Executive summary

On 5 October 2015, the Organisation for Economic Co-Operation and Development (OECD) released the final reports on the 15 Action points identified in its Action Plan on Base Erosion and Profit Shifting (BEPS). It is anticipated that the measures laid out in the Action items will be implemented via changes in domestic law and practices and changes in treaty provisions (including through the multilateral instrument being developed as a mechanism to amend existing bilateral treaties which is currently in progress and expected to be ready for signature at the end of 2016).

It is acknowledged in the reports that further work is required in respect of the policy considerations related to non-Collective Investment Vehicles (non-CIVs) including sovereign wealth and pension funds (SW&PFs). However, investors are seeking to remove uncertainty as to how the proposed Action items impact them, especially as these Action items begin to be implemented in various countries. Investors may want to consider providing further input into the continuing OECD discussions or engaging in direct dialogue with OECD and non-OECD countries in order to get greater clarity with respect to the potential application of the proposed measures to non-CIVs.
Several of the Action items in the final reports, in particular Action items 2, 4, 6 and 13, have the potential to impact SW&PFs’ current investment returns and future investment behavior. Summarized below are brief highlights of such Action items and steps that SW&PFs may want to consider where relevant.

Detailed discussion

Treaty abuse (Action 6)

Technical comments

The final report on Action 6 sets forth changes to the OECD Model Tax Convention and related changes to the Model Commentary to address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios. These changes represent minimum standards agreed to by OECD and G20 countries, but there remains some flexibility as source countries begin the evaluation and implementation of the proposals in this area. Under this minimum standard, countries have agreed to implement in their various 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; or (ii) an LOB rule supplemented by anti-conduit rules (as can be found in the current US-UK treaty); or (iii) a PPT only rule.

There was no consensus on a specific approach to the treaty eligibility of non-CIVs, which would include SW&PFs, but simply the recognition that further work was required and could potentially be built into the multilateral instrument. The final report does not contain any model provisions or related commentary in respect of the treaty entitlement of non-CIVs and notes that further work is needed in this area. This work will also address two general concerns that governments have about granting treaty benefits with respect to non-CIVs: (i) the potential that non-CIVs may be used to provide treaty benefits to investors that are not themselves entitled to treaty benefits; and (ii) the potential that investors may defer recognition of income on which treaty benefits have been granted. The report indicates that this work will benefit from consultation with stakeholders and will need to be completed in the first part of 2016 in order to be relevant for the negotiation of the multilateral instrument.

The final report further states that the new treaty provision on transparent entities, which is included in Action 2 on neutralizing the effects of hybrid mismatch arrangements (which will be discussed in more detail under the Action 2 section below), will be beneficial for non-CIV funds that use entities that one of the two contracting states treats as fiscally transparent since income derived through such entities that will be taxed in the hands of the investors in these entities will generally receive treaty entitlement at the investor level even if these investors are residents of third States. Also, the possible inclusion of a derivative benefits provision in the LOB rule to be finalized in the first part of 2016 will likely help to address some of the concerns regarding the treaty entitlement of non-CIVs in which there are nonresident investors. SW&PFs will need to carefully review how their percentage ownership in the intermediary vehicle and their access to treaty benefits could be affected under the derivative benefits provision. In many circumstances, the derivative benefits provision may not apply, in which case the implementation of the LOB provisions could adversely impact the expected return on certain portfolio investments. This should be carefully reviewed.

The final report notes that work will continue to ensure that a pension fund should be considered a resident of the country in which it is constituted regardless of whether that pension fund benefits from a limited or complete exemption from taxation in that country. In this respect, the final report notes that changes to the OECD Model, expected to be finalized in the first part of 2016, will include a definition of “recognized pension fund” that will consider elements such as whether the fund is created to provide retirement or similar benefits to individuals and whether the laws of the country in which the pension fund is created treat the fund as a separate person. Pension funds and pension reserve funds are encouraged to provide input into the definition to ensure that, where appropriate, their governance structure does not result in the pension fund or reserve fund being unintentionally denied access to treaty benefits.

