Executive summary

On 24 November 2016, the Organisation for Economic Co-Operation and Development (OECD) released the text of a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS) under BEPS Action 15, together with a detailed Explanatory Statement (the multilateral instrument or MLI). The MLI exists in order to combat perceived improper base erosion and profit shifting.

Sovereign Wealth, Pension and Private Equity Funds may see changes to many bilateral tax treaties that will impact the viability of existing or anticipated holding company structures and regional investment related activities. The treaty changes, intended to address perceived improper base erosion and profit shifting, may create unexpected costs for funds in two broad areas:

(i) Loss of tax treaty benefits, resulting in higher taxes on distributions such as interest, dividend, royalties and capital gains received from investments

(ii) Higher in-country tax costs due to asset sourcing/asset management activities carried out by the fund in the source country
Detailed discussion

Background

The MLI will enable countries to implement tax treaty BEPS related measures in a coordinated and consistent manner across the network of existing treaties without the need to bilaterally renegotiate each such treaty.

The MLI is drafted to provide flexibility for Contracting Jurisdictions to implement (parts of) the MLI based on their needs in relation to provisions that do not reflect minimum standards (where the right to opt-out only exists to the extent the Covered Tax Agreement already includes a similar minimum standard).

The published explanatory notes to the MLI exist mainly to clarify the operation of the MLI with the existing tax treaties enabling countries to navigate through the mechanics of various opt ins and outs. With limited exceptions, the explanatory notes are not intended to address the interpretations of the underlying BEPS measures. These new provisions will be interpreted by each acceding country in accordance with its ordinary principles of treaty interpretation.

For countries that have acceded to the Vienna Convention on the Law of Treaties, which the United States (US) has not, this would mean interpreting the MLI in good faith in accordance with the MLI’s context and in light of its object and purpose.

The four areas of anti-avoidance BEPS measures addressed in the MLI are:

- Treaty abuse measures (under BEPS Action 6)
- Hybrid mismatch arrangements (under BEPS Action 2)
- Amendments to the definition of “permanent establishment” (under BEPS Action 7)
- Mutual agreement procedures, including a mandatory binding arbitration provision similar to that found in US tax treaties (under BEPS Action 14)

This alert covers the first three measures.¹

Timing

The MLI is open for signatures as of 31 December 2016, followed by ratification, acceptance or approval per country. A first high-level signing ceremony will take place in the week beginning 5 June 2017, with the expected participation of a significant group of countries.

The MLI would enter into force for each signatory (minimum of five countries must have ratified it as a triggering event). For early adopter countries, MLI provisions could be effective as of 1 January 2019.

Treaty abuse measures (Action 6)

Principle Purpose Test and supplemental options (article 7)

When the final BEPS report on Action 6, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, was published in October 2015,² there were three options being considered to prevent perceived abuses. At that time, countries agreed to implement in their treaties one of the following:

(i) A general treaty anti-abuse rule in the form of a principal purpose test (PPT) and a limitation-on-benefits (LOB) rule (most current US income tax treaties have LOB rules)

(ii) An LOB rule supplemented by anti-conduit rules (as can be found in the current US-UK treaty)

(iii) A PPT only rule

At that time, the OECD recognized that further work on unregulated funds (as opposed to, e.g., US Regulated Investment Companies and European funds regulated under the UCITS³ directives) would be carried out to address the concern around treaty entitlement of funds but also the economic importance of such pools of capital and the need to ensure that treaty benefits be granted where appropriate. This led to an OECD discussion draft in March 2016 to which 523 pages of comments were received raising concerns around the LOB provision, the PPT rule, the anti-conduit rules, as well as proposal relating to special tax regimes not discussed herein.

