at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) in the company or entity.

IV. Ownership and Base Erosion Test

The definition of a “qualified person” under subparagraph e) of paragraph 2 of Article X includes a resident that meets an Ownership and Base Erosion Test. Under the current base erosion prong of the Ownership and Base Erosion Test, a resident will be eligible for treaty benefits if less than 50 percent of its gross income is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to benefits of this Convention under subparagraph a) (i.e., resident individuals); b) (i.e., the Contracting States, political subdivisions or local authorities thereof, or a person that is wholly-owned by a State, political subdivision, or local authority); d) (i.e., tax exempt entities or qualifying pension funds); and entities described in subdivision i) of subparagraph c) (i.e., residents that satisfy the Publicly Traded Entity Test), of paragraph 2 (“Qualifying Payees”). Notably absent from the list of Qualifying Payees is a resident of a Contracting State that satisfies the Subsidiary of a Publicly Traded Entity Test.

From a commercial perspective, in many cases a resident that satisfies the Publicly Traded Entity Test will serve solely as a holding company with any borrowing under a credit facility occurring at a subsidiary level. Accordingly, it is common in a multinational group context for a wholly owned subsidiary of the parent holding company to borrow and then on-lend the proceeds to the group’s offshore affiliates. In this scenario, if residents that satisfy the Subsidiary of a Publicly Traded Company Test are not considered Qualifying Payees, any amounts paid or accrued directly to such
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residents would be viewed as base eroding payments under the base erosion prong of the Ownership and Base Erosion Test.

To address these types of fact patterns, we recommend expanding the definition of Qualifying Payees for purposes of the base erosion requirement of the Ownership and Base Erosion Test to include a resident of a Contracting State that satisfies the Subsidiary of a Publicly Traded Entity Test. This amendment would allow for the granting of treaty benefits in a common commercial fact pattern where a subsidiary of a publicly traded entity borrows and on-lends to members of an affiliated group rather than the publicly traded entity borrowing and on-lending the proceeds itself.

V. Derivative Benefits Test

The Follow Up Report solicits suggestions on possible changes to the Derivative Benefits Test (paragraph 4 of Article X) and the definition of equivalent beneficiary in subparagraph f) of paragraph 6 of Article X to ensure that the inclusion of a Derivative Benefits Test would not raise BEPS concerns while providing for fact patterns where an intermediate company, used for valid commercial purposes, would not be excluded from treaty benefits. Below are our recommendations in respect of the Derivative Benefits Test and the definition of equivalent beneficiary as currently drafted.

Our first recommendation is in respect of the ownership prong of the Derivative Benefits Test. Specifically, the ownership prong currently would require that at least 95 percent of the aggregate voting power and value of a resident’s shares (and at least 50 percent of any disproportionate class of shares) be owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary. With respect to this ownership requirement, we are not aware of any policy reason to limit the maximum number of equivalent beneficiary owners to seven. Accordingly, we recommend that limiting the number of potential equivalent beneficiaries to seven or fewer for purposes of the ownership prong of the Derivative Benefits Test be eliminated.

Our second recommendation is in regards to the requirement that in the case of indirect ownership, each owner in the ownership chain must be an equivalent beneficiary. As currently drafted, the term equivalent beneficiary is limited to specific residents that meet the definition of a qualified person under paragraph 2 of Article X, including: (1) resident individuals; (2) the Contracting States, political subdivisions or local authorities thereof, or a person that is wholly-owned by a State, political subdivision, or local authority; (3) tax exempt entities or pension funds; and (4) entities that satisfy the Publicly Traded Entity Test as described in subdivision i) of subparagraph c), of paragraph 2. Based on a literal read of this definition, a resident that meets the Subsidiary of a Publicly Traded Entity Test is not an equivalent beneficiary.

As mentioned above in Part IV, as a commercial matter, a publicly traded holding company of a multinational group (“State X Parent”) may own an international holding company (“State Y Parent”...
Holdco”) through a wholly-owned subsidiary resident that satisfies the Subsidiary of a Publicly Traded Entity Test (“State X Subsidiary”). If State X Subsidiary in this example is not an equivalent beneficiary, State Y Holdco may not satisfy the ownership prong of the Derivative Benefits Test, whereas it would if it were owned directly by State X Parent. We are not aware of any policy reason for this distinction. The decision of a multinational group to hold its international operations indirectly through one or more wholly owned subsidiaries is not driven by an intention to treaty shop.

Also, paragraph 83 of the Commentary to the Action 6 Deliverable, addressing what it means to be entitled to “all the benefits” of a comprehensive income tax treaty as required under the definition of an equivalent beneficiary, appears to create uncertainty as to whether it was intended that this indirect ownership requirement be included in the ownership prong of the Derivative Benefits Test. Paragraph 83 reads as follows:

The requirement in subdivision i)A) that a person be entitled to ‘all the benefits’ of a comprehensive tax treaty eliminates those persons that qualify for benefits with respect to only certain types of income. Assume, for example, that company CCO, a resident of State C, is the parent of ACO, a company resident of State A. CCO is engaged in the active conduct of a business in State C and, for that reason, would be entitled to the benefits of a treaty between State C and State B if it received dividends directly from a State B subsidiary of ACO. This, however, is not sufficient for the purposes of the application of subdivision i)B) of the treaty between State A and State B. Also, CCO cannot be an equivalent beneficiary if it qualifies for benefits only with respect to certain income as a result of a “derivative benefits” provision in the treaty between State A and State C. However, it would be possible to look through CCO to its own parent company in order to determine whether that parent company is an equivalent beneficiary. Emphasis added.

The italicized language at the end of paragraph 83 in the Commentary of the Action 6 Deliverable suggests the fact that if CCO is not an equivalent beneficiary it does not preclude the application of the Derivative Benefits Test if CCO’s parent company is an equivalent beneficiary. In our opinion, this statement creates uncertainty as to how the phrase “provided in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary” is to be interpreted. Based on a literal read of this phrase, because CCO is not an equivalent beneficiary and is in the ownership chain, the fact that CCO’s parent company is an equivalent beneficiary would be irrelevant. It would appear that because of the limited definition of an equivalent beneficiary, requiring each person in an ownership chain to be an equivalent beneficiary may result in very few fact patterns where the ownership prong of the Derivative Benefits Test can be met. Accordingly, we recommend striking the following language from the ownership prong of the Derivative Benefits Test: “provided in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary.”
Our third recommendation is to expand the definition of an equivalent beneficiary in the Derivative Benefits Test to include a resident that satisfies the Subsidiary of a Publicly Traded Entity Test in subdivision ii) of subparagraph c) of paragraph 2 of Article X. Such an expansion of the definition of an equivalent beneficiary to include a resident that satisfies the Subsidiary of a Publicly Traded Entity Test will prevent the denial of income tax treaty benefits in common commercial transactions. As discussed in Part IV, above, in many cases a resident that satisfies the Publicly Traded Entity Test will serve solely as a holding company with any borrowing under a credit facility occurring at a subsidiary level. Accordingly, it is common in a multinational group context for a wholly owned subsidiary of the parent holding company to borrow and then on-lend these proceeds to the group’s offshore affiliates. In this scenario, if a resident that satisfies the Subsidiary of a Publicly Traded Company Test is not considered an equivalent beneficiary, any amounts paid or accrued directly to it would be viewed as base eroding payments under the base erosion prong of the Derivative Benefits Test. Our view is that the proposed expansion of the definition of equivalent beneficiary to include a Subsidiary of a Publicly Traded Entity Test is necessary to help ensure that a resident that pays or accrues interest to a resident that meets the Subsidiary of a Publicly Traded Entity Test rather than to the resident who satisfies the Publicly Traded Entity Test will not fail the base erosion prong of the Derivative Benefits Test.

VI. Discretionary Relief

A. In General

The Follow Up Report requests factors or examples that should be considered in applying the discretionary relief provision of paragraph 5 of Article X. We agree with the OECD’s acknowledgement of certain factors that, while common in the commercial arena, could constitute developments that might cause a resident of a Contracting State to fail one or more of the objective Entitlement to Benefits tests in paragraphs 2 through 4 of Article X without violating the stated purpose of the applicable income tax treaty. As outlined in paragraph 67 of the Commentary to the Entitlement to Benefits provision in the Action 6 Deliverable, such factors include, but are not limited to, “the history, structure, ownership and operations of the resident that makes the request, whether that resident is a long standing entity that was recently acquired by non-residents for non-tax reasons, whether the resident carries on substantial business activities, whether the resident’s income for which the benefits are requested is subject to double taxation and whether the establishment or use of the resident gives rise to non-taxation or reduced taxation of the income.” Consistent with the Commentary in paragraph 68 of the Action 6 Deliverable, we recommend that the Competent Authorities publish the facts and circumstances leading them to grant discretionary relief pursuant to paragraph 5 of Article X. We recognize that not every member of the OECD makes a practice of doing so, but an encouragement by the OECD within the Commentary to paragraph 5 of Article X supports the stated purpose of granting treaty benefits to residents of Contracting States on a consistent basis.
B. Proposed Examples to be included in the Commentary to Paragraph 5 of Article X

Last, we propose for inclusion in the Commentary to paragraph 5 of Article X the following examples (or some variation thereof), which illustrate non-treaty shopping facts and circumstances that may result in the Competent Authority granting a discretionary determination to a resident of the other Contracting State.

Example 1

Corporation A is a resident of State X. All of the aggregate voting power and value of Corporation A’s shares is owned equally by ten corporations that are not residents of State X. Each of these ten corporations meets the definition of an equivalent beneficiary pursuant to subparagraph f) of paragraph 6 of Article X. It is assumed that Corporation A meets the base erosion prong of the Derivative Benefits Test. Nonetheless, Corporation A does not qualify for income tax treaty benefits under the Derivative Benefits Test since ten equivalent beneficiaries own 95 percent of its aggregate voting power and value. That is, Corporation A does not satisfy the ownership prong of the Derivative Benefits Test.

Assuming the ownership prong of the Derivative Benefits Test will continue to require that seven or fewer equivalent beneficiaries own at least 95 percent of the aggregate voting power and value of a resident’s shares (and at least 50 percent of any disproportionate class of shares), a discretionary determination should be granted if more than seven equivalent beneficiaries own at least 95 percent of the aggregate voting power and value of a resident’s shares (and at least 50 percent of any disproportionate class of shares) (absent other indications of treaty shopping in a given fact pattern).

Example 2

Corporation A is a resident of State X. Fifty percent of the issued and outstanding shares of Corporation A stock is owned equally by six corporations (the “Corporate Shareholders”). Each of the Corporate Shareholders is a resident of State Y and satisfies the Publicly Traded Entity Test under the Entitlement to Benefits provision of the State X/State Y income tax treaty. The other 50 percent of Corporation A’s outstanding shares is owned by an individual resident in State Z (and the individual resident is not an equivalent beneficiary). As Corporation A does not satisfy the Five or Fewer Requirement of the Subsidiary of a Publicly Traded Entity Test, Corporation A does not meet the definition of a qualified person and, therefore, is not entitled to income tax treaty benefits (assuming it does not satisfy the Ownership and Base Erosion Test in paragraph 2.e) or the Active Trade or Business Test in paragraph 3 of Article X of the State X/State Y income tax treaty).

Assuming the Five or Fewer Requirement continues to apply under the Subsidiary of a Publicly Traded Entity Test, a discretionary determination should be granted if more than five residents that satisfy the Publicly Traded Company Test own at least 50 percent of the
aggregate voting power and value of an entity resident in one of the Contracting States (absent other indications of treaty shopping in a given fact pattern).

Example 3

Parent, a resident of State Y, owns all of the outstanding stock of Subsidiary, a resident of State X. The ownership of the shares of Parent is such that 50 percent of Parent’s voting power and value is directly or indirectly owned by individual residents of State Y (“State Y Shareholders”). The other 50 percent of Parent’s stock is owned by residents of a State with whom State Y does not have an income tax treaty. Parent has historically qualified for benefits of the State X/State Y income tax treaty under the Ownership and Base Erosion Test in the Entitlement to Benefits provision. During the first half of the relevant taxable period, one of the State Y Shareholders (“Individual A”), relocates to State A. As a result of Individual A’s change in tax residence, Parent no longer satisfies the ownership prong of the Ownership and Base Erosion Test. Sometime after Individual A’s change in tax residence, Subsidiary distributes a dividend to Parent. If the State X/State Y income tax treaty were to apply the dividend would be exempt from State X withholding tax. Absent treaty intervention, State X imposes a 20 percent withholding tax on cross-border dividend distributions. It is assumed that Parent does not satisfy the Active Trade or Business Test in paragraph 3 of Article X.

Under the criteria of paragraph 2.e), Parent, which had qualified for income tax benefits prior to Individual A’s change in tax residency, technically would not qualify for income tax treaty benefits on the dividend payment date. There are several facts in this Example 3 relevant to a discretionary determination by the State X Competent Authority. First, Parent does not have control over the residency choices of its shareholders, including Individual A; there is no action that Parent can take to prevent its shareholders from changing their respective tax residencies. Second, Parent is unlikely to be able to maintain real-time information on the residency of its shareholders. At the time of the dividend payment, the residency of Individual A may or may not be ascertainable; this information may not be determinable until sometime after the dividend payment is made. Third, there has been no transaction resulting in a change of ownership between persons; Individual A owned his/her equity interest in Parent both prior to, and subsequent to, the change in tax residency event. In such case, the State X Competent Authority might consider an extension of benefits under the State X/State Y income tax treaty for either the length of the taxable period or for the specific dividend payment. Also, because the residency of direct and indirect owners of Parent are outside the control of a resident and cannot always be ascertained at any given moment during the taxable period, the State X Competent Authority may consider testing at the end of the year to be sufficient for testing purposes. It is unlikely that such a fact pattern would be deliberately created for tax avoidance purposes. However, if this was the case the Competent Authority may refuse to grant discretionary relief.
Example 4

Parent, a resident of State Y that satisfies the Publicly Traded Entity Test, owns all of the outstanding stock of a State X resident company ("Subsidiary"). Parent lent money to Subsidiary, an arrangement which has been substantiated by a formal note bearing an arm’s length rate of interest. Subsidiary has been making payments on the interest and principal for several years consistent with the terms of the note. Because Parent has historically qualified for all the benefits under the State X/State Y income tax treaty through satisfaction of the Publicly Traded Entity Test in the Entitlement to Benefits provision, interest has been exempt from State X withholding tax. Several months into the current taxable period, Parent is acquired and taken private by a group of investors, the majority of which are not residents of State X or State Y. As a result of the acquisition, Parent no longer satisfies the Publicly Traded Entity Test (or any other test in the Entitlement to Benefits provision of the State X/State Y income tax treaty).

Because of the objective criteria of the Entitlement to Benefits provision, in this Example a resident of a Contracting State that was previously entitled to claim the benefits of an applicable income tax treaty loses such right as a result of a common commercial transaction. There are several relevant facts and circumstances that support a discretionary determination in this case. First, the financial instrument in question existed prior to Parent no longer meeting the Publicly Traded Entity Test. Second, there has been no change in the relationship between Parent and Subsidiary or their respective activities. Third, payments have been made on the instrument according to its terms for several years, and the transaction does not affect the payment terms of the instrument. Finally, the transaction itself had no tax avoidance purpose with respect to the State X/State Y income tax treaty. These are all relevant facts and circumstances supporting the granting of a discretionary determination.

There are several actions the State X Competent Authority might take in this case. At its discretion, the State X Competent Authority might consider extending full treaty benefits to Parent for a limited amount of time, for example, 2 years. The State X Competent Authority might also consider grandfathering the specific financial instrument giving rise to the interest that has historically been exempt from source country withholding tax under the Interest Article of the State X/State Y income tax treaty. If the latter option were chosen, the grandfathered benefits could be subject to revocation should the terms of the financial instrument be materially altered, or should any of the underlying facts of the structure change in the future.
VII. Conclusion

KPMG LLP appreciates the opportunity to comment on this important initiative and the work performed to date on Action 6. We would welcome the opportunity to discuss any of our recommendations with the OECD.
Private & confidential

Marlies de Ruiter
Head Tax Treaties
Transfer Pricing and Financial Division
OECD/CTPA

9 January 2015

Dear Marlies

Response to OECD Discussion Draft of 21 November 2014 on Follow Up Work On BEPS Action 6: preventing treaty abuse

Introduction

KPMG LLP, the KPMG Member Firm in the UK, are pleased to provide our comments on the above Discussion Draft.

As a preliminary point, we welcome the fact that the final recommendations issued on 16 September 2014 on Action 6 accept that inclusion of a limitation of benefits (LOB) clause should not be mandatory but is one of the options in creating a minimum standard of protection against treaty abuse. We believe that adequate protection can be provided through the principle purpose test (PPT) and therefore it should be left up to member states to decide which test they wish to adopt.

We set out below responses to the specific questions raised.

A. Issues related to the LOB provision

1 Collective Investment Vehicles (CIVs)

Our view is that the findings of the OECD’s 2010 Report on The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles remain sound as it recognises that different fund structures need to exist in order to suit the various requirements of different investor types. Given that CIVs are, generally, widely held and the investors have no day to day control over the assets we consider that such funds should not be subject to an LOB clause.

If a LOB clause is to be introduced into a treaty for CIVs, it should include equivalent beneficiaries in the test and these should not be limited to a particular number or percentage.
CIVs are often marketed cross-border, and this is particularly the case with UCITS funds in Europe. Without counting equivalent beneficiaries this would have the effect of funds (and consequently the entire investor base) suffering unduly from successful marketing in other jurisdictions. The EU single market (and the UCITS Directive) encourages the cross-border marketing of funds which would in theory lead to larger funds being marketed across Europe as opposed to fund houses being required to manage (less efficiently) multiple domestic fund ranges.

Ultimately, if LOB requirements are introduced, there need to be practical ways of being able to ensure that the requirements can be met, given the widespread use of intermediaries in the distribution model.

KPMG in the UK supports the Investment Association’s work in this area.

2 Non-CIV Funds

Pension funds

It may not be possible for a pension fund to know if any beneficiaries have moved abroad which could create an issue with demonstrating that a test based on the residence of 50% of the beneficiaries has been passed.

Where the fund is an occupational scheme set up for the employees of a particular company, it is arguable that there is no need to test the residence of the beneficiaries provided that the fund is resident in the same country as the sponsoring company. As an occupational scheme is usually made available to employees who are resident in the same country as the employer, it is unlikely that such a rule could give rise to a significant treaty shopping risk while it would greatly simplify compliance for many funds.

3 Discretionary Relief Provision

We believe that discretionary benefits test should be available where the taxpayer can demonstrate that incorporating the company in the relevant country was not done in order to obtain treaty benefits. Where the benefit under the relevant treaty are no greater than those provided under the treaty between the parent company and the investee company we consider this should lead to a presumption that the discretionary benefits test should be passed.

4 Issues related to derivative benefit provision

For purposes of subdivision 2 c)ii) of the LOB Article (the “Subsidiary of a Publicly Traded Entity Test”), the requirement that five or fewer residents that satisfy the Publicly Traded Entity Test must own at least 50 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company or entity should be eliminated such that any number of residents that satisfy the Publicly Traded Entity Test must own at least 50 percent of the aggregate voting power and value of the
shares (and at least 50 percent of any disproportionate class of shares) in the company or entity.

For purposes of applying the base erosion prong of the Ownership and Base Erosion Test in subparagraph 2 e), the list of qualifying payees should be expanded to include a resident of one of the Contracting States that satisfies the Subsidiary of a Publicly Traded Entity Test.

For purposes of the Derivative Benefits Test in paragraph 4 of Article X, the requirement that seven or fewer equivalent beneficiaries own at least 95 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company should be eliminated such that any number of equivalent beneficiaries must own at least 95 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company;

For purposes of the ownership prong of the Derivative Benefits Test, in the case of indirect ownership, the requirement that all indirect owners in the ownership chain be equivalent beneficiaries should be eliminated.

The definition of an “equivalent beneficiary” in subparagraph 6 f) should be expanded to include a resident that satisfies the Subsidiary of a Publicly Traded Entity Test.

For more detail on the above recommendations please the representations filed by the US Member Firm of KPMG International Cooperative.

5 Timing issues related to various provisions of the LOB clause

Becoming or ceasing to be listed would not trigger a new taxable period under UK. Therefore where such an event occurs during the tax year the publicly listed test would be failed.

Given, in particular, that the principle class of shares have to be regularly traded, it is unlikely that this test could be used for avoidance purposes. It could therefore be amended to that the test only needs to be satisfied at the date the relevant payment is made.

6 Conditions for the application of the provision on publicly-listed entities

We consider that the tests in subdivision 2 c)(i)A) should be expanded where the relevant contracting state is within the EU so that the recognised stock exchange can be anywhere within the EU or any country with which the other contracting state has a treaty with a full LOB clause. Failure include such a clause may lead to a breach of the free movement of capital requirements under EU law as a parent company would receive less favourable treatment (ie no treaty relief) if it raised capital on a foreign exchange. As the free movement of capital applies to movements into and out of the EU, as well as within the EU, it is necessary for the exemption to extend to non-EU listing. Restricting the extension to exchanges in a countries with a treaties which contain an LOB clause should prevent treaty shopping.

7 Clarification of the “active business” provision

No comment.
B Issues related to the PPT rule

8 Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary of relief provision that deal with the principle purposes test

We do not see that there is any conflict between these two rules.

9 Whether some form of discretionary relief should be provided under the PPT rule

We agree that where the tax authority invokes the PPT on the basis that the taxpayer has structured a transaction so as to be taxed under a more favourable provision in the treaty than the one which would have applied absent the steps taken (as in the example given in the discussion draft of structuring a dividend to become an exempt capital gain), relief should be given under the less favourable provision (the dividend article in the example). To deny relief totally where it would otherwise have been given would create a “windfall” for the tax authority. However the taxpayer should not be able to claim relief on the basis that it could have done an entirely different transaction (eg paying interest rather than a dividend if that would have had a better treaty outcome).

10 Drafting the alternative “conduit-PPT rule”

No comment.

11 List of examples in the Commentary in the PPT rule

Investment funds are generally structured to be tax neutral – ie so they do not create an additional layer of tax above and beyond the tax that investors would incur if they invested directly. The fact that an investor – who would not have access to a favourable treaty rate - invests in a fund which has access to favourable treaties does not mean that obtaining a benefit under the relevant treaty was one of the principle purposes any “arrangement or transaction.” It is therefore considered that the guidance should make it clear that the PPT test does not generally apply to investment funds except in very limited circumstances – eg where the fund has been set up to be marketed primarily to persons who would not have obtained treaty benefits.

C Other Issues

12 The design and drafting of the rule applicable to permanent establishments located in third states

We think that the rule is properly restricted to cases where the PE is exempt and that subparagraphs e) and f) provide sufficient exemptions for non-tax driven situations. As drafted we do not consider that the provision gives rise to a BEPS concern.
13 Proposed commentary on the interaction between tax treaty’s and domestic anti-abuse rules

No comment.

Yours Sincerely

KPMG LLP
BASE EROSION and PROFIT SHIFTING (BEPS)

Follow up work on Action 6 (Public Discussion Draft)

To: Marlies de Ruiter,
Head, Tax Treaties,
Transfer Pricing and Financial Transactions Division,
OECD/CTPA

JANUARY 2015
ABOUT THE LAW SOCIETY OF IRELAND

The Law Society of Ireland is the educational, representative and regulatory body of the solicitors' profession in Ireland.

The Law Society exercises statutory functions under the Solicitors Acts 1954 to 2011 in relation to the education, admission, enrolment, discipline and regulation of the solicitors' profession. It is the professional body for its solicitor members, to whom it also provides services and support.

The headquarters of the organisation are in Blackhall Place, Dublin 7.
1. Introduction

1.1 This submission is made on behalf of the Taxation Committee of the Law Society of Ireland, the professional body representing lawyers qualified as solicitors in Ireland.

1.2 The Law Society of Ireland is committed to supporting measures designed to prevent the abuse of tax and tax treaties.

1.3 It has considered carefully the proposed amendments to the Model Treaty and while the purpose of the measures is welcomed, the Law Society is concerned that the provisions could have a wider impact. In particular, the provisions could result in removing an element of certainty for tax payers and also inhibit international trade, in particular trade with smaller jurisdictions.

2. Limitation of Benefits (LOB)

2.1 It is the view of the Law Society that companies operating in smaller jurisdictions will be prejudiced, as where there is a smaller economic base, there is a greater need to look outward for business and investments. Companies based in these jurisdictions will find it more challenging to fit into the safe harbours of LOB.

2.2 For example, the ‘local stock exchange’ requirement - in addition to possibly breaching EU Law - prejudices companies who list on foreign stock exchanges. Similarly, in many cases, particularly in the smaller territories, entities are owned or funded from sources outside their home territory. This is done to facilitate international trade however those types of companies may have treaty benefits denied to them under LOB provisions because of this international aspect. It is considered that this is discriminatory, particularly in respect of smaller jurisdictions and may also violate EU principles of freedom of trade and establishment.

3. Principal Purpose Test (PPT)

3.1 The Law Society is concerned that the PPT introduces a level of subjectivity and uncertainty for international transactions. It is considered that this is unhelpful for genuine trading activities, and would also be particularly detrimental to smaller jurisdictions dependent on international trade.
3.2 The uncertainty inherent in a PPT may be mitigated by a binding and detailed commentary setting out objective criteria which clarify the limited situations in which the PPT applies.

4. Conclusion

4.1 While the Law Society supports measures to counteract treaty abuse, we are concerned that the proposals drafted are farther reaching than required and create uncertainty in international business relationships.

4.2 We are particularly concerned that the measures will be unduly damaging to smaller jurisdictions. The Law Society is conscious that the purpose of a tax treaty is to promote international trade by removing obstacles to that trade.

4.3 A tax treaty that is subject to restrictions that go beyond what is necessary or are vague, fundamentally undermines the effect of entering into such a treaty.

4.4 Limiting the scope of any LoB and clarifying any PPT (in each case to address only cases of treaty abuse and not other legitimate transactions) is essential to the proper functioning of a treaty.

We urge the OECD to consider representations made above. We are available to expand as required on our views and look forward to doing so at the forthcoming Public Consultation Meeting on the 22 January 2015, for which we have requested registration.

For further information please contact:

Rachael Hession
Secretary,
Taxation Committee,
Law Society of Ireland,
Blackhall Place,
Dublin 7

Tel: 01 8815707
Email: r.hession@lawsociety.ie
By email: taxtreaties@oecd.org

Dear Sirs

BEPS: Action 6 – Treaty Benefits

We wrote to you on 30 October 2014 setting out our concerns that the proposals in the document Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2014 deliverable may inadvertently deny Treaty benefits to certain types of debt fund which play an important systemic role in the European and international loan markets.

On 21 November 2014 you published a follow-up paper that discussed, in particular, certain issues relating to the treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds.

Unfortunately neither the original Action 6 paper nor the 21 November paper considers the position of debt funds of the type discussed in our letter of 30 October.

Most debt funds of this type are targeted at institutional investors and so are not subject to investor-protection regulation (and therefore would not fall within the "collective investment vehicle" definition in the 2010 Report). However most are widely held and hold a diversified portfolio of loans, and hence can be distinguished from the "alternative funds" described in paragraph 15 of the 21 November 2014 document.

Given the balance sheet constraints on banks imposed by recent regulatory measures, the proportion of lending by banks is expected to decline in the medium-to-long term, and the proportion of lending by debt funds is therefore expected to materially increase. It seems to us that the consequences for the loan market and the wider economy would be very serious if the effect of the final Action 6 proposals was to prevent so significant an element of the loan market from engaging in further lending, and indeed triggering a widespread disinvestment by debt funds from their existing positions.
We would therefore stress the importance of any final proposals around *Action 6* addressing the position of debt funds, and preserving their treaty eligibility. We do not see "purpose" tests as problematic, given that debt funds are entirely commercial arrangements; however we continue to believe that LOBs are inherently difficult or even impossible for debt funds to satisfy, given the practical difficulties of identifying investors (and the impossibility of identifying investors in the case of CLOs and other entities that issue cleared debt securities).

We look forward to raising these concerns at the meeting in Paris on 22 January, which both I and our tax counsel, Dan Neidle of Clifford Chance LLP, shall be attending. We would be grateful if Mr. Neidle could speak to the issues we have raised.

Please do not hesitate to contact us in advance of the Paris meeting if you would like further information on any of the above.

Yours faithfully

**Clare Dawson**
Chief Executive

cc HM Treasury
By email: taxtreaties@oecd.org

BEPS: Action 6 – Treaty Benefits

Dear Sirs:


The Loan Syndications and Trading Association (LSTA) is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trading of commercial loans. The 380 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as law firms, service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardised practices, procedures, and documentation to enhance market efficiency, transparency, and certainty.

An important and expanding element of the loan market are corporate debt funds, CLOs, securitisations and other special purpose entities established to advance or acquire loans to corporate borrowers. For ease of reference we will refer to all these entities as debt funds.

Debt funds are typically widely held and invest in a diversified portfolio. Typical investors in debt funds are financial institutions, insurance companies, pension funds, hedge funds and sometimes high net worth individuals. Their investments may take the form of debt securities, shares, units or limited partnership interests. From the investors' perspective, the purpose of the arrangements is, generally speaking, to gain exposure to a diversified portfolio of corporate loans.
We are concerned that the OECD materials referenced above do not consider the positions of entities of this type. Most are targeted at institutional investors and so are not subject to investor-protection regulation (and therefore would not fall within the "collective investment vehicle" definition in the 2010 Report). However most are widely held and hold a diversified portfolio of loans, and hence can be distinguished from the "alternative funds" described in paragraph 15 of the 21 November 2014 document.

An importance of the sector can be illustrated by the fact that non-banks took up 48% of European primary market leveraged lending in 2013 and, of this, just under half was lent by CLOs (and, whilst a detailed breakdown is not available, a significant proportion of the remainder will have been lent by other entities that are "debt funds" as described above)\(^1\). Given the balance sheet constraints on banks imposed by recent regulatory measures, the proportion of lending by banks is expected to decline in the medium-to-long term, and the proportion of lending by debt funds therefore expected to materially increase.

We have seen a copy of a letter which the Loan Market Association (LMA) sent to you on 30 October 2014 concerning the proposals in the document Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2014 deliverable. We share the LMA's concern that these proposals may inadvertently deny Treaty benefits to debt fund SPVs, with potentially very serious adverse consequences for the loan market and the wider economy.

US debt funds lend to borrowers in Europe and across the world, either directly or via SPV subsidiaries established in other jurisdictions. As the LMA notes, whilst debt funds are not tax motivated transactions, some tax planning is required to ensure the transactions are economically viable, as interest rates on loans are typically set on the basis there will be no withholding tax. The debt fund itself or SPV will therefore typically be located in a jurisdiction which has tax treaties with expected borrower jurisdictions to ensure that interest on loans that are acquired can be paid free of any withholding tax. For example, a US debt fund investing in loans to European borrowers will in most cases establish an SPV in Ireland, Luxembourg or The Netherlands to hold those loans.

As the arrangement is entirely commercial, we think it is clear that debt funds are not "abusive". We would therefore agree with the LMA that it is entirely appropriate to grant Treaty benefits to a debt fund SPV. The proposal in the Action 6 document for a Limitation on Benefits (LOB) Article will, however, in many cases have the effect of denying Treaty benefits to debt fund SPVs, because it will generally be impracticable for those SPVs to identify their ultimate investors (or even impossible, e.g. where the investors hold cleared debt securities).

It has been suggested that the inclusion of LOB Articles in the US's existing double tax treaties shows that LOBs are workable. We do not agree – the US's LOB Articles must be seen in the context of the particularities of the US tax system. In particular, the US generally exempts foreign non-banks from US withholding tax on interest (under the "portfolio interest" exemption). Accordingly, whilst most debt funds lending to the US would usually be denied treaty relief by the relevant LOB Article, treaty relief is not typically required. This will of course not be the case if LOBs are adopted universally, as most jurisdictions do not have an equivalent of the portfolio interest exemption.

It also follows from the existing features of the US tax system, noted in the above paragraph, that US borrowers are unlikely to be affected by any of the Action 6 proposals. However the range of approaches suggested in the proposals document will in our view have a very material adverse effect on US funds and investors, and on many borrowers outside the US.

We would make the following specific points (many of which overlap with those raised by the LMA):

- Ignoring the problems associated with debt funds completely will in practice mean that debt fund SPVs will not be eligible for Treaty relief. A large proportion of lenders in the loan market would simply be unable to continue to lend, and would have to exit their existing positions. This would cause a significant loss of liquidity and contraction in credit in the loan market, with potentially very serious adverse consequences for businesses seeking new finance, or to refinance their existing debt.

- There would therefore clearly be a preference for all States to treat all bona fide debt fund SPVs as individuals for the purposes of a Treaty and hence not subject to the LOB provisions at all.

- The "mid" approach of leaving it to individual States to allow fund vehicles to fall within the definition of a "qualified person" will inevitably lead to inconsistent approaches and uncertainty.

- If States choose additional restrictions, those restrictions should be drawn up with debt funds in mind. For example, the suggested requirement that a fund entity's "shares" are listed would disqualify CLOs, securitisations and other debt fund SPVs that issue debt securities. Further, if a "less generous" approach is taken by States such SPVs may have to determine their entitlement to Treaty benefits by reference to their investor base. As noted above, this will be impracticable at best, and impossible in many cases.
• Utilisation of the discretionary relief procedure is unlikely to be practicable for most debt funds, as no investor would invest with a fund that requires a subsequent and discretionary procedure to prevent its investments being economically unviable.

• We would make the additional observation that we would query whether the proposal that States be free to adopt a range of approaches for funds is compatible with the proposal in Action 15 to facilitate swift amendment of multiple treaties through the use of a multilateral instrument.

Finally, we note that the OECD is doing further work in the Funds area and that policy considerations will be addressed to make sure that the Action 6 proposals do not unduly impact collective investment vehicles (CIVs) and non-CIV funds in cases where countries do not intend to deprive them of Treaty benefits. We would kindly request that this stream of policy work also includes debt fund SPVs.

Please do not hesitate to contact us if you would like further information on any of the above.

Yours faithfully

[Signature]

R. Bram Smith
Executive Director

Cc: Robert Stack, Deputy Assistant Secretary for International Tax Affairs, United States Department of the Treasury (robert.stack@do.treas.gov)
9 January 2014

Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development (OECD)
2 rue Andre-Pascal
75775, Paris
Cedex 16
France

By email: tax treaties@oecd.org

Dear Ms de Ruiter

RE: OECD Discussion Draft: Follow up work on BEPS Action 6, Preventing Treaty Abuse

M&G is the UK and European fund management business of the international financial services group Prudential plc. It has over £260 billion of funds under management, making it one of the largest UK fund managers.

We manage a range of different fund types in the three major fund jurisdictions in Europe, which include UK Open Ended Investment Companies, UK partnerships, Irish Variable Capital Investment Companies, Irish Common Contractual Funds, Luxembourg SICAVs and FCPs. Access to tax treaties and the certainty of tax treatment is critical to our business and the products we manage.

We welcome proposals to combat treaty abuse and treaty shopping but would like to emphasize that Action 6 proposals need to be considered in light of the commercial and business needs of funds – both Collective Investment Vehicles (“CIV”) and non-CIVs. Uncertainty in the ability to access double tax treaties has a direct impact on fund performance and consequently the returns of investors.

Funds are designed to provide a cost efficient, diversified pooling vehicle to facilitate investment and savings. The principal reason an investor would choose to invest in our funds is not to take advantage of tax benefits but to benefit from the professional investment expertise at M&G. Funds play an important role in society as well as in the capital markets - M&G funds contribute to the liquidity of securities markets, invest in private debt financing where financial institutions are not able to lend, hold infrastructure assets and direct real estate which includes residential property and social housing. Most importantly, many of the investors in M&G funds are small retail investors and pension schemes where the returns from our funds contribute to their future financial security. Being denied treaty benefits at the level of investments would not be conducive to promoting the long term saving and investment.

We are supportive of the comments put forward by the UK Investment Management Association which M&G is a member of and we are grateful for the opportunity to provide our own comments on Action plan 6. We would be happy to speak in support of our comments.
General comment - Action 6 and TRACE

1. General comments – Action 6 and TRACE

In the discussion draft, we notice that reference is made to the question of treaty entitlement of CIVs taking into account developments since 2010, in particular, the results of the work on TRACE.

It is important to note that these are two separate concepts to consider. Firstly, the treaty entitlement of funds is a question of fact based on the specific nature and type of fund. This point is well documented in the 2010 Granting of treaty benefits with respect to the income of Collective Investment Vehicles report (“2010 CIV Report”). As discussed in that report, there are complexities around the treatment of funds as they rely on the source country being able to understand the specific nature of the fund vehicle. Unfortunately, many treaties do not define the treatment and entitlement of fund types, which often gives rise to uncertainty for funds looking to claim treaty benefits. M&G welcome any proposals which will reduce the uncertainty and improve consistency of treatment for funds. We believe that the work on Action 6 provides a good opportunity to do this.

Secondly, is the concept of TRACE. TRACE is intended to be a mechanism to obtain tax relief by standardising procedures for the claiming and reporting of withholding tax - it does not consider the treaty entitlement of funds. M&G are supportive of the TRACE initiative which can add significant value to funds and investors through increased efficiency in the application of reduced withholding tax rates, which will enable funds to be priced more accurately and performance to be reflected equitably. TRACE will also be valuable for those funds which are not entitled to access treaties in their own right and could allow funds to claim treaty benefits on behalf of its investors.

Discussion on the TRACE mechanism is outside of the scope of Action 6 and our response to the discussion draft. We therefore provide our comments on the issues identified in the follow up discussion draft.

1. Collective investment vehicles (CIVs): application of the LOB and treaty entitlement

The 2010 CIV Report was comprehensive and the recommendations highlight the many factors and complexities that must be considered, which remain relevant today. Perhaps due to this, contracting states have not provided clarity on the treaty entitlement of funds and have instead been raising further questions in relation to the entities claiming treaty benefits.

Since the 2010 Report, M&G like many other fund houses has faced increased uncertainty over whether the funds can continue to receive the same treaty benefits which they have done historically in certain investment jurisdictions. As a consequence, prudent accounting positions have been taken (e.g. assume no access to treaties) which may underestimate the returns to investors. It is important to remember that the value for investors in a fund derives from the ability to accurately report performance and pricing as this determines the income return and capital growth from the fund. Accordingly, reduced performance will negatively impact the appeal of funds as an investment product.

Given the nature of CIVs, it is not appropriate that they are subject to the LOB conditions and we welcome the approach to carve out CIVs from the minimum standard as suggested by Subparagraph 2(f) of the Action 6 report. Undoubtedly, some countries may still choose to implement a LOB clause for CIVs and in such a case, we request OECD provide guidance to assist those countries in forming a practical approach to determining equivalent beneficiaries which is not administratively burdensome and which can be applied by CIVs. In particular, there cannot be a limit to seven or fewer persons.

Whilst there cannot be a single overarching approach to the treaty entitlement of funds, we would welcome further recommendations from the OECD which reiterate some overarching principles in order to help narrow the scope of uncertainty. This will in turn assist contracting states in reaching their conclusions on the treaty
entitlement for specific fund types. We would suggest that the overarching principles could include the following:

i. **CIVs are not vehicles used for treaty abuse**

It should be recognised that CIVs, as ‘widely held’ products, should not be considered as vehicles used for treaty abuse. CIVs by definition allow investors to pool together and benefit from economies of scale. An investor would often choose to invest in a particular fund for the investment strategy or because of the track record of the individual fund manager, not for tax reasons. By way of example, M&G retail funds which are constituted as UK Open Ended Investment Companies (OEICs) are successfully sold across Europe to retail investors despite them being less common and perceived as being vehicles which are subject to UK tax.

The 2010 CIV Report makes a distinction between publicly traded CIVs suggesting that if the fund is publicly traded it cannot be used effectively for treaty shopping. There should not be such a distinction, as a non-listed fund can equally be bought and sold by investors on a daily basis by transacting with the fund manager. Importantly, an investor in a fund cannot select or influence the decision on what the underlying investments should be. Accordingly, an investor in a CIV cannot be considered to be using the vehicle for treaty shopping and abuse.

ii. **CIVs that are corporates (or treated as corporates), tax resident and the beneficial owners of the income should be recognised as ‘persons’ which are treaty entitled.**

As set out in Para 25 of the 2010 CIV Report, a CIV structured as a company clearly would constitute a person. CIVs make investments with money that is raised from investors and does not act on behalf of the investor as agent or nominee or as a conduit. Investors are not aware of the underlying investments that are made, as responsibilities are typically delegated to a professional investment manager. Where the CIV is recognised as tax resident and regularly submits tax returns, this should be considered as further support of its entitlement to treaties. To the extent a company is not considered resident or a beneficial owner then it may be appropriate to consider the beneficiaries of the CIV and whether the CIV may claim treaty benefits on their behalf.

iii. **Allowing CIVs to receive treaty benefits will not result in double non taxation**

In general, CIVs are designed to be tax neutral for investors as investors are generally subject to tax on returns from the CIV. For example, UK individual investors in CIVs generally pay up to 45% tax on income received and 28% tax on capital gains. In some circumstances, tax leakage is suffered at the level of the fund vehicle which could result in three layers of tax – withholding tax on investment, tax at fund level and investor tax when returns are received.

iv. **Unless there are factors which indicate treaty abuse, there should be no requirement to confirm if there are equivalent beneficiaries**

A clause which provides for treaty access where ‘investors are resident in the same jurisdiction as the CIV’ is not practical in a world that is becoming increasingly globalised. Where the funds are open ended and can be bought and sold on a daily basis, the profile of investors can change on a daily basis. It is therefore impractical for a fund to report the status of global investors on a regular basis particularly where funds are sold through various intermediated channels.