SW&PF specific considerations relating to the PPT

EY has been closely following the OECD BEPS project, changes to the European Union directives and amendments to the local tax law in source countries. One issue likely to be of particular interest to SW&PFs is the continuing viability of existing or anticipated holding company structures for regional consolidation of portfolio company investments. The potential effect of Action item 6 could be to deny treaty benefits to intermediate entities where there are limited functions in the holding company jurisdiction. The LOB clause, in particular, would limit treaty benefits to a narrow
range of “qualified persons” which could, depending on the facts, adversely affect SW&PF investors (in the absence of special rules for non-CIVs).

It is expected a significant number of source territories will continue to favor a PPT. SW&PFs should review both their current portfolios and proposed investment diversification plans to determine whether any changes are required to the existing holdings to reflect which direction individual countries are already or will be taking. It is seen as a positive development that the OECD clearly acknowledges the fact that non-CIVs require different guidance and that it recognizes the economic importance of these funds and the need to ensure that treaty benefits are granted where appropriate. SW&PFs should ensure that any equity/employee regional platforms that they have in place will be in compliance with the PPT adopted by the various source countries where their ultimate investments are made.

Engaging directly with the relevant source countries may be a helpful step in making that determination.

**Neutralizing the Effect of Hybrid Mismatch Arrangements (Action 2)**

**Technical comments**

The final report on Action 2 supersedes the interim report that was released in September 2014. Similar to the 2014 report, the final report contains detailed recommendations to address hybrid mismatch arrangements and reflects the consensus achieved on these issues.

The recommendations include “specific recommendations” and “hybrid mismatch rules.” The specific recommendations are modifications to provisions of domestic law aimed at avoiding hybrid mismatches and achieving alignment between those domestic law provisions and their intended tax policy outcomes (e.g., by not applying a dividend exemption at the level of the payee for payments that are deductible at the level of the payer).

The hybrid mismatch rules are linking rules aimed at neutralizing one of the following three mismatches in tax outcomes arising out of certain hybrid mismatch arrangements:

- Payments that give rise to a deduction with no taxable inclusion arising from a hybrid financial instrument (including a hybrid transfer), a disregarded payment made by a hybrid entity or a payment made to a reverse hybrid
- Payments that give rise to a double deduction arising from a deductible payment made by a hybrid entity or a dual resident
- Payments that give rise to an indirect deduction with no inclusion arising from an imported mismatch

The hybrid mismatch rules are divided into a primary response and, where applicable, a secondary or defensive rule. The defensive rule only applies where there is no hybrid mismatch rule in the counterparty jurisdiction or where the rule is not applied to the particular entity or arrangement. Each of the hybrid mismatch rules has its own specified scope of application.

The final report also includes changes to be made to the **OECD Model Tax Convention** in addressing Action 2 to ensure that hybrid instruments and entities, as well as dual resident entities, are not used to obtain the benefits of treaties unduly. It notes 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 examines treaty issues related to dual resident entities, includes a proposal for a new treaty provision dealing with transparent entities and addresses the issue of the interaction between the recommendations and the provisions of tax treaties.

**SW&PF specific considerations on hybrids**

As the proposals need to be implemented domestically, SW&PFs may want to consider engaging in direct dialogue with OECD and non-OECD countries in an attempt to provide input. Furthermore, SW&PFs should closely monitor the implementation in the various jurisdictions and review existing arrangements to identify risk areas, especially where debt instruments are currently in place which have a different tax character in the hands of the holder. Certain countries may also be considering restricting deductions for interest on loans to nonresident tax-exempt entities on the basis that the interest income is subject to no or low tax. SW&PFs should be reviewing their existing loan portfolios or shareholder debt assets to determine whether they have this exposure. Finally, SW&PFs should consider the proposal when structuring new cross-border deals.
Interest deductions (Action 4)

