European Holding and Financing Companies, the OECD MLI, and EU Anti-Tax-Avoidance Directive

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Reprinted from Tax Notes Int’l, January 15, 2018, p. 237
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The countdown for the implementation of the OECD’s base erosion and profit-shifting action plan into domestic European Union legislation has begun following the adoption of EU anti-tax-avoidance directives I and II (ATAD I and II). Another important step was taken in June 2017 when 72 jurisdictions signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (multilateral instrument, or MLI) in a ceremony hosted by the OECD.

Around 1,100 double tax treaties pertaining to those 72 jurisdictions alone are expected to be modified — without the need for further bilateral negotiations — once the MLI enters into force and the domestic ratification procedures are concluded. Several other jurisdictions have expressed their intent to sign the MLI, with a second signing ceremony expected in early 2018.

For withholding taxes, the MLI is expected to modify tax treaties as early as January 1, 2019. That timing would coincide with the timing for domestic implementation in EU member states and the entering into force of most ATAD provisions. The MLI and ATAD will trigger unprecedented changes in tax treaties and European taxation, which will significantly affect U.S. multinationals and funds with a cross-border footprint — even if the United States has not signed the MLI. We will explore some of the key changes for EU tax directives and tax treaty access for holding and financing structures and what actions asset managers should consider to prepare for those changes. Regarding the ATAD, there are several structural options that should be evaluated. The timing of the selection and implementation of these options should be monitored but will likely need to start in 2018.

Figure 1 summarizes the key ATAD and MLI implementation milestones that will affect the funds industry.

The Introduction of a PPT Rule in Tax Treaties

As a result of the MLI, a principal purpose test (PPT) clause will effectively be included in most tax treaties to prevent access to treaty benefits in abusive situations (for example, treaty shopping). The MLI, based on BEPS action 15, allows accelerated implementation of BEPS action 6 minimum standards in a vast number of tax treaties because it circumvents the need for bilateral negotiation, agreement, and ratification.

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1 Only a handful of countries have decided to adopt a simplified limitation on benefits clause in addition to a PPT, and a few others have included in their positions a statement regarding their intent to adopt a detailed limitation on benefits clause through bilateral negotiation, accepting the PPT as an interim measure.

2 The other three BEPS minimum standards are BEPS action 5 (transparency framework), BEPS action 13 (country-by-country reporting), and BEPS action 14 (dispute resolution).
Under the PPT, a treaty benefit shall not be granted if, given all relevant facts and circumstances, it is reasonable to conclude 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 the benefit in the circumstances would be in accordance with these treaties’ relevant provisions. The PPT is broad because it merely requires that obtaining a benefit under a tax treaty be one of the principal purposes (not necessarily the main or only purpose) for entering into specific transactions or arrangements. Moreover, the PPT is a subjective test that will thus give tax authorities flexibility to deny tax treaty benefits should they consider that it is reasonable to conclude that obtaining tax benefits played a principal role in deciding to enter into transactions.

Even though some guidance for the application of the PPT was included in BEPS action 6, there will likely be major uncertainty and differences in interpretation and application of the PPT among tax authorities. There is still no guidance on how different countries will apply the PPT, and the effect thereof can be determined only once the MLI is effective and tax authorities release guidance or start applying the MLI.

Taxpayers will therefore face greater scrutiny, uncertainty, and tax risks. Access to tax treaty benefits might not even be provided in the presence of commercial reasons or of a specific level of operational functionality at the level of holding or financing entities. It is clear, however, that entities situated in some jurisdictions simply to get access to the tax treaty network without further justification will not be able to get access to those treaties.

Applying the PPT in the EU

Despite the above, from an EU perspective, the PPT might have a more limited application because EU countries will need to abide by EU...
Applicability of the PPT to Funds Structures

In the asset management context, the PPT will affect alternative investment funds (AIFs) using investment platforms in jurisdictions with wide treaty networks or engaging in trading strategies that benefit from efficiencies provided by tax treaties. Even so, the OECD has recognized the economic importance and particularities of operating models of non-collective investment vehicles (non-CIVs) and the need to confirm that treaty benefits are granted when appropriate.

