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Grant Thornton discussion draft response

BEPS Action 6: Follow-up work on 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 limitation on benefits (LOB) article with reliance placed instead on a targeted general anti-avoidance provision.

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 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, eg 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, eg 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 principal purpose test (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.

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, eg 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.

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, eg 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, eg to the type of tax planning arrangements at which the new rule is aimed, ie 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 (PEs) 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 PEs 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 speak to your usual Grant Thornton or contact Martin Lambert, Partner for Grant Thornton LLP at martin.lambert@uk.gt.com.

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