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Comments on Discussion Draft on Follow Up Work on BEPS Action 6: Preventing Treaty Abuse

Dear Ms. De Ruiter:

EY appreciates the opportunity to submit these comments to the OECD on the public discussion draft of follow-up work relating to BEPS Action 6: Preventing Treaty Abuse, released November 21, 2014 (Discussion Draft). The Discussion Draft follows the report on Action 6 released by the OECD in September 2014 (September 2014 Report).

The OECD's work on the Model Tax Convention and the related Commentary has been critically important to the ongoing expansion of the global network of bilateral tax treaties. These tax treaties serve to reduce or eliminate double taxation, which unrelieved would be a significant barrier to cross-border trade and investment. We recognize the need to protect against the granting of tax treaty benefits in inappropriate circumstances. At the same time, it is critically important to ensure that tax treaty benefits are granted in appropriate circumstances. It is vital that the OECD strike a proper balance between the two principles and we encourage the OECD to take the appropriate time that such proper balance warrants, even if this means extending the September 2015 deadline.

This submission by EY will provide some general comments on a selection of the issues identified in the Discussion Draft.

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I. Treaty entitlement of Collective Investment Vehicles (CIVs) and non-CIVs

EY welcomes the decision that additional work must be done with respect to treaty entitlement of CIVs and non-CIVs. We would propose that the OECD evaluates these issues outside of the timeline that has been established for the work related to the BEPS Action Items (i.e., September 2015). Considering that it took a significant amount of time to complete the work related to the report entitled "*The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*", issued in 2010 (the "2010 Report"), and that further work must be done to fully evaluate the issues related to CIVs and non-CIVs, it is not realistic to expect that this work may be completed by September 2015. For purposes of the 2010 Report (and the discussion below), a CIV is defined as a vehicle that is widely-held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established. Until further study of these issues may be undertaken, we would suggest that any new provisions not adversely affect CIVs and non-CIVs, and that the OECD acknowledge and continue to support the recommendations made in the 2010 Report.

According to the September 2014 Report, countries should adopt a minimum standard in order to eliminate treaty shopping, which may be implemented in various ways. For example, this report provides that the standard may be met by including (i) a principal purpose test (PPT) rule, (ii) a combination of the PPT and limitations on benefits (LOB) rules, or (iii) the LOB rule supplemented by a mechanism (such as a restricted PPT rule applicable to conduit financing arrangements or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties. Therefore, it is possible that countries will decide to eliminate treaty shopping in different ways. In making any recommendations in connection with treaty entitlement for CIVs and non-CIVs, we urge the OECD to consider and address how those recommended rules would work in relation to applying a LOB test, or a PPT test, or both.

Future work undertaken in this area must take account of the changes in the industry, the motivation to invest in CIVs and non-CIVs, and regulatory restrictions that exist in certain jurisdictions. For example, since the 2010 Report was published, investment in mutual fund assets alone has increased to almost US$30 trillion.[1] A large portion of investors in CIVs and non-CIVs are individuals and institutional investors, which is not surprising given the growing need to self-fund retirement and provide for pension benefits. Further, there is a developing trend across the industry of product rationalization resulting in the proliferation of CIVs being sold outside their domestic jurisdiction to a wide and diverse range of investors. Within the EU, the UCITS Directive is well established and provides a common regulatory framework for CIVs

[1] ICI 2014 Fact Book, http://www.ici.org/pdf/2014_factbook.pdf.

that are sold on a pan-European basis. Similarly, this trend is reflected outside in the EU, particularly in Asia where the recently developed ASEAN CIS fund passport mechanism and the Hong Kong/China mutual fund recognition platform provide further examples of efforts made by governments to increase the availability of financial products to citizens and facilitate cross border investment.

Governments therefore recognize the importance of CIVs in terms of facilitating retirement security and certainly did not envisage that treaty benefits might be called into question as a result of changes made pursuant to BEPS Action 6. Investors in CIVs and non-CIVs generally are not seeking tax advantages from investing through those vehicles and therefore, there should not be BEPS concerns. Rather, investors are motivated to invest because they may pool their funds and benefit from reduced costs and economies of scale as well as the market experience of professionally managed funds. Moreover, the 2010 Report acknowledges the benefits of investing in this way to diversify risk across international markets. At the same time, in providing options for guidance on treaty entitlement for CIVs, the 2010 Report acknowledges the goal of trying to achieve neutrality in the international context such that the tax treatment for the investor should be the same whether the investor invested directly or through the CIV.

In order for institutional investors to satisfy a comprehensive asset allocation so that risk may be properly hedged, those investors invest in asset classes beyond securities. In some countries the term “securities” is defined as debt instruments. We assume that OECD will include stock in such definition and we suggest that the definition also include options, warrants and other equity derivative products. Pension and charitable funds often must invest a small portion of their funds in alternative investments such as commodities, derivatives and foreign exchange; investments which require specialized management and investment skills. Many CIVs with institutional investors have been formed for the purpose of investing in such alternative CIVs.

