

Follow Up Work on BEPS Action 6: Preventing Treaty Abuse: The position of CIVs and non-CIV Funds further considered

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1. INTRODUCTION

On 16 September 2014 the Organisation for Economic Co-operation and Development (“**OECD**”) published seven papers as a first tranche of deliverables under the Base Erosion and Profit Shifting (“**BEPS**”) Project². The OECD will be continuing its work on the remainder of the 15 Actions on BEPS throughout 2015. On 21 November 2014, the OECD published a Public Discussion Draft (the “**Discussion Draft**”) in connection with Action 6 on treaty abuse under its BEPS Action Plan³. The Discussion Draft is titled “Follow Up Work on BEPS Action 6: Preventing Treaty Abuse”. The comments to the Discussion Draft are published in a report of 12 January, 2015⁴ and a public discussion meeting took place on 22 January, 2015⁵.

The Discussion Draft lists the follow-up work that the OECD intends to do after the issuance of the OECD’s 16 September 2014 report named “Prevent the granting of treaty benefits in inappropriate circumstances”⁶ (“**16 September 2014 report**”). The 16 September 2014 report contains several recommendations with respect to changes to the articles of the OECD Model Tax Convention and OECD Commentary together with proposed domestic law provisions to address the inappropriate granting of treaty benefits and other potential treaty abuse situations. The question is perhaps whether the inappropriate granting of treaty benefits to funds and in particular Collective Investment Vehicles (“**CIVs**”, a clarification of the term CIV is provided further below) is indeed a material risk and in fact a phenomenon that requires counteracting provisions in the OECD Model Tax Convention and the related Commentary. Or alternatively, the OECD Model Tax Convention and the related Commentary may be amended in such a way that it is ensured that in “appropriate circumstances” treaty benefits are either granted to a fund itself or to its investors instead.

In this article we will discuss the OECD’s current thinking on contemplated changes to the OECD Members’ domestic laws, the OECD Model Tax Convention and the related Commentary impacting CIV and non-CIV funds. We will also address the general OECD principles applicable to CIV and non-CIV funds in relation to entitlement to tax treaty benefits under the current OECD Model Tax Convention and the related

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² <http://www.oecd.org/tax/oecd-releases-first-beps-recommendations-to-g20-for-international-approach-to-combat-tax-avoidance-by-multinationals.htm>

³ <http://www.oecd.org/ctp/treaties/discussion-draft-action-6-follow-up-prevent-treaty-abuse.pdf>

⁴ <http://www.oecd.org/ctp/treaties/public-comments-action-6-follow-up-prevent-treaty-abuse.pdf>

⁵ Playback of these sessions are available online: <http://www.oecd.org/tax/treaties/public-consultation-action-6-follow-up-prevent-treaty-abuse.htm>

⁶ <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-9789264219120-en.htm>

Commentary. We will conclude with some comments and suggested amendments to the current draft provisions of the OECD Model Tax Convention and the related Commentary impacting CIV and non-CIV funds. We will first start with a description of BEPS action item 6.

2. BEPS 2014 DELIVERABLE ACTION ITEM 6: PREVENT TREATY ABUSE⁷

2.1 Conditions Action 6

Action item 6 on the BEPS agenda is focussing on tax treaty abuse and suggests action with respect to the following items:

- A. Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances;
- B. Clarify that tax treaties are not intended to be used to generate double non-taxation; and
- C. Identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

For purposes of this article a proper understanding of item A. is relevant. We will not discuss items B. and C. With respect to item A. the OECD suggests that, as a minimum, tax treaties should include either:

- i. A principle purpose test (“PPT”);
- ii. A limitation on benefits rule supplemented by a mechanism, such as a restricted PPT rule, for conduit arrangements; or
- iii. A combined approach.

In the below paragraphs we will discuss the suggested principle purpose test and limitation on benefits rule in more detail.

2.2 Definitions

Principle Purpose Test (“PPT”)

The proposed PPT is a general rule similar to the “main purpose” tests found in the recently renewed treaty between The Netherlands and China⁸ and various UK tax treaties⁹ denying tax treaty benefits in case obtaining such a benefit is one of the principal purposes of the transactions or arrangements. In the 16 September 2014 report the following draft PPT rule is provided¹⁰:

⁷ <http://www.oecd.org/tax/treaties/discussion-draft-action-6-prevent-treaty-abuse.htm>

⁸ The principle purpose test in Article 10, paragraph 7 of the Netherlands - China Tax Treaty denies application of the dividend-article of that treaty instead of a full denial of treaty access.