In that context, the 2017 update to the OECD model tax convention provides three examples of non-CIV fund structures that would not be expected to be caught by the PPT — that is, not considered abusive and thus entitled to treaty benefits. The examples, which contain several factors that the OECD believes help illustrate when tax treaty benefits should be available, include a regional investment platform, a specific investment vehicle (securitization vehicle) structure, and a real estate holding platform. Each structure should be considered case by case because it is unlikely that it will contain the exact factors described in the examples. Also, it is expected that the different factors in the examples could be combined. The more factors present in a structure, the greater the likelihood of having a strong position — although it is crucial that overall, the taxpayer has a consistent justification for its arrangements or transactions, particularly at the holding company level. Given that there are no safe harbors for the PPT, which is not objectively defined, the examples will help clarify the application of the rules to non-CIV funds.

The examples and respective fact patterns highlight the need to show the existence of nontax reasons that justify the use of holding or financing vehicles that benefit from access to a tax treaty. Based on the examples, nontax reasons for an AIF

Law (as interpreted by the Court of Justice of the European Union), which restricts the application of antiabuse provisions to “wholly artificial arrangements” without economic activity or substance.

The European Commission has highlighted that position in a recommendation for EU member states to limit the application of the PPT in their tax treaties to arrangements or transactions that result in tax benefits and do not reflect a genuine economic activity, as defined by CJEU case law. The recommendation reflects CJEU jurisprudence on abuse of law; most notably, the landmark case Cadbury Schweppes PLC and CSO Ltd. v. Commissioners, C-196/04 (CJEU 2006), in which the CJEU pointed out that a national measure restricting the freedom of establishment may be justified only if it specifically relates to wholly artificial arrangements meant to circumvent the application of the legislation of the member state concerned and does not go beyond what is necessary to achieve that purpose.

That position seems to be supported by the Court’s September 7 decision in Eqiom SAS (previously Holcim France SAS and Enka SA) v. France, C-6/16 (CJEU 2017). The CJEU ruled that a former French antiabuse provision requiring a taxpayer to prove that benefitting from an exemption is not a main purpose of the structure infringed both the EU parent-subsidiary directive and the EU right of freedom of establishment, because it did not contain an objective test limited to wholly artificial arrangements that do not reflect economic reality.

Even though the PPT is different from a mere substance test, the above highlights the importance that a minimum level of physical presence and functions aligned with the underlying economic rationale for interposing a holding or financing company will have in the application of the PPT, especially in the EU.

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5 European Commission Recommendation C(2016) 271 of January 28, 2016, on the implementation of measures against tax treaty abuse.

6 The CJEU went on to state that to find a wholly artificial arrangement, there must be, in addition to a subjective element, objective and ascertainable evidence — with regard, in particular, to the extent to which the entity physically existed in terms of premises, staff, and equipment — that the transaction does not reflect economic reality.

7 Which will, in principle, fall under the definition of non-collective investment vehicles as used by the OECD. Collective investment vehicles, or widely held and regulated funds with diversified portfolios, will be less affected because they are not covered by most of the BEPS action plans.

8 Those examples were included in the commentary inserted in the 2017 update to the OECD model. Although the OECD model and the draft commentary are considered soft law, they play an important role in the interpretation of treaty provisions by courts and tax authorities.
to use a specific holding or financing vehicle may include:

- regulatory and company law reasons or reputation;
- framework for the company’s operations (for example, securitization regime);
- access to regional trading group or bloc of nations to facilitate cross-border investment, trade, or operations;
- facilitating access to funding and familiarity of lenders and investors with a jurisdiction;
- administration of withholding tax reclaims;
- political stability;
- “passporting” rights (for example, under the EU alternative investment fund managers directive);
- asset management or investment fund hub location;
- availability of a skilled, suitable, multilingual workforce; or
- qualifications of employees or directors.

