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BEPS – practical impact of the hybrid and tax treaties proposals on funds, corporate groups, financial institutions and SPVs

On 16 September the OECD published the first set of seven recommendations under the Base Erosion and Profit Shifting (BEPS) project. Two will have particularly wide implications: hybrids (Action 2) and tax treaty abuse (Action 6). These proposals are not yet law, but some version of them is likely to be implemented fairly soon by many countries. We ask: What will the practical impact be? And what steps should be taken now to anticipate and mitigate the impact?

Action 6 - treaty abuse

What is it all about?

The key target of these proposals is "treaty shopping" – where a person who is not entitled to the benefit of a tax treaty invests via an entity in another jurisdiction which does benefit from the treaty.

The proposals are also aimed at preventing treaty benefits being granted in "inappropriate circumstances", in particular where a person:

- seeks to use the provisions of a tax treaty to circumvent limitations of the treaty itself; or
- seeks to use a treaty to circumvent domestic law provisions.

The full report is here.

What will be affected?

There was some disagreement amongst OECD members as to how to combat treaty shopping. Two approaches were presented:

- a formulaic "limitation on benefit" (LOB) rule, based on that included in the US tax treaties, aimed at identifying cases where income is passed to third countries; and
- a purpose test, similar to the rule included in the UK's recent tax treaties.

The LOB rule was criticised for being too inflexible; the purpose test was criticised for being too uncertain. As is often the way of committees, the BEPS project committee adopted both approaches. So, where the BEPS recommendations are incorporated into a tax treaty, taxpayers will need to satisfy both the LOB and the purpose test.

Who will be affected?

Most corporate groups and financial institutions will be affected, as will funds and SPVs that rely on tax treaties to receive income from their debt and equity investments free from withholding tax. And because the LOB is so formulaic, the proposals could deny treaty benefits to arrangements that are entirely unmotivated by tax considerations.

How does the purpose test work?

The purpose test is simple in principle. It states that treaty benefits shall not be available to a person

> *"if it is reasonable to conclude, having regard to all relevant facts and circumstances, 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 that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of [the treaty]."*

So this could apply if, for example, a bank grants a loan to a borrower, claims relief from withholding tax under the applicable double tax treaty, but passes the economic benefit of the loan to a third party that would not be eligible for treaty relief. The LOB (discussed below) may not apply in such a case (e.g. because the bank's shares are listed). But the purpose test would deny relief from withholding tax.

The difficulty is that the test is inevitably subjective. Our recent experience is that revenue authorities and courts judge "purpose" with the benefit of hindsight, and if an arrangement gives rise to a tax benefit then there is a strong presumption that tax was a principal purpose of the arrangement.

How does the LOB work?

The Limitation of Benefits proposal seeks to only grant access to OECD based tax treaties if the individual or company involved is a tax resident of that country and also meets additional tests, which are aimed at preventing tax treaty shopping.

The starting point of the Limitation of Benefits proposal is that tax treaty benefits should only be available if the entity claiming treaty benefits is either:

- a "qualifying person";
- engaged in an active conduct of a trade or business;
- owned for at least 95% by ‘equivalent beneficiaries’ and meets base erosion tests (which aims at allowing benefits to entities where the economic benefit accrues to persons that would have been entitled to treaty benefits had they received the income direct); or
- a person who fails the other conditions, but obtains clearance from the competent authority in the source state on the basis that it is not its principal purpose to obtain tax benefits under the relevant treaty.

In order to be considered a qualifying person, an entity would generally need to be a publicly traded company or meet certain ownership and/or base erosion tests based on objective criteria. Funds, capital market SPVs and structured debt vehicles will generally not satisfy these requirements, and so there are specific provisions for funds and other collective investment vehicles (CIVs) which we discuss further below.

Although the “qualifying person” test mainly requires objective characteristics to be met, the active-conduct test is a more qualitative test that acknowledges that entities actively engaged in actual business activities should generally not give rise to treaty shopping concerns, and so should be eligible for treaty benefits even if they fail the qualifying person test. The extent and the application of this test is therefore of great relevance – unfortunately the OECD leaves that to the domestic law of individual States. The resultant inconsistency will be challenging for (in particular) headquarters companies that need to qualify for treaty relief across a large number of different jurisdictions.

Impact of treaty proposals on funds and SPVs

The treaty proposals will have a particular impact on many funds, SPVs and structured debt issuers which rely upon double tax treaty claims to receive dividend and interest income free from withholding tax. This is fundamental to the economics of these arrangements and is in no sense tax avoidance. However the LOB in the original Action 6 proposals would almost always have denied treaty benefits to funds, SPVs and their subsidiaries.

This was immediately recognised as a problem within the funds industry, and in subsequent discussions with the OECD it became apparent that funds had simply not been considered when the original proposals were drawn up.

