Client Update

Treaty Benefits in a Fund Context: Time to Agitate the Little Grey Cells

Readers, or watchers, of Agatha Christie’s *Murder on the Orient Express* will know that anything involving group action is more complex and takes time to work out. Such has been the case with the OECD’s approach to treaty benefits granted in a private equity fund context (which has been caught up in the OECD’s BEPS work around “non-CIV funds”). Sponsors and investors should take note of the OECD’s recent draft commentary on the Model Tax Convention, which contains two examples of how the OECD expects the Action 6, anti-treaty abuse rules to work in practice.

**TREATY ABUSE REFRESHER**

BEPS Action 6 is about preventing treaty abuse. This will be achieved via the inclusion in double tax treaties of:

- a clear statement that the treaty’s aim is the prevention of tax avoidance; and
- some combination of a limitation on benefits (“LoB”) rule and/or principal purpose test (“PPT”).

Very broadly, the LoB seeks to limit treaty benefits to “good” investors resident in the relevant treaty state (such as individuals, listed companies and persons beneficially owned by “good” people). The PPT prevents treaty benefits’ applying where one of the principal purposes of the transaction or arrangement is to obtain such treaty benefits.

**ACTION 6 AND PRIVATE EQUITY FUNDS**

Action 6 divides the world between CIV funds and non-CIV funds. Broadly, the OECD treats as a CIV a fund that is widely held, holds a diversified portfolio of securities and is subject to investor protection regulation. Most private equity funds will be non-CIV funds.

The OECD has been struggling to work out how the proposed anti-abuse provisions apply to non-CIV funds, and, perhaps more importantly, how it would like them to apply. The OECD has identified two specific concerns: “that non-CIV funds may be used to provide treaty benefits to
investors that are not themselves entitled to treaty benefits, and that investors may defer recognition of income on which treaty benefits have been granted.”

In March 2016, the OECD published a consultation document on the treaty entitlement of non-CIV funds. The LoB—or to give it the apt acronym coined by the multilateral instrument, the SLoB (simplified limitation on benefits)—is technically an easy test to apply because it is mechanical. All a non-CIV fund (or, if the fund is transparent, the underlying holding company) needs to do is trace through to the fund’s beneficial owners and identify whether 75% (the threshold set in the SLoB) are “good” investors. American readers will recognise this approach because funds investing in the United States are already required to identify the withholding tax status of all of their investors. However, if a fund has to collect tax forms for all of its investors for all jurisdictions in which it invests, the administrative burden is potentially phenomenal.

Most European countries, the United Kingdom included, have indicated that they are not inclined to adopt the SLoB, preferring instead the PPT. The PPT is not without its difficulties. Entirely subjective and open to widely differing interpretations, the PPT potentially creates an environment of uncertainty. Accepting these difficulties, in January 2017 the OECD published for comment three examples of how the PPT will apply to non-CIV funds. On 11 July 2017, the OECD published a Draft 2017 Update to the OECD Model Tax Convention (the “Draft Update”). The Draft Update includes the three examples (Examples K, L and M) from the January paper, with slight modifications. Two examples are relevant to private equity funds.

THE REGIONAL INVESTMENT PLATFORM EXAMPLE

- Fund is an institutional investor, tax resident in State T.
- Master HoldCo is subject to tax and regulation in State R.
- Master HoldCo is a regional investment platform holding a diverse portfolio.
- Master HoldCo employs a local team of managers to review investment recommendations from the Fund and also performs various other functions such as monitoring investments, treasury functions, maintaining books and records and ensuring compliance.
- State R was chosen due to the availability of knowledgeable directors and a skilled workforce, State R’s membership of a regional grouping (we assume the European Union is behind this reference), and its extensive treaty network.
• In reviewing its investment, Master HoldCo considers the existence of a benefit under the State R/State S tax treaty (5% withholding in contrast to 10% withholding between State S and State T or 30% where there is no treaty in place). The OECD concludes that “this alone would not be sufficient to trigger the application of [the PPT].” Instead, “it is necessary to consider the context in which the investment was made, including the reasons for establishing [Master HoldCo] in State R and the investment functions and other activities carried out in state R.” Overall the OECD concludes that, absent additional facts, this example would not fall foul of the PPT.

ANALYSIS

Reduced Withholding Tax Permitted

Sponsors (and investors) should take some comfort from the OECD’s comments that the existence of a tax benefit alone is not enough to trigger the PPT. The OECD goes so far as to confirm that “[t]he intent of tax treaties is to provide benefits to encourage cross-border investment…” This statement is backed up with the investor benefiting from a 5% withholding tax rate instead of a 10% withholding tax rate if the investment was made directly.

