Analysis

The BEPS multilateral convention: who loves SLOBs?

Speed read

The BEPS multilateral convention was signed by 68 countries on 7 June 2017. It will ultimately modify over 1,100 double tax treaties. The convention presented two options for countering 'treaty abuse' (following BEPS Action 6): a principal purpose test, very similar to the anti-avoidance rule included in UK treaties for years; and a US-style limitation on benefits article that had the potential to hinder much cross-border investment. However, the principal purpose test is the default position under the convention and very few states have opted for the limitation on benefits article, which means it is of limited relevance in practice.

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On 7 June 2017, 68 countries signed the BEPS multilateral convention ('the Convention'), the effect of which is to modify more than 1,100 existing double tax treaties between the signatory countries. This follows the work undertaken over the last four years by the OECD on BEPS Action 6, the purpose of which is to counter treaty abuse.

After years of uncertainty, we finally know which countries are opting for what variant of the proposed anti-abuse rules and, therefore, the investments that are most likely to be adversely affected.

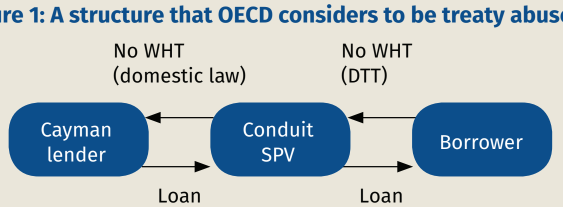
What is BEPS Action 6?

The BEPS project was launched by the OECD and G20 in 2013 to tackle 'base erosion and profit shifting'; i.e. tax planning strategies that shift profits from high tax jurisdictions to low tax/no-tax jurisdictions. The BEPS project has resulted in 15 Actions, of which Action 6 contains recommendations for countering so-called 'treaty abuse'.

A simple example of what the OECD considers to be 'treaty abuse' is set out at figure 1 (below). In this example, a company is not entitled to the benefit of a double tax treaty (for example, because it is resident in a tax haven) and advances a loan to a borrower via a 'conduit' entity. The conduit is resident in a jurisdiction that has a tax treaty with the borrower jurisdiction but does not impose withholding tax on interest payments. Therefore, withholding tax is eliminated from the investment. This kind of arrangement is often described as 'treaty shopping' or 'treaty abuse'; i.e. the conduit has been inserted solely to take advantage of a tax treaty. It is possible to use similar arrangements to mitigate withholding tax on royalties and dividends, as well as capital gains tax on equity investments.

Action 6 proposed to counter treaty abuse of this kind.

Figure 1: A structure that OECD considers to be treaty abuse



What are the anti-abuse rules?

The text of the Convention was published on 24 November 2016 and contained two anti-abuse rules: a principal purpose test (PPT) and a simplified limitation on benefits (LOB) article. On signing the Convention, each country selected the anti-abuse rule (or combination of rules) it wished to adopt. The majority of countries have opted for the PPT rather than the LOB article. The two options were discussed in an earlier article ('The multilateral instrument: anti-abuse provisions' (Heather Self), *Tax Journal*, 27 January 2017), but we summarise the provisions below.

Principal purpose test

The PPT is a simple enough concept. It sets out that 'a benefit under this Convention shall not be granted … if it is reasonable to conclude, having regard to all the relevant facts and circumstances, that obtaining that benefit was the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit'.

The PPT would be expected to counteract simple conduit structures of the type considered in figure 1, as well as less straightforward structures that are clearly significantly tax motivated. However, it would seem that other complex structures that have a tax effect but are commercially motivated ought not to be caught. For example, a debt fund with multiple investors from around the world ought not to be countered by the PPT, even though tax treaty considerations will inevitably have been a factor in the choice of jurisdiction for its lending entity (see figure 2, opposite).

The UK has had a similar provision to the PPT (a 'main purpose test') in most of its tax treaties for some time, and the approach outlined in the above paragraph is broadly reflective of HMRC's historical approach. This has even been the case where (as in figure 2) some of the investors could not have lent directly without suffering withholding tax (i.e. the Cayman investor). HMRC has typically looked at the overall commercial objective of a structure (i.e. collective investment) and granted treaty benefits accordingly.

However, the PPT is essentially a subjective test and the key question is whether the other jurisdictions adopting the PPT will take a similar approach to the UK. It is possible that some will not. A tax authority could, for example, assert that the structure in figure 2 facilitates tax avoidance by the Cayman investor and so apply the PPT to deny treaty relief. Indeed, the PPT has the potential to raise complicated questions about the motivations of parties and the functions of special purpose vehicles (SPVs).