⁹ For example Article 10, paragraph 6 of the Ethiopia - United Kingdom Tax Treaty (2011), Article 10, paragraph 8 of the Iceland - United Kingdom Tax Treaty (2013), Article 10, paragraph 6 of the Albania - United Kingdom Tax Treaty (2013), all focusing on the denial of dividend withholding tax relief at source.

¹⁰ http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances_9789264219120-en, p.12

“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.”

Limitation on benefits (“LOB”) rule

A LOB rule is already included in many US tax treaties¹¹. Those provisions in general limit the entitlement to treaty benefits if the person applying treaty does not have sufficient presence in the Contracting State in which it is a tax resident. The scope of presence is determined on the basis of various factors such as nature, activities, ownership, listing of its shares on a recognised stock exchange, etc. In the 16 September 2014 report the proposed LOB rule is summarized as follows¹²:

“The LOB rule included in the report restricts the general scope of the treaty rule according to which a treaty applies to persons who are residents of a Contracting State. Paragraph 1 of the LOB rule provides that a resident of a Contracting State shall not be entitled to the benefits of the Convention unless it constitutes a “qualified person” under paragraph 2 or unless benefits are granted under the provisions of paragraphs 3, 4 or 5. Paragraph 2 determines who constitutes a “qualified person” by reference to the nature or attributes of various categories of persons; any person to which that paragraph applies is entitled to all the benefits of the Convention. Under paragraph 3, a person is entitled to the benefits of the Convention with respect to an item of income even if it does not constitute a “qualified person” under paragraph 2 as long as that item of income is derived in connection with the active conduct of a trade or business in that person’s State of residence (subject to certain exceptions). Paragraph 4 is a “derivative benefits” provision that allows certain entities owned by residents of other States to obtain treaty benefits that these residents would have obtained if they had invested directly. Paragraph 5 allows the competent authority of a Contracting State to grant treaty benefits where the other provisions of the LOB rule would otherwise deny these benefits. Paragraph 6 includes a number of definitions that apply for the purposes of the Article. A detailed Commentary explains the various provisions of the LOB rule.”

Combined approach

The combined approach is an inclusion of the PPT as well as the LOB rule. The OECD acknowledges that the PPT and LOB rule both have their strong and weak points and a combination is therefore suggested.

2.3 Comments on CIV’s

Under the current draft paragraph 2 sub f) of the LOB rule, a possible inclusion of CIVs as qualifying persons is described, but it is recognized by the OECD that follow-up work is required with respect to the treaty entitlement of CIVs, and other funds (“**non CIVs**”). With respect to CIVs reference is made to paragraph 6.8 through 6.34 of the Commentary on Article 1 of the OECD Model Tax Convention. These paragraphs have been included in the Commentary following the 2010 update, and are based on an OECD report of 23 April 2010 with respect to granting treaty benefits to CIV’s (the “**CIV Report**” or “**Report**”) ¹³. The paragraphs address the fundamental questions in relation to tax treaty application with respect to CIV funds: i.e. can it considered to be a “person”, a “resident” and the “beneficial owner” of a certain item of

¹¹ For example Article 26 the Netherlands - United States Tax Treaty (1992), Article 24 the Luxembourg - United States Tax Treaty (1996)

¹² http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances_9789264219120-en, p.10

¹³ www.oecd.org/ctp/treaties/45359261.pdf (OECD: The granting of treaty benefits with respect to the income of collective investment vehicles

income? Below we therefore first discuss the CIV Report more generally and the conclusions of the CIV Report that have resulted in the considerations made in paragraph 6.8 through 6.34 of the Commentary on Article 1 of the OECD Model Tax Convention.

3 CIV REPORT

On 23 April 2010, the OECD published a report containing proposals for the granting of tax treaty benefits to CIVs. In 2010, these proposals were also included in the Commentary to the OECD Model Tax Convention. The OECD Model Tax Convention itself does not contain provisions regarding the tax position of funds nor in particular CIVs. CIVs are defined in the CIV Report 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 CIV Report does not consider issues related to funds that do not fall within the definition of a CIV, such as alternative investment funds (for example private equity and hedge funds). The recommendations in the CIV Report are also considered not to impact tax transparent investment pooling arrangements. In this article we will not discuss the tax position of partnerships (either tax transparent or tax opaque) and investment pooling vehicles and hybrid classification differences which may arise. In that respect, we refer to the 1999 OECD partnership reports¹⁴ and BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements¹⁵.