Technical comments

Action 4 makes recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense. The report discusses several approaches to limiting deductions for interest expenses, such as a fixed ratio rule (that looks to the ratio of an entity’s net interest expense to its earnings before interest, taxes, depreciation and amortization (EBITDA) or exceptionally EBIT) and group ratio rule (that looks to the group’s leverage ratio). The report recommends use of a fixed ratio rule which would allow an entity to deduct net interest expense up to a benchmark net interest/EBITDA ratio. The OECD recommendation is for countries to choose their fixed ratio within a corridor of 10-30%. Countries may be adopting this corridor inclusive (i.e., the UK) or potentially exclusive of third party debt. As a secondary provision, the report suggests the option of a group ratio rule that would complement the fixed ratio rule. Example 7(e) in the report may be helpful for SW&PFs that qualify as investment entities in the group. As illustrated in the example, where the ultimate parent qualifies as an investment entity, the ultimate parent, for purposes of applying the group ratio rule, would be the top holding company for a particular investment and not the SWF itself. Each fund will have to individually evaluate its existing accounting results (not dissimilar to the Action 13 country by country reporting discussed below) to evaluate whether it would potentially have to apply the group ratio rule at the fund level or at each portfolio investment holding company level. Further consideration would have to be given to how the related party rules would be interacting with the group ratio rule. Depending on whether and how any related party rule mechanisms are adopted by individual source countries, SW&PFs may modify their investment behavior to adapt to the rules being proposed by the particular source country.

While many jurisdictions currently apply a range of restrictions on the availability of interest deductions, including transfer pricing and thin cap rules, many do not currently use the approach recommended by the OECD report of limiting deductions to a fixed percentage of earnings. Imposing such a rule could significantly impact sectors which are traditionally heavily leveraged, such as the infrastructure sector and, in many countries, real estate.

However, the OECD has suggested that the fixed ratio rule should be applied flexibly and there may be good reasons for applying different ratios to different circumstances. One area specifically mentioned in the report is the infrastructure sector. The report suggests that a country “may apply a higher ratio within the corridor where it applies a macro-economic policy to encourage third party lending, not related to base erosion and profit shifting, to increase investment (e.g., in infrastructure).”

In addition, the report recognizes the possibility that jurisdictions may choose to exempt from the rules limiting interest restrictions certain “public benefit projects.” Recognizing that, in some countries, privately-owned public-benefit assets may be large-scale assets financed using a high proportion of debt, the report accepts that a country may choose to exclude interest expense incurred on specific third party loans meeting strict conditions in relation to such projects. The nature of such projects and the close connection with the public sector means that such financing arrangements present little or no BEPS risk.

The conditions mentioned in the report would require:

- A project to provide (or upgrade), operate and/or maintain assets on a long-term basis, lasting not less than 10 years
- Involving a public sector body contracting for the provision of goods or services in which there must be a “general public interest”
- Funding via third party loans on non-recourse terms and not exceeding the value or estimated value of the assets once constructed
- The operator, the interest expense, the project assets and income arising from the project are all in the same country, where the income must be subject to tax at ordinary rates

The current OECD drafting of the public benefits project exclusion appears to narrowly define and potentially target Public-Private Partnership structures and only a very limited class of regulated assets. It remains to be seen whether specific countries adopt broader public benefits project exclusions such that a broader range of regulated and non-regulated industries are covered by such exclusion.

SW&PF specific considerations on shareholder debt (and possibly third party debt)

As each of the participant countries will be looking to adopt some version of the Action 4 proposals, SW&PFs, and other investors of capital, are encouraged to provide input to the particular source countries on how the implementation of such rules, whether as primary (i.e., fixed ratio rules) or secondary provisions (i.e., group ratio rule and potential public benefit project exclusions) could impact their existing...
and potential future investment behavior. Countries, such as the UK, through a consultation process, are encouraging interested parties to engage in such dialogue with existing/target country tax policy makers and administrators and/or portfolio investment management to ensure that countries are well aware of optimal capital structures that non-CIV investors would be looking to when making capital investments in various countries, in particular as it relates to injection of capital into the respective country for long term holdings (i.e., infrastructure and real estate). In particular, as it relates to privatization of assets, SW&PFs as a long-term reliable source of capital investors should actively engage in dialogue with governments in discussing the potential impact that the ranges and various options with respect to the proposed rules could have on asset values where constraints on optimal capital structures may come into play.

Furthermore, SW&PFs should closely monitor the implementation in the various jurisdictions and review existing arrangements to determine the potential impact of interest limitation models.