As a consequence of EU principles and the UCITS regulations, funds are able to be distributed and sold cross border. To illustrate, one of M&G’s largest funds, the M&G Optimal Income Fund which has a fund size of £25bn, has a majority of its investors from outside the UK.
2. **Non CIV funds – application of the LOB and treaty entitlement**

M&G funds that would fall within the definition of non-CIV funds are (i) funds which may not be considered to be ‘widely held’ – e.g. funds with pension/charity only investors, or (ii) funds which do not invest in securities e.g. infrastructure and real estate funds. As highlighted above, these types of funds provide significant social benefits and subparagraph 2(f) carve out should apply to non-CIV funds in the same way as CIV funds. Each of these fund types are discussed in turn below.

**i. Non ‘widely held’ pension/charity funds**

Pension schemes and charities are generally tax exempt. Tax treaties often afford favourable tax treatments to such entities but it is without doubt that these entities are not used for treaty abuse. In order to facilitate efficient investment by such entities, tax transparent pooling vehicles are often used to ensure the pension scheme/charity receives exactly the same tax treatment as if they had invested directly. In many cases a tax transparent fund vehicle is established to ensure the exempt investor is not adversely impacted by tax. Due to the nature of these transparent funds, it is often required to be able to identify each investor specifically which in turn means that only a small group of investors invest in the fund. We suggest that OECD clarifies that the commentary on Article 1 of the Model Treaty which applies the convention to partnerships would also apply to other fiscally transparent vehicles, which would help provide certainty of treatment. For example, this is applied in practice under in Article 1(8) of the US/UK tax treaty, which provides that income, profit or gain derived by a fiscally transparent entity will be considered to be derived by a resident of a contracting state if a resident is treated under the taxation laws of that state as deriving the item of income.

As well as transparent vehicles, other opaque vehicles may be established to facilitate investment by pension/charity investors. In such a case, consideration should be given to the principal purpose of the vehicle, which is discussed further at point 5 below. Opaque vehicles should be able to access treaties in their own right provided they are properly constituted and treated in the same way as CIVs as above in point 1(ii).

**ii. Funds which invest in alternative assets**

M&G manage infrastructure funds and real estate funds which hold physical assets and also have debt funds which provide a vital source of capital to companies which own real estate. We are seeing a strong interest from investors for social infrastructure which encompasses owning and funding residential developments including social or affordable housing, student accommodation, care homes and social residential care. Such investments provide secure long term income streams that investors desire. Funds play a vital role in pooling the capital to fund the projects as the size of the investments may pose too much of a risk for a single investor.

In many cases, the fund vehicles does not hold the physical assets directly and there are layers of intermediate holding companies and special purpose vehicles constituted as companies which hold the assets. The layered structures are often required for commercial reasons e.g. to facilitate the segregation of investments, to provide flexibility on the future disposal of investments, or financing and bankruptcy remoteness. Importantly, the underlying companies within such structures operate viable business operations and should in their own right be entitled to treaty benefits.

Similar to CIVs, non-CIV funds are not designed for treaty abuse and investors do not invest in funds with the intention to seek tax advantages. Further, the investors are subject to tax on income and capital returns from the fund based on their individual tax profile, so should not give rise to double non-taxation. Consequently, we believe that a specific rule as per subparagraph 2(f) should also apply to non-CIVs. However, as the fund vehicle is not necessarily the entity claiming the treaty benefits, attention should be given to the general definition of ‘qualified person’ and further guidance issued to state that companies (as ‘persons’) should qualify for treaty benefits based on its economic activities and substance. Given the purpose of funds is not for treaty abuse,
where the entity claiming benefits is wholly owned directly or indirectly by a fund, we would suggest that this would be further support for the entity to claim treaty benefits.

In terms of debt funds, these make private unlisted loans which are typically subject to interest withholding tax. As this asset class is not an eligible asset for UCITS regulatory purposes, investors in such funds are limited to institutional investors – many of which should qualify for treaty access themselves e.g. pension schemes. Private loans are burdensome to trade and settle given the specific documentation that is required, so a vehicle which can pool investments is vital for commercial purposes. In addition, a fund vehicle significantly reduces the administrative burdens for the investors to access the treaties they are generally entitled to access. Such funds may be established with one the principal purpose of benefiting from tax treaties, but as this is to reflect the position of the investors, we consider that they should qualify for treaty access nevertheless. Please refer to 5 below for comments on the application of the principal purpose test in this scenario.

3. **Commentary on the Discretionary Relief provision of the LOB rule**

M&G welcomes the discretionary relief provision. This would be particularly useful when a new structure/fund vehicle is developed by a contracting state. A further example of when this provision would be appropriate to employ would be when there is a requirement to modify/change the fund vehicle due to regulatory or commercial requirements. However, we note that this provision should only be used in very limited circumstances to avoid creating uncertainty.

4. **Issues relates to the derivative benefits rules**

Where contracting states choose to adopt a LOB provision without specific provisions for funds, then it is vital that OECD recommends that a derivative benefits provision which is appropriate for funds. Such a provision should not be limited to entities which are controlled by seven or fewer persons.

When applying this rule, the contracting states need to be mindful of the fact that structures are heavily intermediated. Whilst some investors invest directly into the fund, many invest via fund distributors and nominee accounts set up by them. In an ideal world it would be possible to obtain the residency of all investors. However, under the Common Reporting Standard we are not required to look beyond financial institutions (e.g. wealth managers) and outside of this, M&G have approximately 190,000 investors to keep track of in the M&G retail funds. Dividends on investments are received throughout the year and it would be impossible to accurately report on the equivalent beneficiaries at any given time. As suggested in 6.31 of the Model Treaty, a review at the end of the fiscal year or at most on a quarterly basis, should be considered sufficient.

In order to limit the administrative burdens and as a practical solution, we suggest that consideration is given to where the funds are being distributed and the value of the fund held through those distributors to determine the proportion of investors from that jurisdiction. Para 56 of the 2010 CIV Report discusses potential options and we consider that a threshold, which once passed, allows access to 100% of the benefits would be most straightforward to operate in practice, though we respect that the detail of this would need to be determined in bilateral negotiations.

OECD should be as prescriptive as possible in its commentary on how the derivative benefit rule is applied as we have seen different approaches from jurisdictions on whether consideration is given to (i) the value of holdings, or (ii) the number of investors. For example, in order to claim the treaty benefits under the Switzerland/UK tax treaty, the Swiss tax authorities require a review of the number of UK investors regardless of how much value they hold in the fund.

5. **Issues related to the PPT rule**

As alluded to above, certain structures are set up for administrative purposes to pool investors collectively and there are many non-tax reasons for the use of special purpose vehicles. However, it cannot be denied that in
order to ensure a tax neutral effect for investors in a fund, a specific type of fund vehicle may be deliberately established. The principal purpose would therefore be to obtain a treaty benefit but the reason for this would be to reflect the benefits an investor would have received had they invested directly. Accordingly, further commentary on the circumstances where benefits could continue to apply (i.e. granting of benefit would be in accordance with the object and purpose of the convention) would be appropriate.

For example, RCo, an investment company resident of the State R, holds a portfolio of investments in State S. Under the tax convention between State R and State S, the withholding tax rate is reduced from 10% to 0%.

Investors in RCo are pension schemes and other entities that would have been subject to the 0% under applicable tax treaties had they invested directly in investments in State S. For commercial reasons (e.g. professional management, economies of scale) as well as administrative reasons (e.g. RCo is considered to be one investor and therefore one loan agreement is made for each underlying investment), the investors have chosen to collectively pool their investment in RCo which will hold the portfolio of underlying investments. In making their decision to invest in RCo, the investors considered the tax treaty between State R and State S in order to achieve tax neutrality.

Whilst the principal purpose was to achieve the same treatment as if they had invested directly, this should not be caught as the object and purpose of the principal purpose test is to combat tax abuse and to prevent the granting of treaty benefits in appropriate circumstances.

Thank you again for the opportunity to provide comment in relation to this important issue. If you would like to discuss any of our comments please do not hesitate to contact me at Malcolm.richardson@mandg.co.uk or on 0207 548 2316.

Yours sincerely

Malcolm Richardson
Head of Tax, M&G Investments
Dear Ms de Ruiter

Follow-up work on Action 6 (Preventing Treaty Abuse)

We welcome the opportunity to comment on the second discussion draft issued under BEPS Action 6 containing the follow-up work to the report on BEPS Action 6 issued in September 2014.

Matheson is an Irish law firm and our primary focus is on serving the Irish legal and tax needs of Irish and international companies and financial institutions doing business in Ireland. Our clients include over half of the Fortune 100 companies. We also advise seven of the top ten global technology companies and over half of the world’s 50 largest banks. We are headquartered in Dublin and also have offices in London, New York and Palo Alto. More than 650 people work across our four offices, including 75 partners and tax principals and over 400 legal and tax professionals.

In this letter, the “Discussion Draft” refers to the second discussion draft issued under BEPS Action 6 containing the follow-up work to the report on BEPS Action 6 issued in September 2014. The “Report” refers to the September 2014 report. The “2010 Report” refers to the OECD Report “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles”. “LOB” refers to the limitation of benefits clause proposed in the Report. “CIV” refers to collective investment vehicles 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.

Comments in this letter are made solely on our own behalf.
1 Issues related to the LOB provision

1.1 Collective investment vehicles

**2010 Report** The recommendations included in the 2010 Report continue to be adequate for CIVs. It is entirely appropriate that CIVs should be entitled to treaty benefit as recognised in the 2010 Report. By their nature as widely-held regulated investment vehicles designed to promote collective investment, CIVs are clearly not established for treaty shopping purposes.

**Single preferred approach** It is not possible to adopt a single preferred approach for CIVs’ entitlement to treaty benefit. The 2010 Report illustrates that there is a divergence of views between OECD member states regarding the treatment of CIVs, with a minority considering that CIVs should not be automatically entitled to treaty access. These standpoints will not have changed over the past five years.

**Detrimental effect of LOB on CIVs** The LOB should not be applied to CIVs. An application of the LOB to CIVs would have an immediate and very serious detrimental effect on cross-border CIVs (ie, CIVs whose units are primarily distributed on a cross-border regional or global basis):

- ‘Cross-border’ CIVs are good for the financial market and for the stability and efficiency of the financial sector. The 2010 Report recognised that such CIVs can be much more efficient and can offer investors greater economies of scale. The advantages of ‘cross-border’ CIVs has also been recognised by regulators and is reflected in the work done by the EU to promote undertakings for collective investment in transferable securities (“UCITS”) and in the work relating to the Alternative Investment Fund Managers Directive (“AIFMD”). Both of these initiatives are designed to promote cross-border investment funds. Cross-border CIVs would be materially, unjustifiably and permanently disadvantaged if the LOB provision was applied to CIVs.

- An application of the LOB to CIVs would generally mean that a majority of their investors would need to be tax resident in the country of residence of the CIV. By their nature, cross-border CIVs would rarely, if ever, be able to satisfy such a requirement. Accordingly, cross-border CIVs would suffer withholding taxes where CIVs primarily distributed within a single jurisdiction (single country CIVs) would not. This would incentivise establishment of single-country, domestically-distributed CIVs and would quickly lead to segmentation of the CIV market on a country-by-country basis. Action 6 must not have such a permanent, unnecessary and destructive impact on the investment fund industry.

- Incentivising the establishment of single-country, domestically distributed CIVs would prejudice smaller economies and investors resident in those jurisdictions. In a European context, this is incompatible with the objectives of the EU fundamental freedoms.

- The 2010 Report envisaged that member states could agree to grant treaty access on a proportionate basis to CIVs, reflecting the portion of the CIVs’
investors who are themselves equivalent beneficiaries. However, given the vast majority of investors in CIVs hold their interests through intermediaries, it is difficult in practice for CIVs to confirm who their investors are (and consequently to confirm whether they satisfy such requirements). The Treaty Relief and Compliance Enhancement (“TRACE”) project seeks to assist CIVs and tax authorities in establishing the identity of investors for treaty purposes. However, the TRACE project has not yet been fully implemented. It may be sometime before it can solve the issue for CIVs and tax authorities of confirming who holds interests in CIVs. In advance of full implementation of TRACE, any provision that limits treaty relief for CIVs by reference to the investor base will be unworkable.

LOB Commentary on CIVs The proposed additional commentary for CIVs in respect of the LOB is superfluous, and potentially inconsistent with the commentary on Article 1. The relevant issues for CIVs are already adequately addressed in the commentary dealing with Article 1 (reflecting the carefully considered conclusions of the 2010 Report). This LOB commentary in respect of CIVs should therefore be omitted from the final agreed commentary.

In summary, we agree with the conclusions of the 2010 Report and believe that it continues to be the best approach for CIVs. We do not agree that a single preferred approach can be adopted for CIVs on entitlement to treaty benefits. We strongly oppose the application of the LOB to CIVs.

1.2 Non-CIV funds

Similar commercial features Non-CIV funds share many of the same characteristics as CIVs. They are established for the purposes of collective investment (though may not be as widely held as CIVs). They are generally regulated (at least, to the extent they are resident in OECD jurisdictions). They invest on a ‘diversified asset’ basis. Most importantly, in the vast majority of cases, they are established for bona fide commercial purposes, and not as vehicles for treaty shopping.

LOB unsuited The LOB is equally unsuited for non-CIV funds. It would, in most cases, automatically deny treaty access to non-CIV funds, even though no abusive treaty shopping is taking place. In particular, the derivative benefits test in the LOB would not be satisfied in most cases, as non-CIV funds also tend to be held by investors in a number of different jurisdictions (and tend to have more than seven investors).

Review required Work similar to the 2010 Report needs to be undertaken through the OECD Informal Consultative Group to identify issues across the various types of non-CIV funds and develop practical solutions for treaty entitlement.

Wider derivatives benefit provision Until such work has been completed, we would recommend that the ‘equivalent beneficiaries’ approach set out in the 2010 Report be applied for non-CIV funds who are not otherwise entitled to treaty benefits.
1.3 **Securitisation companies**

We remain concerned that sufficient attention has not yet been given to the position of cross-border securitisation companies.

- **Securitisation companies similar to CIVs** Securitisation companies are in a similar position to CIVs. They are established to hold financial assets on an arm’s length basis for bona fide commercial purposes (and not tax abuse purposes). The securities issued by securitisation companies (generally in the form of debt instruments) are typically widely held. They are subject to various regulatory regimes (including, in an EU context, the ‘capital requirement regulations’ rules, the ‘financial vehicle corporation’ rules and the ‘credit agency regulations’).

- **Benefits of securitisation** Securitisation companies are recognised by regulators as an essential part of a well-functioning capital markets. The European Banking Authority has stated that “a well-functioning and prudentially sound securitisation market in the EU helps the real economy and strengthens the resilience of the financial system to banking crises”.

- **Alternative funding in Europe** The European securitisation market remains in difficulty. It has not recovered in the same way as the US securitisation market since the global financial crisis. This has left European companies heavily dependent on bank finance with almost 85% of European finance being provided by banks. Accordingly, the EU has been looking at ways to revive the European securitisation market and develop it as a viable alternative to bank finance for the real economy.

- **Revival of European securitisation market** Cross-border securitisation companies are central to the revitalisation of the European securitisation market. They facilitate efficient allocation of capital by investors located in different jurisdictions. However, if cross-border securitisation companies were denied treaty relief, this would seriously inhibit a revival in securitisation activities.

- **Base erosion test inappropriate** The proposed LOB, if applied to securitisation companies, would deny treaty relief to cross-border securitisation companies in almost all cases. By their nature, cross-border securitisation companies will not be able to satisfy the base erosion test included in paragraph 2(e)(ii) of the LOB (as a majority of the securities issued will typically not be held by residents of the jurisdiction where the securitisation company is established). This will lead to single country securitisation companies being preferred over cross-border securitisation companies. Overall this would be a negative development for the securitisation industry and the broader financial system. In addition, it would be prejudicial to smaller countries and to the investors located in those jurisdictions.

- **Derivative benefits test impossible to apply** Although it may be possible, theoretically, for cross-border securitisation companies to satisfy the derivative benefits provision in paragraph 4 of the LOB, in practical terms, it usually will not be possible for most securitisation companies to confirm who holds their securities. This is because securities issued by securitisation companies are usually listed and held in clearing systems. In those circumstances, it is impossible for the issuer to know who holds the securities and consequently would be impossible for an
issuer to apply the LOB. It seems unlikely that, even if fully implemented, the TRACE project would offer a solution for securitisation companies seeking to satisfy the base erosion test where securities are held in a clearing system.

Therefore, widely-held securitisation companies need to be treated in a similar way as CIVs. Otherwise, the capital markets will be unintentionally but seriously fragmented, in a situation where there is no tax mischief causing concern.

In summary, a similar review needs to be carried out with respect to the treatment of securitisation companies. Our view is that an approach similar to that adopted for CIVs should be applied to widely held securitisation companies.

1.4 Alternative LOB for EU countries

We welcome the acknowledgement that an alternative LOB is required for EU members states. We look forward to commenting on the proposed drafting in due course.

1.5 Requirement that each intermediate owner be a resident of either Contracting State

We are strongly of the view that it is unduly restrictive to require intermediate owners to be resident in either of the Contracting States. There is clearly scope to permit intermediate owners to be resident in other jurisdictions (eg, companies which are ‘equivalent beneficiaries’), without creating opportunities for treaty-shopping.

1.6 The derivative benefit provision

A well-functioning derivative benefits provision is particularly important for small open economies such as Ireland. We have the following comments in this regard:

We do not see any policy reason for restricting the derivative benefits provision to entities that are owned by seven or fewer equivalent beneficiaries. If a company is owned by 20 (or 100) persons, all of whom are equivalent beneficiaries, what policy reason justifies the denial of treaty relief? This arbitrary numerical limitation will cause unfair discrimination in the context of smaller economies and needs to be removed.

The sub-clause in the derivative benefits provision which states that “provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary,” should be in square brackets. This is to recognise that some States may consider it to be unduly restrictive.

Instead of a full denial of treaty relief in circumstances where the indirect beneficiary’s own tax treaty provides for a higher rate of withholding tax than the resident company’s tax treaty with the source country, proportionate tax relief should be available. For example, if a company is resident in State R (which has a treaty with the source country, State S, providing for 0% withholding tax on interest payments) and its sole shareholder is tax resident in State X (which has a treaty with Source S providing for 10% withholding tax on interest payments), the company should be entitled to partial treaty relief to obtain the 10% withholding tax rate (instead of the default higher rate).
Domestic law or EU directives  An additional rule should be included to reflect that a rule of domestic law or an EU directive may provide for a lower rate of withholding tax to an equivalent beneficiary than the rate provided for under a tax treaty.

1.7 Timing issues related to the various provisions of the LOB rule

A new taxable period is not triggered, in many jurisdictions (including Ireland), by a company becoming, or ceasing to be, a publicly listed entity, unless statutory accounts are prepared. The proposed temporal limitation is likely to be problematic particularly for fast growth companies. Given the significant and onerous obligations typically associated with becoming publicly listed, it is unlikely listing would be undertaken for treaty shopping purposes.

1.8 Application of the LOB to publicly listed entities

Too restrictive  The draft conditions applicable to publicly listed entities are too restrictive for companies based in smaller countries. Publicly listed entities located in developing (though larger) countries will be at a similar disadvantage. For example, compared to the Irish Stock Exchange, the London Stock Exchange and New York Stock Exchanges offer increased access to capital and liquidity and the opportunity to be included in frequently traded indices. In recognition of this, in the past four years a significant number of Irish headquartered companies have de-listed from the Irish Stock Exchange in favour of listings in London and / or New York.

Listing nexus  Paragraph 29 of the Discussion Draft implies that a listing of itself establishes a nexus with the jurisdiction of listing that should be considered in the context of treaty access. We believe that position is fundamentally flawed. In our view, the choice of exchange on which a company has listed its shares is not a relevant consideration when determining which country’s tax treaties a company may rely upon. As acknowledged by the OECD on a number of occasions, the fact that a company is publicly-listed and is regularly traded is enough to illustrate that treaty shopping should not be a concern. Going a step further to consider which exchange has been chosen is seeking, perhaps, to address other types of concerns (eg, regarding migrations) which are not tax treaty abuse concerns but are better addressed in the context of domestic tax regimes and exit charges.

Sufficient nexus  Residence for tax purposes should be sufficient nexus to warrant the application of the provision for listed companies. This is particularly the case given the OECD definition of place of effective management. It seems strange that the OECD should propose an LOB model that clearly reflects the default preferences of a small number of large countries when most tax treaties in the world are between relatively small countries.

Absurd results  If the language was retained as currently proposed, there would be publicly listed companies who would not be entitled to access any tax treaty network (eg, if the company did not have a sufficient management structure in its country of residence to satisfy the primary place of management requirement and the company was not listed in its country of tax residence). These companies would undoubtedly have a very large proportion of shareholders who themselves
are resident and fully taxable in jurisdictions with large tax treaty networks. It would be absurd to deny treaty benefits in these circumstances, where treaty benefits would be permitted had the publicly listed company instead been a privately held company which satisfied the derivative benefits test.

**All OECD exchanges** However, if a version of this condition is to be retained, we request that it is as broadly drafted as possible, so that any recognised exchange in the OECD member countries is automatically included as a recognised stock exchange for this LOB purpose.

**Intermediate companies** We do not agree that it should be a requirement that intermediate companies should be resident in one of the contracting states. Multinational companies tend to be highly acquisitive and have many legacy intermediate holding companies in their group structure from those acquisitions. In addition, multinational companies often establish regional headquarter companies to manage the business across those regions and hold shares in subsidiaries in those regions. If a requirement for intermediate companies to be resident in one of the contracting states was introduced, it would impact the ability of subsidiaries established for commercial reasons to claim treaty relief in situations not involving abuse.

### 1.9 Active business test

The active business test in paragraph 3 will give rise to interpretative issues for taxpayers and tax authorities.

**More guidance needed** A number of the concepts included in this provision are subjective and accordingly will require comprehensive guidance. In particular, very limited guidance is included in the draft commentary on what constitutes the “active conduct of a business”. This concept is fundamental to the operation of paragraph 3 and taxpayers and tax authorities need clear and detailed guidance from the OECD on what it should cover.

**Headquarter companies** We do not understand the rationale for concluding that no headquarter company can ever be treated as carrying on active business. In many cases, multinational companies use regional headquarter companies to centralise administrative and management functions across that region. Such headquarter companies have premises, local staff and senior personnel responsible for the management of the business in that region. We see no reason why such headquarter companies should not be considered to be engaged in the active conduct of a business and recommend that paragraph 48 be amended. Alternatively a specific exclusion to the LOB should be included for a recognised headquarters company for a multinational corporate group. This provisions is found in many U.S. tax treaties.

### 2 Issues related to the principal purposes test

#### 2.1 General comments
Uncertainty There is a risk that a PPT will create uncertainty and will be interpreted in a manner detrimental to smaller countries. For this reason extensive guidance must be provided by the OECD as to what is and is not acceptable.

Tax considerations Tax will frequently be a valid commercial consideration in international dealings and investments. While this is recognised to some extent in the examples provided we would request that the paragraph 10 of the draft commentary should be revised to expressly acknowledge that having regard to the tax treatment of a cross-border transaction should not by itself result in the PPT denying treaty benefit.

Furthermore, to avoid every transaction potentially being suspect paragraph 7 must be reworded to state “...that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit and it is established that granting that benefit in these circumstances would be contrary to the object and purpose...”.

Burden of proof The burden of proof under the PPT, as currently drafted is too low. Tax authorities only need to determine that it would be “reasonable to conclude” that obtaining treaty benefit is the principal purpose of an arrangement entered into by a taxpayer. This burden of proof is wholly inappropriate where denial of treaty access can have very serious commercial consequences. It seems that the burden of proof “reasonable to conclude” is lower than “more likely than not”. All that seems to be required is for a tax authority to conclude that a person could reasonably decide that obtaining treaty benefits was one of the taxpayer's principal purposes (even if the better view was the taxpayer’s principal purpose was a commercial one). In other words, a tax authority could apply the PPT to deny treaty benefits in a situation where it was less than 50% likely that a transaction had a principal purpose of obtaining treaty benefit. This cannot be the basis for the administration of tax regimes. This burden of proof must be replaced with a clear language that indicates that it must be more likely than not that the conditions are satisfied.

Discretionary relief We agree that in cases where the PPT is invoked by a tax authority to deny a particular benefit under a treaty it may, in some circumstances, be appropriate to permit that taxpayer to obtain another form of treaty relief. Tax authorities should have discretionary authority to grant relief in those circumstances.

Credit relief As the PPT will, more often than not, be used by a source state to deny treaty benefit, this should not preclude the state of residence from permitting that taxpayer credit under Article 23 for the tax suffered. This should be clarified in the commentary on the PPT.

2.2 The anti-conduit rule

We have the following comments on the anti-conduit rule:

Too broad in current form In our view, the anti-conduit rule as currently drafted is too broad. In particular the language included in brackets “(at any time or in any form)” is far too broad and if applied literally would require a company that claims
treaty benefit to constantly keep under review all payments it makes and consider whether those recipients would be entitled to treaty benefit on the same terms. As all payments received by a company will ultimately be paid on by it (whether in the form of dividends, interest, payments to suppliers or employees), it seems that applied at its extreme every payment in respect of which treaty relief is claimed could fall within the remit of (a). We expect that the only reasonable application of the rule would be in circumstances where there is a nexus between the payment received by the taxpayer in respect of which treaty relief is claim and a payment subsequently made by the taxpayer. The requirement for such a nexus should be stipulated in the language.

Indirect payments In addition paragraph (a) applies where a “resident pays, directly or indirectly, all or substantially all of that income...”. It is not clear to us when a taxpayer will be considered to indirectly pay income to another party. We would welcome clarification on this aspect of the anti-conduit rule.

US / UK approach The language is similar to that included in the UK / US double tax treaty. As noted in the Discussion Draft the inclusion of the language was accompanied by a series of letters between the UK and the US which clarified when the rule should and should not be applied. If an anti-conduit rule along the lines suggested in the Report is to be included in the Model Tax Convention similar detailed guidance would be required.

2.3 Examples for commentary on PPT

CIVs etc If a PPT is adopted, the position of CIVs, non-CIV funds and securitisation companies needs to be specifically be addressed. In particular, the commentary should confirm an assumption that obtaining the benefit of a tax treaty is not one of the principal purposes of a CIV or a widely-held securitisation company. In cases of treaty abuse involving a CIV or widely held securitisation company, it would be open to tax authorities to establish that the assumption does not apply.

Thank you for the opportunity to comment on the Discussion Draft. Should you wish to discuss any of the comments raised, please let us know.

Yours faithfully

Sent by email

MATHESON
1 **Cross-border CIV**

RCo, a collective investment vehicle resident in State R, manages a diversified portfolio of assets. The interests in RCo are widely-held. RCo currently holds 15% of its portfolio in shares of companies resident in State S, in respect of which it receives annual dividends. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30% to 10%.

RCo’s investment decisions take into account the existence of tax benefits provided under State R’s extensive tax convention network. A majority of investors in RCo are residents of OECD member states or countries with which State S has a tax convention. 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 subject to investor protection regulation in State R and is not taxed in State R on income or gains.

In making its decision to invest in shares of companies resident in State S, RCo considered 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. In this example, unless 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 **Cross-border securitisation company**

RCo, a securitisation company resident in State R, was established by a bank which transferred to RCo a portfolio of loans and other receivables owed by debtors located in a number of jurisdictions. RCo is fully debt-funded. The majority of RCo’s debt finance was raised through a note issuance. The notes are widely held by investors and are held in a clearing system and are listed on a recognised stock exchange. The bank also retained an interest in RCo. RCo currently holds 15% of its portfolio in receivables of SMEs resident in State S, in respect of which it receives regular interest payments. Under the tax convention between State R and State S, the withholding tax rate on interest is reduced from 30% to 10%.

In establishing RCo, the bank took into account the existence of tax benefits provided under State R’s extensive tax convention network. It is likely that a majority of investors in RCo would be pension funds and other financial institutions located in OECD member states. 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 transfer receivables owed by companies 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, unless 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.
Comments on: FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE

Dear Marlies,

MEDEF is pleased to provide comments on the follow-up work on Treaty abuse.

As we have already sent a number of comments, we will mainly focus on questions that have been added to the previous version of the draft.

We hope our contribution will give you a clearer insight into our expectations and will be pleased to answer any questions you may have regarding these comments.

Yours sincerely,

Vanessa de Saint-Blanquat
A. Issues related to the LOB provision

As a general comment, LOB provision should include a most favoured nation clause in order to avoid discrimination for taxpayers. Such most favoured nation clause would create a level playing field between countries since a Contracting State would not be allowed to agree provisions with a tax treaty partner more favourable than with another one.

1. Collective investment vehicles: application of the LOB and treaty entitlement

2. Non-CIV funds: application of the LOB and treaty entitlement

3. Commentary on the discretionary relief provision of the LOB rule

Some situations are the result of previous, external or historical group structure: in case of acquisition of foreign groups, it is quite common to acquire holding structures for which it is difficult for the buyer to keep local management. LOB clause will deny the benefit of the treaty although the new place of management of the holding is located in a State which treaty provides for the same treatment as the source State.

The discretionary relief provision should apply to those situations that have been inherited by a company.

More generally, in its current drafting, this clause does not seem to take into account the fact that business structures and activities are evolving all the time. Guidance should be provided on when should the factors be fulfilled for being eligible to the treaty benefit (i.e., at the time of the investment in the resident entity or the structuring of the group of entities, at the time of the cross-border flow for which the tax treaty benefits are claimed, year by year?).

Besides, this provision may not provide sufficient protection against the strict application of the LOB since it requires a decision of the contracting State, which is discretionary by definition.

4. Alternative LOB provisions for EU countries

MEDEF welcomes this.

LOB clause inserted in tax treaties signed by countries members of the European Union may prove contrary to the freedom of establishment and free movement of capital (e.g., the US has inserted the “derivative benefit” provision in its tax treaties signed with EU member States in order to mitigate this risk).
5. Requirement that each intermediate owner be a resident of either Contracting State

As it is designed, the LOB clause is too complex and rigid, thus not adapted to the multiple situations which can be encountered on a day to day basis. It might deny the treaty benefits although the objective tests are fulfilled at the level of the direct or indirect shareholders of the resident entity and no treaty shopping exists. In order to soften such consequences and to the extent a LOB clause is adopted, the “derivative benefits” provision should be included to ensure a non-qualifying treaty resident to be eligible to the benefits of the treaty as the parties owning him would themselves be.

It could also be discriminatory within the EU.

6. Issues related to the derivative benefit provision

Regarding the “derivative benefit” provision, the OECD should take this opportunity to amend its provisions in order to take into account the difficulties which have already been identified (see, for instance, the recommendations of the NYC Bar Committee on Taxation of Business Entities: NYC Bar Report on Derivative Benefits Provisions in Tax Treaties, Tax Notes International, vol. 51, July 7, 2008, p. 43).

Ex: If the treaty between the Parent state and the source state (or any treaty with an intermediate state) is less favorable than the treaty between the residence state and the source state, state S should not be prevented from applying a treaty if R is not 'qualified' ( eligible ) under the R/S treaty. State S should apply the rate of P/S convention instead of the R/S clause taking the assumption that P is eligible in P/S treaty (only the advantage of passing through R must be questioned). Otherwise there is a significant risk of losing access to treaties in many situations.

7. Provisions dealing with “dual-listed company arrangements”

8. Timing issues related to the various provisions of the LOB rule

9. Conditions for the application of the provision on publicly-listed entities

10. Clarification of the “active business” provision

This notion needs to be further explained through guidelines since the notion of “active conduct” depends on the nature of the activity. It is particularly not adapted for holding companies, cash pooling companies or financing companies. After “active business” the words “in consideration of the specific nature of its activity” should be added.

B. Issues related to the PPT rule
11. Application of the PPT rule where benefits are obtained under different treaties (clarifying the wording)

Concerning the drafting of the GAAR, we are concerned by the vague, arbitrary and unclear definition that is provided in the draft:

a. “it is reasonable to conclude”: this is very general and there is no burden of proof on the tax authorities. Besides which contracting State shall prevail?

b. “one of the main purposes” should be replaced by the “main/principal/dominant purpose”. It is framed too widely and does not provide sufficient clarity, as illustrated by the examples set out in §33 of the Report (what are the tests used in order to determine whether or not the GAAR would apply?). It requires probing into taxpayers’ intentions underlying the transaction, which may be difficult to ascertain objectively.

Apart from the fact that merely obtaining a favourable tax treatment on application of the tax treaty, by itself, cannot be sufficient to allege “treaty abuse”, it seems clear that there has been a strengthening.

In the same way, §31 of the Report should be deleted as structuring its business with a view to optimise taxes should remain a right for businesses/individuals as long as it is not artificial or mainly tax driven.

c. “indirectly” we wonder how a benefit which is only indirect can be the main objective.

d. “unless it is established”: the burden of proof is there required from the taxpayer, contrary to the above wording “reasonable to conclude” which benefits to the tax authorities; that comes from the wording of the present §9.5 of the Comments on article 1, but a comment is not the same as hard law. Moreover, taxpayers should not be requested to provide a negative proof i.e. prove that tax is not one of the objectives of a transaction. Taxpayers should only be requested to prove that there were genuine business reasons to organise a transaction in a certain way and that the reality was in line with the legal form (i.e. form consistent with substance).

There should be a conscious and deliberate attempt to structure a transaction to obtain such advantage which otherwise is not in line with the intent of the relevant provisions, and is not merely an incidental result of the transaction.

e. “object and purpose of the relevant provision”: this will be difficult to define as frequently each signing State has a different view on the meaning of the treaty provisions; in treaties there is hardly something like the intention of the legislator. Besides, where is the taxpayer supposed to find such information?

12. Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level

13. Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable
14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

As mentioned above, taxpayers should not be requested to provide a negative proof i.e. prove that tax is not one of the objectives of a transaction. Under French law, asking to provide negative evidence is not accepted. In this respect, the sentence stating that taxpayer “did not have as one of its principal purposes the obtaining of benefits under this Convention” (discretionary relief provision of the LOB) should be deleted.

Concerning the phrase “obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit” (PTT rule), see our comments above.

15. Whether some form of discretionary relief should be provided under the PPT rule

16. Drafting of the alternative “conduit-PPT rule”

17. List of examples in the Commentary on the PPT rule

C. Other issues

18. Application of the new treaty tie-breaker rule

In most cases, the “effective management” criterion is sufficient to determine the residence state of a taxpayer and should remain the principal test. As a consequence, the “effective management” test should not be replaced by another tie-breaker rule especially as, the proposed rule raises several concerns since a mutual agreement procedure is unlikely in practice to be an improvement, as prior experience of such a rule in some treaties has shown. Furthermore, double residence situations do not necessarily derive from abusive arrangement but, in most cases, derive from the authorities of the Contracting States having a different interpretation of the tax treaty. As a consequence, in our view, in case the “effective management” test does not eliminate the double residence, the double residence should prevail until the Contracting States commonly agree and determine which the residence State is. The Contracting States would then be motivated to reach an agreement.

19. The design and drafting of the rule applicable to permanent establishments located in third States

20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules
Position paper BEPS Action 6:
Preventing Treaty Abuse

With great interest we have welcomed the public draft “Follow up work on BEPS action 6: preventing treaty abuse 21 November 2014 – 9 January 2015”. With respect to the public consultation we would like to share our comments with you by means of this position paper.

Our comments concern:

- The definition of a pension fund in tax treaties – which is not always clear;
- Entitlement to treaty benefits if more than 50% of the beneficial interests in that pension fund is owned by individual residents in “either contracting state”;
- Beneficial ownership of pension funds;
- Tax treaty exemptions of withholding taxes in a contracting state to a pension fund of another contracting state;
- The possibility to qualify CIV’s/non-CV’s as a resident, entitled to treaty benefits, and the impact on cross border investments by pension funds;
- In addition, we would also like to propose a few suggestions related to CIV’s/non-CIV’s and REIT’s in particular, often used by pension funds as investment vehicle.

MN is a Dutch asset management and pensions administrations company representing various Dutch pension funds with total assets under management of more than Euro 100 billion. The pension funds MN represents are exempt from Dutch corporate income tax and Dutch dividend withholding tax. Our comments are based on the general assumption that pension funds are tax exempt and that their pensioners are individually taxed on their pensions when received. This is fundamental to our objective to not impose additional taxes on pension funds as otherwise the mere purpose of pension funds, i.e. to provide pension payments, would be undermined.
9 January 2015

SENT VIA E-MAIL TO TAXTREATIES@OECD.ORG

Marlies de Ruiter
Head
Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2, rue André Pascal
75775 Paris Cedex 16
France

Re: Comments on the OECD Discussion Draft on Follow Up Work on BEPS Action 6

Dear Ms. De Ruiter:

The National Association of Real Estate Investment Trusts (NAREIT\(^1\)) appreciates the opportunity to provide comments on the OECD’s 21 November 2014 Discussion Draft on Follow Up Work on BEPS Action 6 Preventing Treaty Abuse (Discussion Draft). The Discussion Draft invites comments on a variety of issues with respect to changes to the OECD Model Tax Convention and related Commentary that have been proposed under Action 6 of the BEPS Action Plan with the objective of preventing the granting of treaty benefits in inappropriate circumstances.

The Discussion Draft identifies issues to be addressed with respect to the proposed limitation on benefits (LOB) provision and with respect to the proposed principal purpose test (PPT) provision. The Discussion Draft highlights in particular issues related to the treaty entitlement of collective investment vehicles (CIVs) and certain other investment entities.

**EXECUTIVE SUMMARY**

This submission focuses on the treaty entitlement issues with respect to U.S. REITs. Our comments build on work already done by the OECD with respect to REITs as reflected in its 2007 Report *Tax Treaty Issues Related to REITs*. As discussed in more detail below, U.S. REITs are different from both CIVs and non-CIV funds in ways that are directly relevant to treaty qualification.

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\(^1\) NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT’s members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.
Consistent with the OECD’s prior work, the eligibility of U.S. REITs for treaty benefits should be determined under the rules applicable to companies. Given that resident status is a threshold question for treaty qualification, we urge the OECD to explicitly reference its prior work on REITs and their residence status in the current work on Action 6. Moreover, in light of the special circumstances of REITs as recognized by the OECD in its prior work, we urge the OECD to provide greater clarity regarding the application of both the proposed LOB provision and the proposed PPT provision to U.S. REITs.

DISCUSSION

I. Differences between U.S. REITs and CIVs and Non-CIV Funds

The first two issues identified in the Discussion Draft are the application of the LOB provision, and treaty entitlement more generally, in the case of CIVs and non-CIV funds. With respect to CIVs, the Discussion Draft references the work done in connection with the 2010 OECD Report *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*.

The Discussion Draft specifically refers to REITs, stating that “REITs are covered by the 2010 Report on CIVs to the extent that they are widely-held and regulated.” In this regard, the CIV Report defines the term “CIV” to mean “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.”

U.S. REITs do not fall within this definition of a CIV. Unlike U.S. regulated investment companies (RICs), U.S. REITs are not generally within the scope of the Investment Company Act of 1940, which regulates the organization and disclosure of financial information of entities, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. Importantly, *Section 3(c)(5)(C) of the 1940 Act* specifically excludes from the 1940 Act any person who is primarily engaged in “purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.”

Given the asset and income tests applicable to U.S. REITs, virtually all U.S. REITs fall outside of 1940 Act governance. Thus, U.S. REITs are not subject to the type of investor protection regime contemplated in the OECD definition of a CIV.

Many U.S. REITs are registered with the U.S. Securities and Exchange Commission (SEC) and are publicly traded on a stock exchange. Other U.S. REITS that are not listed on a stock exchange are widely-held and therefore also are registered with the SEC. These U.S. REITs are subject to provisions in the Securities Exchange Acts of 1933 and 1934 that contain rigorous disclosure obligations. However, this disclosure regime applies to any public-traded U.S. corporation. We do not believe that rules that generally are applicable to listed companies are what motivated the investor protection regulation requirement in the OECD definition of a CIV.

Moreover, the assets of U.S. REITs generally would not be characterized as a “diversified portfolio of securities.” U.S. REITs own, operate, and finance income-producing real estate, such as apartments, shopping centers, office buildings, health care facilities, hotels, and warehouses. Under U.S. tax law requirements, i) at least 75% of the value of a U.S. REIT’s total assets must be represented by real estate assets (including mortgages), cash and cash items, and
government securities; and, ii) not more than 25% of its total assets may be represented by securities that are not qualifying assets for purposes of i). In addition, U.S. tax law requires that at least 75% of a U.S. REIT’s gross income must be in the form of real estate rents, interest on real estate mortgages, gains from real estate sales, and other real estate related income. The types of assets required to be held by U.S. REITs is in contrast to the definition of “securities” contained in the Investment Company Act of 1940.2

Consequently, while U.S. REITs share some characteristics in common with CIVs, they cannot be considered CIVs for purposes of the Discussion Draft because they do not meet the regulatory regime or asset ownership requirements that are central to the OECD definition of a CIV.

The Discussion Draft briefly refers to REITs that do not qualify as CIVs as potentially facing treaty issues similar to issues faced by alternative funds and private equity funds. In this regard, it is important to recognize that U.S REITs are not “funds.” U.S. REITs are not passive investment holding entities. Rather, U.S. REITs are active businesses that engage in a full range of corporate activities. U.S. “equity” REITs acquire, develop and hold properties in order to generate rental income, and they primarily operate such properties (as opposed to developing and selling properties similar to a merchant builder). U.S. “mortgage” REITs actively finance both residential and commercial real estate assets.