It also follows from the OECD’s examples that holding or financing vehicles of investment fund structures would still be entitled to tax treaty benefits if the taxpayer can show that access to those benefits is not one of the principal purposes for the use of those vehicles or for the related transactions or arrangements. Many of the nontax considerations outlined above can be found in some typical (for example, European) holding or financing jurisdictions and should thus be considered when reviewing the tax risks regarding the applicability of the PPT to new and existing structures.

Finally — and perhaps somewhat surprisingly — the regional investment platform example includes access to the tax treaty network of the holding company jurisdiction as an acceptable factor for choosing that jurisdiction even if the investors themselves would not have direct access to the treaty.9

The PPT is not a substance or beneficial ownership test; rather, it focuses on whether it can be reasonably inferred from the objective facts that tax treaty benefits were one of the principal purposes for the taxpayer to enter into specific transactions or arrangements. Arguably, and as highlighted in some of the commentaries in the 2017 update to the OECD model, however, the substance and functions present in the holding or financing jurisdiction are part of those key objective factors, and one should not overlook the need to review, enhance, and adapt the substance and operations in a holding or financing company jurisdiction in line with the overall business objectives and operating model. That is particularly relevant in an EU context.

Other MLI Provisions and Actions to Be Taken

While the PPT might result in a paradigm shift in how tax treaties will be applied, the MLI’s effect goes well beyond that, because several countries have opted (or have not made any reservation) for the other antiabuse provisions to modify their treaty networks.

For instance, real estate structures may be affected for those MLI countries opting into the “real-estate-rich” clause that gives the country where the underlying real estate is located the right to tax capital gains on shares. Also, private equity and real estate deal teams may suddenly face permanent establishment risks in countries that have opted for the heightened PE definition. PE exemptions may no longer be available. Dual resident companies in countries that have opted for determining tax residence by a mutual agreement procedure (instead of the current tiebreaker that allocates tax residence to the place of effective management) could be denied the application of a tax treaty if no agreement is reached, or could at least face a long period of uncertainty while the tax authorities try to settle the questions of tax residence.

Unlike the PPT minimum standard, to determine the applicability of the above provisions, a matching exercise must occur to assess whether both parties to a tax treaty have decided to include those provisions.

As mentioned, the PPT has a broad and subjective nature, and there is not yet enough guidance on how each country will apply it.

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9 The securitization vehicle example also recognizes treaty access as an acceptable factor but assumes that the investors would themselves also be entitled to a tax treaty with the investment country if investing directly. The real estate holding platform example assumes that the holding company does not obtain treaty benefits that are better than the benefits the investors would obtain if investing directly. These differences highlight the relative weight of each factor and the need to look at the full picture to assess to what extent existing tax motives can be considered a principal purpose of the structure.
Further, although MLI signatory countries have already expressed their initial positions regarding the other MLI clauses they wish to adhere to, whether those positions will actually be adopted is still subject to final approval and possible change. Therefore, taxpayers should watch for developments in the near future as further guidance and final positions that will allow them to assess the implications for their structures, possibly from January 2019, become publicly available. Despite that, a high-level preliminary assessment of the key investee jurisdictions should be considered with some urgency.

**ATAD I and II and Actions to Be Taken**

In addition to the MLI, the rules under ATAD I and II to be implemented in EU domestic tax legislations by January 2019 (ATAD I) and January 2020 (ATAD II) will have a material effect on the tax structuring of typical holding and financing jurisdictions.

Figure 2 illustrates some areas affected by ATAD I and II.

Under the interest limitation rules, the deduction of so-called exceeding borrowing costs will be limited to 30 percent of the borrower’s earnings before interest, taxes, depreciation, and amortization or, if opted into on transposition of the ATAD, a €3 million safe harbor. The rule will be applicable to related and unrelated party financing expenses from EU or non-EU lenders and may materially increase the effective tax rate for companies with taxable income other than interest income (for example, taxable capital gains on the sale of some assets). However, a grandfathering provision might apply to loans concluded before June 17, 2016, so the risk of forfeiting that potential benefit should be considered before amending or terminating loans concluded before that.