Simplified limitation on benefits (SLOB) article

The effect of the SLOB article is to deny treaty relief to an entity unless it passes an essentially arithmetical test which looks to the ultimate beneficial owners of a payment and asks whether at least 50% of them would have been entitled to treaty relief. Hence, in figure 2, it would be necessary to consider both the identity of the investors and their respective holdings. The US and Spanish investors would likely have been entitled to treaty relief; thus if they hold two-thirds of the interests in the fund, then the SLOB should not prevent it from qualifying for relief. However, if the Cayman investor holds more than half the interest in the fund, then the SLOB would deny treaty relief and the borrower would be obliged to apply withholding tax.

This kind of mechanism presents funds and some other non-banks with a significant problem: they will need to determine the identities of their ultimate investors; and, if those investors 'trip' over the 50% threshold of a SLOB, protect their other investors against suffering the withholding tax consequences.

That is bad enough – but the SLOB becomes a fatal problem for entities like repackaging SPVs, securitisation issuers and CLOs which issue listed and cleared securities, as they are not able to identify their ultimate beneficial owners. The SLOB would seem to exclude such entities from treaty relief entirely. The OECD spent much time discussing an exemption for collective investment funds (CIVs), but it became quickly apparent that agreement would not be reached in extending that exemption beyond retail funds.

Many therefore feared that widespread SLOB adoption would significantly impede cross-border investment.

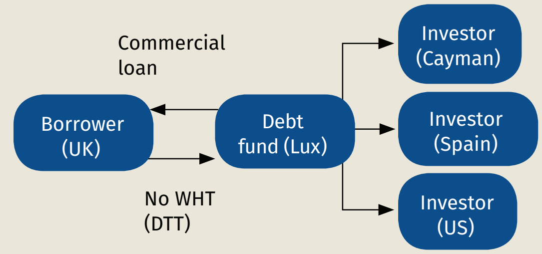
It became clear early on that the UK would not in fact be adopting the SLOB. The big question was: who would?

Who loves SLOBs?

That question now has an answer.

Figure 3 (below) illustrates which countries have opted for the PPT (shown in blue) and which have opted for the SLOB (shown in red).

Figure 2: A structure that may be caught



There will be 57 of the Convention signatories incorporating a PPT into their tax treaties (the 'PPT states'). Ten signatories have opted for the SLOB article: Argentina, Armenia, Bulgaria, Chile, Colombia, India, Mexico, Russia, Slovak Republic and Uruguay (the 'SLOB states'). Norway has yet to reveal its position (but is expected to opt for the PPT).

Ten out of 68 is a reasonable number, and it might therefore be thought that SLOBs will dramatically change the tax treaty landscape. However, that is unlikely to be the case. A treaty will only be modified to include a SLOB in limited circumstances, as follows:

- Treaties between two SLOB states will include a SLOB; for example, the Argentina/Chile tax treaty.
- Treaties between two PPT states will include a PPT; for example, the UK/Luxembourg tax treaty.
- Treaties between a PPT state and a SLOB state will generally include a PPT and *not* an LOB; for example, the India/UK tax treaty will include a PPT. There are exceptions:
  - Denmark and Iceland are PPT states but have opted for a SLOB where their treaty partner is a SLOB state – so, for example, the Denmark/India tax treaty will now apply a SLOB; and
  - Greece is a PPT state, but has agreed that SLOB state treaty partners may apply a SLOB on payments out of

Figure 3: Countries which opted for PPT (blue) and SLOB (red)