In addition, it is not uncommon for a small number of institutional investors to come together to pool their investments. As such, the guidance related to treaty entitlement contained within the 2010 Report would not cover these types of investments because that report defined a CIV as a vehicle that is widely-held, and holds a diversified portfolio of securities. Yet, a significant portion of the investors in these so-called non-CIVs or alternative funds are institutional investors (including public and private pensions, university endowment funds, health care endowment funds and other charitable investment funds) that are resident and tax exempt in treaty countries. Future work should consider these types of circumstances recognizing that the principle of neutrality is equally important with respect to investments in non-CIVs.

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Considering that industry practice generally seeks to diversify risk across international markets, and that governments are increasingly facilitating such cross-border investment, qualifying CIVs and non-CIVs for treaty benefits should take account of the beneficial interests held by equivalent beneficiaries. Future work in this area should consider setting a threshold of ownership by equivalent beneficiaries above which benefits would be provided with respect to all income received by the CIV or non-CIV.[2] An appropriate ownership threshold would protect against treaty shopping. Consideration should be given to providing proportionate treaty benefits in cases where this ownership threshold is not met. A practical and reliable approach of determining the extent to which the beneficial interests in the CIV or non-CIV are owned by equivalent beneficiaries could be established and agreed to.

It will also be important that any future recommendations made with respect to treaty entitlement of CIVs and non-CIVs in the context of the PPT take account of the commercial realities in connection with investing in such vehicles. Currently, the September 2014 Report includes an example in relation to the PPT in which the majority of the investors are residents of the country where the CIV is established. However, as noted above, many investors diversify risk across international markets. Moreover, the example makes no mention of the many non-tax reasons to invest through such a vehicle (such as pooling capital, cost efficiencies, diversification of risk, professional investment management, etc.), which would be important to evaluate in the context of applying a PPT because those non-tax reasons generally outweigh any tax motivated purpose in this particular context.

II. Issues related to the PPT rule

As noted above, EY recognizes the concern on the part of many governments in relation to treaty abuse and the desire to have a set of rules in place in order to prevent double non-taxation and eliminate treaty shopping. At the same time however, it is necessary to strike a balance so that treaty benefits are available in all appropriate circumstances. Tax treaties play a key role in facilitating international trade and investment including by preventing double taxation of cross-border transactions. It is therefore, imperative that any proposed changes with respect to

[2] Future work would also have to take account of the prior resolution of the issues relating to CIVs and their treatment as a person that is a resident of a contracting state and beneficial owner of the income received. The 2010 Report defined the term "equivalent beneficiary" as a resident of the Contracting State in which the CIV is established, and a resident of any other State with which the Contracting State in which the income arises has an income tax convention that provides for effective and comprehensive information exchange who would, if he received the particular item of income for which benefits are being claimed under the particular Convention, be entitled under that convention, or under the domestic law of the Contracting State in which the income arises, to a rate of tax with respect to that item of income that is at least as low as the rate claimed under the particular Convention by the CIV with respect to that item of income.

treaty entitlement as a result of the work related to BEPS are well understood because uncertainty regarding the availability of treaty benefits would seriously undermine the role of tax treaties and the function they are intended to perform and would impede cross-border commerce.

As noted above, the September 2014 Report provides, in part, that countries should adopt a minimum standard to eliminate treaty shopping and suggests that one of the ways to meet that standard would be to implement a PPT in the tax treaty. The PPT rule in the September 2014 Report provides that:

> *Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital 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 this Convention.*

This test is vague and would add uncertainty to the treaty by introducing a subjective standard that would be difficult to evaluate and administer in practice because it is dependent on the intent of the taxpayer. Such uncertainty would interfere with how tax treaties function because business, pension entities and charitable organizations would have significantly less certainty about whether they qualify for benefits of a treaty until after the fact, potentially long after the fact. Many pension and endowment fund administrators or trustees are subject to fiduciary duties. They are charged with preserving the assets of the fund and they usually consider the tax effects of their investments including the fact that that the CIV will or will not qualify for treaty benefits. It is not the predominate consideration but some countries could treat such prudent investor tax planning as "one of the principal purposes of the arrangement".

We urge the OECD to eliminate such a subjective test or to make modifications to the test to make it more practical and to reduce the uncertainty. For example, where a transaction would have been undertaken for commercial reasons, notwithstanding whether a treaty benefit might be applicable, the PPT should not be applicable. The OECD should consider ways that taxpayers may demonstrate, through objective means, that they would have entered the arrangement absent the treaty benefit. In such cases, the PPT should not apply.

For example, assuming that a taxpayer seeking treaty benefits with respect to an item of income may demonstrate that they beneficially own the income and meet the base eroding prong of a derivative benefits test, and that the ultimate owner in the chain of ownership is a resident of a country entitled to treaty benefits that give a rate of tax at least as low as the rate applicable with respect to the income received by the beneficial owner, the OECD should consider a rule

that confirms that the PPT rule would not apply in these circumstances. In this case, the ultimate owner in the chain of ownership is a resident of a country, entitled to all of the benefits of a comprehensive tax treaty, and would have been entitled to a rate of tax with respect to a particular class of income that is at least as low as the rate applicable with respect to the income received by the payee. Concerns about double non-taxation as a result of the intermediate owners could be alleviated by focusing on other anti-treaty abuse rules. For example, in order to qualify for treaty benefits, the income must be beneficially owned by the payee. Moreover, applying the base eroding prong of a derivative benefits test would protect against concerns about base eroding payments to persons that are not qualified residents for treaty purposes.

