BEPS Action 6 – where do the final proposals leave the asset management industry, securitisations and capital markets SPVs?

Following the release of the OECD's final reports on Base Erosion and Profit Shifting (BEPS) on 5 October, the position of funds, securitisations and SPVs remains unclear. Some of the proposals, if adopted, would be widely disruptive to the asset management industry and capital markets – however wide adoption of the more disruptive proposals at this point seems unlikely. Market participants will now need to wait and see which of the different proposals are adopted by different jurisdictions before clarity as to their positions can be obtained.

What is it all about?

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 Action 6 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 has been proposed?

There was some disagreement amongst OECD members as to how to combat treaty shopping. Two approaches were presented in early BEPS discussion drafts:

- 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 "main purpose" test included in the UK's recent tax treaties.

We summarised these proposals in our September 2014 BEPS briefing.

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. The original Action 6 proposals contained both separate approaches with OECD members able to include either or both in their treaties.

In May 2015 a third alternative was added. The discussion draft issued by the Action 6 Working Group proposed that, where a treaty includes the principal purpose test, it can include a "simplified LOB" instead of the original detailed LOB. A description of the "simplified LOB" as set out in May 2015 can be found in our May 2015 BEPS briefing. The OECD acknowledges that further work is needed on this simplified LOB and will produce further commentary on this in early 2016. The idea seems to be that the terms of the simplified LOB can then be relatively speedily agreed between the OECD members and incorporated into treaties by a "multilateral instrument", with the remaining points of detail settled bilaterally between treaty partners and/or in subsequent OECD guidance.

The multilateral instrument

It was hoped that the October publications would give the first insights as to what the multilateral instrument would look like. Unfortunately, the Action 15 report simply confirms that the ad hoc group developing the multilateral instrument started work in May 2015 and confirms the intention to have a final form of the instrument ready for signature by 31 December 2016. As a result, we still have no insight as to how the optionality that forms part of the Action 6 recommendations will be accommodated within a single multilateral instrument.

There are several possibilities. One is that the multilateral instrument implements only those elements which are agreed by all the countries involved; however given there are 90 countries discussing the multilateral instrument, it seems unlikely there could be unanimity on many points. Another is that the multilateral instrument itself contains optionality, so that bilateral treaties are amended in accordance with those issues where both contracting parties agree (although how this would work in practice is unclear). Less ambitious would be for the multilateral instrument to simply be a framework to enable countries to amend multiple treaties by mutual agreement without needing to go through the ratification process each time.

The impact of the proposals on asset management structures, securitisations and SPVs

The Action 6 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.

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 and the simplified LOB is similar in this respect. The problem with this approach is that many SPVs cannot do this as they are owned by multiple investors and, for securitisation issuers and SPVs issuing cleared notes, it is simply not possible to identify the ultimate noteholders.

Following representations made by us and others that the LOB needed to be more flexible to accommodate such vehicles, the OECD responded with a number of measures that would enable regulated funds such as UCTIS and other mutual funds (so-called "CIV funds") to qualify under the LOB. These proposals did not, however, extend to other funds (such as private funds structured as limited partnerships who invest through investment subsidiaries) and special purpose entities ("non-CIV funds"). Private funds, CLOs, securitisations and SPVs will usually be classed as non-CIVs for this purpose.

The October final report does not include new exemptions or other provisions for non-CIVs. The OECD has stated 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 the deferral of tax on income. We understand that the OECD is continuing to give thought to this issue (and there may be further public consultation on this matter).

In order to feed into negotiations regarding the multilateral instrument, further information will be needed by early 2016.

Remaining areas of uncertainty

Accordingly, some fundamental issues are still far from clear and it is impossible to assess the impact of the proposals on the asset management industry, securitisations and capital markets SPVs until it becomes clear how the proposals will be implemented in different jurisdictions. 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 and much will turn on the operation of the multilateral instrument that will be developed over the coming year.

It seems unlikely, however, that those OECD members that have historically recognised the importance of capital markets SPVs, securitisations and funds would agree to bar such entities from treaty relief. It will be key therefore to see whether such jurisdictions (and others) either fail to sign the multilateral instrument or (more likely) seek to sign it in such a way as protects asset management structures, capital markets SPVs and securitisations from any adverse effect.

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