The CIV Report emphasises the importance of the collective investment fund industry, especially as a complement to other savings vehicles in terms of facilitating retirement plans, which become more and more important for an ageing population of many OECD Member countries. According to the report, in various countries participants in defined contribution retirement plans invest primarily in CIVs, as these allow small investments, and are highly liquid in order to facilitate withdrawals by retirees.

One of the basic principles of the CIV Report is that an investor should have tax neutrality between direct investments and investments through a CIV, which is already the primary result in many countries' domestic tax system. However, in the current international investment market there are still significant challenges for CIVs to obtain certainty regarding their tax treaty status, which may lead to disadvantages for investors and non-compliance with tax affairs by funds or their administrators. As tax treaties do generally not include specific provisions dealing with CIVs, the concepts of: a “person”; a “resident” and the “beneficial owner” with respect to CIVs claiming tax treaty benefits on their own behalf are addressed in the Report. Below we further analyse these three concepts and will consider which recommendations may be implemented in the OECD Model Tax Convention and Commentary in combination with the amendments suggested in the Discussion Draft in connection with Action 6 on treaty abuse under its BEPS Action Plan.

4. ANALYSING THE CIV

4.1 Is a CIV a “person” for tax treaty purposes?

¹⁴ http://www.oecd-ilibrary.org/taxation/the-application-of-the-oecd-model-tax-convention-to-partnerships_9789264173316-en

¹⁵ http://www.oecd-ilibrary.org/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements_9789264218819-en

Both CIV and non-CIV funds can be structured as companies (i.e. legal entities), contractual arrangements (e.g. a partnership) or other forms of joint ownership or as a trust. CIVs structured as companies generally constitute a 'person' for tax treaty purposes whereas joint ownership CIVs are not treated as a 'person' in their state of residence and would not constitute a 'person' for tax treaty purposes pursuant to article 1 of the OECD Model Tax Convention, unless qualified as 'any other body of persons' according to article 3, paragraph 1, sub a) of the OECD Model Tax Convention. Trusts are generally treated as taxpayers in their country of residence and constitute from their perspective a "person" for tax treaty purposes, but source countries may view this differently. The CIV Report describes that in view of the wide meaning of the term "person", the fact that countries of residence treat CIVs as taxpayers should be indicative – for example to a source State - that a CIV is a "person" for tax treaty purposes in line with article 3, paragraph 1, sub b) of the OECD Model Tax Convention.

4.2 Is a CIV a “resident” for tax treaty purposes?

As a consequence of the desired tax neutrality between direct investments and investments through a CIV, CIVs are typically set up in such a way that the CIV itself does in fact not pay or pay little tax in its country of formation. This may be achieved due to an exemption in case conditions are met (e.g. for certain funds falling within the scope of the Undertakings for Collective Investment in Transferable Securities, Directive 2001/107/EC and 2001/108/EC (“**UCITS**”)), a reduction of the tax base referring to distributions made to the investors (e.g. applicable to certain Real Estate Investment Trusts (“**REITs**”)), taxation at a low or zero rate (e.g. the Dutch fiscal investment institution). Full taxation with integration at investor level in order to avoid double taxation is also a known alternative. Again, CIV and non-CIV fund structures should be set up in such a way that it results in no or limited tax leakage at fund level, taking into account that most private and institutional investors are taxed over their investment income in their residence State or are fully exempt from tax in that State (such as pension funds). The CIV Report indicates and supports that the “liable to tax test” of the Commentary to article 4 of the OECD Model Tax Convention should not exclude the CIV from being a “resident” in case effectively no or little tax is imposed, unless the CIV is tax transparent or unconditionally exempt from tax¹⁶.