The outcome of the MLI seems to be that, for most, countries are likely to adopt a PPT rule only as depicted in the following three highlighted provisions:

(i) The minimum standard PPT provision to be included in all signatory countries

The MLI only offers the minimum standard test of PPT with the ability to supplement the PPT rule with additional provisions. The PPT language is effectively the existing standard language in many tax treaties denying the treaty benefit where one of the principal purposes of an arrangement or transaction is to directly or indirectly obtain the benefit, unless the granting
of that benefit in the circumstances would be in accordance with the object and purpose of the relevant treaty provisions. The one material difference between the PPT under the MLI and what currently may exist between treaties is that the PPT would now apply to all relevant articles in the treaty, whereas historically, certain countries may only have applied the PPT anti-avoidance measures to specific articles (mostly found in the Dividend, Interest and Royalty articles). Countries without existing PPT provisions will also have to include PPT provisions (or a detailed LOB provision meeting the minimum standard) to the extent of their participation in the MLI.

(ii) Supplemental option of discretionarily alongside the PPT

In addition to the PPT minimum standard, an optional provision is included in the MLI to provide some relief to investors in a fund. The provision allows the competent authority to grant treaty benefits that would otherwise be denied under a PPT if such benefits would have been granted absent the arrangement or transaction. Because it requires discussions with the competent authorities, investors will have to assess the risk/uncertainty of engaging in such potential conversations after (versus before) making investments.

(iii) Supplemental option of a simplified LOB

The simplified LOB can be helpful to funds that, in addition to meeting the PPT test above, can also demonstrate that at least 75% of the investors to their fund are “equivalent beneficiaries.” Equivalent beneficiaries are investors that, had they invested directly, would be granted similar benefits to what the fund is seeking to obtain through its holding company structure.

Example: Investor A resides in Country X, which has an income tax treaty with Country Y limiting Country Y withholding tax on dividends to 15%. Entity B resides in Country Z, which also has an income tax treaty with Country Y limiting Country Y withholding tax on dividends to 15%. A is an investor in B. Since A could get a 15% withholding tax rate on dividends if it invested directly, A cannot be using an investment in B to obtain better treaty rates than if A had invested directly. A would be considered an equivalent beneficiary under this test.

One helpful comment on the MLI with respect to how to compute the “benefit” as it relates to dividend distributions is that an equivalent beneficiary investor is deemed to own the same percentage interest as what Holdco is holding in the portfolio company for purposes of determining such benefit. In other words, in order to measure the benefit that a holding company is receiving from an income tax treaty with respect to dividends from a portfolio company, one compares (a) the dividend withholding tax that would be imposed on the holding company with (b) the hypothetical aggregate dividend withholding tax that would apply if the investors in the holding company had invested proportionately in the portfolio company.

In summary, in the absence of a discretionary relief clause and/or a prescriptive equivalent beneficiary provision, failure to meet the PPT would likely lead to domestic tax rates rather than a proportionate rate that would have applied had the investors invested directly.

Reduced/Exempt dividend withholding tax – minimum shareholding period added (article 8)

Tax treaties often provide a reduced dividend withholding tax rate when the investor is a corporation that owns a minimum amount of capital or voting power of the distributing company. For example, a typical US income tax treaty would provide for a 15% withholding tax rate on dividends, but would grant a 5% rate for dividends paid to a corporate shareholder that owned at least 10% by vote of the distributing company. In order to prevent transitory use of treaty-protected holding companies, the MLI contains an optional provision requiring a minimum 365 consecutive day holding period inclusive of the day of payment for the treaty eligible reduced rate to apply.

Capital gains on real property interests – testing period added (article 9)

In a number of countries, the taxing country reserves the right to tax capital gains realized on shares (or similar interests including in trusts and partnerships) that derive their value principally from real property in that country, i.e., “land-rich” entities. This MLI optional provision recommends the addition of a provision that an entity will be treated as land-rich for this purpose if it would have been land-rich at any time during the 365 day period preceding the sale. This would prevent diluting the entity out of land-rich status by contributing non-real estate-related assets to the entity shortly before the sale of interests in the entity.

Hybrid mismatch arrangements (Action 2)

The October 2015 OECD final report had several recommendations to ensure that hybrid instruments and entities, as well as dual resident entities, are not used to obtain what were perceived as improper treaty benefits. The report noted that special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention.
Furthermore, it specifically examined treaty issues related to dual resident entities, including a proposal for a new treaty provision dealing with transparent entities and addressing the issue of the interAction between the recommendations and the provisions of tax treaties.