The U.S. Internal Revenue Service has affirmed that a U.S. REIT functions as an operating company, as distinguished from a passive manager similar to an investment fund, because a U.S. REIT “is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property.”3 Moreover, as discussed further below, U.S. REITs must be taxable as U.S. corporations.

U.S. REITs also are characterized as operating companies rather than investment vehicles in a variety of other contexts in the United States:

- The North American Industry Classification System (NAICS) lists U.S. REITs in the “Lessors of Real Estate” category, which is where active real estate operators are classified, as opposed to the “Other Financial Vehicles” category, where passive investment entities are classified.

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2 The Investment Company Act of 1940 defines “security” as: “any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.” (15 U.S.C. § 80-2(a)(36).)

The U.S. Commodity Futures Trading Commission (CFTC), in a 2012 Interpretive Letter issued to NAREIT, concluded that U.S. REITs are not commodity pools because they are operating companies rather than pooled investment vehicles.

Standard & Poor’s (S&P) classifies U.S. REITs as operating companies in all of its broad equity indices. As of 31 December 2014, the S&P 100 includes one U.S. REIT, the S&P 500 includes 21 U.S. REITs, the S&P 400 includes 31 U.S. REITs and the S&P 600 includes 34 U.S. REITs.

Finally, in this regard, we note that the Discussion Draft states that treaty qualification issues affecting non-CIV funds can arise because their investor base typically is not restricted to a single country and because they may not meet the active business requirement. Contrary to the suggestion in the Discussion Draft, U.S. REITs do not share these issues. The vast majority of investors in U.S. REITs are U.S. persons and, as discussed above, U.S. REITs conduct active businesses in the United States.

Although U.S. REITs do not constitute CIVs or non-CIV funds, as discussed further below, clarification regarding the treaty status of REITs would be valuable in light of the proposed changes to the OECD Model Tax Convention and related Commentary.

II. Treatment of U.S. REITs as Residents for Treaty Purposes

The starting point in applying both the proposed LOB provision and the proposed PPT provision is a determination of resident status. The Discussion Draft underscores the connection between residence and qualification under the proposed provisions in its discussion of issues with respect to CIVs and non-CIV funds. The status of REITs as residents for treaty purposes was considered and addressed in the OECD’s 2007 REIT Report. Given its relevance and importance, the OECD should explicitly incorporate this prior work into the current work on treaty qualification under Action 6.

The primary focus of the 2007 REIT Report was the tax treaty treatment of REIT distributions to foreign shareholders. The Report included proposed treaty provisions regarding the withholding tax treatment of such distributions that could be included by countries in their bilateral treaties. These provisions subsequently were incorporated in the Commentary to the OECD Model Tax Convention with the 2008 update.

Consideration of the question of the tax treaty treatment of distributions by REITs to foreign shareholders first requires a determination of the tax treaty entitlement of the REIT itself. As the 2007 REIT Report noted, this is because Article 10 of the OECD Model applies to dividends paid by a company that is a “resident” of a treaty country. Thus, the resident status of a REIT is relevant to the application of tax treaties, both with respect to the income earned and to distributions made by a REIT.

The 2007 REIT Report concluded that REITs generally should be considered to be “residents” for treaty purposes:
Since the income of a REIT is typically distributed, the REIT is not, in a purely domestic context, taxed on that distributed income. As already mentioned, the tax mechanisms that ensure that result vary from country to country and can include, for example, rules that allow the deduction of REIT dividends or distributions, the tax exemption of a REIT that meets certain conditions, the tax exemption of all the REIT’s income, the tax exemption of only the part of the REIT’s income that is distributed within a specified period of time or rules that allocate the income to the investors rather than to the REIT itself. It seems, however, that in most cases, the REIT would meet the condition of being liable to tax for purposes of the treaty definition of “resident of a Contracting State”, subject to the particular problems arising from the application of tax treaties to trusts. There are a few countries, however, where this may not be the case and this is a question that would need to be clarified on a country-by-country basis during treaty negotiations.

Under this analysis, U.S. REITs are residents of the United States. Under U.S. tax law, a U.S. REIT is taxable as a U.S. corporation (and, in fact, must be taxable as a U.S. corporation in order to qualify as a U.S. REIT). The taxable income of a U.S. REIT is computed in a manner similar to the manner in which taxable income is computed for non-REIT corporations. A U.S. REIT is required to distribute at least 90% of its taxable income on a current basis in order to qualify as a REIT and is entitled to a “dividends paid deduction” to the extent that it distributes its taxable income and any realized capital gains. To the extent that a U.S. REIT does not distribute its net capital gain, it still qualifies as a REIT, and it pays corporate tax on such net capital gain.

It should be noted that, although a U.S. REIT does not pay income tax at the entity level to the extent that it distributes its annual taxable income, the mandatory distribution rules mean that U.S. REITs pay significant amounts of taxable dividends relative to other corporate entities. Further, shareholders pay tax on the REIT dividends they receive at the ordinary income tax rate rather than the lower rates generally applicable to corporate dividends. In 2013, SEC-registered U.S. REITs distributed approximately $34 billion. Thus, the amount of U.S. federal and state taxes collected on a current basis with respect to income distributed by U.S. REITs is high.

The OECD’s analysis and conclusion regarding the qualification of REITs as residents for treaty purposes formed the basis for the provisions on the withholding tax treatment of distributions by REITs that were set forth in the 2007 REIT Report and incorporated in the Commentary to the OECD Model Tax Convention. This same matter of the qualification of REITs as residents for treaty purposes is a threshold question in applying both the proposed LOB provision and the proposed PPT provision. Application of these proposed measures to REITs necessarily requires a clear understanding of the threshold question of resident status. The OECD should provide the needed clarity by explicitly referencing its prior work on the resident status of REITs in the Commentary with respect to the proposed provisions.
III. Treatment of U.S. REITs under LOB Provisions

The September 2014 Report under Action 6 Preventing the Granting of Treaty Benefits in Inappropriate Circumstances describes the proposed LOB provision and its various tests as “based on objective criteria that provide more certainty than the PPT rule.” However, that certainty exists for a taxpayer only if it is clear that the tests under the LOB provision are available to be applied to the taxpayer. We believe that many U.S. REITs clearly would satisfy the requirements of one or more of the entity-based tests in the LOB provision if it is made clear that such tests are available to be applied to U.S. REITs.

With respect to U.S. REITs that are registered with the SEC and are publicly-traded on a stock exchange (U.S. Listed REITs), the primary test in the proposed LOB provision is the test under paragraph 2(c) (Exchange Traded Test).

Under the proposed Exchange Traded Test, a resident of a Contracting State would be entitled to benefits under the relevant treaty if such resident is a company or other entity and two requirements are met. First, the principal class of its shares (and any disproportionate class) must be regularly traded on one or more recognized stock exchanges. Second, either: i) its principal class of shares must be primarily traded on one or more recognized stock exchanges located in the Contracting State of which it is a resident; or, ii) its primary place of management and control must be in the Contracting State of which it is a resident.

U.S. Listed REITs typically are listed on the New York Stock Exchange, the NYSE MKT, or the NASDAQ. The shares of U.S. Listed REITs regularly are traded on such market, with active turnover and significant liquidity. In addition, the shares of U.S. Listed REITs primarily are traded on the U.S. market where listed. Moreover, U.S. Listed REITs have their primary place of management and control in the United States, where the day-to-day responsibility for the management of the REIT is exercised.

While the entitlement to treaty benefits under this test would be based on the particular facts and circumstances, it would be helpful for the Commentary to specifically state that this test is available for application to a U.S. REIT provided that it meets the specified conditions with respect to exchange trading and management.

With respect to U.S. REITs that are widely-held but not listed on a stock exchange (U.S. Public Non-listed REITs), the primary test in the proposed LOB provision would be the test under paragraph 2(e) (Ownership and Base Erosion Test).

To satisfy the proposed Ownership and Base Erosion Test, a resident of the Contracting State must satisfy both an ownership requirement and a base erosion requirement.

The ownership requirement would be satisfied if, on at least half the days of the taxable period, persons who are residents of that State and who are entitled to the benefits of the relevant treaty (generally as individuals, Contracting States, exchange traded companies or other entities, or non-profit entities or pension funds) own, directly or indirectly, shares representing at least 50% of the aggregate voting power and value (and at least 50% of any disproportionate class of shares) of the U.S. Public Non-listed REIT. This rule may be subject to a further requirement
that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State.

In addition, to satisfy the base erosion requirement, less than 50% of the gross income, as determined in its Contracting State of residence of the U.S. Public Non-listed REIT, for the taxable period could be paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of the relevant treaty (also as individuals, Contracting States, exchange traded companies or other entities, or non-profit entities or pension funds) in the form of payments that are deductible for purposes of the taxes covered by the relevant treaty in the person’s Contracting State of residence (but not including arm’s length payments in the ordinary course of business for services or tangible property).

U.S. Public Non-listed REITs typically would satisfy both prongs of this test. They are predominantly owned by U.S. persons, including U.S. mutual funds, individual investors and pension funds. Moreover, the income of U.S. REITs is distributed to their owners on a current basis, and the owners are subject to tax on such income. Because such distributions are deductible by U.S. REITs, they could be considered to be payments that are taken into account under the base erosion requirement. As noted above, the owners of U.S. REITs are predominantly U.S. persons who would themselves qualify for treaty benefits under one of the specified categories, and the distributions to such persons would not run afoul of the base erosion requirement.

As with respect to the Exchange Traded Test discussed above, while the entitlement to treaty benefits under this test would be based on the particular facts and circumstances, it would be helpful for the Commentary to specifically state that this test is available for application to a U.S. REIT that meets the specified conditions with respect to ownership and base erosion.

IV. Treatment of U.S. REITs under PPT Provision

The September 2014 Report on Action 6 acknowledges that the proposed PPT provision involves relatively less certainty and “requires a case-by-case analysis based on what can reasonably be considered to be one of the principal purposes of transactions or arrangements.” The subjectivity of the proposed PPT provision has been subject to significant criticism as involving a level of uncertainty that is unacceptable with respect to a matter as fundamental as the qualification of a company for treaty benefits. The concern about uncertainty is particularly acute in the case of U.S. REITs which, unlike other non-REIT corporations, not only must distribute the majority of their earnings to their investors on a current basis, but also cannot make effective use of foreign tax credits in the United States (and therefore cannot “absorb” any additional foreign tax liability in the same manner as non-REIT U.S. corporations). The risk of having an unexpected tax liability arise after the full distribution of current earnings because of a challenge with respect to potential withholding tax liability under a PPT provision would have a significant chilling effect on cross-border investments. The distribution requirement applicable to U.S. REITs means that a U.S. REIT must have a high degree of certainty regarding the tax treatment of its structure when deciding to make a cross-border investment. The uncertainty inherent in the proposed PPT provision would be a significant negative factor to U.S. REITs when deciding whether to make a cross-border investment. This uncertainty could impede the free flow of capital.
The fact that U.S. REITs are accorded tax treatment that is different than that of other corporations should not be a factor in applying the proposed PPT provision. Guidance should be included in the Commentary to make clear that the fact that a U.S. REIT is subject to a special tax regime (a deduction for dividends paid) should not be considered a factor that weighs in favor of denying benefits under any application of the proposed PPT provision.

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We appreciate the OECD’s focus on ensuring that the changes to the OECD Model Tax Convention and related Commentary that have been proposed under Action 6 in order to prevent the granting of treaty benefits in inappropriate circumstances do not operate to inappropriately deny treaty benefits to investment vehicles that have become such an important part of the global economy. NAREIT welcomes this opportunity to provide comments on the need for specific clarification regarding the treaty qualification of U.S. REITs under the proposed provisions. With the focus on clarifying the treatment of other investment vehicles such as CIVs and non-CIV funds, the need is all the greater for these clarifications regarding the entitlement of U.S. REITs to treaty benefits under the proposed LOB provision and the proposed PPT provision.

We would be happy to discuss the matters addressed in this letter or to respond to questions or to provide additional information. I can be reached at (202) 739-9408 or tedwards@nareit.com.

Respectfully submitted,

Tony M. Edwards
Executive Vice President and General Counsel
1. Comments regarding tax treaty position of pension funds in general and in relation to the proposed Limitations of Benefits article¹ (hereafter: “LOB”)

A) The definition of a pension fund in tax treaties

In practice the pension fund definition in tax treaties is not always clear; moreover, in some treaties a specific pension fund definition does not exist. In that case, whether the pension fund is taxable or liable to tax can be a problem to qualify as a resident of one of the contracting states. Therefore we would like to propose a general pension fund definition.

We would like to suggest the following definition: a pension fund can be considered a resident if a pension fund qualifies as such based on the tax laws of its country of establishment and if it is subject to regulation in its country of establishment.

B) Entitlement to treaty benefits if more than 50% of the beneficial interests in that pension fund is owned by individual residents in “either contracting state”

In the proposed LOB article paragraph 2 d) subdivision ii) a pension fund is entitled to treaty benefits if more than 50% of the beneficial interests in that pension fund is owned by individuals resident in “either contracting state”. Example: pension fund P is resident in state X and invests in state Z. Then at least 50% of P’s beneficial interest owners should be resident in either state X or state Z. In practice, this may harm pension funds with more than 50% beneficial interest owners that live outside states X or Z. In fact, one of our clients may not meet this specific LOB requirement as the majority of its pensioners live all over the world. This can be explained by the fact that this specific pension fund was established for an industry that employed personnel that operated internationally.

More general, however, within the EU, persons are free to move and reside wherever they wish which is accommodated by the continuing globalization. We believe that a restriction to where the majority of pensioners live is not compliant with EU law nor common reality.

¹ Public Discussion Draft BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances 14 March 2014- 9 April 2014; article X “Entitlement to Benefits”
We suggest that in the LOB article the sentence “..are owned by individuals resident in either Contracting State” is replaced by: “are owned by individuals resident in a OECD convention state that adopted a similar LOB article”.

C) Beneficial ownership of pension funds

In some countries, a pension fund is not considered to be a beneficial owner of the income and gains it derives from the country it invests in. We believe it is in the benefit of pension funds to eliminate such unclarity and confirm the beneficial ownership of pension funds.

The definition of pension fund, see also our suggested wording in 1.A, could be extended by “a pension fund is considered to be the beneficial owner of the income and gains it derived from the other Contracting State”.

D) Tax treaty exemptions of withholding taxes in a contracting state to a pension fund of another contracting state

Tax treaties often grant exemptions of withholding taxes in a contracting state to a pension fund of another contracting state. However, in practice these exemptions cannot always be effectuated or the exemptions do not cover all source taxes. To eliminate a tax burden of pension funds investing cross border, we would suggest to insert a provision in the OECD model tax treaty that if contracting states acknowledge the pension fund status in either state, they grant a full exemption based on reciprocity.

Suggested wording would be similar to paragraph 69 to OECD commentary 2010 to article 18 of the OECD model treaty. However, as our comments relate to investment income and not to employment income, we believe article 18 of the OECD model treaty is not the appropriate section for this wording in this context. We therefore suggest to add the proposed wording to article 21 (‘other income’) of the OECD model treaty, for example as a new paragraph 3.
2. Comments regarding impediments imposed by proposed LOB on CIV’s/non-CIV’s

A) The possibility to qualify CIV’s/non-CV’s as a resident, entitled to treaty benefits, and the impact on cross border investments by pension funds

In general the proposed LOB will impose difficulties for CIV’s/non-CIV’s to qualify as a resident, entitled to treaty benefits. This can be caused by the fact that;

- some CIV’s are subject, but not liable to tax (example: Dutch Fiscale Beleggingsinstelling which is subject to tax at 0%), as a result of which they fail the residency test; or
- some CIV’s/non-CIV’s have the obligation to distribute all or most of their profits to its shareholders (many CIV’s/non-CIV’s have such an obligation) qualifying them as a conduit company, therefore failing the beneficial owner test; or
- most CIV’s/non-CIV’s are not publicly traded, therefore failing the listed company test; or
- often the interests in CIV’s/non-CIV’s are held by residents in third states.

Pension funds very often invest cross border using CIV’s/non-CIV’s. Based on the above mentioned practical issues that pension funds face when using CIV’s/non-CIV’s, pension funds generally suffer additional tax burden which will increase when the proposed LOB will enter into force.

The most preferred solution would be to look through all CIV’s/non-CIV’s that are interposed between the pension fund investor and the underlying ultimate investment. After all, a CIV/non-CIV used by pension funds is set up as an alternative for investors to directly invest for commercial reasons and ensures tax neutrality. The ultimate look through approach would be that pension fund P, resident in state X, investing in state Z via a CIV/non-CIV in state Y, would be entitled to treaty benefits between states X and Z if it had invested directly (i.e. without interposing the CIV/non-CIV). This implies that a “check-the-box” approach is required for the CIV/non-CIV in state Y.

In this respect a less farfetched suggestion would be to consider the CIV/non-CIV in state Y deemed to be a qualified person if its participants or shareholders (among others pension fund P) would have

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2 Often this requirement is fundamental to keep a tax neutral status; if breached, the CIV/non-CIV will become fully taxable.
3 A CIV/non-CIV is often used for economies of scale and reduction of transaction costs, it provides professional asset management services and it offers a diversified portfolio.
been a qualified person in state Y under the treaty between states Y and Z, had they been established in state Y.

In order to prevent the risk of accumulation in claiming treaty entitlement in a look through approach, a provision is required to prevent the CIV/non-CIV from claiming its own tax treaty rights and should only act as an agent on behalf of its participants/shareholders.

B) Suggestions regarding treaty entitlement for CIV's/non-CIV's

Although the look through approach mentioned above would solve many existing and future (upon introduction of the proposed LOB) issues regarding treaty entitlement for CIV’s/non-CIV’s, we would also like to propose a few next best suggestions.

- Grant treaty benefits to CIV’s/non-CIV’s if they are subject or liable to tax.

- Grant treaty benefits to CIV’s/non-CIV’s even if they have an obligation to annually distribute their profits to their shareholders which (or: if and to the extent they) are eventually taxed; in other words: this is a suggestion to exclude these CIV’s/non-CIV’s from being considered a non-qualifying conduit company.

- Change the wording of proposed LOB article paragraph 2 subparagraph d) subdivision ii) as proposed under 1.B; the existing proposed LOB wording makes a CIV/non-CIV fail the 50% residents test under paragraph 2 subparagraph d) subdivision iii) in conjunction with subdivision ii) if under the previous example a CIV/non-CIV in state Y invests in state Z on behalf of pension fund P in state X. The reason is that often the interests in CIV’s/non-CIV’s are held by residents in third states.

This suggestion would then actually solve both the pension fund position itself and the position of a CIV/non-CIV in relation to paragraph 2 subparagraph d) of the proposed LOB article.

- Grant specific treaty entitlement to REIT’s. REIT’s are a specific form of (usually) non-CIV’s that will most likely not be eligible to treaty benefits under the proposed LOB article. If the suggestions mentioned under the three bullet points above, are to be inserted in a new LOB
article, the REIT's most likely will qualify. Otherwise, a suggestion could be to explicitly include “real estate activities” as an active trade or business in paragraph 3 subparagraph a) of the LOB article.

We hope our comments will be considered during further preparations by OECD. Please feel free to contact our colleagues Mrs. K.V.K. Jonker-Beekhuis en Mrs. S.V. Godron for questions and/or remarks:

Mrs. K.V.K. Jonker-Beekhuis  Mrs. S.V. Godron
KJB@mn.nl VGO@mn.nl
+31 (0)610115903 +31 (0)629086220
January 8, 2015

Attn. Marlies de Ruiter
Head of Tax Treaties, Transfer Pricing and Financial Transactions Divisions
Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration

Re: Comments with Respect to November 2014 Public Discussion Draft
"Follow Up Work on BEPS Action 6: Preventing Treaty Abuse"

Dear Ms. de Ruiter:

The National Association of Publicly Traded Partnerships ("NAPTP")\(^1\) is pleased to provide written comments with respect to the Public Discussion Draft referenced above with respect to the entitlement of treaty benefits of Collective Investment Vehicles ("CIVs") and similar vehicles.

NAPTP is a trade association representing U.S. publicly traded limited partnerships, more commonly known as master limited partnerships ("MLPs"). NAPTP currently has 157 full and associate members and represents over 100 MLPs. NAPTP appreciates the opportunity to comment on this matter. In general, NAPTP believes that the treatment afforded CIVs to ensure appropriate entitlement to tax treaty benefits should be extended to MLPs because they are widely-held and subject to investor-protection regulation in the country in which they are established, and the income earned by such MLPs is subject to tax in the country in which they are established at the investor level on a current basis.

MLPs – In General

MLPs have been in existence in the United States since 1981, and they were first created to allow businesses to raise capital from individual investors who could not afford the more sizeable investments often demanded by non-traded partnerships. The majority of the investors providing this capital are individual U.S. investors. MLPs are traded on U.S. stock exchanges, are widely held, and are subject to investor protection regulation in the United States.

MLPs typically are organized as limited partnerships or limited liability companies under the laws of one of the states of the United States. Their distinguishing features, which are discussed in more detail below, are: (1) they are taxed as partnerships for U.S. Federal income tax purposes; (2) their interests are widely-held and traded on U.S. regulated public exchanges;\(^1\)

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\(^1\) The members of NAPTP are listed on Attachment 1.
and (3) the business activities that may be conducted by MLPs are limited by Federal income tax law to certain activities that were historically conducted in partnership form.

The taxation of MLPs under U.S. Federal income tax law differs from the standard corporate taxation of U.S. publicly traded companies. MLPs are taxed under the rules applicable to partnerships. As a general matter, partnerships are treated as fiscally transparent or "pass-through" entities for tax purposes. Thus, no tax is paid at the partnership level. A partnership's income is considered earned by all the partners; it is allocated among all the partners in proportion to their interests in the partnership, and each partner pays tax on his or her share of the partnership income. Because partners are subject to tax on the income of the MLP regardless of whether the income is distributed, in practice MLPs distribute some or all of their available cash flows each year.

Historically, all widely-traded U.S. partnerships were taxed in this fashion with all income "passing through" the entity to the individual investors, who then were subject to tax on their share of the income generated by the MLP. However, changes in law in 1987 limited pass through tax treatment to publicly traded partnerships engaging in only certain types of activities that historically had been conducted by non-traded partnerships, primarily in the natural resources sector. As a result, natural resource MLPs currently constitute about 80 percent of MLPs by number, and about 85 percent of the MLP market capital. At the end of December 2014, the total market capital of MLPs was about $581 billion, of which about $489 billion was in the natural resource sector.

The MLP structure provides small individual investors with opportunities to invest in capital-intensive businesses with a lower (but generally steady) rate of return through readily tradable partnership interests. This investor base, however, gives rise to the same investor tracing concerns described for CIVs in paragraphs 18 – 21 of the OECD publication, "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles", adopted by the OECD Committee on Fiscal Affairs on April 23, 2010.

**MLPs – Cross-Border Investment and Activity**

While there is no restriction on the type or nationality of investors in MLPs, as noted above investors in MLPs organized in the United States and traded on U.S. exchanges are primarily U.S. individuals as well as the U.S. corporations that formed the MLP. There are several practical reasons for this. Non-U.S. investors typically do not invest in MLPs because such investments expose them to unfavorable substantive and administrative U.S. Federal and state income tax consequences. In particular, the activities of a U.S. MLP are attributed to foreign investors, subjecting them to substantive U.S. Federal and state tax and reporting requirements comparable to those imposed on foreign persons that directly conduct trades or businesses in the United States. Distributions are subject to withholding tax to the extent they are attributable to income effectively connected to a U.S. trade or business, and investors

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2 In addition to natural resource activities, U.S. MLPs may be used for traditional investment activities.
generally are required to file tax returns with the U.S. Internal Revenue Service. Investments by foreign persons in U.S. widely-held companies taxed as corporations do not carry such negative consequences.

In addition, wealthy U.S. investors have access to opportunities to invest in capital-intensive businesses in the natural resources sector through direct investments such as non-traded partnerships, the income from which is subject to a single level of U.S. tax. MLPs were designed to offer small U.S. investors similar investment opportunities, and therefore are attractive to such investors.

There are no restrictions on the location of U.S. MLP business investments or activities. Accordingly, MLPs may engage directly or indirectly in business activities outside the United States. This may be the case, for example, when integrated natural resource facilities, such as pipeline systems, cross borders. Accordingly, U.S. MLPs may earn and be subject to tax on income from business activities in other jurisdictions. To the extent that U.S. MLPs structure these activities in local entities, such entities are subject to local country income tax and withholding taxes are imposed on dividend distributions or payments of interest from such entities.

Application of Tax Treaties to MLPs

The issues raised with respect to the application of tax treaties to CIVs, which have been explored by the OECD and are reflected in paragraphs 6.8 – 6.34 of the Commentary to Article 1 of the OECD Model Convention (the "Commentary"), are also raised in the context of U.S. MLPs. Section 6.8 of the Commentary defines 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. Paragraph 6.21(b) of the Commentary, however, permits treaty negotiators to specify the categories of investment funds, arrangements, or entities to which a CIV provision would apply. As is the case with CIVs described in paragraph 6.8 of the Commentary, all U.S. MLPs are widely-held and are subject to investor-protection regulation. In contrast to CIVs, however, U.S. MLPs allow small investors to pool their capital to invest in business assets in certain limited sectors, predominately natural resources, rather than in equity or debt securities issued by such businesses or other entities.

This one difference between U.S. MLPs and CIVs should not cause tax treaties to treat U.S. MLPs and CIVs, as defined in paragraph 6.8 of the Commentary, differently for two reasons. First, the treatment of CIVs in the Commentary is based on a desire to ensure that an investor pooling capital with other investors in a widely-held vehicle be in no worse a position than it would have been had it invested directly in the underlying income producing property held by the vehicle. See, e.g., paragraphs 6.8 and 6.23 (noting favorably the tax policy goal of neutrality as between direct investments and investments through a widely-held vehicle). This tax policy goal is equally applicable to U.S. MLPs. Second, the procedural or administrative accommodations afforded to CIVs because of the practical difficulties of determining the tax treaty eligibility of each of its owners on a daily basis are equally justified in the case of U.S. MLPs given the fact that U.S. MLP interests are widely held and traded on regulated exchanges.
Investors in U.S. MLPs should also be able to claim, directly or indirectly, appropriate tax treaty benefits on non-U.S. source income earned by such MLPs under standards that are clear, practicable, and take into account the widely-held nature of MLPs. Accordingly, the treatment provided CIVs to ensure appropriate entitlement to tax treaty benefits should be extended to MLPs that are widely-held and subject to investor-protection regulation in the country in which they are established, provided that the income earned by such MLP is subject to tax at the investor level on a current basis.

There are two classes of issues related to the application of tax treaties to CIVs and U.S. MLPs. The first is the substantive entitlement to treaty benefits by such vehicles, either in their own right or on behalf of their investors. The Commentary provides for several alternatives in this regard, including the provision of treaty benefits to a vehicle organized in a country based on the extent to which the vehicle is owned by same-country treaty-eligible investors or based on the extent to which the vehicle is owned by treaty-eligible investors in the same country or third countries. See paragraphs 6.21 and 6.26. The Commentary also includes an alternative by which a vehicle that is publicly traded in its country of organization would be entitled to treaty benefits without regard to the residence of its investors. See paragraph 6.32. This alternative is justified on the basis that a publicly-traded vehicle cannot be used effectively for treaty shopping. Each of these proposals has a strong policy basis as each has the effect of putting the investor in the vehicle in no worse a position than it would have been in had it invested directly in the underlying income producing property held by the vehicle rather than pooled its capital with other investors. See, e.g., paragraphs 6.8 and 6.23 (noting favorably the tax policy goal of neutrality as between direct investments and investments through a widely-held vehicle). NAPTP endorses these approaches and recommends they be extended to U.S. MLPs.

The second class of issues relates to procedural or administrative standards for actually determining, claiming, and providing treaty benefits. The OECD has undertaken several projects in recent years aimed generally at simplifying and harmonizing countries’ treaty relief withholding procedures, including the Treaty Relief and Compliance Enhancement (“TRACE”) system, and at providing practical rules in the context of CIVs that are widely held. In cases where the entitlement to treaty benefits depends on the extent to which investors would have been entitled to treaty benefits on direct investments, paragraphs 6.29 – 31 of the Commentary acknowledge that it would be impractical for widely-held vehicles to collect investor ownership information on a daily basis. It therefore concludes that countries should be willing to accept practical and reliable approaches that do not require daily tracing.

The Commentary provides two examples of "practical and reliable" approaches. First, countries could presume that all investors are resident in the country of organization of the vehicle where there are circumstances that discourage investment by third country residents, as is the case with U.S. MLPs. Paragraph 6.30. Second, countries could require the vehicle to disclose the extent to which investors are treaty-eligible on an annual basis, or if conditions suggest that turnover in ownership is high, on a quarterly basis. Paragraph 6.31. Again, NAPTP supports simplifying and harmonizing countries' treaty relief provisions and recommends that they be extended to U.S. MLPs. Moreover, with respect to U.S. MLPs, NAPTP recommends that countries presume that all investors are U.S. persons because of the practical obstacles and
disadvantages that discourage non-U.S. investment. As noted above, interests in U.S. MLPs are
generally not marketed to non-U.S. investors and are not attractive to non-U.S. investors because
the ownership of such interests would subject non-U.S. investors to U.S. Federal and state tax
and reporting requirements comparable to those imposed on foreign persons that directly conduct
trades or businesses in the United States, including the application of U.S. withholding tax on
distributions at generally the highest U.S. income tax rates.

Like other commentators, NAPTP is concerned that the OECD’s March 2014
Discussion Draft on “Preventing the Granting of Treaty Benefits in Inappropriate
Circumstances” did not appropriately reflect paragraphs 6.8 – 6.34 of the Commentary which
deal with potential treaty abuse issues in the context of CIVs. NAPTP believes that the
alternatives provided in paragraphs 6.21, 6.26, and 6.32 of the Commentary, which are outlined
above, adequately address potential treaty abuse issues, and that no further limitation on benefits
provisions or the imposition of a principle-purpose test is needed with respect to CIVs or U.S.
MLPs. These alternatives permit treaty benefits to the extent the investors in such vehicles
would be entitled to such benefits, achieving the goal of neutrality as between direct investments
and investments through widely-held vehicles. Further, these alternatives allow due flexibility to
countries in determining the extent to which investors would be so entitled to treaty benefits
(e.g., on a presumptive basis under appropriate circumstances, as in the case of U.S. MLPs).
Accordingly, widely-held CIVs and U.S. MLPs that meet the requirements set out in the
Commentary should be entitled to treaty benefits.

In summary, the OECD should ensure that the treatment afforded to CIVs also is afforded
to similar vehicles that raise similar policy considerations. U.S. MLPs are similar to widely-held
CIVs that have been the subject of the OECD’s work because they are widely-held and subject to
investor-protection regulation in the country in which they are established. As noted above, the
only distinction between CIVs (as defined in paragraph 6.8 of the Commentary) and U.S. MLPs
is that CIVs invest indirectly in operating businesses by holding a diversified portfolio of
securities, whereas U.S. MLPs invest directly in operating businesses such as pipelines or other
natural resource businesses. In cases where U.S. MLPs receive income from sources outside

3 See, e.g., Mary C. Bennett, The Association of Global Custodians, Comments on Discussion Draft on
BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances 3-7 (2014);
John Cartwright, The Association of Real Estate Funds, OECD Discussion Draft on BEPS Action 6:
Preventing the Granting of Treaty Benefits in Appropriate Circumstances 1-2 (2014); James Charrington,
BlackRock Investment Management (UK) (Limited) ET AL., Proposals with respect to the BEPS Action
Plan, Including Action 6 (Prevent Treaty Abuse) 1-4 (2014); Investment Company Institute, BEPS Action
6 and Treaty Benefits for Collective Investment Vehicles 1-3 (2014); Jorge Morley-Smith, Investment
Management Association, OECD Discussion Draft on BEPS Action 6 1-4 (2014); Matthias Thomas,
European Association for Investors in Non-Listed Real Estate Vehicles, INREV’s Response to OECD
Discussion Draft BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate
their country of organization, however, the tax treaty issues faced by MLPs and their investors are identical to those faced by CIVs.

* * * * *

We appreciate your willingness to consider this submission as you continue your work on developing a final version of the Discussion Draft. Please let us know if you have any questions.

Sincerely yours on behalf of NAPTP,

/s/ Linda E. Carlisle

/s/ Rocco V. Femia

Miller & Chevalier Chartered
Counsel to NAPTP
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|                          | Sunoco Logistics Partners L.P. |
|                          | Sunoco, LP |
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Wise Interests
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Dear Ms. de Ruiter,

NN Group appreciates the opportunity to provide comments as part of the follow-up work on BEPS Action 6. NN Group seeks to address issues related to treaty entitlement of collective investment vehicles (CIVs) and to provide comments on specific questions raised in the November 2014 discussion draft.

NN Group

NN Group (formerly part of ING Group) is a Dutch publicly-listed company that is the holding company of various insurance and investment management companies around the world. NN Group’s investment management business offers a wide variety of actively managed investment products and advisory services to institutional and retail customers. NN Group currently manages CIVs and non-CIVs domiciled in Benelux, Poland, Japan and the Cayman Islands. As of 3Q2014, NN Group’s investment management business had assets under management of EUR 180 billion.

Comments

As a preliminary remark, we want to note that we support the OECD in its commitment to develop sound tax policies, to promote the uniform and equitable enforcement of the tax laws, and to reduce the cost and burden of administration and compliance to the benefit of taxpayers and government alike.

Overall, we want to address the key issue from a fund manager’s and fund investor’s perspective of treaty entitlement of CIVs. We focus specifically on CIVs established for bona fide commercial reasons and not as part of a scheme or arrangement the purpose of which is the avoidance of tax.

We believe that a strict application of the LOB rules will materially and negatively impact the investment performance of such vehicles without contributing to the achievement of the desired objective of combatting tax evasion. Furthermore, we believe that the vast majority of CIVs present a low risk of tax evasion or avoidance and that the application of the LOB rules should be limited to situations in which it is clearly necessary to prevent risks of tax evasion or avoidance. We continue to believe that the over-arching principle of tax neutrality between direct investment and investment through
CIVs, discussed in more detail in the 2010 CIV Report\(^1\), should be given appropriate consideration in designing rules intended to combat harmful tax practices.

In addition, we set out our comments on specific questions raised in the discussion draft.

1. **Do the recommendations of the 2010 CIV Report continue to be adequate?**

The 2010 CIV Report continues to be valid on a number of aspects. Specifically, sections 1 to 3 of that report do not need to be updated in our view.

a. **Section 4**

Section 4.2 addresses concerns by some countries that CIVs (and especially those CIVs that are not subject to taxation in their country of domicile) may serve as vehicles for treaty shopping. While we understand the rationale behind these concerns, we do believe that the risk of treaty shopping through the use of CIVs is remote since:

- CIVs cannot be assimilated to conduit companies which are the primary target of the LOB rules. Conduit companies are typically part of a larger group of companies controlled by one or more other companies or individuals, who use the conduit company for channelling money flows from one jurisdiction to another. In contrast, CIVs are stand-alone entities which do not control and are not controlled by other companies or individuals.

- There is no economic incentives for investors to engage in treaty shopping through the use of CIVs. Investing in CIVs bears costs (subscription and redemption fees, management fees, administrative costs, etc.) which are generally higher than or, at the very least, significantly reduce potential tax savings\(^2\).

- As already mentioned in the 2010 CIV Report, CIVs are widely-held, subject to investor-protection regulation and hold a diversified portfolio of securities\(^3\). CIVs having these features are associated with low risk of tax evasion / avoidance.

On this basis, we recommend the OECD to carry out further research and debate as to the actual risk of treaty shopping through the use of CIVs, taking into account the additional elements outlined above (i.e. non-assimilation to conduit companies and absence of economic incentives). We believe that a clear and accurate description and understanding of the risks would help alleviating the concerns of some countries and could justify, to a large extent, the treaty eligibility of CIVs.

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2. It is worthwhile noting that since the majority of CIVs’ investors qualify as “equivalent beneficiaries” (given the fact that rates in most double tax treaties are nearly always 15% on portfolio dividends), such tax savings would in any case be very limited.
b. Section 5 – Equivalent beneficiaries

Section 5 goes on to suggest various approaches intended to tackle treaty shopping. A common denominator in most approaches is the determination regarding the proportion of investors who qualify as “equivalent beneficiaries”. While the application of the equivalent beneficiary concept offers a sensible solution to treaty shopping, we do have some reservations as to how this provision would work in practice.

As noted in the 2010 CIV Report, interests in CIVs acquired through intermediaries often are registered at the CIV level through nominee accounts. This is almost always the case when interests are acquired through third-party distributors (typically banks). When interests in the CIV are held through distributor/nominee accounts, the CIV will only be aware of who the distributor/nominee is but will have no knowledge of the underlying investors. The CIV will therefore not be in the position to assess whether the underlying investors qualify as equivalent beneficiaries, unless the distributor/nominee agrees to disclose information on the tax residence of such beneficiaries. The issue becomes more complex in the presence of multiple layers of intermediaries as well as in the case of fund-of-funds or master-feeder structures.

This type of issue was specifically addressed as part of the OECD’s TRACE work, which provided a common, harmonised set of procedural requirements for disclosing investors’ tax residence information from one intermediary to another. There has, however, been very little concrete progress on the actual implementation of TRACE by governments, with the result that no harmonised procedures currently exist enabling CIVs to identify the tax residence of the underlying investors.

A wide international implementation of TRACE is a necessary precondition for the application of the equivalent beneficiary concept. Pending that implementation, we recommend the use of an alternative approach to identify the tax residence of the investors, which we will discuss in more detail in section 2 below.

c. Section 5 – Publicly-traded CIVs

Section 5 provides for an alternative approach that would facilitate treaty access to publicly-traded CIVs (i.e. whose principal class of shares or units is listed and regularly traded on a regulated stock exchange). The rationale behind this measure is that publicly-traded CIVs cannot be used effectively for treaty shopping because the shareholders or unit-holders of such a CIV cannot individually exercise control over it.

While we support this alternative approach, we would like to invite your attention to the fact that the exact same rationale can be used for widely-held CIVs that are not publicly traded. Such CIVs have a large number of investors (from hundreds to hundreds of thousands) and no single investor can individually exercise control over them. The fact that such funds are not publicly traded does not change anything with respect to the lack of control by investors.

In addition, restricting the alternative approach to publicly-traded CIVs alone (e.g. exchange-traded funds or ETFs) would create an unfair or otherwise inappropriate competitive advantage for such CIVs as compared to their non-publicly-traded widely-held counterparts. This could have adverse implications for the fund industry in countries where non-publicly-traded CIVs are the dominant force (like, for example, most European countries).

We therefore recommend the OECD to address this issue by treating widely-held CIVs similarly to publicly-traded CIVs.
2. **Possibility of a single preferred approach with respect to the application of the LOB to CIVs**

We do not believe that a single preferred approach would cover all situations encountered by CIVs when applying the LOB rules.

We do, however, believe that the LOB rule and the Commentary to Article 1 of the Model Tax Convention should be amended to include a safe harbour for certain CIVs which present a low risk of tax evasion or avoidance. As outlined above, such CIVs include publicly-traded CIVs, widely-held CIVs and CIVs with specific features supporting their low-risk characterisation (i.e. level of investor-protection regulation, diversification requirements, absence of economic incentives to engage in treaty shopping, absence of control by investors, etc.). European Union Member States may consider including in their tax treaties a safe harbour for UCITS and UCITS-like funds which by their very nature do not pose a threat of tax evasion or avoidance.

For all remaining types of CIVs, an equivalent beneficiary ownership test, performed periodically on specified dates, is adequate but only within the framework of TRACE and under the condition that TRACE is widely implemented (i.e. at least by all OECD member countries). The treaty eligibility of CIVs would then be based on the approach suggested under item 6.27 of the Commentary to Article 1 of the Model Tax Convention, i.e. a CIV whose proportion of equivalent beneficiaries exceeds a mutually-agreed threshold should be entitled to treaty benefits with respect to all income received by the CIV.

Pending the wide implementation of TRACE, CIVs should be allowed to use an alternative approach by considering the residence country of the immediate intermediary (typically a distributor/nominee) as a proxy for the country of residence of the underlying investors. As outlined above, the immediate intermediary is the only one whose country of tax residence is known by the CIV. The proxy is reliable since intermediaries such as banks are generally licensed to cater to clients established in the same jurisdiction as the intermediaries themselves.

**Conclusion**

NN Group appreciates the opportunity to offer its views on the recently released discussion draft dealing with the follow-up work on BEPS Action 6. Please do not hesitate to contact Tjeerd Valk ([tjeerd.valk@nn-group.com](mailto:tjeerd.valk@nn-group.com)), Frederik Evelein ([frederik.evelein@nn-group.com](mailto:frederik.evelein@nn-group.com)) or Nenad Ilic ([nenad.illac@ingim.com](mailto:nenad.illac@ingim.com)), should you have any additional questions.

Respectfully submitted,

NN Group,

Nenad Ilic
Senior Tax Specialist
January 9, 2015

By Electronic Mail: taxtreaties@oecd.org

Marlies de Ruiter,
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue André Pascal, 75775 Paris Cedex 16

Dear Ms. de Ruiter:

Re: Follow-up Work on Action 6 (Prevent Treaty Abuse) relating to CIVs and non-CIVs

Osler, Hoskin & Harcourt LLP\(^1\) welcomes the opportunity to comment on the OECD Discussion Draft, “Follow-up Work on the Report on Action 6 (Prevent Treaty Abuse)” (the “Discussion Draft”), published on November 21, 2014.

Our comments focus on the items in the Discussion Draft most applicable to collective investment vehicles (“CIVs”) (as defined in the CIV Report) and non-CIV funds.