4.3 Investors claiming tax treaty benefits: Is a CIV the beneficial owner of the income?

In certain cases, countries take the view that a CIV is not the beneficial owner of any item of income received. This is based on the relationship between the investors and the CIV, whereby the argument is that the investment in the CIV is for the investors the equivalent of effectively owning the investments directly. The CIV Report expresses the view that as long as the managers of the CIV have discretionary powers to manage the investments on behalf of the investors, the CIV should for tax treaty purposes be regarded as the beneficial owner of the income it receives, subject to qualifying as a 'resident' and 'person' under the provisions of the OECD Model Tax Convention. The Report acknowledges that in case a CIV cannot claim

¹⁶ www.oecd.org/ctp/treaties/45359261.pdf, p. 8 and p in relation to Paragraph5 of the 2010 Commentary to Article 4 of the OECD MTC

treaty benefits, individual investors in such CIV should instead be able to apply a tax treaty in order to avoid that investing through a CIV would put an investor in a disadvantageous position compared to a direct investment. We therefore welcome the suggestion made in the Report to develop a system that would allow CIVs to make treaty claims in respect of investors, which appears to be in the interests of both the investment management and funds business as well as governments. Furthermore, the CIV Report focuses on granting withholding tax credits to investors which may for several reasons not be utilized at the level of the CIV. In view of investor neutrality, the authors of the CIV Report are in favour of granting such credits to investors if not utilized at fund level – which we can generously support from an investor neutrality perspective - but it is recognized that this will be difficult to achieve in practice.

4.4 Tentative conclusion

In order to provide more clarity under existing treaties, the CIV report indicates that tax authorities may want to reach a mutual agreement confirming that (some type of) CIVs are considered to be a person, resident and beneficial owner for tax treaty purposes and are entitled to treaty benefits in its own right.

4.5 Other

Some OECD countries have indicated that CIVs can potentially be used for treaty abuse, especially in situations where a CIV is effectively not subject to (substantial) taxes¹⁷. Therefore, the CIV Report describes that it may be appropriate to include provisions against treaty shopping whereby in deciding on the appropriate approach, the characteristics of the various CIVs are to be taken into consideration. It is suggested to go for an approach whereby tax treaty benefits are granted to CIVs with investors who are 'equivalent beneficiaries', meaning that a direct investment by these investors would have entitled them to at least an equal benefit compared to the CIV itself. We believe that in practice this should work out well as there is a wide coverage of bilateral tax treaties which, to a very large extent, provide for a reduction of withholding tax rates on portfolio investments to 10-15% to CIVs as well as directly to investors, provided these investors are subject to tax in their State of residence. To avoid that no treaty benefits are granted at all to a CIV in case there are no 100% equivalent beneficiaries, the Report indicates that it is recommended and already common practice to grant treaty benefits in proportion to the percentage of 'good qualifying investors' whereby it is allowed to grant 100% of the benefits in case a certain threshold is crossed. Administrative solutions are suggested to determine the percentage of 'good investors'. In our view it is justifiably indicated in the CIV Report that, as an alternative approach, publicly traded CIVs can as a general rule be entitled to treaty benefits as these type of CIVs are not controlled by the investors and it seems therefore unlikely that they are used for treaty shopping purposes or other tax abusive situations.

The CIV Report ends with proposed changes to the Commentary on the Model Tax Convention which describe the conclusions with respect to the issues as outlined above. On July 22, 2010 the OECD Council approved the 2010 update as a consequence of which paragraph 6.8 to 6.34 to the Commentary on Article

¹⁷ www.oecd.org/ctp/treaties/45359261.pdf, p. 13

1 of the Model Tax Convention were added to the OECD Model Tax Convention. As part of the update, the CIV report was added to the section of Volume II of the electronic and loose-leaf versions of the OECD Model Tax Convention that includes reports on the OECD Model Tax Convention.

In the Discussion Draft on BEPS action item 6, the OECD describes follow-up work in relation to CIV funds, mainly with respect to the proposed LOB rule and also with respect to the PPT and tax treaty entitlement in more general. In addition, the OECD is asking for a wider discussion, also with respect to non-CIV funds. Further below, we will describe the items on which follow-up work is requested by the OECD, and include several recommendation in that respect.

