BEPS Action 6 – revised discussion draft on Treaty Abuse: what do the latest proposals mean for securitisations and SPVs?

The previous BEPS discussion drafts on "Treaty Abuse" proposed changes to double tax treaties which would exclude many securitisation issuers and other SPVs from treaty relief. This result appeared to be unintentional, and so we and others made representations to the OECD asking for the proposals to be modified to prevent these important sources of liquidity and funding being excluded from international markets.

The OECD responded on Friday with a revised discussion draft – however, unfortunately very little progress has been made.

This briefing summarises the latest proposals, and consider what these proposals are likely to mean in practice for SPVs and the securitisation market, and how market participants should react.

Why are these proposals being introduced?

The BEPS Project was launched by the OECD and G20 in 2013 to tackle "base erosion and profit shifting" – tax planning strategies that shift profits from high tax jurisdictions to low tax jurisdictions. The project is divided into fifteen "Actions", of which a key element is Action 6 (treaty abuse).

The key target of the Action 6 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 latest discussion draft can be found here.

What was the problem with the original Action 6 proposal?

As a compromise between OECD members with different views, Action 6 contained two separate approaches, with OECD members able to include either or both in their treaties:

- 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 principal purpose test, similar to the "main purpose" test included in the UK's recent tax treaties.

We summarised these proposals in our September BEPS briefing here.

The proposed LOB rule has the broad effect of barring treaty relief for most entities unless they can show that their ultimate beneficial owners are themselves entitled to equivalent treaty relief. The problem with this approach is that many SPVs and securitisation SPVs cannot do this, as they are owned by multiple investors and often have a very limited ability to establish the identity of their ultimate beneficial owners. Indeed for securitisation issuers, and SPVs issuing cleared notes, it is simply not possible to identify the ultimate noteholders.

It should be noted this is not a "look through" approach, permitting treaty relief to the extent the ultimate beneficiaries are themselves entitled to treaty relief. Rather, it is a rule that absolutely denies treaty relief for entities unless they can show almost all of their beneficiaries are themselves entitled to relief.

The proposed LOB had the additional problem of requiring any intermediary entities between entity claiming treaty relief and the ultimate beneficiaries to be treaty qualified. This rule would exclude, for example, many SPVs owned by sovereign wealth funds (which are generally themselves eligible for treaty relief).

We and others made representations that the rule needed to be more flexible, and the OECD responded with a number of measures that would enable regulated funds (so-called "CIV funds") to qualify under the LOB. However there were, until now, no proposals to enable other funds and special purpose entities ("non-CIVs") to qualify under the LOB. CLOs, securitisations, and SPVs will usually be classed as "non-CIVs" for this purpose.

The industry had been hoping that the revised Action 6 draft would include new exemptions or other provisions for non-CIVs. Unfortunately it does not. Indeed, it seems the practical difficulties of agreeing a workable LOB within the BEPS timeframe has led the Action 6 Working Party to adopt a new approach.

The revised proposals

The simplified LOB

Whilst development has continued on the original LOB, the Working Party is now proposing that, where a treaty includes the principal purpose test, it can include a "simplified LOB" instead of the original detailed LOB.

The idea seems to be that the terms of the simplified LOB can then be relatively speedily agreed between OECD members and incorporated into treaties by a "multilateral instrument", with remaining points of detail settled bilaterally between treaty partners and/or in subsequent OECD guidance.

The broad effect of the simplified LOB is that tax treaty benefits should only be available if the entity claiming treaty benefits is either:

- a "qualifying person" – meaning an individual, one of several specified types of state-owned entity, a publicly traded entity, or an entity at least 50% beneficially owned (directly or indirectly) by qualifying persons.
- engaged in an active conduct of a trade or business (other than the business of making or managing investments, unless the business is carried on by a bank, an insurance company, a registered securities dealer or any other institution agreed upon by the relevant Contracting States);
- owned for at least 75% (directly or indirectly) by "equivalent beneficiaries" (persons who would themselves be entitled to equivalent relief under this or another tax treaty); 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.

This approach is simpler than the original LOB proposal for three reasons.

First, there are no base erosion tests looking at (for example) whether there are arrangements so that an entity that appears to satisfy the LOB in fact passes the benefit of the income in question to non-treaty eligible persons. The rationale is that any such arrangements would fail the principal purpose test, and so the additional complexity is not justified.

Second, the references to "indirect" ownership eliminate the problems the original LOB had with intermediary entities – these can now simply be looked-through. The rationale is that any abuse of intermediary entities (e.g. by eroding the tax base) would fail the principal purpose test.

Third, there are none of the exemptions previously discussed, for example for regulated funds (and this is instead intended to be covered in guidance and/or agreement between the relevant Contracting States).