Both CIVs and non-CIV funds are crucially important as providers of capital to businesses often located in countries outside of the country in which the relevant fund is based. The benefits arising from tax treaties in facilitating international trade and investment are important and we believe that facilitating international trade and investment should continue to be a fundamental goal to be pursued as part of the work under Action 6. Accordingly, the features of treaty anti-abuse rules should be crafted with a view to discouraging as little as possible investment into a source country that comes directly or indirectly from investors resident in countries with which that country has tax treaties.

**Issues related to the LOB provision**

**A. Collective Investment Vehicles: Application of the LOB and Treaty Entitlement**

1. Item A(1) of the Discussion Draft requests comments on: whether the recommendations of the CIV Report continue to be adequate for widely-held

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\(^1\) Osler, Hoskin & Harcourt LLP is a leading Canadian business law firm practising nationally and internationally from offices across Canada and in New York. Our clients include pension funds, sovereign wealth funds and the managers of both CIVs and such non-CIV funds as real estate funds, private equity funds and hedge funds.
CIVs; whether any improvements should be made to the CIV Report’s conclusions; and whether it would be advisable to provide for a preferred approach.

2. In our view, the conclusions of the CIV Report continue to be generally adequate for CIVs. Those conclusions are informed by the principle that, in terms of overall taxes on investment returns, investors in a CIV should be no worse off – and no better off – than if they had directly invested in the CIV’s portfolio of securities. To achieve that result, the recommended rules in the CIV Report all to varying extents take into account where a CIV’s investors are resident and their entitlement to treaty benefits. The principle of neutrality embodied in the conclusions of the CIV Report produced a set of recommended rules that by their very nature operate as a safeguard against the granting of treaty benefits in inappropriate circumstances.

3. In respect of CIVs specifically, we have two comments to add in terms of how the OECD could consider building upon and improving the recommendations of the CIV Report and the CIV-related recommendations in the Action 6 Report. First, more work is needed to address how the various recommended model treaty provisions in those reports could work together in a given treaty. For example, and as applied to CIVs specifically, if a treaty contains a provision that grants full treaty benefits to a CIV whose “equivalent beneficiary” investors exceed a certain percentage,2 that provision should be accompanied by another provision for CIVs that fall below the threshold percentage and that would grant them partial/proportional treaty benefits, to the extent that such CIV’s investors are equivalent beneficiaries. This is only by way of example of a multi-prong approach that is discussed in more detail below under “Non-CIV Funds: Application of the LOB and Treaty Entitlement”.

4. Second, we believe that in the absence of the implementation of the Treaty Relief and Compliance Enhancement (“TRACE”) project it would in many cases be extremely difficult if not impossible for CIVs to comply with LOB rules based on the extent to which the CIV has equivalent beneficiaries, and for tax authorities to verify such compliance. Proposals that may be compelling as a matter of tax policy could prove unworkable if CIV managers do not have timely access to the information those proposals require. We accordingly urge the OECD to consider very carefully the relationship in timing between when any Action 6-related changes to the OECD Model are made and the implementation of TRACE across OECD member states.

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2 In this letter, the term “equivalent beneficiaries” includes residents of the contracting state of which the CIV is resident.
5. We do not believe it would be advisable to provide for a “single preferred approach” with respect to issues related to the tax treaty entitlement of the income of CIVs and the application of an LOB to CIVs. Multiple approaches to CIV treaty benefits are presented in the CIV Report and the September 16, 2014 Report on the Work on Action 6 of the BEPS Action Plan (the “Action 6 Report”). Tax treaty negotiators in the various OECD member states require a variety of approaches to CIV treaty benefits due to the wide variety/discrepancies among CIVs internationally in terms of such relevant factors as: legal form of the CIV vehicle; domestic and foreign tax treatment; extent to which CIV investors are resident outside the country in which the CIV is established; extent to which the CIV distributes income on a current basis; whether the CIV’s investors are entitled to a preferential rate (for example, in some cases if they are pension funds); whether the CIV is publicly traded; whether the CIV manager has a direct relationship with the ultimate investors; etc. While uniformity in tax treatment and simplicity in drafting model treaties are laudable goals, a single-minded pursuit of such goals at the expense of taking these important differences into account would likely lead to rules that would fall far short of the goals of Action 6 and of tax treaties generally, which are to prevent the granting of treaty benefits in inappropriate circumstances and, conversely, to ensure treaty benefits are granted in appropriate circumstances.

B. Non-CIV Funds: Application of the LOB and Treaty Entitlement

6. This section of our letter addresses various points raised in section A(2) of the Discussion Draft, including many of the points on which comments were specifically solicited.

(a) Alternative Funds

7. Alternative funds – including private equity funds, hedge funds and venture capital funds, and privately offered mutual funds that are not subject to investor protection regulation and operate much like CIVs but that have largely institutional investors – are all collective investment vehicles through which investors’ capital is pooled and utilized to generate investment returns. Alternative funds often raise funds from investors resident in multiple

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3 We acknowledge that full implementation of the TRACE project would mitigate the importance of this particular factor (i.e., whether the CIV manager has a direct relationship with the ultimate investors) but even assuming such full implementation the other factors would still suggest that there is no one-size fits all solution to the problem of granting treaty benefits to CIVs.

4 For ease of discussion, we use the term “alternative funds” to refer to various types of non-CIV Funds including private equity funds, but not including sovereign wealth funds or pension funds.
jurisdictions and often invest in multiple jurisdictions. For this reason, the ability of alternative funds to operate effectively cross-border is of key importance to the alternative funds industry, investors in alternative funds and, not least, potential recipients of investment capital.

8. Investors in alternative funds are typically pension funds, charities and educational endowment funds, sovereign wealth funds, insurance companies, banks, other alternative funds and individuals. The ultimate investors or the fund may utilize holding companies situated in treaty or non-treaty jurisdictions for a variety of reasons. Some funds will own the shares of one holding company and make all their investments through that company, while others may own the shares of multiple holding companies, with separate companies used for each investment or jurisdiction. Frequently, such holding companies and their ultimate investors are not resident in the same country (particularly when investors may be resident in multiple jurisdictions). However, many of the ultimate investors will often be resident in countries that have tax treaties with the countries in which the fund’s underlying investments are situated (for example, in portfolio companies in the case of private equity funds).5

9. In considering the application of an LOB rule to alternative funds, we believe it is helpful to take the above into account and also to take a step back and note the manner in which the issues have been framed when treaty benefits are discussed in a BEPS context. The Action 6 Report places the establishment of entities in a treaty country by third country residents (i.e., so-called treaty shopping) under the rubric of “Cases where a person tries to circumvent limitations provided by the treaty itself”. In more neutral terms, such planning could as easily be described as a case “where a person tries to satisfy conditions provided by the treaty itself”. We do not wish to debate the morality of treaty shopping but only to point out that Action 6 assumes that the granting or denial of treaty benefits to a treaty resident entity should depend on where its owners are resident. We submit that, having accorded determinative importance to the place where the owners of a treaty resident entity are themselves resident, Action 6 ought to consistently follow through on the logical and equitable consequences of that approach. Chiefly, this means being open to creative approaches that would allow entities to claim treaty benefits to the extent that their ultimate investors would have qualified for the same or similar benefits.

5 Generally speaking, in this letter, where reference is made to an “ultimate” investor or owner that is resident in a country with which the relevant source state has a tax treaty, such investor could be an individual or other entity that is otherwise resident and entitled to benefits under an applicable tax treaty with the source country.
10. In order for the ultimate investors in alternative funds to obtain such treaty benefits as they would have been entitled to had they invested directly in a fund’s holdings, we recommend the following:

(a) Expand the scope of the derivative benefits clause in paragraph 4 of the LOB rule so that alternative funds, and not just multi-national enterprises, can make use of it. This would involve such modifications as:

- allowing trusts and other non-corporate persons to avail themselves of the derivative benefits clause, which currently applies only to “companies”;
- removing the requirement in subparagraph 4(b) of the LOB rule that the number of persons that are equivalent beneficiaries be seven or fewer in number,
- not requiring in the derivative benefits test equivalent beneficiaries to possess above a specified threshold of the “aggregate voting power” in the treaty resident company, since many holding entities utilized by alternative funds may be controlled only by the fund sponsor,
- reducing the derivative benefits test’s ownership threshold from the current proposal (95%) to a number that more funds will be able to satisfy, while still not being vehicles used to circumvent treaty limitations – we recommend 80%, and
- including a “near-equivalent beneficiary” concept, whereby a resident of a third state that is eligible for treaty benefits that are not as favourable as those of the treaty being applied could be counted as a “good” investor in determining whether the entity to which the LOB rule is being applied has satisfied the ownership threshold in the derivative benefits test. If this were permitted, the applicable treaty rate applicable to income of such entity could be increased through blending with the higher rate applicable to such near-equivalent beneficiaries.

(b) Extend some of the recommendations in the CIV report to alternative funds and their holding vehicles. Just because a fund is not widely held or not subject to investor protection regulation (hallmarks of a CIV as defined in the CIV Report) would seem to have little bearing on whether income derived ultimately by treaty-resident investors should be entitled to treaty benefits. Thus, if an alternative fund and/or its holding vehicle is directly or indirectly held by investors 80% or more of which are
equivalent beneficiaries, it should be possible for the alternative fund or holding vehicle, as the case may be, to avail itself of treaty benefits as proposed in respect of CIVs at paragraph 6.27 of the Commentary on Article 1. Alternative funds that fall below such threshold should be granted proportional treaty benefits to the extent its investors are equivalent beneficiaries, as proposed in respect of CIVs at paragraph 6.21 of the Commentary on Article 1. To the extent that the ultimate investors are pension funds or other types of investors that may be entitled to special exemptions from source country taxation, the alternative fund or holding vehicle, as the case may be, should be able to make claims for such exemption on behalf of such investors, as proposed in respect of CIVs at paragraph 6.28 of the Commentary on Article 1.

(c) Consider greater “look-through” treatment in identifying equivalent beneficiaries. The various existing tests for treaty benefit entitlement that take equivalent beneficiaries into account – for instance, CIV-specific rules in the Commentary to Article 1 and the proposed derivative benefits rule in the Action 6 Report – contain a serious deficiency in terms of allowing alternative fund structures to obtain treaty benefits. The CIV-specific rules that test for ownership by equivalent beneficiaries look only to direct ownership. While the proposed derivative benefits test in the Action 6 Report tests indirect, as well as direct, ownership by equivalent beneficiaries it provides that each intermediary owner must itself be an equivalent beneficiary. Consideration should be given in all cases to allow equivalent beneficiary ownership thresholds to be satisfied through indirect ownership without requiring intermediate owners to be treaty residents. Many non-CIV funds (for example, hedge funds formed as Cayman Islands companies) and the holding companies used by non-CIV fund investors or by non-CIV fund managers may not themselves be equivalent beneficiaries. However, where the ultimate owner is an equivalent beneficiary, the investment returns are ultimately being included in income by an investor that is “liable to tax” under a treaty with the applicable source country. If the OECD is concerned that this will allow treaty benefits to be claimed in structures where there is intermediation by tax haven entities, we submit that such concerns could adequately be addressed through domestic CFC rules and anti-deferral rules applicable to investments in non-controlled investment/passive entities.

(d) Consider greater flexibility in determining what counts as equivalent treaty benefits, for purposes of identifying equivalent beneficiaries. Our
final proposal with respect to testing for equivalent beneficiaries in a non-CIV fund context is best illustrated by an example.

*Example:* ACo invests in a Canadian company (Canco) that derives its value primarily from immovable property (a Canadian hotel). ACo is a non-resident corporation which in turn is owned by a U.S. private equity fund. All of the investors in the fund are resident in the United States. ACo realizes a capital gain when it sells the shares of Canco, and such gain is exempt from tax in Canada under Article 13 of the Country A-Canada tax treaty because the business of Canco is carried on through the immovable property from which Canco’s value is primarily derived. An equivalent treaty benefit would have been available to the U.S. investors on a sale of ACo shares, which is an economically equivalent transaction. As a result, the investors or the fund should be considered equivalent beneficiaries under any anti-treaty shopping rule.

Because tax treaties have different conditions for eligibility for treaty benefits and because there are multiple ways in which transactions can be structured, consideration should be given to conceiving of the equivalent benefit concept in a manner that takes into account economically similar transactions/structures.

11. A comprehensive approach to ensuring that treaty benefits are accorded only in appropriate circumstances to CIVs and alternative funds, as well as holding entities used by such funds, would thus build on the recommendations in the CIV Report. The goals of Action 6 and of tax treaties generally would be best served in many circumstances by combining the various approaches and broadening the scope of some of them to apply to non-CIV funds as well.

(b) **Sovereign Wealth Funds**

12. To the extent that sovereign wealth funds invest directly in a source country, or through a wholly-owned entity that is resident in the same country as the sovereign wealth fund, we agree with the statements in the Discussion Draft to the effect that the LOB rule should be satisfied. The sovereign wealth fund should be a “qualified person” under subparagraph 2(b) of the LOB rule (describing a resident that is “a Contracting State, or a political subdivision or local authority thereof, or a person that is wholly-owned by such State, political subdivision or local authority”). An entity that is wholly owned by, and resident in the same country as, the sovereign wealth fund, should similarly qualify under
subparagraph 2(b) of the LOB rule or under the “ownership / base erosion” provision (subparagraph 2(e) of the LOB rule).

13. As noted in the Discussion Draft, problems could arise in the case of investments made through an entity that is a resident of a third State (e.g. a sovereign wealth fund of State R uses a company in State T in order to invest in State S). To address this type of issue, the definition of “equivalent beneficiary” in subparagraph 6(f) of the LOB rule should include not only investors that would be entitled to similar or better benefits under a tax treaty, but also under domestic law. This would allow the derivative benefits test (as well as CIV and non-CIV fund specific LOB rules that utilize the equivalent beneficiaries concept) to accommodate the reality that many sovereign wealth funds enjoy an exemption from source country taxation under some domestic version (statutory or uncodified) of the sovereign immunity doctrine rather than under bilateral treaties.

14. The Discussion Draft also notes that sovereign wealth funds are often among the institutional investors that invest in alternative funds. The above modification to the equivalent beneficiary concept would address this situation to some extent, as would the proposals for alternative funds outlined at paragraph 10 above.

(c) Pension Funds

15. The Discussion Draft notes that pension funds are often among the institutional investors that invest in alternative funds. The proposals for alternative funds outlined at paragraph 10 above should assist in addressing this situation.

16. The Discussion Draft solicits comments on specific items in connection with pension funds. Below, we list and address some of those specific items:

| Whether and how the issue of the treaty residence of pension funds should be addressed |

17. The Discussion Draft suggests that, as part of the work on the treaty entitlement of non-CIV funds, the OECD should look at how the treaty definition of “resident” applies to pension funds in light of the different views reflected in paragraphs 8.6 and 8.7 of the Commentary on Article 4. Those two paragraphs present two opposing views on whether tax-exempt pension funds should be considered “liable to tax” in their home jurisdiction. The Commentary notes that many countries treat such funds as “liable to tax” (paragraph 8.6), while some do not (paragraph 8.7). The Commentary does not indicate which of these two views is more consistent with the purpose and text of bilateral tax conventions based on the OECD Model Tax Convention. We believe that it would be appropriate for
the Commentary to more clearly acknowledge the correctness of the view in paragraph 8.6. While pension funds may not be subject to taxation in their home jurisdiction, they are liable to tax and regularly pay pension benefits that are fully subject to tax in the hands of the recipients of the payments (pensioners). The right policy choice is thus that a pension fund, particularly one whose beneficiaries are largely resident in its home jurisdiction, be treated as treaty resident. For reasons given at paragraph 8.6, the “liable to tax” standard is flexible enough to be applied in a manner consistent with such tax policy.

18. The Discussion Draft asks whether changes should be made to paragraph 69 of the Commentary on Article 18 in order to ensure that two contracting states that follow similar approaches with respect to the taxation of retirement savings consider more thoroughly the appropriateness of including in their bilateral treaty a provision exempting such investment income from source taxation in order to achieve greater neutrality with respect to the taxation of capital.

19. A key purpose of a tax treaty, is to promote exchanges of goods and services, and the movement of capital and persons, between the two contracting states. Pension and retirement funds collect capital from employers and employees and invest them so as to provide pension and retirement savings for ordinary households around the world. The funds so invested are insulated from risk to a greater extent if they are not concentrated solely in domestic investments. In order to achieve neutrality of tax treatment as regards domestic and foreign investments by such entities, we believe it is appropriate for OECD member states to provide bilaterally that income – including capital gains, dividends and interest – derived by such treaty-resident entities be exempt from source taxation. Paragraph 69 of the Commentary on Article 18 should include a more complete endorsement of this application of capital export neutrality[, and the OECD should consider inserting a provision like the model provision contained in that paragraph of the Commentary into the OECD Model itself].
20. We believe that the model provision contained in paragraph 69 of the Commentary on Article 18 (the “Pension Fund Exemption”) should be both expanded and restricted in scope. It should be expanded to take into account that some countries exempt from taxation domestic entities that are wholly-owned by domestic, tax-exempt pension plans. Such a wholly-owned entity ought to enjoy the same treaty status as the pension fund(s) by which it is owned.

21. The Pension Fund Exemption should also be expanded to clearly apply to individuals’ tax-exempt retirement plans. As currently drafted, the Pension Fund Exemption covers treaty residents that are constituted and operated exclusively to administer or provide “pension benefits”. It should be made expressly clear that this encompasses individual retirement plans. Many countries encourage individuals to save toward retirement through tax-exempt retirement savings vehicles. These vehicles are increasingly important as fewer employees are covered by collective pension plans. In order to diversify against risk in their retirement portfolios, individuals should be able to effectively invest such retirement savings funds cross-border. The same policy considerations that favour the inclusion of the Pension Fund Exemption for collective pension plans also apply to individual retirement plans.

22. We do not believe that it would be appropriate to restrict the application of the Pension Fund Exemption by reference to “portfolio investment income”, if that means that pension funds and their wholly-owned entities would cease to be entitled to the Pension Fund Exemption if they are considered to own more than, for example, 10 per cent of the interests in the payor entity. Pension funds, and particularly those organized for the benefit of public sector employees, are very important providers of investment capital cross-border, and they are often in a position of making greater than 10 per cent investments – for instance, because they may be one of the more significant investors in an alternative fund, or because they co-invest with a private equity, infrastructure or real estate fund, or simply by being the principal investor in a company or project. In each case, there is typically a partnering with an entrepreneurial promoter and the pension fund does not itself operate in a commercial manner. This is the type of exporting of capital that tax treaties ought to encourage rather than hamper.
23. As discussed at paragraph 21 above, similar tax policy considerations apply to individual retirement plans and to collective pension funds. On this basis, it would be appropriate to add a reference to “retirement” in subparagraph 2(d) of the LOB rule, such that it would read “person that ... was constituted and is operated exclusively to administer or provide pension, retirement or other similar benefits”. Although this may have been implicit in the reference to “similar benefits” it would be helpful to provide clarity in this regard.

24. The OECD should also consider another way in which the description of qualified persons found in subparagraph 2(d) of the LOB rule could be improved. Currently subparagraph 2(d) applies, generally speaking, to (i) certain non-profit organisations, (ii) pension funds, and (iii) entities operated to invest funds solely for the benefit of persons referred to in clause (ii). Since charities, foundations and endowments and other tax-exempt non-profit organizations often co-invest alongside pension funds, it would make sense for type (iii) entities to be able to invest funds solely for the benefit of type (i) as well as type (ii) entities. This touches on a broader economic and tax policy point. There has been speculation within the investment funds industry that the BEPS Action 6 proposals will lead to a fragmentation of collectively invested capital, as it is expected that often the simplest way for fund/asset managers to secure treaty benefits for treaty-eligible investors will be by setting up managed accounts or “funds of one” (a fund with only one or one class of investor) for particular investors. It would be in investors’ interests if work on Action 6 could seek to prevent such fragmentation and the ensuing loss of economies of scale that otherwise result from the pooling of large amounts of capital.

### Issues related to the derivative benefit provision

25. Item 6 of the Discussion Draft asks for comments on the derivative benefit provision in the LOB rule, including with regard to possible changes that could be made to the derivative benefit provision and the definition of equivalent beneficiary. Our comments on those points are included as part of our above comments on the application of the LOB clause to CIVs and non-CIV funds.
Issues Related to the PPT Rule

26. Item 17 of the Discussion Draft requests comments on the list of examples in the draft Commentary on the PPT rule.

27. The PPT rule, which is framed in terms that are subjective and open-ended (and that therefore could well be applied inconsistently across member states), has the potential to create considerable uncertainty with respect to the availability of treaty benefits for CIVs and non-CIV funds in circumstances where treaty benefits are one of the considerations taken into account in making an investment. Such uncertainty could discourage large providers of cross-border capital from making foreign investments. Accordingly, we would recommend that the preferred approach recommended as a result of the work on Action 6 not be a combined LOB rule and PPT rule, but rather be the adoption of the LOB rule, buttressed by either an anti-conduit rule or a country’s existing anti-abuse rules. The menace of a PPT rule hanging over an investment structure that satisfies an LOB rule seems to us to be a measure that will stifle, and increase the transaction costs of, the flow of cross-border institutional capital more than it would prevent base erosion or profit shifting.

28. If a PPT rule is to be adopted, we believe that for any CIV or non-CIV fund (including their holding entities) that satisfies the LOB rule there should be a rebuttable presumption that the PPT rule does not apply. As well, the present Example D relating to a CIV investing in a treaty country could be clarified to state that it would be only in very unusual circumstances that a CIV that is a qualified person under the LOB rule on the basis of having sufficient equivalent beneficiary investors would be used for the type of treaty abuse to which the PPT rule is directed.

If you have questions or would like further information regarding any of the points discussed above, please contact Patrick Marley (pmarley@osler.com) and/or Matias Milet (mmilet@osler.com).

Yours very truly,

Osler, Hoskin & Harcourt LLP

MM:PJM:pm
Public Discussion Draft Follow up work on BEPS Action 6: Preventing Treaty Abuse

Dear Mrs. De Ruiter,

As a consortium of large pension funds\(^1\), we welcome the invitation of the OECD Committee on Fiscal Affairs (“CFA”) to provide our comments on the Public Discussion Draft which was published on 21 November 2014 in view of the follow up work on BEPS Action 6: Preventing Treaty Abuse (“OECD Invitation”).

We recognize and support the importance of the OECD Base Erosion and Profit Shifting (“BEPS”) project in order to prevent the granting of treaty benefits in inappropriate circumstances. Taking that into account, pension funds differ in many aspects from multinational enterprises (“MNEs”) and safeguarding tax neutrality for pension funds investing globally whilst implementing various measures is of paramount importance.

As recognized in the OECD report dated 21 November 2014, the measures introduced in the 2014 deliverable on BEPS Action 6 did not yet consider the unintended impact thereof on pension funds. In this respect, specific issues have been brought forward by the OECD on which input from the pension fund sector is requested. These are important issues which need to be addressed to prevent ‘over-kill’. As we will stipulate in this response, tax neutrality, i.e. no double or triple taxation for pension benefits, is of very importance.

With reference to the invitation, we will address these issues and provide the OECD with our views as follows:

- Paragraph 1 will provide a short introduction to pension funds;
- Paragraph 2 will address the comments requested on treaty residence of pension funds (page 7 hyphen 1 OECD report dated 21 November 2014);
- Paragraph 3 will deal with a potential clarification of the pension fund definition and the 50% ownership test (page 7 hyphens 4 and 5 OECD report dated 21 November 2014);
- Paragraph 4 will deal with potential changes to paragraph 69 of the Commentary on Article 18 (page 7 hyphens 2 and 3 OECD report dated 21 November 2014);
- Paragraph 5 will deal with the impact of the proposed limitation on benefits provision and the principal purpose test on pension funds; and finally,
- Paragraph 6 will close.

\(^1\) APG as one of the largest pension managers manages € 396 billion (November 2014) for Dutch pension funds representing 4.5 million Dutch citizens. PGGM is a leading Dutch cooperative pension administration organization with its roots in the healthcare and social work sector, which currently manages about € 185 billion of pension assets of more than 2.5 million Dutch participants.
**1. Introduction to pension funds**

Before we discuss pension funds in further detail, we note that the BEPS project is primarily aimed at MNEs and they differ in many aspects from pension funds from a regulatory, tax and policy perspective.

The capital of pension funds is entirely comprised of pension contributions received from employees and/or employers in view of retirement savings. Individuals participating in a pension scheme are the ultimate beneficiaries of the capital of pension funds. The contributions are invested by the pension fund with the aim of providing future retirement benefits for its beneficiaries.

Pension funds fulfil an important role in society (taking note of their special characteristics and purpose) which can be described as the care for former employees on the basis of solidarity and collectivity. In order to stimulate retirement savings and also keeping public pension expenditure affordable many countries have established a specific tax regime for occupational pension funds and pension contributions.\(^2\)

Different models for the taxation of pensions exist. Many of the OECD countries have adopted the EET model for taxing retirement savings\(^3\), which entails that pension contributions and investment income (including capital gains) are exempt from tax at the level of the pension fund, whilst the pension payments are taxed with the individual beneficiaries upon receipt. In this way double or triple taxation will be avoided and the levy of tax will be linked to the moment that the beneficiary enjoys his pension. Please find below an overview provided in OECD Economic Studies of some of the systems used.\(^4\)

Exempt pension funds (whether EET, TEE or TET) are not eligible for credits against taxes on investment income. Such credit can also not be effectuated upon receipt of the pension distributions by the beneficiaries, as such credit cannot be ‘rolled-over’ to them. If an individual would have invested for his own account he would be able to credit these foreign taxes on investment income realized by him against his income tax due.

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Hence, any taxation on investment income at the level of the pension fund would result in double taxation and thus lower pensions for the individual beneficiaries.

Pension funds which are not exempt would in theory be able to credit taxes on investment income. However, in practice, it is unlikely that taxable pension funds will be able to effectuate a credit as their taxable base is often very limited. The different pension systems in general provide for the promotion of retirement saving. For the tax systems described above, any taxes on investment income will result in double taxation and would run counter to the intent to stimulate pension savings in a time where pension savings are already under pressure due to low interest rates, rising pension age and longevity.

Finally, pension funds play an important role in the global economy as institutional investors. As such, they fulfill the financing needs of various sectors of the global economy and contribute to the economic development of countries, as well as to the deepening of their financial system and the promoting of financial stability. We note that pension funds invest globally in different assets to diversify their portfolio and mitigate investment risk. As specific geographical region knowledge, specific asset knowledge and infrastructure is required and in order to increase economies of scale and share investment risks, pension funds typically need to make use of third party funds or other types of pooling entities, in which they are pooled with other investors.

2. Treaty residency of pension funds

This section responds to the invitation for comments in part A, section 17 of the OECD Invitation.

Article 4 of the OECD model convention describes a resident as ‘any person who, under the laws of that State, is liable to tax therein (…)’. The OECD mentions in paragraph 8.6 and 8.7 of the OECD commentary to article 4 that this requirement may sometimes lead to uncertainties for pension funds, since these are often exempt from corporate income tax. As most states already view such entities as residents for purposes of the OECD model convention and as numerous bilateral tax treaties include a definition to that extent, we suggest to formalize current practice by including wording in article 4 of the OECD model convention.

3. Definition of a pension fund and the 50% ownership requirement

This section responds to the invitation for comments in part A, section 17 of the OECD Invitation.

3.1 Definition

It is difficult to provide one clear definition of a pension fund. The World Bank/OECD taxonomy uses a widely recognized three pillar approach, bifurcating different type of retirement income provisions. However, pension funds are also defined along other lines by the OECD.

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6 In 2011 total assets held by pension funds amounted to USD 20.6 trillion; Pensions at a glance 2013: OECD and G20 indicators, page 194; http://www.oecd.org/pensions/pensionsataglance.htm
7 A recent research survey of more than 100 pension fund executives conducted by State Street in conjunction with the Economist Intelligence Unit (EIU) indicated that: “Pension funds will still pay premium for managers with proven investment skills and ideas. Only the very largest and most sophisticated funds, for example, will have the skills to manage all aspects of today’s multi-asset class portfolios in-house. Pension funds need asset managers who can help them develop investment strategies that are compatible with their broader investment philosophy.”; http://www.statestreet.com/vision/assetowners/documents/excesummary.pdf
8 Similar to the inclusion in 1995 of ‘Contracting States, their political subdivisions and their local authorities’ in article 4 of the OECD model convention (paragraph 6.35 on article 1 of the OECD model commentary: “inclusion of these words in 1995 confirmed the prior general understanding of most member States.”) Article 4 of the OECD model treaty might be amended to read (addition in **bold underline**): “For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes **pension funds**, that State and any political subdivision or local authority thereof.”
As part of the OECD global pension statistics project for example, private pensions (which would cover pillar II occupational pension funds and pillar III personal pension funds) are defined as: “The pool of assets forming an independent legal entity that are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. The plan/fund members have a legal or beneficial right or some other contractual claim against the assets of the pension fund. Pension funds take the form of either a special purpose entity with legal personality (such as a trust, foundation, or corporate entity) or a legally separated fund without legal personality managed by a dedicated provider (pension fund management company) or other financial institution on behalf of the plan/fund members.” Other parameters can also be used to classify pension funds. 

To provide a practical definition of a pension fund covering the different regulatory systems used around the world, paragraph 2, subparagraph d), ii) of the LOB provision may be clarified by making reference to pension funds according to national law.

3.2 50% ownership requirement

The requirement that at least 50% of the pension fund participants or beneficiaries be resident in the state of residence of the pension fund, would in our view be unnecessarily restrictive. Pension funds generally have sufficient nexus with the state in which they are resident, either because they are regulated in such a state or because they are generally established in the state of residence of the employer.

Considering the globalization of international business, mobility of employees, the importance of pension funds macro economically as investors, their role in public pension expenditure, the fact they are regulated and the fact that pension fund are in most jurisdictions tax exempt, there is no need for the 50% requirement.

Even in the unlikely event of abuse, another supplementary mechanism (restrictive PPT rule or domestic anti abuse rule) would prevent application of the benefits of the convention.

3.3 Suggested amendment

With reference to the above, paragraph 2, d., ii) of the LOB provision could be amended as follows:

‘a person, other than an individual, that was constituted and is operated almost exclusively to administer or provide pension or other similar benefit, provided that such person is considered a pension fund according to the laws of that State’.
4. Investment income (paragraph 69 of the OECD commentary on article 18)

This section responds to the invitation for comments in part A, section 17 of the OECD Invitation.

As regards source taxation on investment income received by a pension fund, we agree that contracting states should include a provision in the tax convention in line with the OECD commentary on article 18, paragraph 69. In addition, recognized pension funds in a state (home state) should in our view be provided an exemption by the source state irrespective of whether or not the approach to taxation of pension funds is the same. In order to clarify this, the introduction of paragraph 69 to article 18 of the OECD model commentary may be replaced by the following text:

‘In order to achieve greater neutrality with respect to investment income received by a pension fund resident in the other State, both States might wish to include in their conventions a provision drafted along the following lines:’

As raised in the OECD report dated 21 November 2014, we see no reason to restrict the exemption for investment income to portfolio investments, as any taxation on investment income (be it portfolio or not) will result in double taxation. Moreover, any distinction between portfolio investments and non-portfolio investments would be a complex and impractical restraint which serves no clear goal.

5. Impact of the proposed limitation on benefits provision and the principal purpose test on pension funds

The 2014 deliverable on BEPS Action 6 introduces a principal purpose test (“PPT rule”) and/or a Limitation on Benefits provision (“LOB provision”) to disallow treaty benefits in inappropriate circumstances.

For direct investments, the LOB provision includes a clause pursuant to which pension funds should be considered qualifying persons and which should on that basis be entitled to treaty benefits. In addition, pension fund investment vehicles which are resident of the source state or resident of the state of which the pension fund is a resident should be entitled to treaty benefits, provided that substantially all the income of such entity is derived from investments made for the benefit of the pension fund. Entities resident in a third state would not be considered qualified persons (unless they qualify pursuant to any of the other paragraphs of the LOB provision) even though there could be very good reasons to use entities resident in a third state (e.g. for pooling purposes, or entities necessary for legal protection or for financing or administrative reasons).

As noted above, pension funds invest globally for numerous legitimate reasons and as a result need to make use of third party asset managers and pooling entities which require pension funds to invest via intermediary entities.

5.1 Intermediary entities (CIVs / non-CIV funds and other pooling entities)

The application of treaty provisions to intermediate entities such as funds as well as practical issues around how to secure the correct treaty rates (concerning different investors) is complex. This has also been identified in the 2010 OECD report15 (“CIV report”) on the granting of treaty benefits with respect to the income of collective investments vehicles16 (“CIVs”).

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16 Reference is made to the definition of a Collective Investment Vehicle as included in the OECD’s report on The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles, as adopted by the OECD Committee on Fiscal Affairs on 23 April 2010. In this report the term “CIV” is limited to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the state in which they are established. This would include UCITS and AIFMD regulated funds and similar non-EU regulated funds.
In principle, an intermediate entity resident in a third state will not be considered a qualifying person under the LOB provision. For CIVs a specific provision (paragraph 2, subparagraph f) may be included in the LOB provision to address this issue. For non-CIV funds and other pooling entities which serve a similar purpose (pooling, diversification, etc.) similar issues arise.

For pension funds investing through intermediate entities, the following issues raise concern under the LOB provisions:

- If an intermediate entity is not considered a qualifying person, tax neutrality can obviously not be obtained for a pension fund investor;
- Even if an intermediate vehicle is considered a qualifying person, such intermediate entity may only be able to claim the ‘individual’ treaty rate. Pension funds will in many situations, however, be entitled to a further reduction or an exemption had they invested directly.

The derivative benefits provision, which has been included under paragraph 4 of the LOB provision, may also not provide relief for pension funds investing via an intermediate entity, taking into account that the participants in such entity will often consist of more than seven ‘equivalent beneficiaries’, or – even if the number of participants would not exceed seven – the participants may not all qualify as ‘equivalent beneficiaries’, as they have simply been pooled together for commercial reasons. In other words participants may have a different status.\(^{17}\) Please see below example of a typical structure involving an intermediate entity.

For these situations, which do not have an abusive character, application of the LOB provision may result in unintended (withholding) taxes on investment income derived by a pension fund. After all, the pension fund could have applied the treaty with the source state and may even have been exempt on investment income under the treaty had it invested directly\(^ {18} \). Consequently, the individual pension beneficiaries would be confronted with double taxation, as taxation occurs at the time of receiving pension benefits and no credit for underlying withholding taxes will be available.

The OECD recognizes that the tax neutrality between direct investments and investments through CIVs should be ensured in order to address such issues. The CIV report also recognizes that it would be sensible to adopt a look-through approach with respect to a class of investors in the CIV as to ensure tax neutrality. Explicit

\(^{17}\) Such situation is not in the control of pension funds.

\(^{18}\) As described previously pension funds invest in intermediate entities for a variety of non-tax reasons.
reference has been made to applying a look-through approach for pension funds, since they may be entitled to a full exemption from source taxation if invested directly. We fully agree with this conclusion.

In addition, such a look-through approach should be extended to other intermediate entities such as non-CIV funds and other pooling entities.

As stated in the CIV report, it would be inappropriate not to apply the suggested look-through approach where tracking of specific income items to specific investors is clearly possible. The OECD report dated 21 November 2014 also refers to the TRACE report\(^ {19}\), allowing for the tracing of investment income to specific investors. The TRACE report has brought forward that intermediaries should be allowed to claim exemptions or reduced rates of withholding tax pursuant to a tax convention on behalf of its investors. Adopting a look-through approach for pension funds would therefore also be consistent with the approach set-out in the TRACE report.

Without doubt, pension funds can easily identify themselves to an intermediate entity. This approach is further in line with the existing US Qualified Intermediary regime and recent initiatives such as most notably FATCA, the Common Reporting Standard (“CRS”) and the G20 High-Level Principles on Beneficial Ownership Transparency (as endorsed by the G20 Leaders’ final Communiqué at the Brisbane Summit, 15-16 November 2014).\(^ {20}\)

### 5.2 Suggested approach

This section responds to the invitation for comments in part A, section 17 of the OECD Invitation.

Taking the above into account, we suggest to include a provision allowing a ‘look through’ in the OECD model tax convention (for example in article 1 of the convention in conjunction with paragraph 2, subparagraph d of the LOB provision), irrespective of whether an intermediate entity (be it a CIV, non-CIV or other pooling entity) is considered a qualifying person for the purpose of the LOB provision:

\[\text{a) 'A pension fund which is established in a Contracting State and which receives income arising from another Contracting State through intermediate entities established in either Contracting State or a third state, may claim the tax reductions, exemptions, or other benefits that would have been available to the pension fund under this Convention, had the pension fund received such income directly.'}\]

\[\text{b) In order for an intermediate entity to claim such treaty benefits on behalf of the pension fund, the pension fund should identify itself to the intermediate entity or the manager thereof by providing supportive documentation.'}\]

### 5.3 Principle Purpose Test

This section responds to the invitation for comments in part B of the OECD Invitation.

Similarly, the PPT rule should not unnecessarily restrict pension fund investments, either directly or through intermediary entities (whether it be wholly owned SPVs, CIVs or non-CIVs). The principal purpose test has the effect of denying treaty benefits if obtaining that benefit was one of the principal purposes of the transaction.


\(^{20}\) https://www.g20.org/sites/default/files/g20_resources/library/g20_high-level_principles_beneficial_ownership_transparency.pdf

\(^{21}\) The intermediate entity informs the relevant party in the other Contracting State that the pension fund is entitled to treaty benefits. The relevant party in the other Contracting State applies the treaty benefits to the payments attributable to the pension fund. The same principle should apply to a refund procedure.
As brought forward in this letter, pension funds, considering their nature and characteristics, strive to reduce double taxation for their individual beneficiaries. In other words, pension funds are not in the business of avoidance of taxation or achieving double non taxation. Granting treaty benefits to pension funds and their intermediaries in order to reduce or eliminate double taxation should in our view always be in accordance with the object and purpose of tax conventions and the principal purpose test should therefore not restrict the granting of treaty benefits to pension funds.

Also, as pension funds are subject to regulations it will be unlikely that supervisory authorities would allow a pension fund to abuse its status. Only in exceptional cases (e.g. if a pension fund would be solely set up to benefit from a beneficial tax rate), abuse could take place in which case of course the PPT or another anti-abuse measure could be applied.

We suggest that the OECD takes into account the specific position of pension funds in view of the PPT rule.

6. Closure

We are of course more than happy to provide further information and to discuss the above with you in further detail.

Sincerely,

APG Asset Management N.V.

PGGM Investments
Dear Sir

We are writing to you in response to the OECD Base Erosion and Profit Shifting (“BEPS”) Report on Action 6 (“Prevent the granting of treaty benefits in inappropriate circumstances”) issued September 2014 and the related follow up work discussion document published on 21 November 2014, as we are concerned about the implications for Phonographic Performance Limited (“PPL”) and the wider music industry. We trust the comments which follow will be taken into account in your further consideration of the model provisions and related Commentary, as invited in the discussion draft.

Established in 1934, PPL exists to ensure that those people who invest their time, talent and money to make music are fairly paid for their work. PPL licenses recorded music played in public or broadcast on the radio or TV, as well as certain uses on the internet, and then distributes the fees to its performer and record company members. Through agreements with over nearly 70 music licensing companies around the world, PPL also collects royalties for its members globally. PPL is one of many collective management organisations (CMOs) in the UK and globally, which license different types of material protected by copyright and related rights.

While we support the general principles behind BEPS, we are concerned that some of the proposed actions could have unintended adverse consequences for PPL, the wider music industry and the collective rights management industry in general. In particular the proposed actions could lead to over 20,000 sole traders and small businesses suffering double taxation on small payments, leading to such small businesses being placed at a competitive disadvantage against larger businesses. The proposed actions could also potentially deter a significant number of medium sized businesses from utilising collective management of copyright and related rights, leading to significant avoidable inefficiencies in the music licensing market.

We have set out our concerns below, together with some background to PPL and the music industry.

We understand that further work is likely to be undertaken with respect to issues related to the treaty entitlement of Collective Investment Vehicles (CIVs) and non-CIV funds. We would welcome the opportunity to discuss the issues faced by PPL and the wider music and collective rights management industry.
industry in a similar manner to the separate discussions that are being held with the funds industry.

**Background**

*The music industry and collective rights management*

The global recorded music industry is worth around $15 billion per year\(^1\) and the market is changing rapidly. In 2013, digital revenues accounted for 39% of total revenues and revenues from subscription streams have more than tripled to $1.1 billion in the last three years.\(^2\) In particular, over 28 million people paid for music subscription services in 2013, which was up 40% on 2012\(^3\).

Revenue from performance rights for owners of copyright in recordings topped $1.1 billion globally for the first time in 2013, increasing by an estimated 19% in 2013\(^4\), more than double the growth rate in 2012, and accounting for 7.3 per cent of total record industry revenue\(^5\). If income for performers was included this revenue would be closer to $2 billion.

Music CMOs like PPL play a major role in the collection of revenues on behalf of rightsholders. CMOs grant licences to commercial users (TV channels, radio stations, online music service providers), collect royalties and make distributions to rightsholders. CMOs make it possible for commercial users to clear rights for a large number of music tracks or other works, where individual negotiations – such as with individual record companies and performers, in the case of sound recordings – would be impractical. Music CMOs also exist to help level the playing field within the industry by enabling holders of rights in fewer works to collect income efficiently and so encouraging more grass roots music.