5. OECD DISCUSSION DRAFT ON BEPS ACTION ITEM 6: PREVENTING TREATY ABUSE

5.1 Tax reclaims under DTC

The investments made by funds are often held in custody, for example with a financial institution or other depository. If implemented in future tax treaties, it will be up to those custodians and depositories to apply the correct interpretation of the suggested LOB and PPT rules. It is therefore the duty of such custodians and depositories to determine for example the funds' eligibility for relief at source from withholding tax on any income arising on those investments. Uncertainty with respect to the interpretation of the PPT and LOB rules will in that case create complications in practice for these custodians and depositories as well as for local tax authorities. The possibilities to file timely tax reclaims in combination with the increase of the associated administrative costs would make investment through CIVs and non-CIV funds less attractive compared to direct investment. With respect to the LOB provision, the OECD identified follow-up work in the Discussion Draft and asked for specific comments on the following areas concerning CIVs and non CIV funds.

5.2 CIVs: application of the LOB provision and treaty entitlement

In the Discussion Draft, the OECD has explicitly asked for comments from market parties on the question whether the 2010 CIV Report is still accurate, whether it is advisable to go for a preferred approach for CIVs, and if so, what that approach should be. In our view, the recommendations in the 2010 CIV Report are still accurate and applicable. In order to facilitate global investment by institutional investors, the OECD Member States should in our view really include the recommendations of the 2010 CIV Report in their tax treaties policy and should implement the conclusions of the Treaty Relief and Compliance Enhancement ("TRACE") Report 2013 in their domestic laws¹⁸. The TRACE Report 2013 suggests an implementation package for OECD Member States to implement a harmonized system on the basis of which certain qualified intermediaries (i.e. depositories and custodians) would claim withholding tax on behalf of "pooled" investors and should report beneficial ownership information regarding investments to local tax authorities. As far as we are aware, so far, not many OECD Member States have booked great progress towards implementation of the TRACE system. As an alternative approach, CIVs should be allowed to appoint a "qualifying intermediary" as a proxy for the State of residence of the investors in the fund. Taking into

account the developments in the field of exchange of information (such as FATCA¹⁹ and Common Reporting Standards²⁰), both approaches addressed above seem feasible solutions for granting double tax relief to funds and their investors in appropriate circumstances.

In the currently proposed wording of the LOB provision, it is mentioned that CIVs may qualify as “qualified persons” under the LOB provision, whereby the actual wording of this provision should be based on how CIVs are treated in the particular bilateral treaty and in the domestic laws of those Contracting States. This is therefore left up to the decision of the Contracting States. It is mentioned that several alternative options are described in the commentary to the LOB provision which are based on the 2010 CIV Report. The OECD has the intention to further consider these alternative approaches and examine whether it would be feasible to suggest a single preferred approach for the LOB and subsequent tax treaty entitlement of CIVs.

The majority of the CIV and non-CIV funds are unlikely to qualify for treaty benefits under the current draft wording of the LOB provision for the following reasons. The LOB rule requires CIV and non-CIV funds to have significant nexus in the form a listing or the majority of its investors being resident in the State of which the fund should be considered a resident, in order to qualify for treaty benefits. This test may prove too difficult for many funds. Furthermore, funds could generally not be considered to be carrying on an active trade or business, so could for that reason not meet the “active business” test in the LOB rule. Last, many of the larger funds would typically not benefit from the derivative benefits provisions in the LOB rule because of a widespread investor diversification (i.e. having multiple sorts of investors located in different jurisdictions). Particularly for widely-held CIVs, of which the shares are actively traded, the derivatives benefit test is not going to be of very much use, because unfortunately it seems in practice too burdensome to have satisfying beneficial ownership administration on different record dates. Perhaps the “active conduct” exception in the LOB rule could also be confirmed to be available to investors whose principal business activity consists of making investment for their own account. The risk of treaty shopping by widely held CIVs seems remote to us due to the fact that the holders of the interest in the CIV can in principle individually not exercise control over the CIV, and the CIV holds a diversified portfolio. A comparison can be drawn with a publicly traded CIV for which the 2010 CIV Report provides an alternative approach, and facilitates treaty access based on these arguments. Therefore inclusion of a safe harbour in relation to tax treaty entitlement in general, and more specific in the LOB provision (within the suggested article 2, paragraph f of the current draft LOB rule) seems appropriate for certain types of CIVs such as widely held CIVs, publicly traded CIVs, UCITs which by their nature should not likely give rise to tax evasion or avoidance.