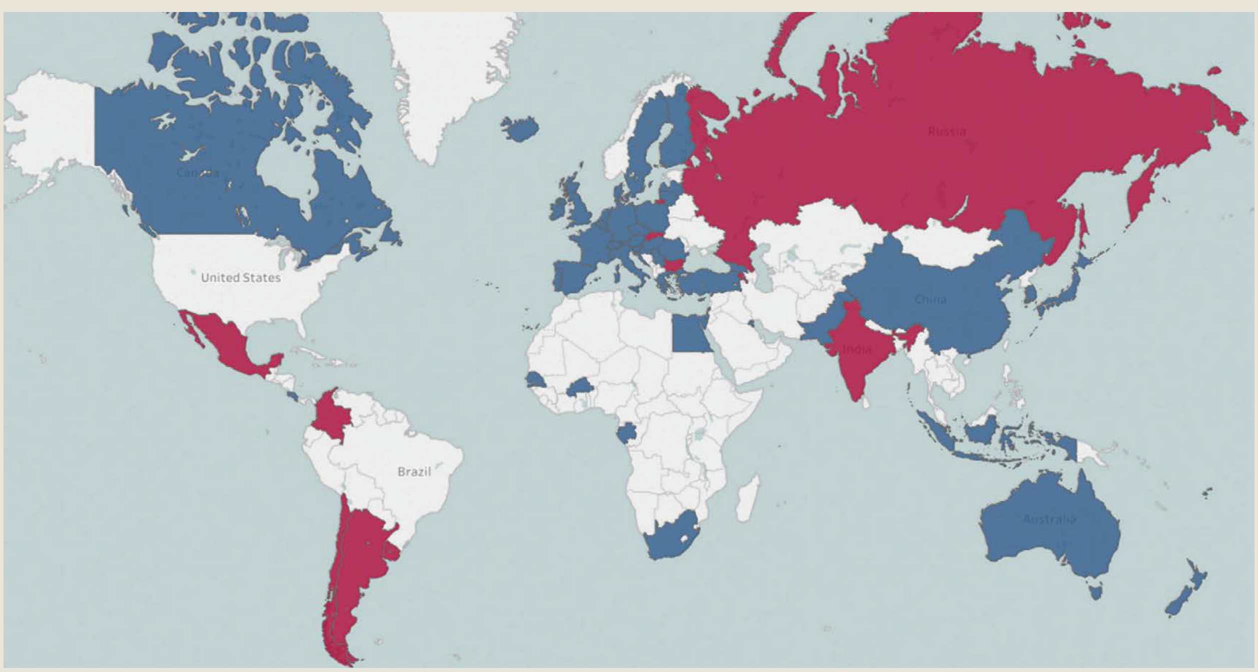


Figure 4: Thirty treaties to be modified to include a SLOB

the partner state – so, for example, the Greece/India tax treaty will apply a SLOB to payments out of India, but a PPT to payments out of Greece.

The PPT is therefore the 'default' position. Indeed, of the 1,100 tax treaties covered by the Convention, only around 30 will be modified to include a SLOB. These are shown in figure 4 (above). Even that exaggerates the impact of the SLOB, as many of the SLOB states have limited tax treaties which do not generally exempt income or gains.

Hence, the SLOB is only likely to be relevant to a handful of cases in practice, such as Russian or Danish entities investing into India.

It is possible that some SLOB states will be unhappy with the limited application of the SLOB to their tax treaties following the execution of the Convention. This creates an element of uncertainty around the current position. There is a risk that either additional bilateral negotiations might result in a tax treaty becoming fully subject to a SLOB, or that 'frustrated' treaty states will apply the PPT more aggressively to compensate for the absence of the SLOB.

Overall, however, the limited application of the SLOB is very good news for cross-border investment.

One final complication to note: although Canada, Kuwait, Poland and Senegal have opted for a PPT, they have stated an intention to negotiate SLOBs into their bilateral treaties. The US stands alone as a significant jurisdiction that has not signed the Convention. However, the US's existing treaties generally include a LOB article.

When do the changes start to apply?

The amendments effected by the Convention relating to withholding tax will apply from the 1 January after both the treaty states in question have ratified the convention. For some countries, like the UK, ratification is typically fast and straightforward; where a treaty is between two such countries, the changes will therefore likely apply from 1 January 2018. However, it is common for ratification in other countries to take many months and, in some cases, even years. It is a reasonable assumption that relatively few changes will apply before 2019.

Finally, it is important to note there is no 'grandfathering', such that all pre-existing investments will become fully subject to the new rules.

What actions should investors take?

Those few investors relying on one of the 30 or so affected treaties should consider their position as soon as possible. It may be that they can immediately show they have the 'right' beneficial owners, and so are unaffected by the SLOB. It may be that they can, with effort, identify their beneficial owners, and come to the same conclusion. In other cases, they may need to either accept a tax cost or exit their position (e.g. by selling to an unaffected investor).

Other investors can be more relaxed, at least until implementation by local tax authorities becomes clearer. If some tax authorities start interpreting the PPT aggressively, then that could have widespread implications. We saw with the *Indofood* case (*Indofood International Finance Ltd v JP Morgan Chase Bank NA London Branch* [2006] STC 1195) that tax treaty interpretations favourable to tax authorities can sweep round the world in a remarkably short time.

So everyone relying on tax treaties will be facing an element of uncertainty that was not there before. In some markets (for example, cross-border lending), parties may wish to protect their position through risk allocation provisions in documentation. ■

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- ▶ BEPS Action 6: preventing treaty abuse (Michael McGowan, Andrew Thomson & Emma Hardwick, 29.10.15)
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