Public performance of music is by its nature localised and most broadcasting of music is organised on a country by country basis. CMOs generally reflect a national model, with a different CMO utilising knowledge of local laws and markets and a local presence to license users of music in the domestic market. The revenue collected is distributed to the owners of rights in the music that has been used, according to detailed usage information gathered by each CMO from its licensees, and each CMO’s published distribution policy.

However, the music used within any given country may have originated in any country. While large record and music publishing companies may have the international infrastructure to operate in each country and join each local society directly, smaller businesses and individual writers and performers will normally rely on their chosen CMO to enter into agreements with CMOs in each country where their music is used in order to collect revenue due to them as a result. In summary, cash travels cross-border in many different transactions as local earnings as passed on to other societies to reach the artist.

Collective management organisations collect around €6 billion in the EU alone every year.\(^6\) For a number of years, the European Commission has been encouraging the music industry to adapt to the changing market, to enable multi-territorial licensing and to facilitate cross border payments for the use of music. The Directive on collective management of copyright and related rights and multi-territorial licensing,

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1. IFPI *Recording Industry in Numbers 2013*
2. IFPI *Recording Industry in Numbers 2013*
3. IFPI *Digital Music Report 2014*
4. IFPI *Digital Music Report 2014*
5. IFPI *Digital Music Report 2014*
6. European Commission - MEMO/14/79 04/02/2014
which was adopted by member states in February 2014, requires improvements to standards of transparency and data accuracy by CMOs to allow effective multi-territorial licensing.

There is concern that BEPS could disrupt the progress made so far, and work against the European Commission’s principles. The BEPS action points could adversely affect the music industry’s efforts to enable multi-territorial licensing and to facilitate cross border payments by increasing withholding taxes (“WHT”) on cross border payments and, at best, increasing the administrative burden of obtaining double taxation relief for WHT suffered.

**Phonographic Performance Limited (PPL)**

PPL collects and distributes UK and international income for broadcasting and public performance of sound recordings on behalf of its members and performer members. As explained above companies such as PPL exist because for members or artists trying to collect royalties individually would be inefficient, if not impossible. CMOs leverage economies of scale to maximise the return to members.

PPL is established as a company limited by guarantee. In 2013, PPL had 79,000 performer members and 11,500 recording right holder members, and membership continues to grow as over 250 new recording rightsholder and over 300 new performer members are registered each month. PPL’s governance structure ensures a fair and balanced representation of the interests of its members and representatives of featured performers, session performers, major and independent record companies all have a place on the PPL Board which meets ten times a year. In addition, separate committees, each with a similar representative make-up review distribution policy, executive remuneration, the company’s finances and the annual audit.

License fee income for 2013 was £176.9m which represented growth of 4% on the previous year, and distributable income grew by 4% to 148.4m. The international income within the license fee turnover was £34.4m, constituting over 19% of the total. Societies in many countries across the world also collect internationally for their local members. The PPL figures demonstrate the large aggregate amounts that these companies are collecting and distributing. However, the aggregate amounts are made up of millions of individual transactions.

PPL has entered into agreements with nearly 70 music licensing companies in 34 countries around the world in order to collect global income in respect of the rights it manages. Some of the major CMOs PPL has reciprocal agreements with include SoundExchange in the United States, Adami in France and Sena in the Netherlands.

In 2013, PPL collected £34.4 million from overseas CMOs. Over the next 5 years these collections are expected to increase as PPL signs additional bilateral agreements with CMOs in new territories. During 2013, over 23,000 performer and rightholder members received an allocation of international revenue. The median payment of international income to a member was £102 and over 89% of members received less than £1,000 in total during the year across all territories. On average PPL’s members received payments from 11 different territories.

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7 PPL website – [www.ppluk.com](http://www.ppluk.com)
8 PPL annual review 2013
9 PPL annual review 2013
10 PPL annual review 2013
The sheer volume of money flows presents real challenges in respect of taxation, particularly in relation to cross border payments. This volume is an unavoidable result of many licensees in many countries paying licence fees in respect of the use of music created by many artists and performers in many countries. At the present time there is real concern that these challenges will be made worse as a result of the proposed BEPS action points.

Challenges arising from the international tax system

Current challenges

PPL and other CMOs already face challenges within the international tax system when collecting international revenues. The application of WHT can lead to double taxation of income and the compliance burden associated with claiming double taxation relief increases the cost of collection and reduces the income received by rights holders.

CMOs currently have to deal with inconsistency of approach by tax authorities. The compliance burden is lowest where tax authorities treat the CMO as the beneficial owner of its income allowing a single claim for double tax relief by the society. Other tax authorities allow the society to claim double tax relief but require the society to collect and provide information on the residence of its members in order to support the claim such as, for example, the UK’s Block Exemption Scheme. In order to prevent double taxation on collections from the United States, PPL has become a Qualified Intermediary and has to spend significant time and resources on an ongoing basis, including 3 additional full time staff, to maintain this status.

If a tax authority does not allow double tax relief claims to be made by the society then the compliance burden is such that only the highest earning rightsholders will be able to claim the relief that they are entitled to. For the nearly 90% of PPL members receiving less than £1,000 of international revenue, the cost of obtaining relief is likely to exceed the WHT suffered leading to double taxation of income. As rights protection becomes more prevalent in developing countries, the cost of double taxation and the administrative burden of claiming relief under double tax treaties will only increase.

Implications of BEPS

The BEPS initiative is aimed at addressing flaws in double taxation treaties and domestic tax systems that lead to base erosion and profit shifting by multinational groups. When developing its action plan, we feel the OECD has not taken into account the particular challenges faced by the collective rights management industry. There is a very high risk therefore that PPL, and the wider music industry, will be caught in the cross fire of the BEPS action points. In particular, we are concerned about the implications of the following action points:

- Action 1: Digital economy
- Action 6: Prevent treaty abuse
- Action 7: Permanent Establishment

As set out above, digital revenues are an increasingly important source of income for the music industry and the music industry is becoming more reliant on businesses operating in the digital economy for its revenues. The music industry is continuing to expand into new markets and international revenues are growing.
The public discussion paper on BEPS Action 1: Addressing the tax challenges of the digital economy broadly suggests that the challenges of the digital economy may be best addressed through changes to permanent establishment rules and, possibly, if needed by withholding taxes.

The proposed changes set out in the discussion paper on BEPS Action 6: Prevention of Treaty Abuse and in the subsequent Report issued in September 2014 could result in fundamental changes to the taxation of CMOs such as PPL and, more significantly, their members. Should CMOs no longer be able to claim the benefits of double taxation treaties then withholding tax could be suffered by members on income collected by the society as well as the income distributed to the member. Many countries impose withholding tax on royalty payments meaning that this would not be an isolated problem.

As explained above, PPL distributed international revenue to over 23,000 members in 2013, from an average of 11 different territories each, with a median payment aggregated across all territories of £102. If all of PPL’s individual members were required to file separate claims for relief in each territory they received income from, this would represent more than 100,000 possible claims for treaty relief for 2013 alone. Such a large volume of claims would represent a significant administrative burden to the overseas tax authorities as well as to PPL’s members and could become a reality if the proposals in the treaty abuse paper are adopted as drafted.

Details of proposed changes to the permanent establishment rules in the model tax convention have not yet been published as this is a 2015 action. However, we are concerned that changes could lead to an increase in the number of overseas permanent establishments for PPL and other CMOs in the music sector, and for users of music.

We have set out below our concerns on some of the specific BEPS proposals.

**Implication of specific BEPS proposals**

**Limitation of benefits clause proposed in the discussion paper on Preventing Treaty Abuse**

The proposed limitation of benefits (LOB) clause limits treaty benefits to ‘qualified persons’ or other persons specified in the treaty. If PPL were not to meet the definition of ‘qualified person’ or other specified persons then its members would potentially suffer double taxation. Our key concerns on the proposals are as follows:

- As noted above, PPL is a company limited by guarantee and therefore has members rather than shareholders. Unlike the LOB clause in the UK-US double tax treaty, it is not clear in the proposed LOB clause whether PPL’s members would qualify as ‘shareholders’ for the purpose of the ownership tests.

- Even if PPL’s members are treated as shareholders, the 50% ownership test in the definition proposed in 2(cc)(ii) would not apply to PPL regardless of the residence of its members due to the requirement for the test to be met by 5 or fewer shareholders. As noted above, PPL has many thousands of members.

- In order to determine whether PPL would meet the 50% ownership and 50% gross income test proposed in 2(e), PPL would need to collect and analyse a large amount of information from its more than 80,000 members. As the proposed LOB clause is an annual test, PPL would incur a
significant annual compliance burden in ensuring that the ownership and gross income tests are met each year.

- PPL employs over 280 people and carries out significant activities in order to manage its rights and collect income so we would expect it to meet the proposed active trade or business test. However, any inconsistency in application of this test by tax authorities would lead to uncertainty for PPL and its members. Clear guidance on this test and how it will apply to the management and exploitation of intellectual property will be essential.

- If PPL is unable to meet the definition of a qualified person or qualify for treaty benefits under the active trade or business test, it should qualify under the proposed competent authority test in paragraph 5 as obtaining treaty benefits is not one of the principle purposes of PPL’s existence and operations. However, obtaining competent authority approval in respect of agreements with more than 50 music licensing companies is likely to be a lengthy and burdensome process.

- The ‘derivative benefits’ clause as drafted at paragraph 4 could not apply to PPL as drafted in the Report issued in September 2014 due to the requirement for the ownership test to be met by 7 or fewer equivalent beneficiaries. As noted above, PPL has many thousands of members.

Where PPL and other music industry CMOs do not meet the conditions in the proposed LOB clause, they will be unable to claim double tax relief for WHT suffered on the payments they receive from overseas CMOs and overseas users of music. This will lead to double taxation for rightsholders regardless of whether the country of residence has a double tax treaty in place with the country in which the income arises.

In this situation, WHT would be likely to be levied therefore on almost all of the payments made to/from music CMOs such as PPL. This includes rates as high as 33.33% in France and 30% in the US. As a result, it is likely that multinational licensing will become uneconomical and high-earning rightsholders will be more likely to register with a CMO in numerous territories. As noted above, nearly 90% of PPL members receive less than £1,000 in international revenues with a median payment of international income of £102. With members receiving payments relating to an average of 11 different territories, this is unlikely to be a feasible option for many members and they will either miss out on income or suffer double taxation. This outcome is directly opposed to the objectives of the European Commission.

In some cases, depending on the nature of agreements, in may be possible for rightsholders to claim double tax relief in their own right. However, given the large volume of rightsholders, this will result in a large number of low value claims and will result in significant compliance burden for both tax authorities and rightsholders. As noted above, in 2013, over 23,000 members received an allocation of international revenue relating to an average of 11 different territories, which would represent over 100,000 potential double tax relief claims for 2013 alone.

Permanent Establishment

Though no detail has yet been released on the Permanent Establishment action point, it is possible that the proposals could result in an increase in the number of Permanent Establishments for PPL and others in the music industry. For example if PPL carries out activities overseas in order to collect overseas revenue for UK resident members/artists, this could potentially result in a Permanent Establishment under
a revised model convention. This could potentially lead to double taxation and an increased tax compliance burden.

In addition, commercial users of music may see an increase in the number of Permanent Establishments, particularly in relation to digital revenue streams. This could result in more than one application of WHT on the same income, increasing the incidence of double taxation and the compliance burden for obtaining treaty relief.

Comparison with the funds industry

The music and wider collective rights management industries face similar issues to the operation of Collective Investment Vehicles (“CIVs”) in the funds industry due to the large number of shareholders and volume of transactions.

Furthermore, the 2010 OECD report on the granting of treaty benefits to CIVs notes that CIVs may face difficulties accessing treaty benefits if they are not considered to be the beneficial owner of their income. The report recommends that the model treaty and commentary are updated to include a number of options to address the issues faced by CIVs, which should be considered by states when negotiating bilateral treaties.

The favoured option would treat a CIV as a resident of a Contracting State and the beneficial owner of its income, rather than adopting a full look-through approach and the proposed Commentary includes alternative provisions that adopt different approaches with respect to the treatment of treaty-eligible residents of third countries. The proposed Commentary also includes an alternative provision that would adopt a full look-through approach, allowing the CIV to make double tax relief claims on behalf of its investors rather than in its own name.

Although this report is not directly relevant to music CMOs, the commercial drivers and the issues with claiming treaty benefits are similar. The proposed options to address the issues faced by CIVs could be extended to address some of the issues faced by music CMOs. While the favoured option would be preferable, the proposed alternative provision allowing the CIV to make treaty claims on behalf of its investors is similar to the UK Block Exemption Scheme that HMRC currently provides to overseas CMOs.

We are aware that the OECD is holding separate discussions with the funds industry on the BEPS proposals due to the nature of the challenges they face, and we would be very grateful for the opportunity to take the same approach for the music industry / collective rights management industry.

Potential solutions

We have provided suggestions below which we believe would help ease the taxation challenges faced by PPL and the wider music industry. These suggestions seek to relieve the risk of double taxation whilst maintaining the integrity ambitions of the BEPS action points. As well as potential solutions that could be achieved within the BEPS process, we have identified solutions that could potentially be achieved through the European Union. Over 60% of PPL’s international income is collected in the EU. An EU based solution, together with the Qualified Intermediary status PPL already has in place to manage double taxation on US sourced income, would mean that double taxation could be prevented on over 90% of PPL’s current international collections.
Solutions that could be achieved through the BEPS process

1. Similar to the approach being suggested to deal with CIVs, include explicit provision in bilateral treaties and the proposed multilateral instrument to allow CMOs to claim treaty benefits in their own right, relieving the administrative burden for CMOs, members and tax authorities. Appropriate conditions on ownership could be included to maintain the integrity of the BEPS actions.

2. Explicitly exclude music royalties from the proposed LOB clause in the model convention. Music rights are not the type of intangible assets that are used by multinational enterprises to shift profits between different jurisdictions and are therefore not the intended target of the BEPS actions.

3. Adopting a block exemption scheme – similar to that which is currently applicable in the UK – which would allow music CMOs to claim treaty relief on behalf of rights holders on a look through basis. This would carry a compliance burden for PPL but would reduce the burden for individual members and tax authorities by avoiding many thousands of individual claims. PPL already has qualified intermediary (QI) status for US tax purposes and therefore has systems in place to collect the relevant information that would be required to implement this solution.

Solutions that could be achieved within the European Union

1. Amending the interest and royalties directive to eliminate WHT on royalty payments between third parties as well as connected parties. The current interest and royalties directive discriminates against smaller businesses that are unable to establish their own operations in other Member States and have to do business with third parties. In the music industry in particular, the major record companies have the resources to establish subsidiaries in other member states and can therefore benefit from the WHT exemption on cross-border royalty payments. Music CMOs and smaller record companies do not have subsidiaries in every Member State in which their rights are exploited and need to enter into agreements with third party businesses in those Member States in order to collect the revenues that they are entitled to.

Conclusion

The purpose of this letter is to draw your attention to the issues arising from the BEPS action that will potentially affect music CMOs such as PPL. We have set out our key concerns in relation to the current BEPS proposals and identified possible solutions to the issues which aim to avoid double taxation and ensure that income that is rightfully due to artists is not unjustly reduced, while maintaining the integrity of the BEPS proposals.

We would welcome the opportunity to discuss the issues faced by PPL and the wider music and collective rights management industry in a similar manner to the separate discussions that are being held with the funds industry.

Yours faithfully,

Chris Barton, Finance Director
cc  Jacques Sasseville, OECD Secretariat
    By email: Jacques.sasseville@oecd.org

James Ferguson and Aisléan Nicholson, Deloitte LLP
By email: jaferguson@deloitte.co.uk, ainicholson@deloitte.co.uk
SUBMITTED ELECTRONICALLY

January 9, 2015

Marlies de Ruiter
Head, Tax Treaties,
Transfer Pricing and Financial
Transactions Division, OECD/CTPA

Re: Comments on Public Discussion Draft Follow-up Work on BEPS Action 6: Preventing Treaty Abuse

Dear Madam:

These comments are submitted by the Private Equity Growth Capital Council (the “PEGCC”). The PEGCC, based in Washington, DC, is an advocacy, communications and research organization established to develop, analyze and distribute information about the private equity and growth capital (together, “private equity”) industry and its contributions to the U.S. and global economy. Our members represent a broad cross-section of the private equity industry in the United States, and include many of the world’s largest and best known private equity firms, as well as leading small and medium-sized private equity firms. Our members are united by their commitment to growing and strengthening the businesses in which they invest. Many of our members invest globally and market their funds to professional investors throughout the world. For further information about the PEGCC and its members, please see our website at www.pegcc.org.

In September, the OECD released its report in respect of the OECD/G20’s BEPS Project Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (the “2014 Report”). The 2014 Report makes several recommendations aimed at curtailing treaty abuse, and in particular treaty shopping arrangements. Among these recommendations is (i) the inclusion of a limitation-on-benefits provision (the “LOB rule”), which would limit the availability of treaty benefits to certain “qualified persons” within the relevant jurisdiction and (ii) a more general anti-abuse rule based on the principal purpose of transactions or arrangements (the “PPT rule”). The PEGCC’s comments in this letter respond to the OECD’s invitation for comments in the Public Discussion Draft Follow-up Work on BEPS Action 6: Preventing Treaty Abuse, 21 November 2014 (the “Discussion Draft”).

The Discussion Draft acknowledges that further work is needed in respect of the 2014 Report, particularly with respect to the policy considerations relevant to treaty entitlement of collective investment vehicles (“CIVs”) and non-CIV funds, and invites comments on specific issues. One of the issues identified by the Discussion Draft is the problems that the proposed LOB rule
creates for CIVs and non-CIV funds, including private equity funds. Since the investor base of private equity funds is not restricted to a single country, such funds would not be treated as “qualified persons” under the proposed LOB rule and therefore would be denied tax treaty benefits. Moreover, any provisions dealing expressly with CIVs would not apply to private equity funds and other non-CIV funds. The Discussion Draft requests comments on whether the treaty entitlement issues of private equity funds and other non-CIV funds are accurately described in the Discussion Draft and on how to address these issues without creating opportunities for treaty shopping.

For reasons discussed in more detail below, the PEGCC believes that the LOB rule proposed in the 2014 Report would substantially limit the ability of private equity funds and their investors to benefit from treaty protections, which would ultimately result in additional, unnecessary taxation for private equity investors. We believe this outcome could adversely affect the private equity industry’s ability to attract capital from investors and to invest that capital effectively on a multi-jurisdictional basis. As a result, the PEGCC supports treating CIVs and private equity funds as “qualified persons” under the LOB rule, so that the LOB rule does not restrict CIVs and private equity funds from accessing treaty benefits. We believe that a properly tailored PPT rule is a better method of addressing any potential concerns with respect to non-CIV funds, including private equity funds. However, the PEGCC believes the PPT rule proposed in the 2014 Report, which looks to whether one of the principal purposes of an arrangement or transaction is to obtain treaty benefits, is overly broad and likely to be applied inconsistently across jurisdictions. We believe the proposed rule would encourage a subjective analysis of arrangements and transactions that would create uncertainties for private equity funds and their investors as to the eligibility of treaty benefits, and would also result in additional, unnecessary taxation for private equity investors. As a result, the PEGCC strongly urges that the PPT rule be revised to apply more objectively to arrangements or transactions the principal purpose of which is inappropriately obtaining the benefits of a tax treaty.

I. Private Equity Funds—In General

Private equity funds are closed-end pooled investment vehicles, generally organized as limited partnerships, which invest in operating businesses (“portfolio companies”). Investors that participate in private equity funds (often numbering more than one hundred and up to several hundred) typically include corporate pension plans, public retirement plans, foundations, university endowments, sovereign wealth funds, insurance companies, banks and, to a lesser extent, very high net worth individuals and family offices. Investors in private equity funds also include private investment funds managed by unaffiliated management companies (for example, “funds of funds” and other investment funds that are formed to pool capital to be invested in one or more private equity funds). A substantial portion of the investors in private equity funds are either exempt from tax by their nature (for example, pension funds and sovereign wealth funds) or are subject to income tax in their country of residence (for example, insurance companies and family offices). Private equity funds have an international investor base, and investors from many different jurisdictions may invest in a single private equity fund.
Private equity funds pursue a variety of investment strategies, including buyout, growth capital, venture capital, real estate, distressed and mezzanine investing, and invest in a broad range of industries and geographies. While each private equity fund typically will make a limited number of investments during the fund’s term, private equity funds generally are not limited to investing in a particular geography and a single private equity fund may make investments across multiple jurisdictions and industries.

A private equity fund is a limited duration investment entity. The typical term of a fund is ten years (subject to extension for up to two or three years if needed by the fund to dispose of any investments then remaining in the portfolio). Most often, new investments are made by a fund only during the first three to six years of the fund’s term. Whatever the investment strategy or focus of a private equity fund, the fund typically invests capital in highly illiquid securities (i.e., securities not tradable on a securities exchange) of operating businesses. A private equity fund typically holds each of its investments for between three and seven years. In each case, the fund works to improve the value of the business in which it has invested so that, eventually, that investment may be sold by the fund at a profit based on the value created during the period that the fund owned a stake in that investment.

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1 Private equity investing can take many forms. For example, a private equity fund may acquire common or preferred stock of a promising start-up or early stage company with the intent of providing its founders with the capital necessary to commercialize the company’s product (i.e., a venture capital investment). Or, the fund may inject equity into, or buy debt of, a struggling company in an effort to turn around its operations (i.e., a distressed investment). Or, the fund may invest in a promising or strong company that needs capital to expand into new markets or develop new products (i.e., a growth capital investment). Or, the fund may make equity investments in more mature businesses, where the purchase price is a combination of the fund’s equity investment and proceeds from new senior and subordinated debt that is borrowed (and eventually is to be repaid) by the business being acquired (i.e., a buyout transaction). These private equity transactions could involve purchases of: unwanted, non-core (and often undermanaged) divisions of large conglomerates; family businesses where the founders are seeking to transition beyond family ownership; public companies that are taken private in an effort to increase value long-term without the short-term earnings pressures of the public markets; and underperforming businesses where not only capital but also operating and financial expertise can be brought to bear to turn around the business.

2 In the past ten years, the private equity industry has invested $4.3 trillion dollars in OECD member countries through over 47,000 transactions. In comparison to the rest of the world, OECD member countries are home to the overwhelming majority of private equity investment. Source: PitchBook and Preqin.

3 From 2009 to 2013, for example, buyout investment in a sector as a percentage of total buyout investment was as follows: for consumer-related companies, 21%; for business services, 21%; for information technology, 16%; for energy, 14%; for financial services, 13%; for healthcare, 10%; and for material & resources, 5%. Source: PitchBook and Preqin, Private Equity Explained, analysis performed by the PEGCC.

4 Regardless of the type of portfolio investment made, the objective of a private equity fund is the same: increase the value of the portfolio company during the time that it is owned by the private equity fund. Private equity funds accomplish this by, for example: strengthening and adding to the management team; assisting the company in achieving an optimal capital structure; requiring the implementation of management and employee equity stock...
A private equity fund generally is controlled by its general partner or an affiliated management company (or, in the case of a fund that has a non-partnership structure, the equivalent controlling entity), which has discretionary power to make investment decisions for the fund and is affiliated with the private equity firm that advises the fund. The investors in private equity funds are not involved in the management or control of the business of the fund except in very limited circumstances (for example, to vote on conflicts of interest or to remove the general partner). Interests in private equity funds typically are not listed; however, the ownership of interests in a fund typically will change over the term of the fund as a result of privately negotiated transfers of interests.

A private equity fund generally is organized as a fiscally-transparent limited partnership and therefore is not subject to entity level tax in the jurisdiction in which it is organized or from which it is controlled. Instead, each of the investors in the fund is subject to tax on its proportionate share of the fund’s profits. A private equity fund typically does not hold directly interests in portfolio companies. Rather, the fund will organize one or more subsidiary investment entities that acquire and hold these interests. These subsidiary investment entities may be formed for a number of different commercial purposes, including providing liability insulation for the fund, facilitating financing arrangements in connection with an underlying investment (including in connection with financing conditions imposed by third-party lenders) and satisfying local legal requirements. Absent the application of the proposed LOB rule, an affiliated investment entity that is tax resident in the country in which it is organized generally would qualify for the benefits of the tax treaties entered into by such country. The ability of an affiliated investment entity to qualify for tax treaty benefits is of high importance because, as discussed in greater detail below, it affords investors in a private equity fund tax neutrality in respect of the capital invested through the fund, by allowing the fund to invest in its portfolio companies on the same basis as a direct investor.

II. Concerns Relevant to CIVs and Private Equity Funds in Relation to Treaty Entitlement

A. Similarities to CIVs.

Private equity funds share many of the same characteristics as other collective investment vehicles, as described in the OECD’s 2010 report on The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles (the “2010 CIV Report”). The 2010 CIV Report defines 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.” The Discussion Draft notes that private equity funds generally would not be viewed as CIVs within the meaning of the 2010 CIV Report since private equity funds “typically have a limited number of institutional investors, may not hold a diverse portfolio and are not subject to the same investor-protection regulation.” We do not believe, however, that the 2010 CIV Report’s conclusion is an accurate comparison of private equity funds to CIVs. Rather, private equity funds, like CIVs, generally have a broad investor base, invest in diverse geographies and industries and are subject to extensive regulatory regimes.

1. **Broad Investor Base.** Private equity funds typically have a broad base of investors that includes pension funds, other tax-exempt entities, sovereign wealth funds, insurance companies, family offices and other investment funds. As a result, a private equity fund may have a large number of direct and indirect beneficial owners.

2. **Diversification.** Private equity funds often hold a number of investments over a range of industries and geographies. In addition, the governing documents of many private equity funds contain provisions requiring such funds to satisfy certain diversification requirements in respect of their investment portfolios. As discussed below, these characteristics give rise to concerns in relation to the application of tax treaties to private equity funds and their affiliated investment entities that are similar to the concerns identified in the 2010 CIV Report in relation to CIVs.

3. **Investor Protection.** Private equity funds and their managers are in fact subject to substantial regulation. The regulation of the marketing, management and operation of private equity funds and/or their advisers/managers varies from jurisdiction to jurisdiction, but in general is focused on investor protection and can be quite extensive. For example, in the United States, (i) the marketing of interests in alternative investment funds is subject to the provisions of the U.S. Securities Act of 1933, as amended, and (ii) for sales of interests in most U.S. alternative investment funds, the U.S. Investment Company Act of 1940, as amended, requires that the investors be limited in number (to no more than 100 beneficial owners) or have investment assets of at least $5 million (in the case of individuals and family companies) or of at least $25 million (in all other cases).

Additional U.S. federal and/or state statutes and rules regulate (1) the management and activities of placement agents and certain other persons who are in the business, for compensation, of marketing securities, including interests in alternative investment funds, to investors (e.g., the U.S. Securities Exchange Act of 1934, as amended), (2) anti-corruption and bribery concerns with respect to the activities of U.S. persons, including U.S. alternative investment fund managers and their affiliates (e.g., the U.S. Foreign Corrupt Practices Act), and (3) a variety of other matters.

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5 See notes 1-2.
Moreover, U.S. advisers (which term includes private equity firms and general partners that control private equity funds) to private equity and other alternative investment funds are regulated under the U.S. Investment Advisers Act of 1940, as expanded and amended by the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Advisers Act”). Even before the Dodd-Frank Act, the marketing activities and ongoing dealings with clients of all U.S. alternative investment fund managers were subject to the anti-fraud requirements and certain other provisions of the Advisers Act. The Dodd-Frank Act, by expanding the scope of the Advisers Act’s registration requirement, layered extensive additional requirements on top of the already extensive and longstanding regulatory regime described above. As a result, every sizeable U.S. alternative investment fund manager is subject to additional substantive regulation by, is required to register with, and is subject to examination (to ensure compliance with the foregoing) by the U.S. Securities and Exchange Commission under the Advisers Act.

European managers of private equity funds are subject to substantial, comprehensive and robust regulation as a consequence of the implementation of the European Union Alternative Investment Fund Managers Directive (the “AIFMD”). In summary, the AIFMD regime requires a European manager to hold significant regulatory capital, to have in place detailed policies that deal with matters such as risk management, conflicts of interest and remuneration and to disclose information on a regular basis to its regulator, its investors and, in certain cases, portfolio companies and their employees. The AIFMD also extends to non-European managers that wish to market their private equity funds in Europe. In addition to other matters, a non-European manager must satisfy the disclosure obligations that apply to European managers. The AIFMD also contemplates that non-European managers marketing in Europe ultimately will be subject to equivalent regulatory requirements to those that apply to European managers.

B. Importance of Tax Neutrality.

The 2010 CIV Report correctly notes that one of the primary goals of tax treaties is to eliminate barriers to cross-border investment. Like CIVs, private equity funds pool capital from a broad investor base to facilitate cross-border investment. Private equity funds typically provide investors with access to global investment opportunities that such investors would not otherwise have access to on a direct investment basis. For private equity funds to continue to serve this important function, however, it is imperative that such funds afford investors tax neutrality in respect of the capital invested through such funds. In other words, investors in private equity funds should not be in a worse position by pooling capital through private equity to make investments in portfolio companies than such investors would have been had they invested directly in the underlying portfolio company. For reasons discussed in more detail below, the PEGCC believes that the LOB rule and the PPT rule proposed in the 2014 Report would result in an inability of private equity funds and their investors to access treaty protections ultimately resulting in additional, unnecessary taxation for private equity investors, and limiting the pool of capital readily available to be invested in portfolio companies and the jurisdictions in which portfolio companies operate. We believe this outcome could adversely affect the private equity industry’s ability to attract capital from investors and to invest that capital effectively on a multi-jurisdictional basis. We further believe that limiting the private equity industry’s ability to deploy capital effectively could harm the global economies in which private equity funds invest,
particularly in the case of emerging markets where private equity funds often make substantial investments.

III. Private Equity Funds—Access to Treaty Benefits

A. LOB Rule.

The Discussion Draft accurately describes the problems that the LOB rule creates when applied to private equity funds. Unfortunately, as the LOB rule is currently drafted, most private equity funds and their affiliated investment entities would not qualify for treaty benefits because (1) such funds and their investment entities generally are not publicly traded, (2) investors in private equity funds typically represent multiple jurisdictions and, in many cases, 50% or more of a private equity fund’s investors would not be representative of any particular jurisdiction or jurisdictions, and (3) as a general matter, the activities of private equity funds are limited to making investments and funds do not otherwise carry on an active trade or business.

As a result, the PEGCC supports treating both CIVs and private equity funds as “qualified persons” under the LOB rule, so that the LOB rule does not restrict CIVs and private equity funds from accessing treaty benefits. This provision should apply to both private equity funds and affiliated investment entities that are organized to acquire and hold portfolio investments. Our proposed approach would not require a look through to the treaty status of any particular investor in the fund and would not subject funds to a reporting regime regarding the identity of direct and indirect investors in the fund. We believe this approach is appropriate from both a policy and an administrative perspective.

As a policy matter, private equity funds do not present the treaty shopping concerns that the 2014 Report targets. Private equity funds are formed for the purpose of pooling capital of a broad base of investors and investing that capital in portfolio companies, with a goal of providing investors with a high rate of return. These funds are not designed to facilitate tax avoidance and do not retain low-taxed or untaxed pools of capital at the fund level. Instead, during the term of the fund, capital is invested and investment proceeds are reinvested or distributed to investors. As discussed above, private equity funds have a limited term, following which all proceeds are returned to investors.

Furthermore, investors in private equity funds often would be entitled to treaty benefits, as residents of a country that has entered into a tax treaty with the country in which the portfolio company is resident, had they invested directly in a particular portfolio company rather than through a fund. For example, the PEGCC notes that over 50% of capital invested in private equity funds globally is invested by pension funds, foundations and endowments. Similarly, sovereign wealth funds also invest substantial capital in private equity. The Discussion Draft appropriately notes the treaty qualification issues that can arise for investors such as pension funds and sovereign wealth funds under the LOB rule, and in particular where such investors invest into a jurisdiction through an intermediary, such as a private equity fund. By denying treaty benefits to investors that invest through a private equity fund, the LOB rule would override policy determinations by treaty countries to grant treaty benefits to such investors. Denying
treaty access to private equity funds would also result in increased costs to private equity fund investors in the form of additional tax burden, which may take the form of double or, in certain cases, even triple taxation. This additional tax burden on private equity funds would be contrary to the goal of maintaining tax neutrality between direct investment and investment through pooled investment arrangements. Given the important role of private equity funds in promoting cross-border investment, we believe governments should be permitted to facilitate such investment by treating private equity funds and their affiliated investment entities as “qualified persons” that are entitled to the benefits of tax treaties. To deny treaty access to private equity funds would be to unfairly penalize the private equity industry and its investors by imposing additional costs in accessing cross-border investments through pooled investment vehicles compared to the costs such investors would recognize in connection with direct investment. These additional costs would ultimately discourage cross-border investment, as many investors do not have the ability to individually undertake a multi-jurisdictional direct investment strategy and thus can only do so by investing in pooled investment vehicles such as private equity funds. As a result, local economies in which private equity funds currently invest could be adversely affected.

The PEGCC also believes that a LOB rule that would apply to determine a private equity fund’s access to treaty benefits based on the status of its ultimate beneficial owners, which is proposed as an alternative approach with respect to the application of the LOB rule to CIVs in the 2014 Report, would be impractical to administer and would place an additional burden on an already heavily regulated industry. As with CIVs, investors in private equity funds often invest in such funds through tiered entities, including other funds. Identifying the ultimate beneficial owners of interests in a private equity fund, including interests that are held indirectly through upper-tier entities would require a level of inquiry that is substantially beyond what is required by currently applicable regimes, including the U.S. FATCA rules. This inquiry would require access to information with respect to indirect investors that the private equity fund may not be able to identify and with which it has no legal relationship. In addition, this information would need to be updated regularly as ownership interests in a fund and the entities investing in a fund change over the term of the fund. Even if this level of inquiry were feasible as a practical matter, it would be a time consuming and daunting process, particularly for funds with large numbers of investors, and would impose substantial additional compliance costs upon funds and their investors.

For all of these reasons, we believe that the additional reporting and administrative burdens associated with determining treaty entitlements at the level of the ultimate beneficial owners of a private equity fund would be disproportionate to the purported benefits that could be afforded by adopting such an approach as a means of preventing treaty shopping. We also believe that no persuasive case has been made that would justify the administrative complexity of attempting to identify on an ongoing basis the ultimate beneficial owners of interests in a private equity fund. To the extent helpful, we would be happy to consult with the OECD and discuss in further detail the additional costs and burdens on the industry as a whole, and the potential adverse corollary effects on the movement of capital across borders, that could arise as a result of the application of this type of rule.
Finally, in determining the appropriate application of the LOB rule to private equity funds, we request that the OECD be mindful of the substantial regulatory reporting regimes that already apply to CIVs and other alternative investment funds and/or their advisers, such as private equity funds and/or their advisers. As discussed above, private equity funds are currently subject to substantial regulatory oversight and reporting regimes. Imposing additional reporting requirements on funds, such as reporting relating to the indirect ownership of funds, could give rise to substantial additional costs and could have a negative effect on a private equity fund’s ability to attract capital for cross-border investment. Reporting regimes applicable to private equity already impose significant compliance costs on the industry—costs that, in many cases, are ultimately born by investors. Since, as discussed above, private equity funds do not present the treaty shopping concerns that the 2014 Report targets, we believe that subjecting private equity funds to an additional information reporting regime would impose a burden on funds that is disproportionate to any benefits that would be obtained through the implementation of such a regime.

B. **PPT Rule.**

The Discussion Draft identifies certain issues in respect of the PPT rule, including the application of the PPT rule in respect of investment funds and their affiliated investment entities. While the PEGCC supports a general anti-abuse rule and believes it would be an appropriate means of preventing potential treaty abuse, we believe that, as currently drafted, the PPT rule is overly broad and imprecise. The proposed PPT rule targets arrangements and transactions with respect to which “one of the principal purposes” is obtaining the benefits of a tax treaty. While the commentary to the proposed PPT rule contained in the 2014 Report acknowledges the broad scope of the rule, the commentary also notes the importance of an objective analysis in determining the applicability of the PPT rule to a particular set of facts and circumstances. As drafted, however, the PPT rule invites a subjective analysis in which different countries may reach different conclusions in applying the PPT test to the same set of facts and circumstances. Such a subjective standard ultimately creates uncertainty as to how the rule will be applied from jurisdiction to jurisdiction. As a result, we do not believe that the proposed PPT rule adequately balances the goal of preventing treaty abuse with ensuring that tax treaties apply in accordance with their purposes (for example, promoting bona fide cross-border investment). The potential for inconsistent interpretations arising from a subjective PPT rule, and the uncertainties created as a result of such varying interpretations, could ultimately impede rather than facilitate the flow of cross-border investment. To address these concerns, the PEGCC recommends that the PPT rule be drafted and applied in cases where it is determined that “the principal purpose” of an arrangement or transaction is inappropriately obtaining the benefits of a tax treaty rather than the more subjective standard of “one of the principal purposes”. The PEGCC believes that formulating a PPT rule based on the principal purpose of a transaction or arrangement will result in a more objective analysis and will minimize the opportunities for varying interpretations of the same set of facts and circumstances across jurisdictions.

As a general matter, the PEGCC does not believe that an objectively drafted PPT rule that analyzes whether a particular transaction or arrangement is undertaken for the principal purpose of inappropriately obtaining treaty benefits should prevent a typical private equity fund and its
affiliated investment entities from qualifying for treaty benefits. As discussed above, private equity funds and their affiliated investment entities are formed for purposes of pooling capital across a broad investor base and investing that capital across a range of industries and geographies. While the application of treaty benefits may be one factor in determining the appropriate jurisdiction of an affiliated investment entity formed for commercial purposes, the principal purpose of the formation such an affiliated investment entity or the private equity fund itself is not to abuse treaties, but rather to facilitate investment. Moreover, the broad investor base of a private equity fund and, correspondingly, its affiliated investment entities, should provide further evidence that the fund and its affiliated investment entities have not been formed for the principal purpose of obtaining treaty benefits. In the case of a private equity fund or an affiliated investment entity that is formed in a particular jurisdiction with no purpose other than to provide access to treaty benefits to fund investors that would not otherwise be entitled to the benefits of any tax treaty, the PPT rule proposed by the PEGCC would appropriately apply to deny treaty benefits. However, we believe that such a fact pattern would be unusual in the context of the private equity industry.

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We would be delighted to discuss this letter or any other issues relating to the private equity industry, if that would be helpful to you.

Respectfully submitted,

Steve Judge
President and CEO
Private Equity Growth Capital Council
**PwC’s comments on Action 6**

**A Issues related to the Limitation on Benefits**

1 **Collective investment vehicles**

The Discussion Draft notes that the Commentary on the LOB rule includes a discussion of how CIVs could be dealt with as well as a number of alternative provisions that correspond to the various approaches included in the 2010 OECD Report *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles* (the CIV Report). The Discussion Draft then invites comment on whether a preferred approach should be sought.

The original draft of the Action 6 recommendations on entitlement to treaty benefits omitted any reference to CIVs, an omission that was corrected in the September report. The September report recognised that the typical LOB article does not adequately address CIVs and we endorse the Discussion Draft’s use of the CIV Report as the starting point. The CIV Report was the result of a concerted effort to provide CIV investors with the opportunity to enjoy the benefits and efficiencies of collective investment without being penalised by the loss of the treaty relief that they would have received if investing directly. We do not believe a preferred approach is practical given the variety of structures for CIVs which are dictated by local law considerations, the targeted investor base, and the targeted investments.

The Treaty Relief and Compliance Enhancement (TRACE) implementation package is an important complement to an effective LOB approach for CIVs. TRACE’s investor documentation and reporting mechanisms are needed to have an effective and efficient means of establishing investor attributes when interests in CIVs are widely held and frequently traded. TRACE will provide assurances that the claims investors make for treaty relief are appropriate.

2 **Non-CIV funds**

This section of the Discussion Draft includes within its scope Real Estate Investment Trusts (REITs), sovereign wealth funds (SWFs), pension funds and alternative funds (including private equity funds). Each is a major source of capital and exists for the principal purpose of the efficient investment of capital. With the exception of SWFs and pension funds, they serve as a means for collective investment. Like CIVs, they may take various forms unrelated to treaty benefits and the goal for these investment vehicles is tax neutrality, in the sense that the taxation of these vehicles should not penalize an investor for investing through the collective vehicle rather than investing directly. The alternative means of determining treaty eligibility in the CIV Report should apply to REITs and alternative funds.

The Discussion Draft questions whether the fact that a SWF or pension plan may invest through vehicles created outside their country of residence raises concerns. We do not see any concern about extending treaty benefits for income arising through such an intermediary. If the SWF or pension fund could have received treaty benefits by direct investment, the same treaty benefit should be available whether the income is received directly or through an intermediary vehicle. Most SWFs and pension funds have an extensive amount of capital to invest. Their investments tend to be diverse and often complex. As noted in the Discussion Draft, they are major investors in alternative funds and to restrict them to local funds to
avoid a tax penalty or loss of treaty entitlement would be extremely disruptive. Outside the alternative fund arena, when these investors invest outside their country of residence, issues of limited liability and other non-tax considerations may dictate the use of a special purpose vehicle where it may be necessary or appropriate that the vehicle be formed outside the country of residence.

With regard to pension funds, they fundamentally provide important social ends by providing a means of savings and retirement security for their participants. We endorse the broad application of treaty benefits to these funds. The Discussion Draft invites comments on the “issue” of residency highlighted in paragraphs 8.6 and 8.7 of the Commentary on Article 4. This is a technicality that should not impede in any manner the ability of these funds to claim treaty benefits. In many treaties, pension funds are directly addressed in the residency article of the treaty and we suggest that is the right way to resolve any concern over whether a fund is technically liable to tax in their home jurisdiction. We also endorse making clear in Paragraph 69 of the Commentary on Article 18 that income exempt from home country taxation should also be exempt from source country taxation. Any other result would undercut the home country’s policy of providing exemption from tax for their pension funds. We recommend against any attempt to distinguish between portfolio investment and non-portfolio investment. Often funds may use an intermediary vehicle, whether it be a special purpose entity wholly-owned by the funds or a joint investment vehicle. Drawing lines between portfolio investment and non-portfolio investment would be a complex and impractical restraint which serves no policy end when the income is received by a tax exempt fund.