In addition, active engagement in a trade or business in a country should suffice for treaty qualification purposes without being concerned that treaty benefits may be denied pursuant to a PPT. Such activity presumably demonstrates sufficient nexus to a particular country and commercial reasons for locating there. Thus, if the payee is a resident of a treaty county and is actively engaged in the active conduct of a business in that country, treaty benefits should be applicable with respect to items of income that are connected with that trade or business, and the PPT should not apply.

Where a country wishes to deny treaty benefits based on a PPT or a domestic general anti-avoidance rule (GAAR), there should be special procedures in place to evaluate that denial of benefits. EY welcomes the suggestion that countries consider establishing some form of administrative process to ensure that the PPT is only applied after approval at a senior level. In this regard, the OECD should propose that the application of the PPT or domestic GAAR to deny treaty benefits should be subject to review by the Competent Authority and that the denial of treaty benefits be subject to mandatory consultation between the Competent Authorities of the two jurisdictions. Finally, the application of the PPT rule should be subject to mutual agreement procedure (MAP) and arbitration under Article 25.

III. Issues related to the Limitation on Benefits Test

Derivative Benefits

The inclusion of a derivative benefits test that allows consideration of comparable benefits under a third-country treaty is essential to the functioning of an LOB provision. Moreover, such a rule would take account of the commercial realities and global nature of business today.

As currently drafted however, the derivative benefits test is too restrictive because it would require that each intermediate owner be an equivalent beneficiary. The Discussion Draft requests comments on possible changes that could be made to this rule to strike a balance

between preventing BEPS and providing treaty benefits in cases where intermediate companies are used for valid commercial reasons.

Rather than requiring that each intermediate owner be an equivalent beneficiary, as discussed above, concerns about double non-taxation as a result of the intermediate owners could be alleviated by focusing on other anti-treaty abuse rules. For example, in order to obtain treaty benefits, there is a requirement that the income received be beneficially owned by the payee. Moreover, the application of the base eroding prong of the derivative benefits test would protect against income stripping to persons that are not qualified residents for treaty purposes.

To bolster the beneficial ownership rules and anti-base eroding rules, and further protect against concerns of treaty shopping through a derivative benefits rule, the OECD could consider modifying that rule to include an anti-conduit component such as the anti-conduit rule proposed in the September 2014 Report. Specifically, consideration could be given to limiting treaty benefits in cases where there is a transaction or series of transactions that are structured as part of a conduit arrangement whereby the payee pays all or substantially all of the income to persons that would not have been entitled to treaty benefits. Such a rule should ensure that the inclusion of a derivative benefits test would not raise BEPS concerns.

As indicated above, having an objective set of criteria to evaluate when determining whether treaty benefits are applicable is critically important. Also important however, is the ability to seek discretionary relief when the objective criteria may not met but the relevant facts and circumstances illustrate that the establishment, acquisition or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of treaty benefits.

Publicly-listed entity provision

Becoming a publicly-listed entity is quite a lengthy and expensive process that requires several steps including drafting the registration statement, conducting due diligence, waiting for and obtaining regulatory approval, conducting syndication and "road shows", determining price and finally making the public offering. Any delay or significant hurdles encountered during the process can have a significant impact on the timing of the IPO. As a result, companies do not tend to acquire or give up their status as a publicly-listed entity very easily, and it would not be realistic for companies to consider qualification for the publicly-listed entity provision as a motivation for the timing of an IPO. Given the complexity associated with obtaining this status, and the safeguards against treaty shopping, the OECD should consider providing a rule that would treat the entity as a qualified person for purposes of claiming treaty benefits even when the corporation would meet the publicly-listed entity provision for less than a full taxable year.

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Active Trade or Business

Consideration should be given to adding a safe harbor to measure substantiality in the active trade or business test in the LOB provision. The U.S. has included such a safe harbor in some treaties and such a rule could be helpful in lending more certainty and clarity to the active trade or business test. Under this test, the trade or business of the income recipient could be deemed to be substantial based on three ratios that compare the size of the recipient's activities to those conducted in the payor State. The three ratios compare: (i) the value of the assets in the recipient's State to the assets used in the payor State; (ii) the gross income derived in the recipient's State to the gross income derived in the other State; and (iii) the payroll expense in the recipient's State to the payroll expense in the other State. In one of the older U.S. tax treaties, the safe harbor provided that the average of the three ratios with respect to the preceding taxable year must exceed 10 percent, and each individual ratio must exceed 7.5 percent. A similar safe harbor could be considered in order to provide more certainty regarding the application of this provision.

IV. Concluding remarks

If you have questions or would like further information on any of the points discussed above, please contact Barbara Angus (barbara.angus@ey.com) or me (alex.postma@uk.ey.com).

Yours sincerely

On behalf of EY

Alex Postma