Debevoise & Plimpton

Analysis - BEPS Action 6 and Private Equity Funds

Speed read: Since BEPS Action 6 was introduced, the OECD and the private equity industry have been grappling with how to apply anti-treaty abuse provisions to private equity fund structures. The OECD is concerned that private equity funds may be used by investors to achieve better treaty results than direct investments would achieve. After representations from the industry, the OECD has accepted that special provision needs to be made for private equity funds and on 6 January 2017 published examples designed to assist the industry. Unfortunately, the examples are not as helpful as they first appear and leave many unanswered questions.

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 is the case with the OECD's approach to non-collective investment vehicle funds (non-CIV funds) and their interaction with the BEPS Action 6 on preventing the granting of treaty benefits in inappropriate circumstances.

Action 6 refresher

Action 6, as set out by Michael McGowan and Andrew Thomson ('BEPS: preventing treaty abuse', *Tax Journal*, 31 October 2015), 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 'goodies' resident in the relevant treaty state (such as individuals, listed companies, and persons beneficially owned by 'goodies'). The PPT prevents treaty benefits applying where the principal purpose of the transaction or arrangement is to obtain such treaty benefits.

Unhelpfully, the phrase 'non-CIV fund' is not defined; therefore, its meaning needs to be deduced as a fund that is not a CIV. Broadly, the OECD treats a CIV as a fund that is widely held, holds a diversified portfolio of securities and is subject to investor protection regulation. For the purposes of this article, we are going to take non-CIV fund to mean a private equity fund: an unregulated, closed ended, collective investment scheme, typically structured as a limited partnership with a regulated investment manager.

Action 6 and non-CIV funds

With the role of Hercule Poirot played by Pascal Saint-Amans, the OECD has been agitating its grey cells 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. Just like in *Murder on the Orient Express*, the harm is easy to identify: tax avoidance (the tax world's equivalent to murder).

In less dramatic terms, the OECD's report identifies 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'.

The optimistic timetable governing the BEPS project meant that there was not time to solve the puzzle before publishing the final report on Action 6 in October 2015. Instead, the report was published with a reservation stating that further work was required on non-CIV funds.

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 'goodies'.

American readers will recognise this approach because funds investing in the US are already required to identify the withholding tax status of all of their investors. Factor in fund of fund investors and the tracing exercise may be enormous: we have seen nearly 1,000 pages of US withholding tax forms for one investor alone. 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. Despite accepting these administrative issues, the OECD has declined to include non-CIV funds in the definition of 'goodies' for the purposes of the SLoB, concluding in its most recent discussion paper that 'few non-CIV funds would fail to qualify for treaty benefits under the [SLoB]'.

It is therefore with some relief that most European countries, the UK 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, the OECD has proposed including practical examples of how the PPT will apply to non-CIV funds and in March 2016 asked interested parties to submit such examples. The discussion paper issued on 6 January 2017 (www.bit.ly/2jAYGpp) is an update to this request.

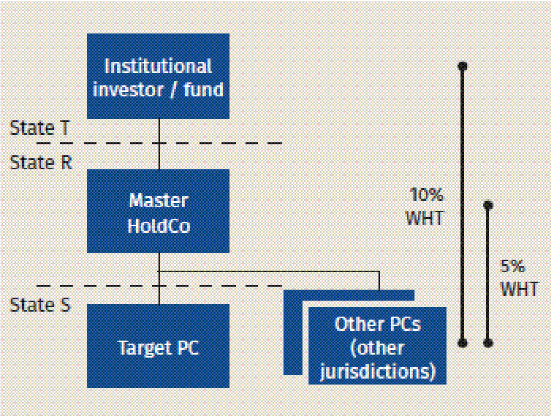
Discussion draft on non-CIV examples

The OECD discussion draft contains three proposed examples, one of which seems irrelevant to private equity funds because it relates to securitisation vehicles. The number of examples is fairly disappointing. Many in the industry will feel that the difficulty in applying the PPT to a non-CIV fund, and the breadth of arrangements potentially falling within the non-CIV fund bucket, justify additional examples.