As a single preferred approach would not cover all CIVs, alternative approaches to this preferred route should therefore be provided as well. For certain funds, a solution would be to relax the current LOB rule by amending the derivative benefit test so that it applies to all shareholders that are resident in a State that has a tax treaty with the source State and not requiring that all shareholders satisfy such test with all of their

¹⁸ http://www.oecd.org/ctp/exchange-of-tax-information/TRACE_Implementation_Package_Website.pdf

¹⁹ <http://www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-FATCA>

²⁰ <http://www.oecd.org/tax/exchange-of-tax-information/automaticexchange.htm>

intermediate-holding entities. We do believe that actual international implementation of TRACE would be an eminent necessity for the application of the equivalent beneficiary concept. Without a proper commonly used method for identification and verification of beneficiaries in multi-layered fund structures, source States may have different identification procedures (and ask for different information) and depositaries and custodians may for that reason not want to be held responsible for the source State filing position with respect to the beneficiaries. Another alternative route would be to specifically refer to funds “that are subject to tax themselves” in the Commentary in relation to the discretionary relief provision of the LOB rule. The downside of this approach is that there would be uncertainty, whilst the Competent Authorities reach their decision, which could be unacceptable to investors.

5.3 Non-CIVs: application of the LOB provision and treaty entitlement

An earlier published draft version of the Discussion Draft did not include comments that were received on the March 2014 discussion draft in relation to non-CIV funds like Real Estate Investment Trusts, sovereign wealth funds, pension funds and alternative investment funds (such as for example private equity or hedge funds). Most comments focus on the LOB rule, and some of the considerations expressed are concerns regarding the applicability of the PPT rule and in general on treaty entitlement of investment funds with a focus on alternative funds. Some of the issues are identified in the Discussion Draft as areas for further consideration. The larger alternative investment funds do typically have an investor base which may be more geographically diverse. As a consequence, these alternative investment funds may face similar issues compared to CIV’s as the suggested LOB provision may not be applicable, and they may likely also not qualify under the active business test. Any specific CIV “escape” provisions in the LOB rule would also not be applicable. We further note that treaty qualification issues like those described in the 2010 CIV Report may also be very much applicable to non-CIV funds too.

It is important to note that non-CIV funds are often not able to benefit from double tax treaties because these funds are located in offshore jurisdictions – for perhaps also other reasons than just tax efficiency reasons – or otherwise (e.g. because the funds are tax transparent). This situation could therefore result in additional tax compared to a direct investment by a tax exempt pension fund investor. In order to eliminate this, such treaty benefits could be made available in relation to indirect investments. The OECD invites parties to further comment on the question how these treaty entitlement items can be addressed in a way that would not create treaty shopping opportunities.

Many alternative funds have an important economic role in the current society. Investors in alternative funds often are institutional investors such as sovereign wealth funds (“**SWFs**”) and pension funds. Denial of tax treaty benefits to alternative funds will consequently impact these tax exempt investors which is not in line with the tax neutrality principle compared to a direct investment of these investors. In order to meet the concerns of governments, alternative approaches could be considered along the lines of an equivalent beneficiary approach as set out in the 2010 CIV report, whereby preferably the alternative fund itself should

be able to claim tax treaty benefits itself. Further below, we will consider the position of certain non-CIVs in greater detail.

5.4 Real Estate Investment Trusts

Well-known in the investment-landscape with respect to the asset class real estate is the REIT, of which the United States' REIT is likely most common. US REITs do not qualify as CIVs as we understand they would typically not fall under the US investor protection rules that the OECD is referring to in the Discussion Draft²¹. We understand that under US tax law, at least 75% or more of the total assets of a US REIT should consist of real estate assets. US REITs are taxed corporations under US tax law and could therefore be considered operating companies instead of funds. REITs should be considered "residents" in the OECD's views on the REIT's tax treaty application, reflected in the 2007 Report "Tax Treaty Issues Related to REITs"²² and the 2006 US model technical explanation accompanying the US model tax convention²³. It is not clear from the 16 September Report of the Discussion Draft whether the LOB applies to REITs. Considering the fact that the shares of most US REITs would be listed on a recognised stock exchange and would also be registered with the SEC, those US REITs would satisfy the LOB provision. Non-listed REITs would be required to meet the requirements set out in paragraph 2(e) of the LOB provision, which includes an ownership and base erosion test. Under this paragraph, only companies of which the shares are, broadly speaking, for 50% or more directly held by qualifying residents satisfy the first test and the companies are not allowed to make deductible payments of, broadly speaking, 50% or more of their gross income to persons who are not residents of either Contracting States. Although the typical investor base of US non-listed REITs would be dominated by US investors, it would in our view be undesirable effect that foreign investors in REITs could negatively impact such REIT's tax treaty entitlement. In our view, an alternative may therefore be to introduce an equivalent beneficiary benefit test that should be considered to be satisfied if 50% or more of the shareholders are shareholders of which it can be demonstrated that they are effectively subject to tax – within the meaning of Article 4 of the OECD Model Tax Convention - over the income distributed by the REIT that is seeking to apply a tax treaty.