Finally, we recommend eliminating the requirement that at least 50% of pension plan participants or beneficiaries be resident in the home country of the fund. This test increasingly becomes a trigger point for inappropriate denial of access to tax treaties. Many employers in today’s economy are global in scale and may move employees from country-to-country in the course of their careers. Further, in smaller countries, it may not be uncommon for employees to retire to another country. Where an employee is when the employee starts receiving benefits under the plan has nothing to do with treaty shopping. Most plans are established in the country of residence of the employer and that should establish sufficient nexus as should be the fact that the plan was established in the treaty country of residence and subject to its requirements for qualification for exemption. Given the clear overriding social importance of pension funds and the fact that they are almost always tax exempt in whatever jurisdiction they are formed, there should be no need for a restraint on eligibility based on the residency of the participants/beneficiaries.

3 The discretionary relief provision

An effective and timely discretionary grant process will be increasingly important if the objective tests in the proposed LOB article are overly restrictive, with the result that, absent an efficient discretionary relief mechanism, a treaty intended to provide benefits for tax residents of the treaty partners only provides benefits for a limited class of tax residents. In the US, the discretionary grant has been described as the “safety net” in recognition that the objective tests in the LOB article may unintentionally deprive bona fide residents of the treaty country access to the treaty. In contrast to the constructive tone of most of the discussion draft, the discussion of the discretionary relief provision conveys a surprisingly restrictive approach, similar to many other aspects of the proposed LOB article. Our concerns over the restrictive nature of the discussion draft include the following:

- The statement that the fact that a tested subsidiary company would obtain a treaty rate reduction no greater than could have been obtained by the parent company under its resident country’s treaty with the source country is not sufficient to establish the lack of a treaty shopping motive. If there has been no greater treaty benefit obtained by an investment through the subsidiary company than would have been obtainable by the parent company, the subsidiary could not have been formed or availed for a principal purpose of obtaining the treaty benefit. There may be other tax benefits obtained by use of the subsidiary company as the investment vehicle but any such
non-treaty benefits that are in conflict with BEPS principles should be dealt with directly, such as through CFC rules, hybrid rules, harmful tax practices and the like.

- The discussion draft does not give adequate attention to the serious problems presented by lengthy procedures that can leave a taxpayer deserving of access to the treaty being subjected to an extended period of uncertainty and deprivation of treaty benefits during the pendency of the procedure. Simply suggesting the Commentary should “encourage” Competent Authorities to process requests expeditiously does not do justice to this concern. Taxpayers should bear the responsibility of establishing that they are not treaty shopping. Tax authorities should have the responsibility of expeditiously confirming treaty access. We recommend adoption of a six month deadline.

- The discussion draft suggests that if a tax authority has “properly exercised” its discretion, that decision should be final and not subject to the treaty's mutual agreement procedure. It is unclear who is the arbiter of whether the tax authority has properly exercised its authority; this underscores the wisdom and fairness of making the process subject to review with the treaty partner. This endorsement of a unilateral denial of treaty benefits to a resident of the treaty partner is in contrast to the Discussion Draft’s recommendation that determinations by a tax authority that a transaction violates the PPT should be subject to the treaty's mutual agreement procedure. When a tax authority is considering denying a resident of a treaty partner access to the treaty, there should be a full and fair airing of that decision with the treaty partner. Subjecting a treaty resident to the potential of double taxation or excessive taxation should be viewed as sufficiently harsh to mandate procedures to protect against inappropriate unilateral action by the source state’s tax authority.

We suggest the following basic principles should apply in developing the proper discretionary grant procedures and policies:

- The standards to be applied by the requested tax authority must be clear and public.

- If the requesting taxpayer is claiming a treaty benefit that it, or its affiliated group, could have obtained without use of the treaty, the standard should be considered met.

- There should be strict time limits set on the amount of time the tax authority has to provide a conclusion with model guidelines set forth in the Commentary subject to bilateral variations or embellishments agreed upon between the treaty partners.

- If a tax authority proposes to deny the request, procedures should be included that require the tax authority to present its tentative decision to the treaty partner’s tax authority with a complete explanation of the reason for the proposed denial of treaty benefits. If the tax authority of the treaty partner does not agree to the proposed denial of treaty benefits, the matter should be resolved through the mutual agreement procedure.

We offer the following examples of cases where the discretionary grant should be given:

- **Treasury centre**: A multinational enterprise places its global or regional treasury function in a separate company. In choosing the country of residence of the treasury centre, the enterprise considers a variety of factors, including creditor rights laws, banking laws, stability of the government, an established infrastructure of professional support, labour laws and various regulatory laws. Also considered are the local tax burden and the network of double tax agreements that avoid excessive taxation of interest income.

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1 We note that we participated in the formulation of the comment letter of the US Council for International Business and the examples provided here are similar to those included in the USCIB letter.
• **Local financing:** Company D would meet the relevant base erosion test except for the fact that it obtains bank financing from a local bank that does not qualify for the exceptions to the base erosion test because the local bank is a subsidiary of a public bank holding company and the exception from the base erosion test only applies to payments to local publicly traded companies.

• **Joint venture (1):** Company E, resident of treaty partner X under the X/Y treaty and Company F, a resident of treaty partner Y, form a joint venture in the form of a corporation resident in Country Y. The joint venture is a 50-50 undertaking but to avoid deadlock on corporate decisions, Company E is given an additional vote. Because the ownership/base erosion test only treats residents of Country Y as “good” owners, the joint venture company fails the ownership part of the ownership/base erosion test.

• **Joint Venture (2):** Companies G and H agree to establish a joint business venture. Company G is agreeing to provide substantial capital to the venture, critical to the venture’s viability. Company G already has significant business and investment activities based in Country X, a country that has a broad network of tax treaties. By reason of Company G’s other activities in Country X, Company G has strong local ties in Country X, including relationships with local financial institutions, professionals, and government agencies. Company G, therefore, insists that the joint venture be formed in Country X. Even though Company G holds a minority interest in the venture, the venture will not be viable without Company G’s investment and, therefore, Company H agrees to have the venture establish a Country X company.

• **Organic expansion:** Company A was established one hundred years ago as a family business (we know of examples that go back 200 or 300 years) created in the family’s country of residence. Over the years the business has grown from a local business to a global enterprise. While management remains in the home country, the local business has diminished in size relative to the global business, causing the company to fail the trade or business test.

• **Ownership expansion:** Company B was established by three family members, all resident in the country of residence of all three family members, Country B. Company B has formed a regional holding company in Country C that holds investments in Country D. The treaties between Country B and Country D and between Country C and Country D provide identical benefits. Over the generations, the family has grown to the point that ownership is now shared by 12 descendants of the three original founders, most retaining residence in Country B. As a result of the family expansion, the derivative benefits test is failed since it requires tracing ownership to seven or fewer equivalent beneficiaries.

• **Going private:** A multinational enterprise, based in Country C, is acquired by a private equity fund. The taxpayer establishes by clear and convincing evidence that the acquisition was driven by solid non-tax business reasons.

• **Holding company:** A multinational enterprise establishes a holding company in Country D to hold its ownership interests in its various affiliates. Most of the affiliates are in the EU and the enterprise selects Country D because it is a jurisdiction within the EU. Included in the criteria for selecting Country D is the fact that the jurisdiction has a wide network of tax treaties. Subsequent to the establishment of the holding company, the enterprise decides to expand into Country E, outside the EU, and acquires a major company in Country E. The enterprise chooses to place ownership of the new company in the holding company, with the result that the income tax treaty between Countries D and E will apply to dividends paid by the new company. Consideration of the fact that a jurisdiction has a wide network of tax treaties should be a neutral factor in determining whether the establishment of the holding company in the chosen jurisdiction has a principal purpose of attaining access to one or more specific treaties. Further, the later addition of the new company to the holdings of the holding company would not, in the absence of extraordinary
circumstances, be a basis for concluding that placing the new company under the holding company had a principal purpose of attaining access to the treaty between Countries D and E.

4 Alternative LOB provisions for EU countries

The discussion draft states that “there is therefore a need to draft alternative provisions that would accommodate the concerns of EU member states.” (Paragraph 22, page 8.)

We agree that it is arguable that ECJ case law, especially the Open Skies cases, would support the view that a derivative benefits provision should be included. It is also arguable that this is not gainsaid by the ACT Class IV case, insofar as the latter dealt with companies in different situations i.e., entitled/ not entitled to the UK’s treaty based half tax credit on dividends from UK resident companies.

We also consider that ECJ case law, especially the Papillon and SCA cases, requires entitlement to any treaty benefit to be traced via any EU company, and not just companies resident in the treaty partner states. See also 5 below.

5 Requirement that each intermediate owner be a resident of either contracting state

The discussion draft (at paragraphs 23 and 24) notes that some states consider the requirement found in subdivision 2 c(ii) and 2 e)(i) requiring that each intermediate owner of a tested company be a resident of either contracting state may be unduly restrictive and states that further work is required in order to determine whether and how the requirement could be relaxed without creating opportunities for treaty-shopping. The same issue exists in the draft provision on derivative benefits. We urge that these requirements be eliminated in all three provisions as they serve no legitimate policy concern.

These restrictions potentially would eliminate access to treaty benefits for many if not most multinational enterprises. These enterprises typically involve 100s, if not 1000s, of affiliated companies and where a tested entity is situated within the multinational group’s organizational structure may be the result of a variety of factors. Some common examples are:

- A multinational enterprise has acquired another corporate group with an existing organisational structure. For example, Company X, resident in Country A, acquires Company Y, resident in Country B. Company Y has a subsidiary in Country A, owned either directly or somewhere down the chain of ownership of the Company Y group.

- A multinational enterprise has organised its corporate ownership structure along regional lines. For example, Company X, resident in Country A, has created a regional holding company in Country B to oversee and own affiliated entities in the EMEA region and one of those affiliates is resident in Country A.

- The comparable fact pattern may exist where Company X has organised its structure based on lines of business. For example, Company X, resident in Country A, has created a company in Country B to oversee and own all affiliates that are in a single line of business, amongst the various lines of business in the enterprise. One of those subsidiaries is a resident of Country A.

Each of the above examples are very common and are simplified examples of why a tested company may be several tiers removed from its parent company with intermediate owners resident in a variety of countries. It often would be costly to restructure to avoid the “no bad intermediate owners” rules. For instance, there may be exit taxation resulting from the extraction of the tested company from its current line of ownership. In addition to being costly, it may be legally impossible or impractical because of regulatory restraints or other local law restrictions, or because of covenants in existing bank or public debt documents. Similarly, shares in the tested company may be held by a lender as security for the loan with
restrictions on any change of ownership. In addition to these economic and legal impediments to changing ownership, doing so would disrupt organisational efficiency creating unnecessary and complex reworking of corporate governance.

We see no policy justification for the rule and have seen no explanation justifying its existence, other than a statement that it may lead to treaty shopping without any explanation or example of how this might be the case. The closest we have seen to any explanation is an example in the discussion of the derivative benefits test in the original discussion draft where an intermediate owner pays a royalty to an affiliate in another country that provides preferential tax treatment for royalty income. But that same royalty could have been paid by the tested entity, with no intermediate owner between the tested entity and the ultimate parent, or it could have been paid by the parent company. The only legitimate concern is the ability of the payee of the royalty to receive favourable tax treatment of the royalty income but that has nothing to do with where the payer is in its corporate chain.

The only impact of having an intermediate owner is that the tested company can pay dividends to the intermediate owner out of treaty-benefited income. However, that dividend payment is not deductible. The treaty benefited income of the tested income has not been reduced by the dividend payment and, accordingly remains in the tax base of the tested company. While the dividend may not be subject to tax by the residence country of the intermediate owner, depending on how its tax system deals with parent/subsidiary dividends, it is likely that the parent company’s country of residence has a similar system for not subjecting dividends to tax. Hence, in most cases, the tax results would be the same whether the tested company paid the dividend to the intermediate company or if the tested company paid the dividend directly to the parent company. If the intermediate company was not in the chain of ownership but a sister company to the tested company, the dividend could be paid to the parent company and then the funds could be contributed down by the parent company to the sister company. In other words, no tax advantage, or treaty abuse, has occurred by reason of the intermediate owner being in the ownership chain. The only practical effect would be to eliminate access to treaty benefits for a large portion of the multinational population.

Any concern with dividend income being held by an intermediate company where the parent company’s country of residence does tax dividends should be addressed directly, such as in the context of CFC rules, rather than making the major tests for the treaty qualification of subsidiary companies inaccessible to many, if not most, multinational enterprises.

6 Issues related to derivative benefits

The discussion draft solicits comments on the definition of equivalent beneficiary and the need for each intermediate owner to be an equivalent beneficiary. We have addressed the intermediate owner test immediately above.

The first discussion draft cited a preferential tax rate as the reason for omitting a derivative benefits test. We note that all three companies in the example would be entitled to the same source country tax reduction under the relevant treaties, so the establishment of the tested company in State S does not provide any treaty benefit that would not otherwise be available. Further, the Parent in State T could also pay a royalty to the affiliate in State R and that apparently does not raise BEPS concerns. If the preferential tax regime for royalties in State R is considered a BEPS concern, then the proper avenue for addressing it is in the harmful tax practices Action Item. If the preferential regime is not harmful, then there is no reason to consider that preferential regime in determining whether derivative benefits are appropriate.

The derivative benefits test provides a level of certainty that is not available with other tests. For example, the active trade or business may be difficult to apply and lead to uncertain results (see discussion below).
Listed below are some instances where it is appropriate to apply a derivative benefits test. Many of these overlap with the cases discussed above and the rationales supporting the application of a derivative benefits provision are the same as those supporting discretionary relief.

Examples of situations in which the derivative benefits test is important include: joint ventures, treasury and regional holding companies, organic expansion, and acquisitions.

7 Provisions dealing with “dual-listed company arrangements”

We welcome the Working Group’s recognition of the unique circumstances of dual-listed company arrangements. These arrangements are commonly referred to as an “economic merger” of two previously independent publicly traded companies. Ignoring the shares holding special voting rights to effectuate the economics of the arrangement would appear to allow the two previously unaffiliated companies to continue to test their eligibility for the publicly traded test independently which is consistent with the purpose of the publicly traded test and we support this end. We also support further study of this area, as there are likely collateral issues, such as the appropriate application of the subsidiary of a publicly traded corporation that merit careful consideration and how to apply the substantial presence test.

8 Timing issues related to the various provisions of the LOB rule

Timing issues are dealt with differently under various provisions of the LOB rule. For instance, the definition of “qualified person” in paragraph 2 applies at the time when a benefit would otherwise be accorded. In our view, this general view is sound for individuals and governments. We offer the following comments for the categories:

8.1 The publicly traded test (and subsidiary of publicly traded entity)

The proposed Commentary on the publicly traded test states that the conditions of subparagraph c) must be satisfied throughout the taxable period of the company or entity. This standard raises several practical concerns:

- First, as noted in the Discussion Draft, this creates a problem in the year the company becomes listed. Similarly, this creates a problem in the year a company de-lists. In these “short-year” situations, there should be no reason to deprive a publicly traded company of treaty benefits in the first or last year of its publicly traded status. Rather, as with the general rule for paragraph 2, the test should be applied at the time the potentially benefitted income is received. As long as a company meets the publicly traded standards (including the “regularly traded” requirement) at the time the payment is received, treaty benefits should be accorded. There are sufficient safeguards in the publicly traded test (including the regularly traded test and the listed stock exchange requirement) to prevent abuse without a requirement that the publicly traded test be met throughout the relevant year. Absent testing at the time of receipt, it would become impractical to administer the withholding regime.

- Second, we suggest that the Commentary: (i) allow the taxpayer to apply the regularly traded test based on the prior tax year, if there is a full prior tax year, in order for the taxpayer to be confident that it can represent to withholding agents that it meets the test, relying on current year trading only where there has not been a full tax year of public trading in the preceding year, and (ii) provide an adjustment to the Commentary’s numerical test of regularly traded (10% of the average outstanding shares traded during 60 days of trading) for short years -- that is, the first year of trading and the last year of trading. US tax regulations applying rules similar to the
publicly traded test substitute, in a short year, one-sixth of the number of days of the short year for the 60 days and adjusts the 10% of the average outstanding shares by multiplying 10% by a fraction, the numerator of which is the number of days in the short year and denominator of which is 365.

- Third, the statement in the proposed commentary that the conditions of subparagraph c) must be met throughout the taxable year should be clarified for purposes of applying the subsidiary of a publicly traded company to make clear that the subsidiary test applies at the time the benefit is claimed. In other words, the fact that a company becomes a subsidiary or ceases to be a subsidiary at some point during the taxable period should not impact the eligibility of the subsidiary for treaty benefits as long as the company met the subsidiary test at the time the treaty benefit is claimed.

### 8.2 The ownership/ base erosion test

This test looks to the percentage of qualifying ownership of the tested entity and whether certain deductible payments to non-qualified persons exceed 50% of the tested company’s gross income. A critical timing consideration is that, with respect to items of income that are subject to withholding at the time of payment, the withholding agent must be able to determine the recipient’s treaty status at the time of payment. Both elements of the test require testing ownership and base erosion payments over the full taxable year. It is not practical for the tested company to know whether it will meet those tests before the end of the year. To make the tests practical, we submit the tested entity should have the option of using the prior tax year for determining eligibility where such prior year exists. We further note, with respect to application of the base erosion test, the same timing issues exist under the derivative benefits test. Accordingly, companies should have the option of applying the test based on the prior taxable year.

### 9 Conditions for the application of the provision on publicly-listed entities

Fundamentally, we do not believe the conditions in 2 c)i(A) and B) (the substantial presence test) are relevant to treaty shopping concerns and should be eliminated. They are an element of the current US treaty LOB article but are there because of a domestic policy concern over so-called corporate inversions. Domestic policy concerns should be addressed under domestic law. Embedding them in a treaty means they will apply and limit access to treaties even if the domestic policy concerns have been addressed domestically and are no longer relevant in the treaty context.

There are two types of treaty shopping. One is the use of a treaty by a third country person who simply sets up an entity in a treaty state. It is virtually impossible to use a publicly traded entity for this type of treaty shopping, (which is the origin of the principle that publicly traded entities should be considered qualified residents in their jurisdiction of residence). The second type of treaty shopping involves conduit financing arrangements where a funding entity that is not eligible for treaty benefits uses a treaty-eligible entity as an intermediary to fund a company resident in the source country; publicly traded entities can be used to achieve these conduit financing results but would be subject to anti-conduit rules. Adding a substantial presence test adds a subjective and difficult hurdle to treaty eligibility that serves no treaty shopping end.

### 10 Clarification of the “active business” provision

One important role for the active business provision of paragraph 3 is to allow treaty benefits for dividends or other payments made by an active operating subsidiary to its active operating parent where they are engaged in the same of complementary lines of business, regardless of whether the parent is a
qualified resident. Unfortunately neither the text of paragraph 3 nor the commentary thereunder makes this as clear as it should be. Below, we suggest adding a new sentence at the end of subparagraph (a) which would help to clarify the intent of the test.

The Follow-Up Discussion Draft, at item 10, invited comments on the exact scope of the last sentence of paragraph 48 of the Commentary, which provides as follows:

“Since a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in the active conduct of a business for purposes of paragraph 3.”

We agree that the function of a headquarters company, standing on its own, should not meet the trade or business test. The role of the trade or business test is that, if a company is conducting an active trade or business in its country of residence, there is sufficient nexus to the country of residence to counter any treaty shopping concern with regard to income that is connected to that trade or business. A vital corollary is that a company should be tested for the trade or business test only after attributing to the tested company trade or business activities of affiliates conducted in the residence country of the tested company, as provided in subparagraph c) of paragraph 3. To not include activities of affiliates would limit the practical application of the test and deny treaty access to companies that are not treaty shopping. It is common practice to set up a holding company structure in the country where business activities take place. To deny attribution would force companies to distort their organisation structure by having to place the management activities and business activities in the same company. It serves no policy goal to disrupt normal corporate policy as the anti-treaty shopping goal is met as long as the affiliated group has a meaningful business presence and only income connected to that business presence is treaty protected.

This same logic applies to testing for whether income from the source country is connected to the business conducted in the residence country. Often that income is sourced with affiliates in the source country and, therefore, is “filtered” through payments made by the affiliate in the form of interest and dividends. As long as the dividend or interest is sourced from earnings of a business connected to the business of the tested company, the connectivity test should be met whether the connected income is received directly or through such dividends or interest. This policy is reflected in many US tax treaties which address, in the technical explanations to the treaty, the treatment of dividends and interest sourced to the conduct of the same or similar business as that conducted by the tested company and allow the taxpayer to use any reasonable method for determining what portion of the dividend or interest income is sourced from good earnings. In order to clarify this tracing through payments made by affiliates, we suggest adding the following sentence at the end of paragraph 3 a): “An item of income shall be considered to be derived in connection with an active business if it consists of a dividend, interest, royalty or other payment from a related person conducting an active business in the other contracting state that engages in a business that is the same or complementary to the active business of the resident receiving such payment.”

B Issues related to the PPT rule

11 Application of the PPT rule where benefits are obtained under different treaties

When a multinational enterprise is selecting the tax residency of an affiliate, a multitude of considerations will be relevant, as set out in our letter. One of those considerations will routinely be whether the jurisdiction has a wide network of tax treaties. Whilst we agree that the fact that the selection criteria have included a wide network of tax treaties should not preclude application of the PPT, it is equally important that the Commentary not imply that choosing a jurisdiction with a wide network of tax treaties triggers
the PPT. In other words, the fact that the jurisdiction has a wide network of tax treaties should be a neutral factor in the application of the PPT. To suggest otherwise would penalise a jurisdiction for entering into a wide network of treaties.

Moreover, we question whether it is necessary to expressly clarify the application of the PPT to the situation where the benefit(s) obtained are from both a treaty and domestic law. A principal purpose is ordinarily the dominant purpose, and ultimately should be evaluated with respect to what provides the maximum economic benefit whether or not there are also lesser benefits. In other words, if the economic benefit of an arrangement which arises from domestic law is significantly less than an economic benefit which arises from a tax treaty, the PPT would prima facie not be prevented from applying by virtue only of that domestic law benefit. It is also worth noting that in countries where treaties are only enabled by domestic law (so-called “duallist countries”), the focus on situations involving both treaty and domestic law benefits would in our view be misplaced since there is no fundamental distinction in that instance from monist countries where treaties directly enter into force without enabling domestic legislation.

12 Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level

We welcome this suggestion but it should be elevated to a recommendation or ideally a requirement. In the UK, for example, the GAAR (enacted in Finance Act 2013) which can override tax treaties, can only be invoked on a notice by HMRC and requires the involvement of a “designated HMRC officer” and a referral to an independent GAAR Advisory Panel (Schedule 43, FA 2013).

13 Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable

We support the majority view that the application of the PPT should be included in the paragraph 5 Article 25 arbitration scope. Denial of access to treaty benefits is a serious infringement on the right of a treaty resident to claim treaty benefits in order to avoid double taxation and excessive taxation and is a major issue for taxpayers. It should not be left to the unilateral action of one treaty partner, which may well be the source state, without the agreement of the residence state.

14 Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purpose test

We agree that the Commentaries should be aligned. We have offered several examples in Section A point 3, above.

15 Whether some form of discretionary relief should be provided under the PPT rule

We agree that some form of discretionary relief should be provided in the example given and other similar situations. The denial of benefits under the PPT rule should be proportionate to the perceived abuse. We would advocate a target period for resolution of discretionary relief of six months from the PPT denial of the relevant treaty benefit.
16 Drafting of the alternative “conduit-PPT rule”

As an anti-abuse rule, the conduit rule should be targeted to cases where it is clear an intermediary company has been used for a principal purpose of accessing treaty benefits. The rule is inherently subjective in nature, particularly when one takes into account that money is fungible and thus tracing funds derived from one source to funds ultimately provided to another party ordinarily is an arbitrary exercise. There is a high risk that, unless carefully circumscribed, the conduit rule could lead to inappropriate denial of treaty benefits and extensive controversy. Accordingly, we consider that the “all or substantially all” threshold coupled with the principal purpose test is the right standard to apply. Conversely, we consider that the “at any time” provision is far too broad, as it would lead to an indefinite period of uncertainty, as any future transaction could be taken into account to deny treaty benefits.

We would moreover point out that the OECD Model Convention Articles 10-12 (Dividends, Interest and Royalties) already require the income recipient to be the “beneficial owner” of that income and that many common law jurisdictions including the UK and Canada have regard to such a test with respect to case law on beneficial ownership of the income such as Indofoods and Prevost Car. In our view, this approach works well as an anti-conduit test, suggesting that such an additional test is not necessary even where a PPT is not adopted.

If however such an anti-conduit rule were included, we would agree that more examples would be important and that those found in the Annex to the US/UK tax treaty exchange of notes should be included.

17 List of examples in the Commentary on the PPT rule

We agree regarding better articulation of the five existing examples and the addition of more examples would be important. We note the examples included in A 3 of this comment letter. Given the very nature of CIVs, we suggest that they should not be subject to the PPT. Similarly, there should be a presumption that, with respect to non-CIVs, any vehicle that is established for the principal purpose of providing a means for the collective investment of capital should be outside the scope of the PPT. A non-CIV should be subject to the PPT only in the rare circumstance where the use of the intermediary entity is clearly established to be a subterfuge for accessing treaty benefits.

C Other Issues

18 Application of the new treaty tie-breaker

We agree regarding the clarification that the tie-breaker rule should not prevent the person from being resident for the purposes of the provisions of the Convention that do not provide reliefs and exemptions to that person.

Moreover, we consider it essential that the new Competent Authority tie-breaker rule have a fixed deadline. We propose a maximum of six months.
19 The design and drafting of the rule applicable to permanent establishments (PEs) located in third States

We would urge the OECD to factor in the work on Action 7 (regarding the prevention of the artificial avoidance of PEs, including the anti-fragmentation proposals) so that any branch triangulation rule which might be adopted reflects the position re attributable PE profits after the impact of the recommendations of that other work stream. Further, the exclusion of income allocable to a PE is fundamentally a means of avoiding double taxation. As long as the standards used do not violate the principles being established for addressing harmful tax practices, the triangulation rule is unnecessary and inappropriate.

Clause e) is unduly restrictive. The premise of that clause should be that if the taxpayer has a legitimate nexus, or business purpose, for locating activities in the PE jurisdiction, with the active conduct of a trade or business being an example of such nexus, the triangulation rule should not apply. For example, where a CIV or non-CIV is managed by an asset manager that has active asset management staff in the PE jurisdiction, allocating assets under management to the situs of the asset manager should not cause the triangulation rule to apply. We further suggest that, with regard to clause f), the standard that the intellectual property must be produced or developed in the PE jurisdiction is too restrictive. The critical factor should be whether there is substantial activity in the PE jurisdiction. For example, a taxpayer may have an active staff of professionals in the PE jurisdiction responsible for the acquisition and management of IP. In that case, the nexus to the PE jurisdiction is clear and should not lead to application of the triangular rule.

20 Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

The OECD's discussion to date pays insufficient attention to the constitutional position of those countries which provide for treaties to override domestic law.
Dear Marlies,

BEPS Discussion Draft: Follow-up Work on Action 6 (Prevent Treaty Abuse)

1. General comments on the Discussion Draft

The response in the pages that follow reflects the views of the PwC network of firms, and we offer our observations on several key aspects of the Discussion Draft. We’ve summarised the main points within this letter and included some additional details and further points in an appendix.

PwC welcomes this opportunity to provide our comments on the Discussion Draft. It provides important guidance on the issues that have been identified as the focus of the Working Group. We appreciate this transparency that allows all stakeholders an opportunity to provide essential input to this process in order to produce an end product that addresses treaty abuse without undermining the fundamental purpose of tax treaties to promote bilateral trade and investment between residents of the contracting states. Income tax treaties provide a vital role in promoting cross-border trade and investment by removing artificial tax barriers such as double taxation and excessive taxation. They are crafted to be accessible to tax residents of the contracting states and it is of critical importance that measures to prevent abusive use of tax treaties do not become obstacles to their availability for the great bulk of investors and business enterprises that rely on treaties to engage efficiently and legitimately in cross-border trade and investment.

A multitude of considerations enter into the choice of country of residency, including the country’s infrastructure, its various commercial and social laws, proximity to the marketplace, stability of the government, etc. While a broad network of tax treaties that mitigate double taxation and excessive taxation is an important consideration, it is only one of many in most cases. Choosing a country of residency is also choosing to be subjected to residency based taxation. If that residency based taxation includes, for example, harmful tax practices or opportunities for double non-taxation, those are potential abuses best addressed in the context of other BEPS Actions, not by adding subjectivity or limits on accessibility to tax treaties where the abuse can otherwise be addressed. It is with this overarching principle in mind that we offer our comments.
We note that the OECD Model Income Tax Convention and accompanying Commentaries already extensively address concerns about treaty abuse, including recommendations on domestic law measures. It is only where there are shortcomings in the existing standards where it is appropriate for Action 6 to make recommendations for change and those changes need to be carefully circumscribed to ensure that their impact is restricted to cases of abuse that are not otherwise addressed in the BEPS recommendations.

In various places there should be better articulation of existing examples and the addition of more examples.

Over all, it is essential that time limits be applied so that matters are carried out expeditiously. We propose a six month period for the new Competent Authority tie-breaker rule, for tax authorities to confirm treaty access and for resolution of discretionary relief.

A. Issues related to the Limitation on Benefits (LOB)

As a preliminary comment, we note that the current proposal for a model Entitlement to Benefits article is accepted as a means of combatting abuse of tax treaties but that there could be considerable controversy over the detailed and restrictive rules. Only a handful of countries seem to have indicated an interest in choosing an LOB article over the alternative of a principal purpose test. In addition, the current draft is based on the latest version of the LOB article used by the US, which is impacted by US domestic policy issues and is under review with the potential for material changes. Given the limited number of countries that will probably opt for an LOB article, if indeed difficulties are perceived as significant, another way to address the LOB alternative might be to reference the current Commentary on the general parameters of an LOB article and leave it to the bilateral negotiations between the Contracting States to further develop the details that can then take into account the interaction of the LOB article with the domestic laws of the two parties.

We endorse the broad application of treaty benefits to pension funds (and recommend eliminating the requirement that at least 50% of pension plan participants or beneficiaries be resident in the home country of the fund) and sovereign wealth funds (SWFs). We do not believe a preferred approach to collective investment vehicles (CIVs) is practical given the variety of structures which are dictated by local law considerations, the targeted investor base, and the targeted investments; but we do see the Treaty Relief and Compliance Enhancement (TRACE) implementation package is an important complement to an effective LOB approach for CIVs. The alternative means of determining treaty eligibility in the 2010 CIV Report should apply to REITs and alternative funds (including private equity funds).

An effective and timely discretionary grant process will be increasingly important, particularly if the objective tests in the proposed LOB article remain as overly restrictive as we point out at the moment. We also point out some basic principles that should apply in developing the proper discretionary grant procedures and policies. We note that we participated in the formulation of the comment letter of the US Council for International Business on when discretionary relief should be applied and provide similar examples covering treasury centre, local financing, joint venture, organic expansion, ownership expansion and holding company scenarios. In equivalent circumstances, the derivative benefits test also provides a level of certainty that is not available with other tests.
We agree that it is arguable that ECJ case law would support the view that a derivative benefits provision should be included. We also consider that ECJ case law requires entitlement to any treaty benefit to be traced via any EU company, and not just companies resident in the treaty partner states.

We urge that requirements that each intermediate owner be a resident of either contracting state be eliminated as they serve no legitimate policy concern. There are also economic and legal impediments to changing the ownership structure, while doing so would disrupt organizational efficiency creating unnecessary and complex reworking of corporate governance. Any concern with dividend income being held by an intermediate company where the parent company's country of residence does tax dividends should be addressed directly, such as in the context of controlled foreign company (CFC) rules.

The proposed Commentary on the publicly traded test states that the conditions of subparagraph c) must be satisfied throughout the taxable period of the company or entity but we suggest various reasons why it should be at the time the payment is received or, failing that, based on the prior tax year (or a part thereof) as it should be for practical purposes for the ownership/ base erosion test.

Adding a substantial presence test adds a subjective and difficult hurdle to treaty eligibility that serves no treaty shopping end.

One important role for the active business provision is to allow treaty benefits for dividends or other payments made by an active operating subsidiary to its active operating parent where they are engaged in the same or complementary lines of business, regardless of whether the parent is a qualified resident. Unfortunately neither the text nor the commentary thereunder makes this as clear as it should be and we propose alternative wording.

**B. Issues related to the Principal Purpose Test (PPT) rule**

Whilst we agree that the fact that the selection criteria have included a wide network of tax treaties should not preclude application of the PPT, it is equally important that the Commentary not imply that choosing a jurisdiction with a wide network of tax treaties triggers the PPT.

We think it should be a requirement that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level.

We support the majority view that the application of the PPT should be included in the paragraph 5 Article 25 arbitration scope.

We agree that some form of discretionary relief should be provided in the example given for PPT and other similar situations.

There is a high risk that, unless carefully circumscribed, the conduit rule could lead to inappropriate denial of treaty benefits and extensive controversy and we suggest some clarifications.
C. Other issues

It should be clarified that the tie-breaker rule should not prevent the person from being resident for the purposes of the provisions of the Convention that do not provide reliefs and exemptions to that person.

We note some unduly restrictive elements of the branch triangulation proposal but also point out that, as long as the standards used for PE exemption do not violate the principles being established for addressing harmful tax practices, the triangulation rule is unnecessary and inappropriate.

On behalf of the global network of PwC Member Firms, with the contribution of our colleagues, we respectfully submit our response to the Public Discussion Draft. For any clarification of this response, please contact the undersigned or any of the contacts below.

Yours sincerely

Peter Cussons  
Partner  
PricewaterhouseCoopers LLP, London

Steve Nauheim  
Managing Director  
PricewaterhouseCoopers LLP, Washington D.C.

cc Stef van Weeghel, Global Tax Policy Leader

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<tr>
<td>Steve Nauheim</td>
<td><a href="mailto:Stephen.a.nauheim@uk.pwc.com">Stephen.a.nauheim@uk.pwc.com</a></td>
</tr>
<tr>
<td>Peter Cussons</td>
<td><a href="mailto:Peter.cussons@uk.pwc.com">Peter.cussons@uk.pwc.com</a></td>
</tr>
<tr>
<td>Suchi Lee</td>
<td><a href="mailto:Suchi.lee@us.pwc.com">Suchi.lee@us.pwc.com</a></td>
</tr>
<tr>
<td>David Burn</td>
<td><a href="mailto:David.burn@uk.pwc.com">David.burn@uk.pwc.com</a></td>
</tr>
<tr>
<td>Tim Anson</td>
<td><a href="mailto:Tim.anson@us.pwc.com">Tim.anson@us.pwc.com</a></td>
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<tr>
<td>David Ernich</td>
<td><a href="mailto:David.ernick@us.pwc.com">David.ernick@us.pwc.com</a></td>
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January 9, 2015

BY E-MAIL: TAXTREATIES@OECD.ORG

Marlies de Ruiter
Head
Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA

Dear Madam

Re: BEPS Action 6

We are grateful for the opportunity to submit comments on the public consultation document entitled Follow-up Work on BEPS Action 6: Preventing Treaty Abuse released by the OECD on 21 November 2014 (the “Consultation Document”) relating to the report on the work on Action 6 of the BEPS Action Plan (“Preventing the granting of treaty benefits in inappropriate circumstances”) (the “Report”).

We welcome the announcement that further consideration is being given under the consultation to the position of both CIVs (as defined in the Report) and alternative investment funds, including private equity funds, under tax conventions and the implications of the BEPS Action 6 proposals for such entities.

Ropes & Gray is an international law firm with approximately 1,100 lawyers worldwide. We represent a broad range of industry leaders across multiple practice areas.

We act as legal adviser to a wide variety of investment funds. However, these comments are limited to certain specific issues raised by the Consultation Document with respect to typical private equity structures. Nevertheless, these comments will also be relevant to other fund structures that are organised in a similar manner (such as venture capital funds and certain other alternative investment funds).

Please note that we have limited our response to comments on the specific questions raised immediately after each of “issue 17” and “issue 37” of the Consultation Document.

1 Industry Background

Investors in a private equity fund will frequently include pension funds, insurance firms, other investment funds, sovereign wealth entities, not for profit entities (including charities and local authorities) and individuals. Investors in a fund may make their investments directly or via a “fund of funds” (which itself may be in corporate, trust or other legal form).
These investors choose to pool their capital through private equity funds for a variety of reasons. As an asset class, private equity offers the potential for returns which can substantially exceed those available on the public markets. Private equity firms typically take control positions in unlisted equity investments, which many investors will lack the expertise, and often the capacity, to assume. Furthermore, investors in private equity funds benefit from the market experience and insight of professional investment managers, while the cost of these managers is spread across all of the investors in the fund.

Private equity funds are an important source of capital for private businesses internationally. If the Action 6 proposals were introduced in the form that they currently take in the Report, they could prevent holding vehicles in private equity structures from accessing the benefit of tax conventions generally. This would significantly impact investors’ returns and prejudice the principle of “tax neutrality” of the fund (discussed at 2 below). This would negatively impact the private equity industry, investors and potential recipients of investment capital.

Accordingly, we recognise that it is important for stakeholders in the private equity industry to engage with the BEPS process to ensure that a satisfactory position can be reached which satisfies the OECD’s concerns regarding treaty abuse in a proportionate manner without prejudicing the legitimate structuring of private equity funds and their investments.

2 Structural considerations

In considering the position of private equity funds, it is important to bear in mind a typical investment structure. Private equity funds are typically organised as fiscally transparent entities. This ensures, inter alia, that investors are taxed according to their own tax attributes, rather than those of an opaque fund entity. This is important, as it helps to ensure that, so far as possible, investors choosing to pool their investment with other investors by way of a fund are not left in a worse position from a tax perspective than they otherwise would have been in had they invested in the underlying assets directly.

This principle of “tax neutrality” is an important feature of many funds (including CIVs, as is noted in the 2010 report entitled “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles” (the “2010 Report”)) which, if disturbed, would significantly reduce the appeal of the fund industry as a whole for pension funds and other investors. As discussed in more detail below, these concerns are particularly acute in relation to the anticipated treatment of holding companies established by funds under the proposals made in the Report.

3 Specific Comments

3.1 Limitation-on-benefits (“LOB”) rule

Comments were invited as to whether paragraphs 15 to 17 of the Consultation Document accurately summarise the treaty entitlement issues of private equity funds.
In our view, while similar issues arise as for other CIVs, the key issue for private equity funds is the application of the LOB rule to holding vehicles established by the fund (in an “intermediated structure” as described in paragraph 4 of the 2010 Report). This is because the fund vehicle is typically fiscally transparent and will establish fiscally opaque holding vehicles for the purpose of making investments.

Private equity funds seek investment from a broad range of international sources. Accordingly, it is typically the case that the majority of investors will not be established in the same jurisdiction as the fund vehicle (or any holding vehicles established by the fund). However, many such investors will be resident in jurisdictions which do have tax conventions in place with the jurisdiction of the target entity. As a result, similar “third country” issues arise with respect to private equity funds as are recognised at paragraph 11 of the Consultation Document in connection with sovereign wealth funds and pension funds, with the further complication that the investor base will be multinational, rather than organised in any one jurisdiction.

From the perspective of private equity funds, it is crucial that any exclusion or variation of the LOB rule for CIVs and private equity funds should also apply to holding vehicles established by CIVs and private equity funds. In the absence of such a clause, it is likely that a typical private equity fund and its holding vehicles would not be able to satisfy the LOB rule as it is currently drafted in the Report. For example:

- the fund and any relevant holding vehicles are unlikely to be listed;
- the fund and any holding vehicles are unlikely to satisfy the requirements of Condition 2(d), which is aimed at charitable organisations and pension funds;
- in many cases more than 50% of the fund’s beneficiaries will be resident outside of the relevant Contracting State, given that private equity funds typically seek investment from a broad and international investor base;
- the activities of the fund and any holding vehicles may not satisfy the requirements of the “active conduct of a business” exception as this is currently drafted;
- the derivative benefits rule in its proposed form (if included) is unlikely to apply, as most funds will have more than seven direct investors holding in aggregate 95% of any relevant shares.
- in any event, although, as noted above, many investors in private equity funds will qualify for the benefit of a relevant tax convention, any proposed solution which requires the fund (or a relevant holding vehicle) to trace beneficial entitlement through to its ultimate beneficial holders is unlikely to be workable in the context of the private equity industry. In many cases, it will not be possible for a private equity fund (or its holding vehicles) to determine the treaty status of its ultimate investors, especially (as is common) where one or more of the fund’s investors is itself a fiscally transparent fund or “fund of funds”, or where investors choose to invest through nominees or similar arrangements; and
• as identified in the Consultation Document, any provisions that are explicitly drafted to apply to CIVs (as defined in the Report) may not currently apply to private equity funds or their holding vehicles unless the definition of “CIV” is expanded appropriately.