Pre-empting this response, the OECD states that there are currently 10 examples provided in the Commentary on the PPT (para 14, for those interested), meaning that any more than three non-CIV specific examples would be inappropriate. In terms of how it selected the examples, the OECD admits that it rejected all 50 examples received in response to its request for examples because they were 'too long, too specific or too controversial for inclusion'.

Shunning controversy and length, the OECD has produced two unhelpfully specific examples relevant to the funds industry, which make the prospect of practical application daunting. We are aware that many respondents to the OECD's paper have made this comment; and have asked that a generalised statement be made that the examples are purely illustrative and neither reflect all of the relevant considerations nor specify a fixed definition of a safe harbour.

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. It employs a local team of investment managers.
- State R was chosen due to the availability of knowledgeable directors, skilled workforce, State R's membership of a regional grouping and use of regional currency, 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). 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 [MasterCo] in State R and the investment functions and other activities carried out in State R'.

Concerns with this example

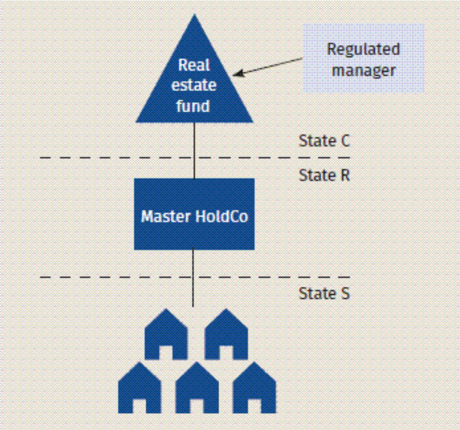
The glaring issue for many private equity funds is the fact that the fund is an opaque vehicle that is tax resident in State T, whereas the majority of funds are structured as partnerships, and therefore not resident anywhere for tax treaty purposes. Without amendment, this example appears irrelevant to many private equity funds.

Assuming that the example may be interpreted to apply to fiscally transparent funds, the next issue is that there is only one investor, an institutional investor. The OECD does not clarify what it means by institutional investor but later comments suggest that it includes sovereign wealth funds and pension funds.

Moving down the structure, although many funds invest through a master holding company, many have a separate holding company for each investment. One of the considerations that this example seems to rely on in its conclusion is the fact that Master HoldCo holds a number of investments in a variety of jurisdictions. Given that the real estate example (discussed below) also includes a single holding company, funds with multiple holding company structures may be feeling a little uncomfortable.

Finally, 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.

Immovable property non-CIV fund example



- Real estate fund is fiscally transparent with a range of institutional investors from various jurisdictions.
- Real estate fund invests in real estate via Master HoldCo.
- Master HoldCo is established 'for a number of commercial and legal reasons', including to shield the real estate fund from liabilities, to facilitate third-party borrowing and because applying for treaty clearances through one body is administratively easier.
- Real estate 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 the extensive tax treaty network.
- State S is 'allowed to tax the income derived directly from such investments'.
- 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'.

Concerns with this example

This is a somewhat odd example for the OECD to choose because, unlike the case in other asset classes, taxing rights relating to real estate are typically vested in the country where such real estate is located. It is therefore not entirely clear what treaty benefits Master HoldCo (or indeed the ultimate investors) will be obtaining. Assuming, however, that there are benefits, the value of this example is negated by the fact that Master HoldCo puts the investors in no stronger position than if they each invested directly. To be of use to the private equity industry, the example needs to include a mixture of 'goodie' and 'baddie' investors reflecting the reality of many situations. Similarly, the restriction to institutional investors is unhelpful. Would a single high net worth individual holding a small interest disqualify the whole fund?

Practical impact

The Action 6 train is currently between stations. The examples have been published, feedback has been submitted and we await the OECD's determination. Private equity funds should take comfort from the fact that no country is yet applying the new PPT and so there is still time. The examples are not especially helpful, but they do highlight that, as with so much that is BEPS related, substance is increasingly important. If they have not done so already, we recommend that private equity funds take a serious look at what substance they have in their holding jurisdictions; and, for new investments, to document the considerations factored in when choosing a holding company jurisdiction.

If the examples are left as drafted, we will all need to take heed of 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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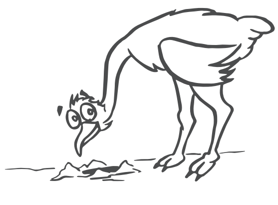

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