5.5 Sovereign Wealth Funds

SWFs are owned and operated by sovereign states. SWFs typically qualify for source country exemption on portfolio investment income under sovereign immunity doctrine or may claim treaty benefits more generally. The paragraphs 6.35-6.39 of the Commentary to Article 1 of the OECD Model Tax Convention discuss the application of the sovereign immunity doctrine to taxation and the definition of "resident" of one of the Contracting States. The definition in the LOB rule of a "qualified person" would apply to a SWF being a "resident of a Contracting State ... or a person that is wholly owned by such State..." Paragraph 10 of the commentary to the proposed LOB rule indicates that the proposed subparagraph 2, sub b) of the LOB rule

²¹ <http://www.oecd.org/ctp/treaties/discussion-draft-action-6-follow-up-prevent-treaty-abuse.pdf>, paragraph 15, p.6

²² <http://www.oecd.org/tax/treaties/39554788.pdf>

²³ <http://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf>

covering SWFs may need to be amended by contracting parties to reflect the different legal nature that state owned entities may have in their contracting states as well as the different views that states may have concerning the application of the residency Article 4 (i.e. residency article) to these entities. Reference is made to paragraph 6.35 to 6.39 of the Commentary to the OECD Model Tax Convention to Article 1 and paragraphs 8.5 to 8.7 of the Commentary to the OECD Model Tax Convention to Article 4. Under the proposed LOB rule, problems could however arise if a SWF would make an investment through a fund or a legal entity that is a tax resident in a third State, which fund or legal entity would be denied tax treaty entitlement by the source State. This is for example the case in structures whereby SWFs co-invest together with other investors located in different jurisdictions,

5.6 Pension Funds

The LOB rule does not intend to impose restrictions on tax treaty benefits granted to pension funds. Paragraph 2 of the proposed LOB rule qualifies a pension fund as a resident of a Contracting State and a qualified person. A pension fund is described as a resident who “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”. The requirement that at least 50% of the beneficiaries of the pension fund should be resident in the State in which the pension fund is established seems a too restrictive test as particularly upon retirement such beneficiaries may well decide to reside abroad. Such a test may also not be compatible with EU law.

We take the view that the regularly seen pooling arrangements used between pension funds should be considered to qualify under sub d (iii) of the paragraph 2 of the proposed LOB rule, provided such arrangement is “a person that was constituted and is operated exclusively to invest funds for the benefit of persons referred to in sub ii”. Similarly to SWFs, investments made by a pension fund that is a resident of a Contracting State through a subsidiary established in the same State would typically be covered by the “ownership / base erosion” provision in subparagraph 2 e of the LOB rule. Like the SWFs, pension funds would typically not be entitled to tax treaty benefits under the proposed LOB rule in case of investments made through an intermediate entity that is tax resident in a third State, as discussed in greater detail above. In that case the tax treaty between the State in which the legal entity is a resident and the source State may deny tax treaty benefits to the legal entity of the pension fund in the third State. We believe it should be even more common practice for OECD countries to include provisions in their bilateral tax treaties that grant pension funds treaty benefits in line with paragraph 69 of the current Commentary to Article 18 of the OECD Model Tax Convention. Granting treaty benefits to pension funds should in our view not even be limited to an exemption of withholding taxes at source over portfolio income but – on a reciprocal basis - should include all sorts of income and capital gains realised by such pension funds, provided both Contracting States agree on what qualifies as an exempt pension fund under the laws of both States. We would therefore recommend further clarifying the current definition of pension funds in the proposed LOB provision where it currently reads “...was constituted and is operated exclusively to administer or provide

pension or other similar benefits.” We would suggest to explicitly explain in that sentence that such “person” should qualify as a pension fund under the laws of the country in which it is established.