As can be seen from the above, if an LOB rule were to be introduced in its current form, there is a significant risk that it would act to deny treaty benefits to private equity funds and their holding vehicles. This may result in the imposition of withholding taxes on dividends and interest received by the fund and/or its holding vehicle. Furthermore, the relevant entity would not be able to rely on any exemption from capital gains tax on the sale of shares that might arise in the jurisdiction of the target, which could result in the double taxation of any gain realized on exit from any investment. In both such cases, the fund’s investors would generally be unable to claim any refund or credit in respect of the additional tax burden.

This would put many investors in a worse after-tax position than if they had made the relevant investment directly. In our view, the costs to investors and the private equity industry in general caused by this approach would be disproportionate to any risks of treaty abuse presented by the formation of private equity funds.

In the Appendix to this letter, we have set out a simple illustrative example that shows the impact that the LOB rule as currently drafted could have on typical private equity holding company structures.

Accordingly, if a general LOB rule is to be included, our suggested approach would be for private equity funds, together with other alternative funds and CIVs (and, crucially, any relevant associated holding vehicles), to be explicitly included in the category of “qualifying persons”, such that they would not be subject to the LOB rule in addition to any “principal purpose test” that may ultimately be introduced (or should be excluded from the LOB rule in some other manner). For the reasons mentioned above, we do not think that it will be workable to address this position through an adjustment to the LOB rule which requires the private equity fund (or the relevant holding vehicle) to trace treaty entitlement through to the ultimate beneficial investors.

3.2 Principal Purpose Test (“PPT”)

Comments were invited to suggest examples of the non-tax motivated use of a special purpose vehicle to pool the investment of investors from different countries which could be included to illustrate situations in which the PPT rule would not be breached.

As noted above, private equity funds are typically organised as fiscally transparent entities. Accordingly, it is generally necessary to incorporate a new holding vehicle for the purpose of making investments. There are a wide variety of reasons for this. These include:

• ensuring the limited liability of the fund (and its investors) in respect of its investments;
• facilitating co-investment strategies (with either or each of management, other funds and strategic investors);
facilitating external financing of investments (including bank finance); and
• centralising holding and administrative functions relating to investments, which may be in multiple jurisdictions.

In selecting a jurisdiction for the newly-incorporated holding vehicle, a fund will consider a range of factors. These will include, among other factors:

• the local legal, regulatory and tax environment1;
• the relative economic cost of establishing the vehicle in such jurisdiction;
• the availability of local financial, legal and management expertise;
• the fund’s familiarity with operating in such jurisdiction; and
• any other efficiencies that can be created by locating the holding vehicle in a jurisdiction where the fund may already have incorporated similar entities.

Depending on the holding vehicle’s activities, the fund may also consider any applicable tax conventions. For example, if the holding vehicle will invest in debt obligations, or grant loans to portfolio companies, it is sensible to organise the entity in a jurisdiction which has appropriate treaties in place that would address withholding taxes on interest payable to the holding vehicle by residents of other jurisdictions in order to avoid double taxation of that interest.

We would welcome clarification that the PPT rule should not be breached simply because a fund considers the tax conventions available in potential holding vehicle jurisdictions before selecting a jurisdiction. We consider that this is analogous to “Example C” at paragraph 14 to the commentary on the PPT rule in the Report, which describes a company resident in State R that chooses to establish its outsourced functions in State S as this is the only one of the three proposed jurisdictions that has a suitable tax convention in place with State R. The fact that the availability of treaty benefits has been taken into account by the fund, among other factors as described above, does not render this behaviour abusive.

The availability of treaty benefits at the holding company level is an important part of achieving tax neutrality for investors in a fund, such that the investors are not left in a worse position as a result of having invested through a fund, rather than investing directly. As noted above, if holding companies are unable to access treaty benefits, this may result in withholding tax costs and capital gains tax at the investment level that the fund investors are unable to recover, whether by way of refund or by credit, even if they would have been so entitled had the investment been made directly.

In the interests of certainty, this clarification would ideally be made by way of amendment to the terms of the PPT rule itself. However, at least, this should be clarified by way of a specific

1 We understand it is not intended that consideration by a fund of the local tax environment should prejudice treaty benefits under the PPT rule. However, care should be taken in the commentary to avoid the suggestion that consideration of local tax treatment is a “bad fact” for treaty entitlement purposes and, accordingly, we suggest that loose references to, e.g., “non-tax rationale” should be avoided.
example in the commentary which considers the position of a fund establishing an investment holding vehicle.

4 Conclusions

To summarise the points made above:

i. In addition to considering the position of CIVs, in our view specific consideration should be given to the position of private equity funds and their holding vehicles in the context of the Action 6 proposals.

ii. The principal purpose in structuring private equity investments is not to avoid taxation that would otherwise be payable, or to create abusive “double non-taxation” results. Rather, the key objective is to ensure that, so far as is possible, investors should not be left in a worse position as a result of investing through a fund as opposed to investing in the underlying asset directly. The wholesale denial of tax treaty benefits to holding vehicles in the fund structure will have this effect.

iii. In our view, it is unnecessary and disproportionate for the application of the LOB rule to result in the denial of treaty benefits within private equity structures. Truly abusive behaviour could be addressed through an appropriately targeted PPT rule.

iv. Any exception to the general LOB rule in the context of funds which requires the fund (or its holding company) to trace through to the treaty status of ultimate investors is unlikely to be workable with respect to private equity funds.

v. Accordingly, we suggest that private equity funds (including associated holding vehicles) are included in the category of “qualifying persons” that are not subject to the LOB rule.

vi. We would welcome clarification that consideration by funds of the availability of appropriate tax conventions in proposed holding company jurisdictions, among other factors, should not result in a breach of any PPT rule that may be included.

We would like to thank you in advance for taking our comments into account as part of the consultation process. We would welcome the opportunity to engage further with the OECD in due course. Please do let us know if it would be helpful to discuss any of the points raised in this letter in further detail.

Yours faithfully

Ropes & Gray International LLP
Set out above is a simple example of the difficulties that the current proposals present for a typical private equity fund structure. In this example, all of the jurisdictions of the investors have tax conventions with jurisdictions A, B and C which provide for a reduced rate or exemption from withholding tax on dividends and interest and exemption from capital gains tax on the sale of shares, in addition to a comprehensive network of conventions with other jurisdictions around the world providing similar benefits.

- The Fund, a transparent partnership established in jurisdiction A, has investors that are resident in multiple jurisdictions around the world (potentially including jurisdictions A, B and C).

- The Fund has established Master Holdco in Jurisdiction B as a holding company for its investment. Master Holdco has also established further holding companies in Jurisdiction C for the purpose of acquiring the Target. This may be to satisfy collateral requirements of the financial institution providing finance for the acquisition of Target (amongst other reasons). Master Holdco has funded Midco by way of both equity and debt.

- The likely result of the LOB rule as it is currently drafted in the Report is that Master Holdco would not be able to take advantage of the tax convention in place between jurisdictions B and C.

- Accordingly, Midco may be required to withhold tax in respect of dividends and interest payable to Master Holdco. Moreover, Master Holdco may not be able to benefit from the treaty exemption in respect of any capital gains tax which may arise in jurisdiction C upon the sale of Master Holdco’s shares in Midco.

- This additional tax burden will be an absolute cost to investors in the Fund, who will generally be unable to claim refund or credit in respect of this tax. Accordingly, many investors will be left in a worse position as a result of investing through the Fund than they would have been had they invested in the Target directly.
8 January 2015

Via E-Mail
taxtreaties@oecd.org

Ms. Marlies de Ruiter
Head Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

Comments of SwissHoldings on the OECD Follow-up Report regarding Action 6 (Preventing Treaty Abuse) of 21 November 2014

Dear Ms. de Ruiter

The business federation SwissHoldings represents the interests of 61 Swiss based multinational enterprises from the manufacturing and service sectors (excluding the financial sector). SwissHoldings is pleased to provide comments on the Follow-up Report regarding Action 6 (Prevent Treaty Abuse) (hereafter referred to as “the Draft”).

I. Comments regarding all Issues

SwissHoldings supports tackling the abuse of tax treaties. However, such measures must not endanger the main objective of tax treaties, which is to (i) facilitate cross-border trade through the allocation of taxing rights and (i) provide for mechanisms to eliminate double-taxation. To avoid negative input for genuine business operations any new anti-abuse provision should be sufficiently specific and targeted. In our view, both the proposed LOB provision and the PPT fail in this respect, since they are too general in nature and not limited to abusive situations.

We fear that the proposed amendments to the Model Treaty will have very negative impacts on genuine business operations. In particular, anti-abuse provisions should recognize that holding, financing and investment activities are normal and legitimate business activities that should not suffer blanket exclusions from treaty protection, which seems to be the outcome with the proposed LOB provision. The LOB provision is technically complex and unintendedly targets genuine business operations.

The PPT does not provide sufficient guidance with respect to when the treaty benefits will be granted. It opens a door for tax administrations to disqualify taxpayers from treaty benefits where that tax administration deems this appropriate. With the possibility of such subjective interpretation, tax treaties lose the advantage of providing legal certainty and eliminating obstacles to cross border trade. Generally, the burden of proof of misuse is with tax authorities. Unfortunately, practice shows that often tax authorities assume a misuse right from the outset. While more developed countries have a sound court practice against such approach, less developed countries might apply the PPT as a gate not to eliminate double-taxation due to "exceptional circumstances".
II. Comments on Specific Issues

Ad 3. Commentary on the discretionary relief provision of the LOB rule

We propose clarifying paragraph 63 of the Commentary on the LOB rule in the case of a resident subsidiary company with a parent in a third State as follows: The conditions for granting the discretionary relief are met (automatically) if the “relevant withholding rate provided in the Convention [i.e., the tax treaty between the State of resident subsidiary and the State of source] is not lower than the corresponding withholding rate in the tax treaty between the State of source and the third state”. Since in such case there is no risk of treaty abuse, there is no reason for denying treaty benefit.

Furthermore, discretionary relief under an LOB concept should always be granted in case abusive behavior is absent. Abusive behavior requires by definition control or at least significant influence. If these pre-conditions are not met, a treaty-shopping situation can be excluded. Therefore, the rationale of the stock exchange test is well understood. However, there is a number of non-quoted companies with widespread shareholdings in various countries, where (individual) shareholders (i) do not have control or (ii) the individual shareholders are not able to exercise significant influence and, therefore, the place of management of the company cannot be determined by the individual shareholders. In these cases treaty abuse is absent and, therefore, the conditions for granting discretionary are met (automatically).

Ad 4. Alternative LOB provisions for EU countries

We propose that any alternative provisions intended to soften the requirements of the LOB rule and of the PPT rule in order to accommodate the concerns of the EU member states should also be available to states which are not EU member states but which have close economic ties to a group of other states, i.e., EEA and EFTA (of which Switzerland is a member). In any case the solution must not lead to a discrimination among OECD member countries.

Ad 5. Requirement that each intermediate owner be a resident of either Contracting State

We are of the opinion that each intermediate owner be a resident of either contracting state for purposes of the indirect stock exchange test and the ownership test is unduly restrictive. Therefore, we propose deleting this requirement.

Ad 6. Issues related to the derivative benefit provision

We are of the opinion that the existence of a comprehensive double taxation treaty between the state of the equivalent beneficiary and the source state is a sufficient requirement for the application of the derivative benefit provision. A comparison of withholding tax rates in respect of Article 10, 11 and 12 income is unduly restrictive. Therefore, we propose to adjust the definition of equivalent beneficiary by deleting clause B of paragraph 6(f) (i) of the LOB rule.

Ad 9. Conditions for the application of the provision on publicly-listed entities

Certain provisions such as subdivision 2 c) i) B seem to relate to specific US issues and should consequently be dealt with on a bilateral basis and not be inserted into the Model Treaty. Furthermore, we are of the opinion that the way the provision on publicly-listed entities is drafted is discriminatory towards small countries that do not have important stock exchanges. We,
therefore, propose either to delete clauses A and B of paragraph 2(c) (i) of the LOB rule or to delete in clause A the words “located in the Contracting State of which the company or entity is a resident”. If this is not feasible, we propose, at least, to adjust the definition of “primary place of management and control” according to paragraph 5(d) of the LOB rule in order to make sure that regional holding companies of publicly-listed entities are not harmful for a qualification under the stock exchange test.

**Ad 10. Clarification of the “active business” provision**

We are of the opinion that the requirement that the business of making or managing investments can never qualify under the active business provision is unduly restrictive. We propose to modify paragraph 3(a) of the LOB rule and the corresponding Commentary in order to clarify in which circumstances the business of making or managing investments may qualify under the active business test. Furthermore, we propose to clarify in which circumstances group internal financing activities and cash pooling activities combined with management oversight activities may qualify under the active business test of the LOB rule.

LOB rules should only focus on treaty shopping cases and therefore on abuse of treaty benefits. There is no convincing argument to exclude certain activities and, hence, we are of the opinion that the requirement that the business of making or managing investments shall never qualify under the active business provision is unduly restrictive. In relation to a holding company, we would recommend removing the related Commentary in paragraph 48 which excludes headquarter companies from satisfying the active conduct of a business test, if its business is managing of investments. It appears inappropriate and disproportionate to exclude all holding companies from treaty benefits. The structures of holding companies may vary significantly and there may be a number of bona fide reasons as to why a holding company is being used.

A respective rule has also to acknowledge that according to OECD principles (paragraph 7.4 of the OECD transfer pricing guidelines) and EU jurisprudence a group can organize itself differently, meaning more centralized or decentralized and therefore “same line of business etc. requirements” are unduly restrictive (especially if banks, insurance etc. are excluded from that requirement even if forced by supervisory law).

The LOB provision should take into account especially substance and purpose of the holding company, existence of substantive elements such as premises, employees in the holding state etc. Therefore, the key parameter should be whether the adequate (people) functions are performed in relation to the activity. Holding, financing and investment activities including licensing should not suffer blanket exclusions from treaty protection in the light of an activity test, provided that the adequate substance related to these functions is given.

Furthermore, political stability and geographical location could be factors that may warrant a regional holding company, thus rebutting claims of abusive behavior.

**Ad 13. Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable**

We strongly support the view that the application of the PPT rule is an issue suitable for the arbitration mechanism of paragraph 5 of Article 25 OECD Model Tax Convention.
Ad 14.  Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

The application of the discretionary relief rule of the LOB, and the PPT rule should both be under mandatory arbitration. In any case, if the Contracting States are unable to agree, then there should be an underlying assumption that it is therefore not reasonable to conclude that obtaining a benefit was a principal purpose, and therefore the PPT rule should not apply (and discretionary relief should be available).

Ad 17.  List of examples in the Commentary on the PPT rule

Under the LOB rule, a regional holding company is, in most cases, not a qualifying entity. Given the fact the minimum standard regarding treaty shopping will be fulfilled if a double taxation treaty does not contain an LOB rule, but only a PPT rule, the question of the substance requirements of a regional holding company becomes important. We, therefore, propose to add some guidance and examples under which circumstances one of the main purposes of setting up of a regional holding company is not considered obtaining the corresponding treaty benefits. What are the substance requirements for a regional holding company in order not to be caught by the PPT rule?

Ad 18.  Application of the new treaty tie-breaker rule

We are of the opinion that the new tie-breaker rule for dual-resident companies leads to a huge risk of double taxation since in the absence of a mutual agreement between the competent authorities the treaty benefits are denied and, even more important, the competent authorities are not bound to agree on the residence state of the dual-resident company but the competent authorities are only bound to endeavor to determine the residence state. We, therefore, propose to replace the words “shall endeavor to determine” by the words “shall settle” in the new tie-breaker rule.

We kindly ask you to take our comments and proposals into due consideration.

Yours sincerely

SwissHoldings
Federation of Industrial and Service Groups in Switzerland

[signature] [signature]

Christian Stiefel  Dr. Martin Zogg
Chair Executive Committee  Member Executive Committee

Cc:  - SwissHoldings Board
     - Nicole Primmer, Senior Policy Manager BIAC
     - Will Morris, Chair BIAC Tax Committee Bureau
     - Krister Andersson, Chair BUSINESSEUROPE Tax Policy Group
Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation and Development
Paris, France

Via Email: taxtreaties@oecd.org

Dear Ms. de Ruiter:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries’ tax bases are being eroded or profits shifted improperly. Pursuant to Action 6 of the Plan “Prevent treaty abuse,” the OECD issued a public discussion draft on 21 November 2014 entitled *Follow Up Work on BEPS Action 6: Preventing Treaty Abuse* (hereinafter the Discussion Draft or Draft). The Draft follows on the OECD’s first public discussion draft under BEPS Action 6 released on 14 March 2014, and requests additional input on various issues after the release in September 2014 of the OECD’s report on BEPS Action 6 regarding *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (the Report).

The OECD requested comments on the Discussion Draft no later than 9 January 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD’s request for comments on the Draft.

**TEI Background**

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North
and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.

**TEI Comments**

TEI submitted comments to the OECD regarding preventing treaty abuse in response to the issuance of the first public discussion draft under BEPS Action 6, in a letter dated 8 April 2014. Our comments focused primarily on the proposed limitations on benefits provision (LOB provision), treaty anti-abuse rule (the principal purposes test), and the need for transition relief.

As we stated in those comments, the principal purposes test is highly subjective and susceptible to inconsistent and unpredictable interpretations by tax authorities. This continues to be the case with the test in the Report, which would deny treaty benefits if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction . . . unless it is established that granting that benefit . . . would be in accordance with the object and purpose of the relevant provisions of this Convention.

This provision will inject a high degree of uncertainty into the determination of whether a taxpayer is entitled to treaty benefits. For this and other reasons, TEI opposes the inclusion of a principal purposes test in the OECD model treaty. Nevertheless, the Report recommends treaties based on the OECD model include such a provision, or a more targeted provision addressing specific concerns, unless there is an adequate domestic law anti-abuse regime to police treaty abuses that are not addressed by an LOB provision. In light of this recommendation, TEI reiterates its suggestion that jurisdictions adopt an effective process through which a taxpayer can obtain a timely independent administrative determination regarding the application of the test if the government asserts it applies to deny the relevant treaty benefit. There is considerable dismay among MNEs that the principal purposes test will cause sufficient uncertainty regarding whether an MNE is entitled to treaty benefits that the MNE may not satisfy its burden for reporting the benefit on audited financial statements under the relevant financial accounting standard. An MNE may thus forego the investment or transaction at issue because of the uncertainty, which would have a corresponding negative

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1. TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

impact on foreign direct investment and economic growth. An effective and timely administrative ruling process would help allay this concern.

Moreover, in cases where a treaty also incorporates an LOB provision, the Report makes it clear that treaty benefits may be denied under the principal purposes test even if a multinational enterprise (MNE) has satisfied the LOB provision. Thus, having gone through the time consuming, but relatively objective, exercise of testing its eligibility for treaty benefits under the LOB provision, an MNE may nevertheless find the benefit denied under the principal purposes test. For treaties that adopt both provisions, TEI recommends that tax authorities use the LOB provision as the primary tool to combat perceived abuses, as it is the more objective test. The primary purposes test would then be limited to the most egregious cases of abuse and not the main tool for policing access to treaty benefits, which would be simpler and more certain for taxpayers as the test is vague and susceptible to subjective interpretation.

TEI also reiterates its recommendation that the OECD set forth standards for transition relief for MNE structures that presently qualify for benefits under various bilateral income tax treaties, but would no longer qualify under the revised OECD model. TEI recommends an effective date for the changes in the Report of at least two years from when the provision enters into force for new structures, and significant additional time for structures in place before the effective date. The new rules should also be accompanied by a directive that the principal purposes test may only be applied by tax authorities prospectively to arrangements and transactions that arise after the effective date and only to preexisting structures once the transition period expires.

Conclusion

TEI appreciates the opportunity to comment on the OECD public discussion draft regarding follow up work under BEPS Action 6. These comments were prepared under the aegis of TEI’s European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of TEI’s legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,

TAX EXECUTIVES INSTITUTE, INC.

Mark C. Silbiger
International President

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3 See Report at p.67.
Dear Marlies de Ruiter,

**RE: Taxand responds to the OECD invitation for public comments on the OECD discussion draft on follow-up work on Action 6 (Prevent treaty abuse) of the BEPS Action Plan**

Further to the publication of the OECD’s invitation for public comments on the OECD discussion draft on follow-up work on Action 6 concerning the prevention of treaty abuse, Taxand is honoured to provide written comments based on the practical experience we have as tax advisors.

The consultation of the prevention of the granting of treaty benefits in inappropriate circumstances is a key initiative of the BEPS Action Plan, which we support. This is particularly important in light of the fragmentation of domestic approaches to treaty shopping and multiplication of different treaty interpretation issues on abuse, leading in some cases to divergent national case law.

We would like to salute the efforts of the OECD Committee of Fiscal Affairs for its continual and vast work on laying down the cornerstones for the ambitious and comprehensive Action Plan aimed at addressing base erosion and profit shifting in an open format that allows all stakeholders to provide their views.

Taxand can confirm that we have no objections with posting the comments on the OECD website and that comments represent Taxand and are based on our experience working with multinationals worldwide.

We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further and to participate in any further discussion on these matters.

More information about Taxand is provided below. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

If you wish to discuss any of the points raised in this letter, please do not hesitate to get in touch with us directly via the contact details below.

Yours faithfully,

Taxand

* Taxand’s comments on the previous OECD discussion draft concerning Action 6 can be accessed here >
ABOUT TAXAND

Taxand provides high quality, integrated tax advice worldwide. Our tax professionals, more than 400 tax partners and over 2,000 tax advisors in nearly 50 countries - grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

We're passionate about tax. We collaborate and share knowledge, capitalising on our expertise to provide you with high quality, tailored advice that helps relieve the pressures associated with making complex tax decisions.

We're also independent—ensuring that you adhere both to best practice and to tax law and that we remain free from time-consuming audit-based conflict checks. This enables us to deliver practical advice, responsively.

Taxand has achieved worldwide market recognition. Taxand ranked in the top tier in Chambers Global Guide 2014 global network rankings and in the International Tax Review's (ITR) World Tax 2015, 41 Taxand locations were commended and a further 26 locations listed in ITR's World Transfer Pricing Guide 2015. 31 countries were voted top in the ITR Transaction Tax Survey 2014 and 29 in ITR Tax Planning Survey 2013. Taxand has received 65 national awards and 14 regional awards in the ITR European, Americas and Asia Tax Awards since 2009. These include Latin America Tax Disputes Firm of the Year, European TP Firm of the Year, European Indirect Tax Firm of the Year, Asia Transfer Pricing Firm of the Year, and Asia Tax Policy Firm of the Year. Full details of awards can be viewed at www.taxand.com/about-us

www.taxand.com
Our response to the issues posed by the OECD report under BEPS Action 6 on preventing treaty abuse and the follow up work issued respectively on 16 September 2014 and 21 November 2014 complete our comments made on 9 April 2014, which can be accessed here.

The OECD Committee of Fiscal Affairs made a huge effort of analysing the various comments on public discussion draft published on 11 April 2014. The OECD report and the follow up work issued are very detailed and well drafted. However, the combination of their numerous provisions increases their complexity and therefore they may not be easily comprehensible by a person who is not a lawyer or tax professional.

The follow up report acknowledges that the adoption of both types of rules (LOB and PTT), together, might not be appropriate for all countries. We believe that the combination of the limitation on benefits (LOB) provision and the principal purpose test (PTT) rules could create significant fiscal complexity and uncertainty for international business, in particular as the PTT may apply independently of the LOB clause.

1. Comments on the inclusion of a comprehensive limitation on benefits provision

The LOB rules should be as detailed and comprehensible as possible with specific tests and examples.

- **Publicly traded test provision**
  We believe that a publicly-listed entity should benefit from the LOB provision during the year of its listing. The publicly-listed company which ceases to be listed should continue to be treated as if it were a listed company together with its existing subsidiaries at that time, unless it has been listed for a very short period of time or the group is ceasing its activities and starting new activities.

- **Investment vehicles provision**
  The 2010 OECD report includes clear guidelines for treaty benefits for collective investment vehicles (CIVs). CIVs, like a lot of listed companies, generally have a broad and diversified range of investors and are often not majority owned by investors who are resident in the country where they are established.

  We believe that the nature and idiosyncrasies of the investment fund industry, in particular for non CIVs, should be taken into account to establish safe harbour rules for this type of entity.

- **Active trade or business provision**
  As the term ‘trade’ or ‘business’ may not apply in certain civil law countries, a note could be added to mention that the active trade or business definition includes independent personal services.

- **Discretionary relief provision**
  The example mentioned below in section 2 concerning the creation of a joint-venture by several groups could be included as an instance where the discretionary relief provision of paragraph 5 of the LOB should apply. In general, the discretionary relief should also
apply if one of the main reasons for the location of a subsidiary in a foreign country is the favourable tax regime granted by local tax authorities and approved by regional authorities (such as the European Commission).

2. Comments on the inclusion of the principal purpose test provision

Should the PPT rules be adopted by certain countries, considerations should be given to an alternative definition where the PPT provisions would not be applicable. For instance, if there were one or several valid business reasons which reflect economic reality and explain the arrangement or the transaction. For example, in the situation where 2 or more industrial or commercial groups decide to create a joint-venture, they will often decide to set up a holding company in a “neutral” country in which none of the partners or their main subsidiaries are located. In these circumstances it should be acknowledged that there are valid business reasons (i) to set up the holding company and (ii) to locate it in a third party country. Therefore in these circumstances, it should be considered that the PTT provision should not be applicable.

3. Comments on other issues

- Application of the new treaty tie-breaker rule
  The new tie-breaker rule proposed in paragraph 39 of the report provides that in the absence of an agreement between the competent authorities, a legal person that is resident of each Contracting State under Art. 4(1) shall not be entitled to any relief or exemption from tax provided by the Convention, except as agreed by the competent authorities. The competent authorities should address the requests made to them under the new rule during a specific period of time mentioned in the Convention.

- Interaction between tax treaties and domestic anti-abuse rules
  Some countries have committees composed of experimented persons approving the application of the domestic general anti-abuse rules. In order to avoid adverse interaction between tax treaties and domestic anti-abuse rules, such committees should also be in charge of the approval process for the application of tax treaty anti-abuse rules. In order to benefit from the experience of various experimented persons, such committees could be composed of senior officials, academics and tax experts from the private sectors.

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We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further, and to participate in any further discussion on these matters.

More information on how to contact Taxand is provided above. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

Yours faithfully,

Taxand
This response is the sole view of Taxand advisors and does not represent the opinions of Taxand clients or contacts. As provided in Treasury Department Circular 230, this response is not intended or written by any Taxand firms to be used, and cannot be used, by a client or any other person or entity for the purpose of avoiding tax penalties that may be imposed on any taxpayer. The information contained herein is of a general nature, is up to date as of January 2015 and is subject to change. Readers are reminded that they should not consider this response to be a recommendation to undertake any tax position, nor consider the information contained therein to be complete. Before any item or treatment is reported, or excluded from reporting on tax returns, financial statements or any other document, for any reason, readers should thoroughly evaluate their specific facts and circumstances, and obtain the advice and assistance of qualified tax advisors. Even though all reasonable care has been taken in the preparation of this response, Taxand and all of its firms do not accept any liability for any errors that it may contain or lack of update before being submitted, whether caused by negligence or otherwise, or for any losses, however caused, or sustained by any person. Taxand is a global organisation of tax advisory firms. Each firm in each country is a separate and independent legal entity responsible for delivering client services.
January 9, 2015

Marlies de Ruiter,
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division,
Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
2 Rue André Pascal
75775 Paris Cedex 16
France

Via e-mail to taxtreaties@oecd.org

Dear Ms. De Ruiter

TD appreciates the opportunity to submit comments on the Discussion Draft on Follow Up Work on BEPS Action 6: Preventing Treaty Abuse issued by the OECD on November 21, 2014 (the “Discussion Draft”).

These comments build on the comment letter we submitted on April 9, 2014 on the Discussion Draft on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances issued by the OECD on March 14, 2014. Like our April comment letter, these comments focus largely on the principal purpose test (PPT) provision that is proposed to be included in the OECD Model Tax Convention. We also comment briefly on some key aspects of the proposed limitation on benefits (LOB) provision and the critically important issue of the interaction between domestic law anti-abuse rules and tax treaties.

We commend the OECD for continuing to work to refine the proposed measures for preventing the granting of tax benefits in inappropriate circumstances. Tax treaties play an essential role in the global economy by reducing or eliminating the risk of double taxation which otherwise would be a substantial barrier to cross-border trade and investment. Clarity and certainty in the application of tax treaties is vital to global companies both in understanding the tax consequences of their cross-border activities and in understanding and satisfying their global tax compliance obligations. In this regard, uncertainty about the availability of treaty benefits can be tantamount to a denial of benefits. Therefore, as the OECD continues this important
work, we urge that care be taken to ensure the anti-abuse rules being developed are not so burdensome as to deny effective access to treaty benefits to the intended beneficiaries.

Before turning to the specific issues with respect to this Discussion Draft, we want to express grave concern about the implications of these proposals restricting access to tax treaties, together with the other pending BEPS proposals, for cross-border trade and investment and the global economy. Changes of the type being contemplated under the rubric of the BEPS project, and the uncertainty that would be created by abandoning clear standards and principles in favor of vague and subjective concepts, would have a profound adverse effect in terms of stifling global business. We of course recognize the need for governments to raise revenue to support essential government functions. However, they must do so efficiently and without having a chilling effect on essential commerce.

We urge the OECD to ensure that the work on all the BEPS Actions includes full consideration of the microeconomic and macroeconomic implications of any changes. The OECD has the world-class resources needed to contribute to the global debate by educating participants about the economic, policy, and revenue dimensions of the issues to be addressed and the solutions to be developed. This should go beyond the corporate income tax system and include the whole range of tax approaches available to governments.

The Proposed PPT Provision – Overall Comments

We welcome the OECD’s decision, as reflected in the September 2014 report on Action 6, to allow flexibility regarding the use of the proposed LOB provision and/or the proposed PPT provision, rather than mandating the use of both provisions in combination. However, we continue to be concerned that the proposed PPT provision would seriously undermine the clarity and certainty that are necessary for the effective operation of treaties.

The operative standard in the proposed PPT provision looks to whether “it is reasonable to conclude” that the obtaining of a treaty benefit was “one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.” As expressed in our earlier comments, we believe this standard is both overly broad and overly subjective. When companies are considering an investment or a transaction they would not know whether the application of treaty benefits to the arrangement might be subject to challenge under this standard. The uncertainty is exacerbated by the fact that it is the interpretive standards of the foreign country, not the company’s home country, that generally would be relevant to a company trying to evaluate whether or not it would be entitled to treaty benefits. Moreover, these interpretive standards could well change over time and companies would need to know the current – and in many cases, the future – standards of the relevant foreign country.
The PPT provision includes an exception under which treaty benefits would nevertheless be allowed if “it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.” As noted in our earlier comments, while the inclusion of an exception is helpful, this standard similarly is overly vague and uncertain. Companies would not know whether a contemplated investment or transaction might be eligible for this exception. Countries would not know how their treaty partners would apply this exception, and such application also could change over time. Moreover, query why the rule denying benefits requires only that it be “reasonable to conclude” that there was an inappropriate purpose, while the exception that would allow treaty benefits requires that it be “established” that the benefits would be in accordance with the treaty provisions’ object and purpose. In addition, we urge the OECD also to incorporate an expeditious advance ruling process that would provide the certainty necessary to reduce impediment to cross-border trade and investment.

We recognize that the OECD is committed to including the PPT provision as an approach that countries could choose to use to prevent treaty shopping and other inappropriate uses of treaties. However, we urge the OECD to continue to work to tighten up the language of such provision and to provide further explanation and illustrative examples regarding where the provision would apply to deny treaty benefits and where it would not so apply.

In this regard, we would like to reiterate our concern about the loose standard of “one of the principal purposes” and the commentary language indicating that there can be multiple principal purposes. Our concern can best be illustrated with the following language from proposed commentary paragraph 13:

A purpose will not be a principal purpose when it is reasonable to conclude, having regard to all the relevant facts and circumstances, that obtaining the benefit was not a principal consideration and would not have justified entering into any arrangement or transaction that has, alone or together with other transactions, resulted in the benefit. In particular, where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to obtain that benefit.

Under the conditions laid out, which involve an arrangement that is inextricably linked to a core commercial activity where not even the form of the arrangement reflects treaty benefit considerations, how can it be said that it is only unlikely, and therefore presumably still possible, that treaty benefits would be denied under the PPT provision? Simply tightening up
the language of the provision to focus on “the” main purpose would be a significant improvement in terms of the operation of the proposed PPT provision and would significantly reduce the level of uncertainty.

Finally, as countries consider whether or not to include in their own bilateral treaties a PPT provision such as the OECD is proposing, we believe that they should evaluate the potential harmful macroeconomic impact of the uncertainty that such a test would create and the negative implications for cross-border trade and investment. These harms must be weighed against the expected benefits of such a test as an anti-abuse tool. Moreover, this cost-benefit analysis must also reflect the additional compliance costs for both taxpayers and tax administrations from such a subjective test. It should be noted that these increased costs will further exacerbate the inefficiency of the corporate income tax, which the OECD has already identified as a relatively inefficient tax as compared to other forms of taxation.

The Proposed PPT Provision – Specific Comments

In addition to reiterating our overall concerns about the PPT provision, we also wanted to comment on some of the specific issues raised in the Discussion Draft.

Approval process for application of the proposed PPT provision

Issue 12 in the Discussion Draft references the practice in some countries of requiring approval for any application of a domestic general anti-abuse rule. In some countries, the approval committee is composed of senior tax administration officials; in other countries, the approval committee includes academics and/or private sector tax experts. The Discussion Draft indicates that consideration is being given to including in the commentary on the proposed PPT provision a suggestion that countries consider establishing a similar process of senior level approval for application of the PPT provision.

We would strongly support this proposal. Indeed, we recommend that the OECD go farther and develop a model approval process for countries to put in place under their treaties. Moreover, we believe that such a process should be made an integral part of the proposed PPT provision and an automatic step in its potential application to deny treaty benefits. We would also suggest that the OECD recommend that taxpayers should be ensured access to the approval process and should have the ability to make representations as part of the process in order to ensure the accuracy of the facts and circumstances as well as to provide information demonstrating their original intentions and motivations in entering into the transaction.
Eligibility of the proposed PPT provision for arbitration

Issue 13 in the Discussion Draft references the conflicting views of countries on whether application of the proposed PPT provision is an issue suitable for the arbitration mechanism included under Article 25(5) of the OECD Model Tax Convention, noting that the majority of countries are of the view that such application should be subject to arbitration. The Discussion Draft indicates that a determination must be made regarding whether and how to reflect the views of the minority who believe that the proposed PPT provision should be excluded from any arbitration mechanism.

We believe that it is critical that it be made clear that determinations regarding the application of the proposed PPT provision are subject to treaty arbitration mechanisms. We would urge that the proposed PPT provision be coupled with a mandatory arbitration provision so that there is an effective mechanism in place for resolving the disputes that would invariably arise under a PPT provision.

Discretionary relief in connection with the proposed PPT provision

Issue 15 in the Discussion Draft references the potential for some form of discretionary relief upon application of the proposed PPT provision, such as treaty relief for the transaction as it would be recharacterized under the theory that supported the application of the PPT.

We believe that such discretionary relief must be an inherent part of the application of the proposed PPT provision. If treaty benefits are denied under a PPT provision because the tax authorities see the transaction differently than the taxpayer, the treaty ought to be applied to the transaction as the tax authorities see it and any benefits available on that basis granted.

Explanation and illustrative examples for the proposed PPT provision

Issue 17 in the Discussion Draft references the potential for additional examples to be included in the commentary to the proposed PPT provision. As stated above, we believe that further explanation, including illustrative examples, is needed in order for taxpayers and treaty partners to better understand how and when the PPT provision might be applied.
Comments on Other Aspects of the Proposed Measures

While our comments focus mainly on the proposed PPT provision, we also wanted to take this opportunity to comment on some key issues with respect to other aspects of the measures proposed under Action 6.

**Treaty qualification of collective investment vehicles under the proposed LOB provision**

Issue 1 in the Discussion Draft focuses on the entitlement of collective investment vehicles (CIVs) for treaty benefits under the proposed LOB provision and refers to the various approaches developed by the OECD in its 2010 report on CIVs. The Discussion Draft seeks input on whether the OECD should provide for a preferred approach for the treaty entitlement of CIVs and, if so, what approach should be selected.

We agree that it is important that the entitlement of CIVs to treaty benefits under the proposed LOB provision be made clear. However, we would note that the form and tax status of CIVs is not uniform across countries. In Canada, for example, these investment vehicles are taxable entities with special rules regarding the treatment of earnings distributed to their owners. Such entities are residents for Canadian tax purposes and for purposes of Canadian tax treaties. Many of these entities would satisfy the exchange traded entity test or the ownership/base erosion test in the proposed LOB provision. This may not be the case for other types of CIVs common in other countries.

Given the differences across CIVs, we do not think development of a preferred treaty qualification approach for CIVs would be advisable. For those CIVs that are structured with an entity that is resident for tax purposes, it should be made clear that the proposed LOB provision can be applied at the entity level such that the exchange traded test, for example, could be applied to determine qualification for treaty benefits.

**Derivative benefits test under the proposed LOB provision**

Issue 6 in the Discussion Draft involves the design and inclusion of a so-called “derivative benefits” test under the proposed LOB provision, noting that developments under other BEPS Actions are relevant to the determination of whether a derivative benefits test should be included.
As discussed in our earlier comments, a derivative benefits test is essential to the operation of an LOB provision in today’s global economy. Any concerns with respect to the potential results of a derivative benefits provision should be addressed under the OECD’s other work on the BEPS Action Plan, including in particular the work on Action 3 (CFC rules), Action 5 (harmful tax practices), and Action 8 (transfer pricing for intangibles). An entity cannot be considered to be a vehicle for treaty shopping if its owners would be entitled to the same benefits under their own treaties had they made the investment or conducted the activity themselves.

**Relaxation of intermediate entity restrictions under the proposed LOB provision**

Issue 5 in the Discussion Draft involves the restrictions on intermediate entities in the various tests under the proposed LOB provision, including the derivative benefits test, and indicates that the OECD is considering whether the restrictions that have been proposed should be relaxed.

We believe that the proposed restrictions on intermediate entities should be relaxed and that the presence of a third-country intermediate entity should not run afoul of the tests for qualification under the proposed LOB provision. As noted above with respect to the derivative benefits test, any concerns in this area should be addressed under other elements of the BEPS Action Plan.

**Interaction of treaties and domestic law anti-abuse rules**

Issue 20 of the Discussion Draft involves the interaction of the countries’ domestic general anti-abuse rules and treaties and suggests that further clarification to the commentary in this regard may be made.

As discussed in our earlier comment letter, we are very concerned about the use of domestic law general anti-abuse rules to override treaties and deny treaty benefits. The trend of greater use of such overrides around the world is extremely disruptive to the ability to rely on the availability of treaty benefits. With such overrides, companies are not able to anticipate a potential denial of treaty benefits which would have retroactive effect. It would be troubling for OECD commentary to include language that could be cited by countries as supporting denial of benefits under existing treaties, without a bilateral negotiation or the incorporation of any new standards into a treaty agreement.

We urge the OECD to take a strong stand in this area. Domestic law general anti-abuse rules should not be able to be used by countries in cases where they are dissatisfied with the results
under the provisions, including an LOB provision and a PPT provision, they negotiate in their treaties. The commentary should state this clearly.

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We appreciate the opportunity to provide these comments on key issues with respect to the Action 7 Discussion Draft. We would be happy to respond to questions or to provide any further information that would be useful as the OECD continues its work in this important area.

Sincerely,

Peter van Dijk
Senior Vice President, Tax
TD Bank
Ms. Marlies de Ruiter  
Head, Tax Treaties  
Transfer Pricing and Financial Transactions  
Division  
OECD/CTPA

Via email: taxtreaties@oecd.org

Comments on Follow-up Work on BEPS Action 6: Preventing Treaty Abuse

Dear Ms. de Ruiter,

We welcome the opportunity to comment on the follow-up work on BEPS Action 6, Preventing Treaty Abuse, published on 21 November 2014.

The German business association The Family Entrepreneurs - ASU represents almost 5,000 family businesses in various sectors. Founded in 1949, it speaks on behalf of 180,000 family entrepreneurs with more than 8 million employees. They reflect a wide range of businesses from small, medium sized and international corporations.

Our members constitute a substantial part of the nation’s GDP. They are significant drivers of the German economy and export industry as well as internationally well connected. We therefore welcome the OECD/G20 initiative and its aim to create a single set of consensus based international tax rules to address Base Erosion and Profit Shifting by simultaneously encouraging non-harmful tax competition among states.

The Family Entrepreneurs - ASU has closely monitored the BEPS Project from its beginnings and applaud the fast pace of work at the OECD. Nonetheless, we have become increasingly concerned that the initial objectives of the project are lost in technical details. With a rising number of countries proposing unilateral measures to counter BEPS and increase domestic tax revenues the risk of uncertainty, complexity and double taxation for taxpayers is once again growing.

Objectives of Action 6

We generally agree on the aim of the work on Action 6 to prevent treaty abuse which may distort competition. Nevertheless, double tax treaties play an important role for German family businesses to overcome barriers to cross country trade and investments. Because a key issue for
international business transaction is still avoiding double taxation, treaty benefits are crucial to minimize the tax burden and to stay competitive on the global market. Restricting the application of treaty protection should therefore be approached with considerable caution.

The initial proposals of the discussions draft on Action 6 published on 16 September 2014 and the follow-up work fail to take note of these crucial implications for business. For example, the OECD notes, that the use of treaties may lead to double non taxation. This however should not be taken as a reason for speaking of abuse. On the one hand, it may be intentional by governments granting specific incentives for investments, infrastructures, etc. These cases should be clearly exempted from any work on BEPS.