**Country by Country (CbC) reporting (Action 13)**

**Technical comments**

The final report on Action 13 contains revised guidance on documentation and reporting that will be included in the OECD Transfer Pricing Guidelines as a replacement for the current content of Chapter V. The report sets out a three-tiered standardized approach to transfer pricing documentation and CbC reporting, which consists of a “master file”, a specific “local file” and a “CbC reporting template.” According to the OECD, taken together, these three documents will require taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit inquiries. The final report further indicates that this information should make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments. Finally, the OECD states that the countries participating in the BEPS project agree that these new reporting provisions, and the transparency they will encourage, will contribute to the objective of understanding, controlling, and tackling BEPS behaviors.

In order to achieve these objectives, countries are being encouraged to adopt a standardized approach to transfer pricing documentation, to be implemented in their domestic law.

Some of the questions that SW&PFs should ask as they navigate through the CbC reporting recommendations

**Are there exemptions from filing for SW&PFs under the OECD guidance?**

The OECD guidance is clear that the only exemption from filing for a multinational group is if total consolidated group revenue is less than €750 million or the equivalent. There is no general exemption for investment funds, non-corporate entities or non-public corporate entities.

SW&PFs can take a variety of forms: separate legal entities or pools of assets without separate legal personality. Where SW&PFs have entity constructs that in some form ring fence their holdings, they may be viewed as separate legal entities from the government and may fall into the definition of “Group.” The term “Group” means a collection of enterprises related through ownership or control such that it is either required to prepare Consolidated Financial Statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public securities exchange.

**Could the SW&PF be the ultimate parent entity of the group under OECD guidance?**

The term “Ultimate Parent Entity” means a Constituent Entity of a multinational enterprise (MNE) Group that meets the following criteria:

- It owns directly or indirectly a sufficient interest in one or more other Constituent Entities of such MNE Group such that it is required to prepare Consolidated Financial Statements under accounting principles generally applied in its jurisdiction of tax residence, or would be so required if its equity interests were traded on a public securities exchange in its jurisdiction of tax residence.

- There is no other Constituent Entity of such MNE Group that owns directly or indirectly an interest described in subsection (i) above in the first mentioned Constituent Entity.

The question of whether a particular Sovereign Wealth or Pension Fund has constituent entities depends on the definition of the group in the reporting jurisdiction, which in turn will depend on which entities are required to consolidate and which entities may fall under the investment entity rules.
In the case where a reporting requirement exists, the financial statements that an SW&P prepares are for its supervisory board; they are drawn up under IFRS and audited often by both government and independent auditors. One consideration, in particular for a Sovereign Wealth Fund will be whether these are "required" or whether just done for management purposes (i.e., Santiago principles) only. Additional consideration will also have to be given to whether, through specific rules introduced by the country of the Sovereign any exemptions would be granted to either inbound or outbound sovereigns/exempt investors. Precedence for such exemption can already be found in the CbC reporting guideline Australia recently published allowing a “significant global entity” that does not engage in international transactions to apply for an exemption on the basis of having a low risk profile. In addition, it also allows sovereign wealth funds which have secured sovereign immunity status through a private binding ruling to apply for a similar exemption.

Could an SWF claim "sovereign immunity" from preparing a CbC report?

On the international front, sovereign immunity is a judicial doctrine under international law according to which one country is immune from suit in another country. This principle also extends to imposition of taxation on foreign governments although most governments will distinguish between "sovereign" and "commercial" acts. However, in order for foreign governments to be considered sovereignly immune from tax in another country, local tax laws or the tax treaties in the investee countries must contain specific provisions to provide the exemption. Different countries have taken different approaches to granting sovereign immunity from tax. Not exempted, however, is income that is derived from commercial activities, received from a controlled commercial entity determined by reference to 50% direct or indirect interest by vote or value), or derived from the disposition of an interest in a controlled commercial entity.

Given the disparate approach to sovereign immunity principles for tax purposes across the globe, it would appear that if the home country does not have CbC reporting rules in place, there could be many jurisdictions anticipating direct filing of a CbC report in respect of the entire portfolio, under the secondary filing mechanism.

Penalties for non-filing

The OECD did not include penalty provisions in the model CbC reporting legislation, under the stated assumption that countries would want to extend their transfer pricing documentation penalties to failure to comply with the new CbC reporting requirement.

As a potential next step to assess the CbC reporting requirement risk, it is recommended that SW&PFs obtain accounting advice in determining which entities are included in their group for CbC reporting purposes.
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