5.7 Conclusions on LOB

The examples above clearly show that based on the current wording of the proposed LOB provision, a variety of CIV and non-CIV funds may not be able to access tax treaties. Careful follow-up considerations with respect to entitlement to the LOB provision for CIV and non-CIV funds is therefore required, and we welcome the fact that this is acknowledged by the OECD as well as the various interested parties who provided comments to the OECD discussion draft.

Under paragraph 5 of the proposed LOB rule a discretionary relief provision is included meaning that tax authorities have the discretion to grant treaty benefits in case these would otherwise be denied under the LOB rule. We will comment on this provision in more detail under 6 below.

6. THE PPT RULE

In the Discussion Draft it is acknowledged by the OECD that both the PPT rule and discretionary relief provision of the LOB rule include a test related to the question whether one of the principal purposes for arrangements / transactions is the obtaining of benefits under a tax treaty, and that these should therefore be aligned.

The main problem with the PPT provision really is whether a non-CIV fund would fall under it or not. It seems to us that the investment manager should be in the position to successfully argue that the fund is located in its State of residence for other reasons than principal tax reasons in order to stay out of the PPT rule. We believe that a principal purpose test should not apply to CIV and non-CIV funds, at least not when these funds are actively subject to regulatory supervision or of which the investment manager is subject to such supervision. The same reasoning should be true for the discretionary relief provision of the LOB rule.

The OECD is asking for additional examples and specifically refers to an example concerning a non-tax motivated use of a special purpose vehicle in order to pool the investment of various institutional investors from different countries. Special purpose vehicles are often used for asset segregation purposes related to limitations of exposures to liabilities for investors or for regulatory purposes. In combination with an alternative test based upon which it can be concluded that obtaining a benefit under the treaty is not one of the principal purposes of the arrangement due to the fact that a direct investment by the investors should end up in the same result (in other words, it could also be argued that the tax treaty benefits are necessary to avoid an additional layer of taxation) this should be a valid argument.

7. CONCLUSIONS: FOLLOW-UP WORK ON THE DISCUSSION DRAFT

We understand the OECD is grateful to all these parties and bodies that provided over 750 pages of comments to the Discussion Draft²⁴. It is acknowledged by the OECD that further work is needed with respect to certain items, amongst others the policy considerations relevant to treaty entitlement of CIVs and non-CIV funds. The extensive amount of comments clearly shows that careful consideration should be given and further work needs to be done with respect to the precise contents of any revisions to the provisions of the OECD Model Tax Convention and the Commentary. The persons and bodies who sent the OECD Committee their comments to the Discussion Draft were invited to a public consultation meeting that took place in Paris on 22 January 2015. From the received comments to the Discussion Draft it can be derived that various types of, particularly non-CIV, funds all have their own issues in relation to their current entitlement to tax treaty benefits as well as the contemplated amendments, such as the LOB rule or the PPT, to the OECD Model Tax Convention and the Commentary. We doubt whether CIVs or non-CIV funds, particularly when these are widely-held, actively-traded or subject to regulatory supervision, should be considered the “typical tax treaty abusers”, also considering the fact that BEPS aims to targets multinational enterprises. Question is therefore really whether the OECD should limit the scope of its work now to combat the improper use of tax treaties to the “hardliners” or extend its work to further refine the considerations of the 2010 CIV Report and push for further implementation of the conclusions therein. Certainty with respect to the tax treaty position of funds would be desired and perhaps safe harbour provisions for certain CIVs and non CIV funds (for example for UCITS funds and funds managed by regulated investment managers) should in our view be further considered. Furthermore, the PPT and LOB rules aim to counteract treaty abuse. We believe however that it should first be further considered what the impact to the investment management industry would be of the suggested changes to the articles of the OECD Model Tax Convention and OECD Commentary. We would expect that currently existing uncertainty with respect to the interpretation of the PPT and LOB rules will create complications in practice for custodians and depositories as well as for local tax authorities. As a result, investment through CIVs and non-CIV funds may become less attractive compared to direct investment. Many of the OECD Member States may want to avoid this detrimental side-effect of the anti-treaty abuse BEPS Actions.

²⁴ <http://www.oecd.org/ctp/treaties/public-comments-action-6-follow-up-prevent-treaty-abuse.pdf>

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