On the other hand, double non taxation may indeed be the result of an incongruence of two or more national tax regimes. To align tax regimes internationally a common standard needs to be agreed upon, which all countries adhere to. By proposing various options of implementing the limitation-on-benefits rule (LOB) and/or principle-purpose-test (PPT) to limit treaty benefits and regions such as the EU, the OECD will instead foster a “cherry picking” culture among states. Because of the very different application of each of the rules, its tests and consequences, this cannot be considered a minimum common standard.

The recommended measures rather exasperate the already extremely complicated and complex treaty benefits rules. Treaty benefits as such may become so difficult to obtain - especially by non-multinational corporations with less resources - that they could be completely undermined and useless.

In order to align differences of national tax regimes, a comprehensive approach needs to be taken. The work on Action 6 should come forward with one clear proposal how to prevent treaty abuse. In this context, it is advisable to further coordinate the work on Action 6 more closely with Actions 2, 3, 4 and 8-10. Otherwise the overlap of specific and general anti avoidance rules, the LOB Rule and domestic judicature on anti-avoidance regimes will result in further international incongruences and multiple taxation for business.

Implications for German Family Businesses
The fast pace of the project and the public attention on very few international tax avoidance cases suggests that an objective, comprehensive analysis and assessment of the effects of the proposed rules is overlooked. The proposed measures may indeed effectively
target abusive tax arrangements by multinational corporations. Nevertheless, due to their broad reach they also heavily affect small, mediums sized and even large companies with international business activity.

In this context it should be noted that the German tax regime already encompasses an elaborate system of anti-avoidance measures. Many German double tax agreements include extensive treaty abuse rules. Although this may be viewed as a role model, the rules have an overbearing character so that even multinational corporations and their expert tax directors cannot handle them anymore lest smaller companies with less resources.

This holds especially true for German family businesses competing internationally. These companies will need to adhere to stricter tax laws and compliance responsibilities without having the same resources as multinationals. It is thus essential for the work on Action 6 to reflect on the consequences for large corporate taxpayers who cannot be considered multinational enterprises.

**Purpose to Obtain Treaty Benefits**

The follow-up work again fails to recognize the need for companies to minimize costs where they can. The expected tax burden is an essential component of these costs. By choosing the wording “one of the principle purposes” behind entering into an arrangement in order to obtain treaty benefits, the main purpose test goes much further than preventing treaty abuse. A similar vague wording is used for the LOB clause.

The wording rather implies that for any business decision which was also based on the tax implications the treaty benefit would be denied. This seems overbearing and unrealistic. Especially business decisions for holding and financing companies depend heavily on the country’s treaty network.

The European Court of Justice applies a clear definition of treaty abuse in which the business arrangement was entered into for ‘wholly artificial’ reasons. It could be reasonable to follow this well established concept rather than issuing new definitions and allowing alternatives for different regions.

**Discretionary Relief and Application of PPT**
The OECD’s suggestion for countries to establish an administrative process for discretionary relief and that ensures the main purpose test is applied only after approval at a senior level in order to increase certainty may be a step in the right direction if the proposed LOB and PPT rules are pursued. The use of competent authorities nonetheless encompasses a lot of obstacles.

With the increasing dependence on competent authorities, the process would need to be sufficiently transparent. Although the essential details of the process should remain confidential, countries should gather statistics on the competent authority cases and regularly publish them. If the number of cases, the length of the processes and the outcomes would be published, it would serve as an initial controlling mechanism and provide more certainty for taxpayers.

In addition, the process should be efficiently streamlined and a time limit should be included in order to obtain legal assessment swiftly. It should also be clarified that the process is free of charge for taxpayers. The compliance burden will already cause significant costs.

Most importantly, international guidance would need to be issued to avoid that national competent authorities apply domestic guidance or jurisprudence causing more confusion and conflicting assessments between jurisdictions. Ultimately, this raises the question if the use of an additional administrative process to ensure the correct application of treaty benefits does not actually undermine the use of double tax treaties in itself.

Another aspect to keep in mind is who would hold the burden of proof. Although formally the tax administration should only open a case on treaty abuse ‘having regard to all relevant facts and circumstances’, the mere insinuation may suffice in practice. In the end, it would be the taxpayer needing to prove that the principle purpose of the arrangement was not tax abuse motivated. Blanket assumptions by tax administrations would need to be restricted and proper evidence provided before opening a case.

Finally, the implementation of an administrative process for treaty benefits does not circumvent the need for adequate protection via access to mutual agreement procedures. We therefore reiterate the need for effective dispute resolution mechanisms in the framework of Action 14.

In all, we strongly encourage the OECD to emphasize on issues of complexity, uncertainty and compliance burdens keeping in mind how
the rules will affect small, medium and larger companies doing business internationally.

Should you have any questions, please do not hesitate to contact us.

Kind regards,

Dr. Peer-Robin Paulus

Ninja-Antonia Reggelin, LL.M.
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VIA EMAIL
Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(taxtreaties@oecd.org)

Re: USCIB Comment Letter on the OECD Discussion Draft on Follow Up Work on BEPS Action 6: Preventing Treaty Abuse

Dear Ms. de Ruiter,

USCIB is pleased to have this opportunity to provide comments on OECD’s discussion draft on follow up work on BEPS Action 6.

General Comments

USCIB stands by its comments of April 4, 2014, on the OECD’s Discussion Draft on BEPS Action 6. The Action 6 2014 Deliverable did not address many of the concerns we raised. In particular, the 2014 Deliverable and the follow-up discussion draft (hereinafter “the guidance”) retain the singular focus on combating treaty abuse. The guidance does not have due regard for the impact on the vast majority of potential beneficiaries of income tax treaties that do not engage in abusive practices and that, due to the broad reach and vagueness of the proposals, would in many cases, lose access to tax treaties and, in any event, will be deprived of the certainty and predictability that is a fundamental goal of tax treaties. We want to be very clear that, in our

1 USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.
view, the recommendations in the guidance would fundamentally change the role of tax treaties by effectively depriving bona fide enterprises and business transactions of the protection accorded by tax treaties from excessive and double taxation, at serious cost to the global economy.² Action 6 should start with the premise that the vast majority of beneficiaries of tax treaties are bona fide and then recommend solutions to treaty abuse that are focused, objective and administrable.

Paragraph 6 of the 2014 Deliverable states: “When examining the model treaty provisions included in this report, it is also important to note that these are model provisions that need to be adapted to the specificities of individual States and the circumstances of the negotiation of bilateral conventions.” USCIB strongly agrees with this statement. Presumably, the OECD intends to implement the guidance through the negotiation and adoption of a multilateral instrument. While a laudable goal, this is inconsistent with the OECD’s own recognition of the need to adapt approaches to account for different circumstances. This conflict may prove difficult to resolve. That is, the drive to create a MLI may lead to trying to resolve on a multilateral basis issues that can only effectively be resolved on a bilateral basis. USCIB believes that much of the complexity of the guidance and the unresolved issues in the discussion draft reflect this tension. USCIB believes this is especially the case with respect to the LOB provisions as discussed below.

Having considered the LOB provision that appears in the guidance, USCIB recommends that the OECD take a step back and consider the best way to move forward with incorporating the LOB concept into the proposed minimum standard under Action 6. We believe this could best be done at this stage by approaching the task at a more conceptual level, without attempting to develop specific text for a model LOB provision.

There are several good reasons for shelving the attempt to develop a model LOB provision at this stage. The reality is that only a small handful of the countries engaged in the discussions have expressed the view that an LOB provision would be their primary policy choice for addressing treaty abuse, and we understand the large majority of countries believe the PPT is a better approach. It is not customary, and it does not make sense, for the OECD to try to develop a model provision that only a small minority of countries prefer. It is not obvious to us that even those few countries that prefer LOB provisions will be prepared to follow a model provision worked out by the OECD in the current BEPS process. The September Report itself notes that the model provisions set out there “are model provisions that need to be adapted to the specificities of individual States and the circumstances of the negotiation of bilateral conventions”. One of the main advocates of LOB provisions, the United States, is currently in the process of rethinking its own LOB policies in connection with its development of a new U.S.

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2 The OECD should be attempting to measure the impact of these changes on global trade and investment.
Model Treaty, just the latest in a very long series of evolutionary changes to the preferred U.S. LOB rules.

The LOB provision presents a large number of complicated policy issues, as is evident from the discussion draft itself. The majority of countries engaged in the discussions have limited background in negotiating LOB provisions and relatively little stake in how those issues might be resolved. That, along with the serious time pressure imposed by the BEPS process, means that issues are unlikely to get the careful analysis they deserve. It would make more sense for those issues to be the subject of direct negotiations between the countries that prefer LOB provisions and their treaty partners. That would also leave more time for the delegates to the BEPS project to resolve the many other outstanding treaty-related issues that feature in that project.

We think it is also clear that the amount of commentary and controversy generated by the draft LOB provision published by the OECD, a provision that was acknowledged to have been largely based on the complex provisions appearing in recent U.S. treaty practice, highlights the fact that the draft is not well-suited to form part of a “minimum standard” of treaty anti-abuse provisions to be endorsed by the OECD.

Therefore, rather than expending more effort to try to develop LOB model text which is unlikely to serve as a real model for widespread use in treaty negotiations, we recommend that the OECD endorse the concept of an LOB provision in principle. Such an endorsement could include a broad description of the basic building blocks typical to an LOB provision (i.e., a requirement that a resident of a Contracting State satisfy one or more specified tests to be entitled to treaty benefits; a series of objective safe harbor provisions designed to provide qualification to individuals, governments, tax exempt entities and pension funds, publicly traded companies and their subsidiaries, entities meeting an “ownership / base erosion” test, entities meeting a “derivative benefits” test, and income derived by entities in connection with or incidental to the active conduct of business in the residence State; and a provision authorizing a Contracting State’s competent authority to grant treaty benefits on a discretionary basis by applying a standard comparable to that applied under the PPT). The OECD might or might not refer to certain examples of LOB provisions appearing in countries’ treaty practice as satisfying the LOB leg of the minimum standard, without endorsing the specific drafting of those provisions. We believe this approach would be best suited to achieving the objectives of Action 6 and would protect the OECD from being drawn into further time-consuming and contentious debate about the design of a provision which is unlikely to operate as a broadly accepted model.

USCIB believes this approach is preferable to rushing through a model LOB provision that has not been carefully considered. We therefore think it should be unnecessary to answer many of
the questions posed by the discussion draft. We do, however, comment on those questions below.

As a final general comment, USCIB strongly disagrees with the statement in the discussion draft on BEPS Action 4 concerning the interaction of rules on interest deductibility and BEPS Action 6. Paragraph 225 of the Action 4 discussion draft states: “following the introduction of best practice rules to combat base erosion and profit shifting using interest expense, some groups may look to other available planning opportunities, which could place greater pressure on anti-abuse clauses in treaties and domestic law.” The stated goal of Action 4 is to encourage groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group.3 If Action 4 has the intended effect, then treaty abuse becomes less likely and the appropriate relief from double taxation becomes even more important. Thus, an inappropriately narrow LOB provision becomes even more harmful to global trade and investment.

Specific Comments

1. Collective investment vehicles: application of the LOB and treaty entitlement

USCIB strongly supports the BIAC comments advocating for treaty rules based on the 2010 report.

2. Non-CIV funds: application of LOB and treaty entitlement

USCIB strongly supports the BIAC comments on non-CIV funds.

3. Commentary on the discretionary relief provision of the LOB rule

The ability of taxpayers to have access to an efficient and practical discretionary grant process becomes increasingly important if the objective tests in the proposed LOB article are overly restrictive, with the result that a double tax agreement intended to provide treaty benefits for tax residents of the treaty partners only provides benefits for a limited class of tax residents absent a practical and expeditious process for the discretionary grant of treaty benefits. In the United States, the discretionary grant has been described as the "safety net" in recognition that the objective tests in the LOB article may unintentionally deprive bona fide residents of the treaty country access to the treaty and the protections it affords against double taxation and excessive taxation. Thus, we were disappointed that, in contrast to the constructive tone of most of the discussion draft, the discussion of the discretionary relief provision conveys a disturbingly restrictive approach, similar to many aspects of the proposed LOB article more broadly. Our concerns over the restrictive nature of the discussion draft include the following:

3 Discussion draft, BEPS Action 4: Interest Deductions and Other Financial Payments, paragraph 10, page 10.
• The statement that the fact that a tested subsidiary company would obtain a treaty rate reduction no greater than could have been obtained by the parent company under its resident country's treaty with the source country is not sufficient to establish the lack of a treaty shopping motive. We submit that it is quite clear that if there has been no greater treaty benefit obtained by an investment through the subsidiary company than would have been obtainable by the parent company, the subsidiary could not have been formed or availed for a principal purpose of obtaining the treaty benefit. There may be other tax benefits obtained by use of the subsidiary company as the investment vehicle but any such non-treaty benefits that are believed to violate BEPS principles should be dealt with directly, such as through CFC rules, hybrid rules, harmful tax practices and the like but not by denying treaty benefits indirectly obtained that could have been obtained directly.

• The discussion draft gives insufficient attention to the serious problems of lengthy procedures that can leave a taxpayer deserving of access to the treaty with an extended period of uncertainty and deprivation of treaty benefits during the pendency of the procedure. Simply suggesting the Commentary should "encourage" competent authorities to process requests expeditiously undervalues this serious concern. Taxpayers should bear the responsibility of establishing that they are not treaty shopping. Tax authorities should have the responsibility of confirming treaty access expeditiously.

• In contrast to the discussion draft's recommendation that determinations by a tax authority that a transaction violates the principal purpose test should be subject to the treaty's mutual agreement procedure, the discussion draft suggests that if a tax authority has "properly exercised" its discretion, that decision should be final and not subject to the treaty's mutual agreement procedure. It is unclear who is the arbiter of whether the tax authority has "properly exercised" its authority, which underscores the wisdom and fairness of making the process subject to review with the treaty partner. We believe that when a tax authority is considering denying a resident of a treaty partner access to the treaty, there should be a full and fair airing of that decision with the treaty partner. Subjecting a treaty resident to the potential of double taxation or excessive taxation should be viewed as sufficiently harsh to mandate procedures to protect against inappropriate unilateral action by the source state's tax authority.

We encourage the Working Group to be sensitive to the above concerns and suggest the following basic principles that should apply in developing the proper discretionary grant procedures and policies:
• The standards to be applied by the requested tax authority must be clear and public, not leaving the standards subject to the whim of any tax authority.

• If the requesting taxpayer is claiming a treaty benefit that it, or its affiliated group, could have obtained without use of the treaty, the standard should be considered met.

• There should be strict time limits set on the amount of time the tax authority has to provide a conclusion with model guidelines set forth in the Commentary subject to bilateral variations or embellishments agreed upon between the treaty partners.

• If the requested tax authority intends to deny the request, procedures should be included that require the tax authority to present its tentative decision to the treaty partner's tax authority with a full explanation of the reason for the proposed denial of treaty benefits. If the tax authority of the treaty partner does not agree to the proposed denial of treaty benefits, the matter should be resolved through the mutual agreement procedure.

We offer the following examples of cases where the discretionary grant should be given:

• **Treasury center:** A multinational enterprise places its global or regional treasury function in a separate company. In choosing the country of residence of the treasury center, the enterprise considers a variety of factors, including creditor rights laws, banking laws, stability of the government, an established infrastructure of professional support, labor laws and various regulatory laws. Also considered is the local tax burden and the network of double tax agreements that avoid excessive taxation of interest and investment income.

• **Local financing:** Company D would meet the relevant base erosion test except for the fact that it obtains bank financing from a local bank that does not qualify for the exceptions to the base erosion test because the local bank is a subsidiary of a public bank holding company and the exception from the base erosion test only applies to payments to local publicly traded companies.

• **Joint venture:** Company E, resident of treaty partner X under the X/Y treaty and Company F, a resident of treaty partner Y, form a joint venture in the form of a corporation resident in Country Y. The joint venture is a 50-50 undertaking but to avoid deadlock on corporate decisions, Company E, is given an additional vote. Because the ownership/base erosion test only treats residents of Country Y as "good" owners, the joint venture company fails the ownership part of the ownership/base erosion test.
• **Organic expansion:** Company A was established one hundred years ago as a family business (we know of examples that go back 200 or 300 years) created in the family's country of residence. Over the years the business has grown from a local business to a global enterprise. While management remains in the home country, the local business has diminished in size relative to the global business, causing the company to fail the trade or business test.

• **Ownership expansion:** Company B was established by three family members, all resident in the country of residence of all three family members, Country B. Company B has formed a regional holding company in Country C that holds investments in Country D. The treaties between Country B and Country D and between Country C and Country D provide identical benefits. Over the generations, the family has grown to the point that ownership is now shared by 12 descendants of the three original founders, most retaining residence in Country B. As a result of the family expansion, the derivative benefits test is failed since it requires tracing ownership to 7 or fewer equivalent beneficiaries.

• **Going private:** A multinational enterprise, based in Country C, is acquired by a private equity fund. The taxpayer establishes by clear and convincing evidence that the acquisition was driven by solid non-tax business reasons.

USCIB believes all of these cases should be granted discretionary relief and examples indicating that should be included.

4. **Alternative LOB provisions for EU countries**

The discussion draft states that “there is therefore a need to draft alternative provisions that would accommodate the concerns of EU member states.” (Para. 22, page 8.) This may be necessary because the absence of a derivative benefits test is an instance in which the proposal would violate the EU freedom of establishment rules. From the point of view of U.S. observers, if the goal is to provide derivative benefits to the EU residents that are equivalent beneficiaries, then that issue should be resolved by drafting an appropriate derivative benefits/equivalent beneficiaries rule as described below (issue 6) and not providing a special rule for EU residents. EU residents should not be any more or less entitled to derivative benefits than residents of any other country.

5. **Requirement that each intermediate owner be a resident of either Contracting State**

USCIB opposes the proposed requirement that would eliminate access to treaty benefits based on the existence of an intermediate owner. The proposed requirement would serve no policy goal and would place a severe restriction on the access to treaty benefits.
The discussion draft (at paragraphs 23 and 24) notes that some States consider the requirement found in subdivision 2 c(ii) and 2 e(i) requiring that each intermediate owner of a tested company be a resident of either Contracting State may be unduly restrictive and states that further work is required in order to determine whether and how the requirement could be relaxed without creating opportunities for treaty-shopping. The same issue exists in the draft provision on derivative benefits. We fully endorse a further review of these intermediate owner restrictions and urge that they be eliminated in all three provisions.

In regard to the view that these intermediate owner restrictions are unduly restrictive, we note that they potentially would eliminate access to treaty benefits for many if not most multinational enterprises. These enterprises typically involved 100s, if not 1000s of affiliated companies and where a tested entity is situated within the multinational group’s organizational structure may be the result of a variety of factors. Some common examples are:

- A multinational enterprise has acquired another corporate group with an existing organizational structure. For example, Company X, resident in Country A acquires Company Y, resident in Country B. Company Y has a subsidiary in Country A, owned either directly or somewhere down the chain of ownership of the Company Y group.

- A multinational enterprise has organized its corporate ownership structure along regional lines. For example, Company X, resident in Country A, has created a regional holding company in Country B to oversee and own affiliated entities in the EMEA region and one of those affiliates is resident in Country A.

- The comparable fact pattern may exist where Company X has organized its structure based on lines of business. For example, Company X, resident in Country A, has created a company in Country B to oversee and own all affiliates that are in a single line of business, amongst the various lines of business in the enterprise. One of those subsidiaries is a resident of Country A.

Each of the above examples are very common and are simplified examples of why a tested company may be several tiers removed from its parent company with intermediate owners resident in a variety of countries. It often would be costly to restructure to avoid the “no bad intermediate owners” rules. For instance, there may be exit taxation resulting from the extraction of the tested company from its current line of ownership. In addition to being costly, it may be legally impossible or impractical because of regulatory restraints or other local law restrictions, or because of covenants in existing bank or public debt documents. Similarly, shares in the tested company may be held by a lender as security for the loan with restrictions
on any change of ownership. In addition to these economic and legal impediments to changing ownership, doing so would disrupt organizational efficiency creating unnecessary and complex reworking of corporate governance.

Underscoring the inadvisability of an intermediate owner rule is the fact that we can perceive of no policy justification for the rule and have seen no explanation justifying its existence, other than an esoteric and unsubstantiated statement that it may lead to treaty shopping. The closest we have seen to any explanation is an example in the discussion of the derivative benefits test in the original discussion draft where an intermediate owner pays a royalty to an affiliate in another country that provides preferential tax treatment for royalty income. But that same royalty could have been paid by the tested entity, with no intermediate owner between the tested entity and the ultimate parent, or it could have been paid by the parent company. The only legitimate concern is the ability of the payee of the royalty to receive favorable tax treatment of the royalty income but that has nothing to do with where the payee is in its corporate chain.

We note that the only impact of having an intermediate owner is that the tested company can pay dividends to the intermediate owner out of treaty-benefited income. However, that dividend payment is not deductible. The treaty benefited income of the tested income has not been reduced by the dividend payment and, accordingly remains in the tax base of the tested company. While the dividend may not be subject to tax by the residence country of the intermediate owner, depending on how its tax system deals with parent/subsidiary dividends, it is likely that the parent company's country of residence has a similar system for not subjecting dividends to tax. Hence, in most cases, the tax results would be the same whether the tested company paid the dividend to the intermediate company or if the tested company paid the dividend directly to the parent company. We further note that if the intermediate company was not in the chain of ownership but a sister company to the tested company, the dividend could be paid to the parent company and then the funds could be contributed down by the parent company to the sister company. In other words, no tax advantage, or treaty abuse, has occurred by reason of the intermediate owner being in the ownership chain. The only practical effect would be to eliminate access to treaty benefits for a large portion of the multinational population.

Any concern with dividend income being held by an intermediate company where the parent company’s country of residence does tax dividends should be addressed directly, such as in the context of CFC rules, rather than making the major tests for the treaty qualification of subsidiary companies inaccessible to many, if not most, multinational enterprises.
For the above reasons, we urge that the restraint on intermediate ownership be eliminated from all three tests where it now appears.

6. Issues related to derivative benefits

The discussion draft solicits comments on the definition of equivalent beneficiary and the need for each intermediate owner to be an equivalent beneficiary. Our comments on issue 5 apply equally here. We also reiterate the portion of our comments on issue 3 (concerning discretionary relief) that relates to rate reductions. If a tested company would obtain a treaty rate reduction no greater than could have been obtained by the parent company under its resident country's treaty with the source country, then it is clear that a treaty rate reduction is not the principal purpose of the structure.

The OECD has repeatedly stated in the context of the BEPS project that BEPS is not about tax rate competition, yet the first discussion draft cited a preferential tax rate as the reason for omitting a derivative benefits test. We note that all three companies in the example would be entitled to the same source country tax reduction under the relevant treaties, so the establishment of the tested company in State S does not provide any treaty benefit that would not otherwise be available. We further note that the Parent in State T could also pay a royalty to the affiliate in State R and that apparently does not raise BEPS concerns. If the preferential tax regime for royalties in State R is considered a BEPS concern, then the proper avenue for addressing it is in the harmful tax practices Action Item. If the preferential rate is not considered to constitute a harmful tax practice, then the appropriate response is for State S to take this into account in its treaty with State R. If the preferential regime is not harmful and State S has considered it in the context of the treaty with State R, then there is no reason to consider that preferential regime in determining whether derivative benefits are appropriate.

One of the reasons that a derivative benefits test is important is that it provides a level of certainty that is not available with other tests. For example, the active trade or business test may be difficult to apply and lead to uncertain results (see discussion below). Listed below are some instances when USCIB believes it is appropriate to apply a derivative benefits test. Many of these overlap with the cases discussed above and the rationales supporting the application of a derivatives benefits provision are the same as those supporting either discretionary relief or deleting the intermediate owner requirement or are intended to address problems with the active trade or business test.

Derivative benefits should be available in the case of: joint ventures, treasury and regional holding companies, organic expansion, and acquisitions. To the extent that the active trade or business test requires that the business be substantial in relation to the business conducted in
the source country, this standard may be impossible to meet for, for example, a small local distributor.

7. Provisions dealing with “dual-listed company arrangements”

USCIB has no comments on this issue.

8. Timing issues related to the various provisions of the LOB rule

As noted in paragraph 28 of the discussion draft, timing issues are dealt with differently under various provisions of the LOB rule. For instance, as noted, the definition of "qualified person" in paragraph 2 applies at the time when a benefit would otherwise be accorded. In our view, this general view is sound for individuals and governments. We offer the following comments for other categories:

1. The publicly traded test (and subsidiary of publicly traded entity)

The proposed Commentary on the publicly traded test states that the conditions of subparagraph c) must be satisfied throughout the taxable period of the company or entity. This standard raises several practical concerns:

- First, as noted in the Discussion Draft, this creates a problem in the year the company becomes listed. Similarly, this creates a problem in the year a company de-lists. We submit that, in these "short-year" situations, there should be no reason to deprive a publicly traded entity of treaty benefits in the first or last year of its publicly traded status. Rather, as with the general rule for paragraph 2, the test should be applied at the time the potentially benefitted income is received. As long as a company meets the publicly traded standards (including the "regularly traded" requirement) at the time the payment is received, treaty benefits should be accorded. There are sufficient safeguards in the publicly traded test (including the regularly traded test and the listed stock exchange requirement) to prevent abuse without a requirement that the publicly traded test be met throughout the relevant year. Absent testing at the time of receipt, it would become impractical to administer the withholding regime.

- Second, we suggest that the Commentary: (i) allow the taxpayer to apply the regularly traded test based on the prior tax year, if there is a full prior tax year in order for the taxpayer to be confident that it can represent to withholding agents that it meets the test, relying on current year trading only where there has not been a full tax year of public trading in the preceding year, and (ii) provide an adjustment to the Commentary's numerical test of regularly traded (10% of the average outstanding shares traded during
60 days of trading) for short years -- that is, the first year of trading and the last year of trading. By way of example, U.S. tax regulations applying rules similar to the publicly traded test substitute, in a short year, one-sixth of the number of days of the short year for the 60 days and adjusts the 10% of the average outstanding shares by multiplying 10% by a fraction, the numerator of which is the number of days in the short year and denominator of which is 365.

- Third, the statement in the proposed commentary that the conditions of subparagraph c) must be met throughout the taxable year should be clarified for purposes of applying the subsidiary of a publicly traded company to make clear that the subsidiary test applies at the time the benefit is claimed. In other words, the fact that a company becomes a subsidiary or ceases to be a subsidiary at some point during the taxable period should not impact the eligibility of the subsidiary for treaty benefits as long as the company met the subsidiary test at the time the treaty benefit is claimed.

2. The ownership/base erosion test

This test looks to the percentage of qualifying ownership of the tested entity and whether certain deductible payments to non-qualified persons exceed 50% of the tested company's gross income. A critical timing consideration is that, with respect to items of income that are subject to withholding at the time of payment, the withholding agent must be able to determine the recipient's treaty status at the time of payment. Both elements of the test require testing ownership and base erosion payments over the full taxable year. It is not practical for the tested company to know whether it will meet those tests before the end of the year. To make the tests practical, we submit the tested entity should have the option of using the prior tax year for determining eligibility where such prior year exists. We further note, with respect to application of the base erosion test, the same timing issues exist under the derivative benefits test. Accordingly, companies should have the option of applying the test based on the prior taxable year.

9. Conditions for the application of the provision on publicly-listed entities

These conditions should be deleted. USCIB believes there are two types of treaty shopping. One is the use of a treaty by a third country person who simply sets up an entity in a treaty state. It is very difficult to use a publicly traded entity for this type of treaty shopping (which is the origin of the principle that publicly traded entities should be considered qualified residents in their jurisdiction of residence). The second type of treaty shopping involves conduit financing arrangements; publicly traded entities can be used to achieve conduit financing results and would be subject to any conduit rule. Thus, the status should be irrelevant with respect to conduit financing arrangements.
Further, these provisions are based on U.S. domestic concerns with inversions. As the OECD pointed out in paragraph 6 of the 2014 Deliverable, these provisions are intended to be a model and will need to be adapted to the specificities of individual States. This is a prime example of a rule that should be left to individual States to determine on a bilateral basis whether this rule is needed. If the U.S. believes this is essential, then they can insist on including it in their bilateral agreements, but it should not become part of the model.

10. Clarification of the “active business” provision

One important role for the active business provision of paragraph 3 is to allow treaty benefits for dividends or other payments made by an active operating subsidiary to its active operating parent where they are engaged in the same or complementary lines of business, regardless of whether the parent is a qualified resident. Unfortunately neither the text of paragraph 3 nor the commentary thereunder makes this as clear as it should be. The Follow-Up Discussion Draft, at item 10, invited comments on the exact scope of the last sentence of paragraph 48 of the Commentary, which provides as follows:

Since a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in the active conduct of a business for purposes of paragraph 3.

This sentence was taken from the Technical Explanation of the U.S. Model Treaty. It is merely an illustration of the general rule that, in order to qualify for benefits under paragraph 3, the recipient of the income must be engaged in an active business, and that the term active business, while not defined, specifically excludes the business of making or managing investments for one’s own account (unless that business is carried on by a bank, insurance company or broker). Moreover, because a headquarters company conducts no active business, it would be impossible to apply the general rule of paragraph 3 to it, as the general rule requires that the benefitted item of income be derived in connection with, or incidental to, an active business.

However, the attribution rule of subparagraph (c) may permit a headquarters company to receive treaty-benefitted payments in certain cases where the headquarters company is affiliated with other companies that are engaged in same country active businesses. The attribution rule recognizes that, for business reasons unrelated to treaty shopping, multinational businesses often do not conduct all activities incident to an active business in one entity. It would be helpful for the Commentary to clarify that the last sentence of paragraph 48 of the Commentary does not preclude the attribution of a same country active business from an affiliate to a headquarters company for purposes of treating the headquarters company as if it were engaged in that active business.
The attribution rule would work as follows: the taxpayer must be connected to the person from which the active trade or business is attributed and the income must be derived in connection with or incidental to the active trade or business. USCIB believes that a taxpayer that is resident in the same country in which the active trade or business is conducted may be attributed the active trade or business regardless of whether that entity is a parent, subsidiary, or brother/sister entity. If the recipient of the income is a holding company, then the income must be derived in connection with or incidental to the attributed active trade or business.

11. Application of PPT rule where benefits are obtained under different treaties

Paragraph 13 of the Commentary on the PPT rule (para. 17 of the Report, page 71) is very poorly drafted. The paragraph starts off explaining when a purpose will not be considered a principal purpose. It states:

[W]here an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to obtain that benefit.

It is difficult to imagine when it would ever be appropriate for a tax authority to challenge the bona fides of such an arrangement. Thus, the use of the word “unlikely” is disturbing. This illustrates the core issue with the principal purpose test: its application is uncertain. If the OECD is unwilling to make a conclusive statement that a principal purpose of obtaining a treaty benefit is not present in such a case, when will the taxpayer ever be able to achieve certainty?

Paragraph 13 then returns to explaining when a purpose may be a principal purpose. The focus of this part of the paragraph is confused. The example seems to be dealing with a conduit financing arrangement, in which case one would expect to look at the purpose of the transaction rather than the “arrangement” of the entity. This goes to the view that USCIB expressed above and in its earlier comment letter, that there are two types of treaty shopping and issues relating to the establishment of an entity should not be confused with issues relating to conduit financing arrangements. If a taxpayer is attempting to determine whether a transaction is a conduit financing arrangement, then purposes relating to the establishment of the entity are irrelevant. Similarly, if the treaty benefit does not relate to a conduit financing arrangement, but rather the status of the entity as a qualified resident of a jurisdiction, then that determination generally ought to be based on purposes relating to the establishment of the entity and not the intent with respect to a particular transaction.4 A properly functioning LOB article is intended to provide guidance that defines appropriate boundaries on the status of

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4 The active trade or business test is a bit of a hybrid, since the test is transactional, but in general a properly functioning LOB provision is not an item by item test.
the resident. The PPT is confused because these two different types of treaty shopping are not
distinguished. We anticipate that this will lead to problems in the application of the PPT.

12. Inclusion in the Commentary of the suggestion that countries consider establishing
some form of administrative process ensuring that the PPT is only applied after approval
at a senior level

USCIB strongly agrees with this suggestion as the ability of lower-level tax authorities to
routinely assert the PPT will greatly increase uncertainty.

13. Whether the application of the PPT rule should be excluded from the issues with
respect to which the arbitration provision of paragraph 5 of Article 25 is applicable

USCIB strongly agrees that this issue ought to be covered by an agreement to submit to
binding arbitration. It is unclear why the views of the minority would need to be expressed in
any way other than as a reservation or observation, as has been the traditional practice with
respect to the OECD Model. Further, to the extent that countries are unwilling to agree to
arbitration generally, their objection to arbitration in this case ought to be clear.

14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the
LOB discretionary relief provision that deal with the principal purpose test

USCIB believes that where facts warrant a discretionary LOB ruling they should also warrant
good treatment under the PPT rule. Thus, all of the examples set out on page 5 above ought to
be considered cases in which the PPT does not apply. As discussed above, in the context of the
LOB provision, the tax authorities ought to be taking into account “foot faults”. It is not clear
that this concept has any relevance for the PPT. Thus, it may be necessary for the OECD to
provide more extensive examples to make clear the proper scope of the PPT rule. It would be
helpful to provide certainty and harmonized policies for both if the examples under the PPT
were broadly aligned with the LOB provisions.

15. Whether some form of discretionary relief should be provided under the PPT rule

USCIB agrees that discretionary relief ought to be available as suggested in the Discussion Draft.

16. Drafting of the alternative “conduit-PPT rule”

As stated in the general comments section of this letter, USCIB believes that the LOB should not
be part of the OECD model. Because the anti-conduit-PPT is intended to be applied in
conjunction with the LOB test, we also believe (for the reasons set forth above) that the OECD
should not draft specific text with respect to the anti-conduit rule. To the extent that the LOB
conduit arrangement option is specifically targeted to the U.S. because of its inability to agree
to a principal purpose test and the U.S. already has extensive rules on conduit financing arrangements in place, it ought to be unnecessary to provide additional rules in the OECD model.

We nevertheless make the following high-level comments. The “at any time or in any form” standards contained in the 2014 Report are far too onerous, particularly in light of the application of this rule in conjunction with the LOB provisions. That is, an LOB provision will already contain an ownership/base erosion provision, so the qualified resident is by definition not paying out excessive amounts to non-residents. Thus, if the OECD feels compelled to add something, perhaps it should focus on defining structured transactions. Perhaps it would be good to adapt the standards from the Report on Hybrids (recommendation 10) to define a structured transaction that is a conduit financing arrangement.

17. List of examples in the Commentary on the PPT rule

USCIB suggests that all of the examples identified on page 5 as deserving of discretionary relief should also be entitled to treaty relief under the PPT rule.

18. Application of the new treaty tie-breaker rule

USCIB notes that the proposed rule denying any relief or exemption when the Contracting States cannot agree on a residence reflects current U.S. treaty policy. Thus, this does not represent a change for U.S. companies. We agree with the proposed clarifications set forth in the discussion draft.

20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

USCIB is very concerned about the UK’s recent so-called “diverted profits tax” proposal. We understand that the UK believes this proposal does not violate its treaty obligations. We are not privy to the UK’s analysis but believe it must be based on the notion that the “diverted profits tax” is a domestic anti-abuse rule that is permissible under the principles expressed in the current Commentary. We disagree strongly with this view.

To the extent that the UK has agreed to PE thresholds, imposing tax on companies that do not satisfy that standard as a penalty for taking legitimate steps to avoid the threshold is not consistent with the specific obligations set forth in the treaty. The point of a threshold is to provide a rule that is clear and uniform, if a company chooses to stay under that threshold that is not abuse of the treaty. If, in the opinion of the UK, there ought to be a maximum amount that can be earned without becoming subject to tax in the UK, then the UK should propose that standard as part of the PE threshold. Absent, such a rule, the so-called “diverted profits tax” is
not an appropriate anti-abuse rule and would violate the UK’s treaty obligations. The commentary on domestic anti-abuse rules should make clear that simply moving the bar is not an acceptable anti-abuse provision.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business (USCIB)
Dear Marlies,

The Confederation of Netherlands Industry and Employers VNO-NCW is pleased to provide comments on the Discussion Draft Follow Up Work on BEPS Action 6: Preventing Treaty Abuse that was published on 21 November.

General comments

1. We are supportive of a common OECD framework to prevent treaty abuse. In fact, we feel that international consensus and consistent guidance by the OECD, EU and UN is key to improve the international tax system and achieve coherence therein, enhance economic growth and stimulate free trade.

2. We would point out that tax treaties first and foremost are in place to promote international trade and investments by allocating taxing rights and thus prevent double taxation. It is this function that above all needs to be fostered while this common framework is set up to prevent the abuse of treaty networks. Otherwise, the reason for concluding a treaty in the first place is rendered moot.

3. It is in the direct interest of especially countries with more extensive treaty networks to make sure that the access to that network is closely guarded so that treaty benefits can only befall taxpayers for which they are intended. In the long run, it would be to the detriment of the quality of their own treaty network, should this not be the case.
4. It is equally imperative to countries that their treaty network – in attempting to prevent abuse – does not deny these benefits to taxpayers that are clearly deserving of them.

5. The rules determining whether or not access to tax treaty benefit is granted need to be clear, targeted and sustainable. Both taxpayers and governments must be able to rely on objective, predictable and clear-cut rules.

6. Inconsistent interpretation and application by tax authorities due to lack of clarity may result in inappropriate denial of benefits, and even if no denial, a delay, confusion and uncertainty in the meantime.

7. We feel that the proposed changes to the OECD model treaty should offer far more certainty and guidance to avoid that treaty benefits are wrongly denied to taxpayers, specifically where perfectly normal and legitimate holding, financing, licensing, insurance and investment activities are concerned.

8. The proposed changes do not appear to recognize the economic and organizational requirement of enterprises to centralize support functions (e.g. via shared service centers), segregate strategic from operational functions and create efficiencies in their operations through the (digital) outsourcing of these operations to third parties. Both these strategic and supporting functions and the outsourcing thereof to third parties should in principle be accepted as having economic value i.e. economic reality and qualify as trade or business.

9. The risk of overkill of the proposed measures and the consequent significant potential commercial impact on genuine business structures must be addressed. For this reason we feel more clarification and guidance on the above points (as mentioned under 6. and 7.) is needed and the proposed measures should be amended accordingly.

10. In addition, to preserve legal certainty application of the PPT and the LOB rule resulting in the denial of treaty benefits should not be possible through unilateral action by one authority and should be subject to binding arbitration.

Specific comments on the PPT rule

11. The wording of the proposed PPT rule is very wide and as a result there is a risk of misinterpretation or misapplication by tax authorities.

12. According to the European Court of Justice, an anti-abuse measure must, in the interest of legal certainty, be clear, precise and predictable\(^1\) and the mutual

\(^1\) SIAT (C-318/10, para. 58) and ITELCAR (C-282/12, para. 44)
burdens of proof must be distributed evenly between taxpayer and tax authority\textsuperscript{2}. Due to the fact that the wording is so wide, the PTT would in our view be in conflict with EU law in both respects.

13. We feel that in recognition of a choice of jurisdiction all relevant elements should be weighed in the PPT. These elements should include the economic and organizational requirement of enterprises to centralize support functions, political and financial neutrality of the location of choice, the local infrastructure in the broadest sense and the practical use of that location in geographic terms. These elements should account for having economic value and thus qualify as business reasons.

14. There should be no unilateral discretion to deny benefits based on subjective criteria since this leads to great uncertainty for business that will deter businesses from engaging in cross border trade or investments.

**Specific comments on the LOB rule**

15. We believe that the proposed LOB rule will certainly deny treaty benefits to situations where there is no treaty abuse. These situations will also include, but are not limited to, publicly traded companies.

16. We welcome the discretionary relief provision, however – much as with the PPT rule – this constitutes a subjective test that would give very little or no certainty to business. Thus, providing little comfort regarding decisions to engage in cross border trade and investments.

17. To give the necessary certainty and prevent the unjust denial of treaty benefits resulting in double taxation and thus frustrating cross border trade and investments, the LOB rule should focus on the ultimate beneficial owners and eliminate testing intermediary companies.

18. We would refer to the practical examples that are given in the BIAC commentary to substantiate this and we would strongly support the amendments to the LOB rule as proposed by BIAC regarding the Subsidiaries of public traded companies test, the Ownership/base erosion test, the Derivative benefits test.

19. Secondly, we would refer to the practical examples provided by BIAC regarding the Active business provision and strongly support the comments made by BIAC to that respect.

\textsuperscript{2} SIAT (C-318/10 para. 54 through 56)
20. The proposed LOB-provision contains rules that discriminate a company on the basis of the ownership of its shares\(^3\). This discrimination of a company on the basis of the ownership of its shares would conflict with EU law. We therefore suggest expanding the list of shareholders to include shareholders of the member States of the European Union and the European Economic Area.

We hope you will take our comments into consideration in further developing this action point. Of course, we are available to elaborate on these comments should this be helpful.

Sincerely Yours,

\[\text{Signature}\]

Jeroen Lammers
Manager Fiscal Affairs

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\(^3\) If Company X is tax resident in EU State X and receives income that arises in non-EU State Y and if State X and State Y were to have concluded a tax treaty that includes the LOB provision as proposed, Company X would be entitled to treaty benefits if at least 50% of its shares are owned by residents of State X. But if 50 percent or more of the shareholder’s rights in Company X are owned by shareholders of EU-State Z, Company X would not meet this shareholder’s test and would be entitled to treaty benefits only if it were to meet the ‘activity test’ (paragraph 4) or the derivative benefits test (paragraph 5). The derivative benefits test itself, however, also discriminates companies on the basis of share ownership.