The new proposals recognise this concern, although it is expressly acknowledged that further work will be needed before the

final version of the Model Treaty and Commentary is produced in September 2015. A range of different approaches is suggested as being open to contracting states when dealing with "collective investment vehicles" (CIVs):

- At the most generous end, states could choose to deem the CIV to be an individual for the purposes of a treaty and hence not be subject to the LOB provision at all.
- At the other extreme, States would be free to ignore the problems associated with funds altogether and have the treaty deal with them in the same way as any other entity (which would likely mean in practice that many funds and SPVs would not be eligible for treaty relief).
- In between the two extremes, the proposals allow for the inclusion of CIVs within the definition of "qualified person" in the LOB provision - in effect, making CIVs "good" entities for these purposes. The Commentary, however, then allows for a wide range of possible additional restrictions to be put on the qualification of the CIV for treaty benefits depending largely upon the view of the relevant contracting states as regards the possibility of CIVs being used for abusive purposes.

Areas of uncertainty

While accepting the OECD's acknowledgment that further work is needed in this area, some very fundamental issues are still far from clear:

- The new provisions are all focussed on the CIV itself. While this may be of great assistance to some types of fund vehicles, such as UCITS and other mutual funds, they do nothing for private funds (such as limited partnerships) where investments are held through subsidiary companies.
- The proposed restrictions for CIVs to qualify for treaty benefits do not seem applicable to SPVs issuing capital markets instruments – for example there is a requirement that the entity's "shares" are listed, when SPVs typically issue debt securities.
- The wide range of possible approaches that contracting states can choose to adopt will make it very difficult in practice for funds and SPVs to achieve a consistency of approach across jurisdictions.
- Where one of the "less generous" approaches to CIVs is adopted, funds and SPVs may have to determine their entitlement to treaty benefits by reference to their investor base. The practical implications of undertaking this sort of exercise on an ongoing basis could be considerable; and even impossible in some cases (e.g. for SPVs issuing cleared securities).

What to do next?

Given the uncertainty in how these rules will be developed and implemented, it is likely premature to take any action now. However, investment managers, investors and others who wish to prepare for the worst may wish to review change of law provisions in existing fund/deal documentation. Those structuring new deals may wish to put more focus on change of law provisions than has historically been the case.

Action 2 - hybrids

What is it all about?

The proposals are aimed at so-called "hybrid mismatch structures" - arrangements which use hybrids to:

- generate a deduction in one jurisdiction with no corresponding income recognised in the recipient's jurisdiction;
- generate deductions in two jurisdictions for the same item of expense; or
- enable multiple tax credits for one amount of foreign tax.

The proposals do not contain any kind of "purpose" or "motive" test. So financings and corporate structures that have been put in place for entirely non-tax reasons may still be caught by the rules.

The full report is here.

What will be affected?

Hybrids include *hybrid instruments* (e.g. an instrument that is treated as debt in the jurisdiction of the payer and as equity in the payee's jurisdiction), *hybrid transfers* (e.g. a repo treated for tax purposes as a collateralised loan by one jurisdiction but as an outright sale of the collateral in another), or *hybrid entities* (e.g. an entity which is treated as a taxable corporation in one jurisdiction but as tax transparent in another). The definition is broad and could even include payments for goods.

The rules apply to hybrids that are within a group (with a 25% ownership/common ownership test) or "structured arrangements" outside of a group. A structured arrangement would be one where the tax mismatch is priced into the terms of the arrangement or the arrangement has been designed to produce the mismatch. A taxpayer would not be treated as a party to a structured arrangement if it (and its group) could not reasonably have been expected to be aware of the mismatch and did not share in the tax benefit.

Who will be affected?

Whilst the proposals can impact all sectors of the economy, they will be of particular interest to:

- **Multinational groups,** particularly those with US operations or those that are held by a US parent (as the US "check the box" entity classification rules mean that hybrid entities are abundant in such groups).
- **IP holding structures or group treasury/financing structures** in corporate groups which involve hybrid entities (e.g. Dutch CV/BV structures and Luxembourg SCS/Sarl structures).
- **Issuers of hybrid regulatory capital.** The OECD notes in its paper that concerns have been raised about the implications for regulatory capital and that further investigation is required. Conclusions on this will be announced no later than September 2015.
- **Capital market and structured debt issuers** where some of the issued securities may be regarded as equity by investors (for example, subordinated debt may be regarded as debt by an issuer, but equity by a US holder).
- **Participants in the repo market,** given that the tax treatment of repos varies widely across different jurisdictions..
- **Funds.** Use of hybrid instruments and hybrid entities are comparatively common in fund structures, although the reasons will vary and the structures will often be driven by the need to accommodate the varying requirements of a diverse body of investors within a single fund.