The MLI contains the new treaty provision with a set of general rules concerning hybrid mismatch and non-hybrid payments/arrangements. Its focus is on the treaty and not potential domestic law changes.

It also includes three optional alternative methods to address hybrid mismatch issues. The first option provides that provisions that would otherwise exempt income would not apply where the other State applies the provisions of the Agreement to exempt such income from tax or to limit the rate at which such income or capital may be taxed (switch over clause). Instead, a deduction from tax is allowed subject to certain limitations. The second option would deny the exemption method with respect to dividends if those dividends are deductible in the other contracting state. The last option includes that the credit method should be restricted to the net taxable income. Contracting Jurisdictions may choose different options resulting in an asymmetrical application of this provision. Countries may also opt not to apply article 5 to one or more of their Covered Tax Agreements.

Most hybrid/transparency related issues are found in the portfolio company and in the structure of the fund itself or where transparent entities are being used in the structure.

Funds should be cautious when implementing/reviewing their capital structure. For example, if a fund has exempt investors, their (indirect) ownership interest in the portfolio company may ultimately result in an interest deduction in a Source Country where the interest income is not subject to tax. Depending on the opt-in options that a particular source country adopts, there may be exposure in the interest deduction being denied. When there are multiple relevant jurisdictions, the inclusion of a hybrid/transparent entity, which may be permissible under the domestic law of one country, may be treated as a tax benefit under the PPT, resulting in the denial of a treaty benefit in a third country (this despite the fact that the benefit is a result of the operation of a particular Contracting Jurisdiction’s domestic law rather than by operation of the relevant treaty). Finally, when performing due diligence on a target group and their internal financing arrangements for hybrid mismatch exposures, the SPA should include reps and warranties addressing these exposures.

Avoidance of permanent establishment status (Action 7)

The anti-abuse rules in the MLI for permanent establishments (PEs) create several levels of complexities and potential exposure for funds. The scope of the MLI is broader and goes beyond preventing tax avoidance and significantly expands the scope of what constitutes a PE in a source country. To counter artificial avoidance of a PE, three sets of optional rules are proposed under the MLI. They include: (i) agency/commissionaire arrangements; (ii) preparatory or auxiliary exemption; and (iii) splitting up of contracts.

The one most relevant to funds is the agency/commissionaire arrangement. Historically, a PE “threshold” would get triggered where a nonresident of a country would have employees or agents in the source country who would ordinarily act and habitually exercise their authority to conclude contracts on behalf of the nonresident; exceptions would apply where it is established that the agent is an independent agent acting in the ordinary course of business. The MLI has lowered this threshold shifting from a bright line test of “concluding contracts” to “habitually playing a principal role... which leads to contracts being concluded without material modification.” Although this provision is optional, countries applying the United Nations Model Treaty in practice have been applying these optional PE rules. For example, one of the contentious activities that certain source countries and source country tax administrators have been challenging on the basis that it has created a PE has been the activities carried out by regional investment/asset management teams flying into the source country on a regular basis. The focus is often on the “principle role” played by the fly in investment team while physically in the source country. This behavior seems to be commonly encountered even in the absence of optional provisions.

It would seem that, irrespective of whether the optional test is opted in or not, Funds will have to be extra cautious when carrying out investment or asset management related activities from sourcing to recommending to negotiating to executing/asset managing when its employees carry out certain activities in a source country. Any activity that habitually results in an approved course of Action to be taken with material engagement from employees on the ground in the source country could expose the fund in having a PE in the source country.
Endnotes

1. For more detailed discussion on the full content of MLI, see EY Global Tax Alerts, *OECD releases multilateral instrument to implement treaty related BEPS measures on hybrid mismatch arrangements, treaty abuse, permanent establishment status and dispute resolution*, dated 2 December 2016, and *Mandatory Binding Treaty Arbitration under OECD’s Multilateral Instrument*, dated 2 December 2016.


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