Further, structures that entail hybrid mismatches (for example, payments on hybrid financial instruments\(^\text{10}\) and payments to or by

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\(^{10}\) That is, payments under a financial instrument that give rise to deductions in the payer jurisdiction without inclusion in the recipient country, or to a double deduction.
hybrid entities\textsuperscript{11}) will also be affected by January 1, 2020. The deduction will be denied in the EU member state that is the payer jurisdiction, which would be that of the holding or financing company. The disallowance of deduction, however, could also take place at the EU investment country level even if the hybrid instrument is placed higher up the chain (based on the so-called imported mismatch rules\textsuperscript{12}).

Finally, CFC rules intended to tax undistributed passive income of controlled low-taxed entities must be implemented by all EU member states by January 1, 2019. Under those rules, a CFC is an entity or PE in which the parent directly or indirectly holds at least 50 percent of the voting rights, capital, or profit rights, and the corporate tax paid on its profits is less than 50 percent of the corporate tax that would be paid in the parent’s member state.

EU member states can choose between two different approaches when allocating the income of the CFC to the resident parent entity: (i) the CFC’s nondistributed passive income (for example, intercompany interest, royalties, leasing, and licensing) would be allocated and taxable at the resident parent’s level, or (ii) only nondistributed income arising from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage — that is, income from assets and risks, which are linked to the significant people functions carried out by the controlling company and can thus not be linked to the CFC’s significant people functions — are allocated and taxable at the resident parent’s level.

Many EU member states have not yet adopted rules like the ones foreseen in the ATAD, so it is expected that the ATAD rules will have a substantial tax effect on many holding or financing structures of investment funds.

The ATAD rules still leave some discretion to EU member states in implementing them into their domestic tax legislations: for instance, whether to allow a grandfathering clause for loans and how to apply the definitions of interest and economically equivalent payments for the interest limitation rules; when to conclude that a payment under a hybrid instrument has not been included in the recipient’s taxable income within a reasonable time; which method to apply for the allocation of income under CFC rules; and the option to exclude financial undertakings (for example, AIF managed by an AIF manager or supervised under applicable national law) under the ATAD from the scope of the interest limitation rules.

Even so, the rules are objective and clearly delineated in such a way that market participants can determine the risks for their European structures. Some may want to perform (or have already performed) a risk assessment to anticipate potential restructuring alternatives during 2018 and be able to act before the ATAD is transposed into domestic legislations, effective 2019.

\textbf{Jurisdictional Reactions}

Traditional holding and financing company jurisdictions have continued to be proactive in setting their tax agendas to maintain their viability in the uncertainty of the post-BEPS environment while modernizing their tax frameworks and committing to abide by at least the minimum standards imposed by the BEPS and EU anti-tax-avoidance initiatives.

Some country-specific tax developments across those jurisdictions include:

- increased transparency and reporting (country-by-country reporting, OECD/EU exchange of information requirements on tax rulings and tax information, and the U.S. Foreign Account Tax Compliance Act/common reporting standard);
- modernization of local transfer pricing rules in line with OECD standards;
- reactions to increased state aid scrutiny by the European Commission into fiscal advantages allegedly granted by EU member states, including imposing stricter standards for issuing tax rulings; and
- ongoing implementation of targeted anti-tax-avoidance measures.

\textsuperscript{11}That is, payments to or by an entity that qualify as nontransparent in one jurisdiction and as transparent in another jurisdiction.