Tax exempt entities such as pension funds should not be affected, as the rules apply only where a mismatch is generated by a hybrid and not where a recipient is generally exempt from tax. Similarly there will be no impact on entities in tax havens which are simply not subject to tax.

How will the rules apply?

The basic proposal (the "primary response") is that, in situations involving a deduction with no corresponding income, the deduction will be disallowed. For double deduction situations, the parent company would disallow a deduction (to the extent income is not recognised).

However the OECD recognises that not all jurisdictions will implement the proposals – the US, for example, is most unlikely to do so. There is therefore a proposed "defensive rule" so, for example, in the case of mismatches involving a deduction with no corresponding income, if the payer's jurisdiction does not in fact deny the deduction, then tax is imposed on the recipient.

"Indirect" hybrid mismatch structures will also be addressed so that it would not be possible to use chains of financial instruments to transfer the benefit of a hybrid mismatch that is not caught by the rules (because the jurisdictions involved have not implemented the recommendations).

Other recommendations

In addition to recommending domestic rules to neutralise the effect of hybrid mismatches, there are also specific recommendations designed to reduce the incidence of such mismatches arising in the first place. These include:

- Denial of dividend exemption for deductible distributions.
- Limiting foreign tax credits in proportion to the tax payer's net income from the arrangement.
- Better CFC-style rules to address reverse hybrid structures.
- Limitation of tax transparency where non-resident investors do not recognise income of the entity under the tax rules in their jurisdiction.
- To reduce abuse of dual-resident entities: replacing "effective place of management" residency tie-breaker provisions in treaties with a "competent authority" tie-breaker (a recommendation under Action 6) and also ensuring that treaty non-resident entities are not resident under domestic law.

The implementation of these rules will require a good deal of cooperation between jurisdictions but it is clear that the rules have been designed to be capable of implementation on a piecemeal basis. The OECD paper suggests there will be transitional rules, but that there should be no presumption of grandfathering for existing arrangements.

What should you be doing?

As the recommendations principally require changes to domestic rules, it will be difficult to analyse precise impacts on existing structures until those domestic rules begin to develop. For example, in relation to an existing structure it will be necessary to establish whether the relevant jurisdictions will implement the recommendations (will it be the primary response or the defensive rule that will apply?) and how any transitional rules would operate. So it will be some time before it is possible to assess the impact of the rules, and to restructure existing arrangements.

However we recommend that corporate groups in particular look at their existing structures to identify areas that are at risk. Given the complexity of many corporate groups this may not be a straightforward task. However, starting this assessment now will greatly assist in assessing the impact of the new rules as they develop, and beginning the task of developing strategies for how existing arrangements could be restructured.

Naturally any ongoing projects should be looked at afresh, and the cost-benefit analysis reconsidered in light of the OECD's proposals.

Funds and capital markets/structured debt issuances should in most cases not amount to "structured arrangements", as rarely will one investor hold more than 25% of the fund. However, fund managers will need to be aware of these rules and may need to make themselves more aware of the tax position of their investors than they may have been to date. This is something that will be more difficult for capital markets/structured debt issuances, where establishing the identity of investors on an ongoing basis is impracticable or even impossible – the capital markets industry will no doubt wish to discuss the practical implementation of these rules with the tax authorities in key issuer jurisdictions.

What happens next?

The OECD will refine the proposals, particularly around CIVs and the interactions between the different sets of BEPS proposals. However we anticipate that there are unlikely to be many other material changes.

The treaty abuse proposals will then be incorporated in the next OECD Model Treaty, and Action 15 contemplates a "multilateral instrument" by which States could (relatively) swiftly update their existing treaties. The hybrid proposals will need to be implemented by States directly into domestic law.

The question then is: which jurisdictions will implement the proposals, how long will that take, and how much consistency will there be between different implementations? There are no precedents, as there has never been an attempt to coordinate tax rules in this way. Those jurisdictions which have historically acted as financial centres, attracting business with favourable tax regimes, would have every incentive to not implement any of the proposals. However we would expect there to be significant pressure on such jurisdictions to comply, whether under the aegis of the OECD or the EU – or even under the threat by other States of revoking existing tax treaties.

There is also the question of whether the proposals are permitted under EU law. The treaty abuse report notes that EU law restrictions may prevent EU Member States from adopting some of the proposed approaches. The hybrid report does not mention EU law – but it seems to us that, if some Member States implement and others do not, the "defensive rule" in particular could be vulnerable to EU law challenge.

All this inevitably means uncertainty for business. For now, we advise focusing on:

- monitoring implementation;
- helping implementing authorities to understand the implications of the proposals on non-tax motivated structures;
- reviewing group structures, particularly given the complex interaction between the hybrid rules and many legacy group arrangements; and
- having regard to the proposals when documenting new funds and capital markets/structured debt issuances.

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