The simplicity therefore will make it more practicable for OECD members to implement the simplified LOB. However it does not assist SPVs and securitisations at all – they continue to need to identify their beneficial owners, and many securitisation issuers and other SPVs cannot do that. The only solution for such entities is to be an institution of a type agreed upon by the relevant Contracting States (so the "active conduct or a trade or business" limb applies) or for the SPV in question to obtain specific clearance.

Further developments on the original LOB

Given the developments on the simplified LOB, it is unclear whether the original LOB proposal will be taken up by more than a handful of OECD members. Nevertheless, a considerable amount of time seems to have been spent on further development on it.

The Working Party acknowledges that a large number of representations were made that the proposed LOB was unworkable for non-CIVs and states that it recognises the economic importance of these entities and the need to ensure that treaty benefits be granted "where appropriate". However some OECD members seem to be concerned that non-CIVs can be used for treaty shopping and for deferral of taxation on income. So, whilst the draft stays that the Working Party intends to discuss at its June meeting include adding a specific provision on non-CIVs to the LOB rule, we would not expect much progress to be made

One point made in the discussion draft is that is that treaty relief could potentially be claimed "through" non-CIVs if the OECD "TRACE" Project is implemented. This was a 2010 report (the "Treaty Relief and Compliance Enhancement Project") which recommended that countries develop systems to allow funds and other intermediaries to make treaty claims on behalf of multiple investors on a "pooled" basis, with a US-style withholding agent regime that allowed beneficial ownership information to be obtained by the last intermediary in the chain and passed to the relevant tax authorities. In principle such a system would be welcome. However, although the OECD subsequently endorsed a report recommending how TRACE could be implemented, it has subsequently sat on the shelf. Some of the consultation responses suggested deferring implementation of Action 6 until TRACE is implemented, but this suggestion was rejected.

There were a number of other developments on the "full" LOB:

- It was agreed that where a taxpayer requests to be permitted treaty relief notwithstanding failing the LOB then the tax authority receiving the request must process the request "expeditiously". No timeframe is given, and historic experience has been that taxpayers find it commercial difficult to invest in circumstances where their treaty position is dependent upon a process that has no fixed timetable.
- Following criticism of the requirement, mentioned above, that each intermediate owner be a resident of either Contracting State, that condition has been put in square brackets, so that some OECD members can omit it. Further discussion will take place at the June Working Party meeting.
- The full LOB may continue to be developed after the September 2015 adoption of the final report on Action 6, but the intention is that it should be finalised before the December 2016 deadline for the negotiation of the multilateral instrument implementing Action 6.

New "special tax regime" rule

The US Delegate on the Action 6 Working Party has made a new proposal to exclude entities benefiting from a "special tax regime" from treaty relief. This proposal does not form part of the LOB, but adds a new exclusion to the interest, royalties and other income articles.

The "special tax regime" concept targets regimes that result in a low effective tax rate, with limited safe harbours for pension funds, charities, regulated funds, and a few other cases. The relevant Contracting States can agree for additional classes of entity to be excluded from this rule, but it seems only if the rules in question do not result in a low effective rate of taxation (and this would therefore seem to be of very limited relevance).

On its face, this test would seem to be failed by the securitisation tax regimes in the UK, Ireland and Luxembourg, and many other jurisdictions. If implemented it could therefore bar many securitisation issuers and other SPVs from treaty relief, even if they satisfy the LOB.

The Working Party invites comments from interested parties on the proposal, and will reach a decision at its June meeting.

How likely are these proposals to be implemented?

Unless there is a considerable change of heart by the Action 6 Working Party, it seems likely that the final Action 6 proposals in September will continue to include a LOB that excludes securitisation issuers and other "non-CIV" SPVs. This will then presumably be included in the "multilateral instrument" that will be developed in late 2015 and 2016.

It seems unlikely that those OECD members that have historically recognised the importance of capital markets SPVs and securitisations would agree to bar such entities from treaty relief. If those members cannot persuade other Working Party members of their case, they will presumably either fail to sign the multilateral instrument or (more likely) seek to sign it in such a way as protects capital markets SPVs and securitisations from any adverse effects. The worst case option is that even these OECD members end up adopting the simplified LOB, and SPVs have to work within its limitations (for example by seeking specific clearances for classes of entity or even individual entities).

The position may be bleaker for SPVs that invest in OECD members that have historically looked less favourably upon SPVs and securitisations. It now seems quite plausible that these jurisdictions will end up adopting an LOB (or even the new special tax regimes rule) and so effectively exclude securitisation SPVs and others from investing in their markets.

The future looks more difficult still for SPVs that are not traditional funds or securitisation/capital markets issuers, but are privately held by persons not themselves entitled to treaty relief. In the long term we would question whether SPVs of this type will be able to access treaty relief in the majority of jurisdictions.

Next steps

The OECD has invited comments on the revised discussion draft by 17 June. We will be working with representative bodies and other clients to ensure that the Working Party is fully aware of the adverse effect these proposals will have on the securitisation market.

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