\textsuperscript{12}Situations in which the effect of a hybrid mismatch between parties in third countries is shifted into the jurisdiction of a member state using a non-hybrid instrument, thereby undermining the effectiveness of the rules that neutralize hybrid mismatches. That includes a deductible payment in a member state under a non-hybrid instrument used to fund an expenditure involving a hybrid mismatch.
Those jurisdictions also continue enhancing their attractiveness as financial service hubs when there is also increased pressure for offshore funds to relocate onshore. That is accomplished by:

- enhancing legal and regulatory regimes;
- developing new vehicles tailored to different types of investors and investments, thus enhancing time-to-market, investor protection, and flexibility while mitigating costs; and
- attracting workforce experience and increasing and modernizing the local financial service infrastructures.

When substance and business reasons are key considerations in getting access to tax treaties, jurisdictions are equipping themselves with the appropriate attributes to allow investment funds to efficiently consolidate and carry out their functions in those countries.

**Actions to Be Taken for Compliance**

Besides preparing for the MLI and ATAD changes, taxpayers with presence in traditional holding and financing jurisdictions should confirm that their structures are compliant with transfer pricing rules and supported with appropriate documentation as required by local law. They should also document the various factors (taking into account OECD guidance) that prompted them to locate their activities in that specific jurisdiction in response to potential questions by source countries once the MLI enters into force. The ability to demonstrate before local and foreign tax authorities that intragroup transactions are at arm’s length and commensurate with existing assets, risks, and functions is a key element in supporting existing structures.

Further, companies should confirm that they have made the required self-certifications and notifications under CbC reporting, FATCA, and CRS and that internal processes have been put in place to provide ongoing compliance with reporting rules. Substantial penalties might be levied for noncompliance or delay.

**Source-Country Standpoint**

The analysis of the footprint required for a holding or financing company to get access to tax treaties cannot be complete without looking at how the investee countries would apply their anti-treaty-abuse rules, because those countries will ultimately have their taxing rights enhanced.

Some investee countries have never been reluctant to invoke concepts such as beneficial ownership, substance, or valid or genuine business reasons under domestic tax laws and tax treaties to challenge access to withholding tax reductions or exemptions on income or gains from local investments held by AIFs through foreign holding company structures. However, given that those concepts are broadly subjective and not precisely stated or defined, the analysis is usually factually driven, and each tax authority takes a different approach. The future adoption of the PPT rule under the MLI as an overarching antiabuse provision denying tax treaty entitlements, and the almost 100 countries that participated in the MLI discussions, will provide foreign tax authorities with an additional and potentially powerful tool to challenge tax treaty benefits invoked by holding or financing structures that may be perceived as lacking sufficient substance and business purpose.

**Improving Taxpayers’ Positions**

Several actions may be taken to improve taxpayers’ positions, given future PPT assessments. First, taxpayers should consider aligning the holding company location and the activities and functions carried out therein with the operating substance footprint (leveraging on or increasing existing substance at the holding company level) and typical AIF business model:

- concentrating holding or financing companies or investments in the same region, or having the same type of investment policy under one umbrella or platform in a given jurisdiction;
- consolidating in the holding jurisdiction the fund vehicles or asset management entities (for example, licensed under the EU AIF managers directive); and
- improving premises and local relevant headcount with appropriate skills for the functions carried out and the structuring of employment contracts in case of the sharing of resources between different entities (for example, by using global employment
contracts whereby each entity has the employees allocated to its own payroll).

Taxpayers should also consider using regulated holding vehicles or transparent fund structures that rely on tax residency of the investors rather than an investment platform. Finally, taxpayers should consider that evidence of tax and nontax reasons will be critical in evaluating a PPT, with nontax reasons helping evince the nontax business purpose.

**Conclusion**

It is important to develop a holistic approach to addressing MLI and ATAD challenges for the alternative investment funds. Although drastic changes are probably not immediately necessary, it is crucial to conduct an assessment and review potential implementation options to manage the overall fund effective tax rate. Figure 3 provides a brief summary of the steps that could be considered to assess the MLI impact, and a similar assessment is recommended to determine the ATAD impact. As discussed above, because of the 2019 effective date, those assessments are warranted in 2018.