What about Funds that are Structured as Partnerships?

The glaring issue for many private equity funds is the fact that the fund in this example is an opaque vehicle that is tax resident in State T, whereas the majority of funds are structured as partnerships, and therefore not resident anywhere for tax treaty purposes. This point was made by a number of respondents when the examples were introduced earlier this year and yet no amendment has been made.

It’s worth noting the principles underlying the example also seem to apply to a tax transparent fund that holds its investments through one or more treaty holding companies that have local substance that is consistent with the facts of the example. Funds with a master holding company would be particularly well positioned from this perspective.

Management Team

The management team is employed by Master HoldCo in the example, so one is left wondering whether the holding company must employ its own management team, or whether it would be sufficient for it to engage a team from the fund manager or another affiliate.

REAL ESTATE FUND EXAMPLE

• Real estate fund is fiscally transparent with a range of institutional investors from various jurisdictions.
- Real estate fund manages all of its investments via Master HoldCo. Investments are held indirectly through local holding companies. Local holding companies are funded by debt/equity from Master HoldCo.

- Each state invested into is allowed to tax the income derived directly from such investments.

- Master HoldCo is established “for a number of commercial and legal reasons,” including to shield the fund from liabilities, to facilitate third-party borrowing and because applying for treaty clearances through one body is administratively easier.

- The fund reviews a number of jurisdictions but settles on State R due to its political stability, its regulatory and legal systems, lender and investor familiarity, access to personnel and its extensive tax treaty network.

- Master HoldCo “does not obtain treaty benefits that are better than the benefits to which its investors would have been entitled if they had made the same investment directly.” Unsurprisingly, the OECD concludes that “it would not be reasonable to deny the benefit of the tax treaties.”

ANALYSIS

Application Beyond Real Estate

This example has been amended slightly from the version published in January this year with the addition of the local holding companies and the reference to such holding companies being financed by Master HoldCo. With the updated facts, it is now clear that the treaty benefits relate to dividends and interest payments made by the local holding companies to Master HoldCo. The insertion of the local holding companies also widens the scope of the example significantly so that the example should apply whatever the asset class ultimately invested in. The changes are therefore very welcome.

Substance

The regional investment platform example above sets out a pattern for a heavily substance-based holding company jurisdiction. Indeed, the substance in the investment platform jurisdiction was increased in the latest version of the examples when compared to their January iteration (monitoring of investments is a new addition). The real estate fund example offers a lighter approach to substance, with the Master HoldCo performing a more legal role and undertaking administrative functions rather than people-intensive activities such as monitoring investments. Sponsors should take comfort from the fact that a full, experienced management team does not necessarily need to be in place to comply with the PPT.
Treaty Benefits Compared to Direct Investment

The value of this example is significantly negated by the fact that Master HoldCo puts the investors in no better position than if they each invested directly, suggesting that some degree of investor analysis will be required to rely on the example. If this is the case the PPT essentially gets moved into the same place as the LoB with its associated administrative issues. To be of real use to the private equity industry, the example would ideally include a mixture of “good” and “bad” investors, reflecting the reality of many situations. However, if the regional platform example and the real estate fund examples are read in conjunction, we may derive some comfort that some flexibility will be permitted here. In the regional investment platform example the institutional investor was after all, permitted to reduce its withholding tax rate by investing through the Master HoldCo.

Similarly, the restriction to institutional investors is an unhelpful detail in the example. Would a single high-net-worth individual holding a small interest disqualify the whole fund? Based on the regional investment platform example, our view is that this should not be the case but that each fund will need to be considered on its facts.

PRACTICAL IMPACT

The Action 6 train is currently between stations. The examples have been published, they have been tweaked and we now await final approval from the OECD and, more importantly, market practice for how the examples will be applied.

Sponsors who have not done so already should take a serious look at their holding jurisdictions and consider:

- why they were chosen;
- what substance they have;
- what function they perform; and
- what treaty benefits are obtained.

For new investments, we recommend that sponsors document the considerations factored in when choosing a holding company jurisdiction.

The big difficulty is going to be applying these examples in real life; in many cases the fact patterns will be a mixture of the two examples but with significant divergences. In such cases significant judgment calls will need to be made and risk appetite measured. We will all need to take heed of Hercule Poirot’s approach when facing the murder on the Orient Express: “Lie back and think—use . . . the little grey cells of the mind.”

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Please do not hesitate to contact us with any questions.

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