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## ***OECD discussion drafts on treaty abuse and hybrid arrangements may impact private equity arrangements***

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### ***In brief***

The OECD released draft reports between March 14, 2014 and March 19, 2014 as part of the Base Erosion and Profit Shifting program (BEPS Action Plan) that call for substantial changes to domestic tax rules, double taxation agreements, and amendments to the OECD Model Tax Convention and Commentary. If the recommendations are widely adopted they will have a significant and fundamental impact on many private equity arrangements, in particular those traditionally used to facilitate international investment.

Some key proposals coming out of the individual OECD reports are:

- restricting the benefits of tax treaties very substantially by new anti-abuse measures and by limiting benefits to only public companies, pension funds and other persons in limited circumstances under a 'US style' Limitation on Benefits (LoB) clause
- more generally preventing the double non taxation of income using tax treaties and/or differences between domestic legislation across international borders
- eliminating circumstances where expenses are deductible more than once or where income is exempt from tax in one country yet is deductible in another, in particular due to the misuse of participation exemption regimes
- denying deductions in range of circumstances, including those involving non-related parties where there is an 'avoidance arrangement'
- introducing further tax filing and information reporting requirements on a potentially large number of intermediary entities utilised by offshore funds

The recommendations will undoubtedly reduce treaty abuse, but also create significant uncertainty for international investment. Given that tax treaties play such a critical role in removing barriers and costs of cross-border investment, the primary concern with these OECD proposals is that their focus on

combating treaty shopping will have a disproportionate impact on cross-border activity. The inclusion of LoB clauses as drafted would risk removing the benefit of tax treaties for a wide range of international investors simply on the basis of the ownership structure, even where no treaty abuse is evident. The recommendations may also inadvertently or otherwise, create situations where so called dry income and gains may be taxed in advance of real returns to investors and so require substantial restructuring of the holding of investments.

Whilst the reports are at this stage discussion documents, the time given to public consultation is extremely limited given the complexity and magnitude of the recommendations.

Written responses on the Action Point 6: Preventing the granting of treaty benefits in inappropriate circumstances are requested by April 9, 2014. A public consultation is scheduled for April 14/15, 2014 but those attending and those wishing to speak will have to be invited to do so, following an application to be received by the OECD by April 3, 2014.

Written responses on the Action Point 2: Neutralise the effects of hybrid mismatch arrangements are requested by May 2, 2014. A public consultation is scheduled for May 15, 2014 but those attending and those wishing to speak will have to be invited to do so, following an application to be received by the OECD by May 2, 2014.

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## ***In detail***

A consistent element in the tax policy of most countries is the desire to encourage economic growth and to attract capital investment. Many countries have adopted policies that conclude that so long as the level of debt, and rate of interest thereon, do not exceed arm's length rates in accordance with the defined OECD principles, no other limitation of interest deduction is necessary. Accordingly the linkage of the proposals in this report with the working party reporting on interest payments resulting in base erosion will be critically important.

It would appear that the greatest risk for private equity investors and managers in the documents so far relate to the potential for severe curtailment of treaty benefits, leading to significant increases in taxation as a result of withholding taxes that are either not fully creditable within existing structures or an additional burden on tax exempt investors. Given the complexity and scale of the issues, the accelerated time line for consultation means there is limited scope for the ability to address the

range of issues within the time allowed.

In the context of hybrids, many countries have already adopted a domestic version of the proposed rules. These countries include the United Kingdom, Germany, Sweden, Denmark, Mexico, France, Australia and the Netherlands. Consistency of the tax environment is critical to the availability of cross border funding that is so conducive to sustainable economic growth.

The ultimate test of success of the OECD recommendation in these (and to an extent the forthcoming BEPS Action Plan discussion papers) will be the extent to which the new changes proposed are adopted broadly. An equally important test of success for the OECD recommendations will be the consistency of the rules adopted on a domestic basis. Each of the countries referred to above has adopted different approaches to the issue at hand. For example, the United Kingdom includes a domestic tax purpose test which is in apparent conflict with the proposals suggested.

## ***Treaty benefits in more detail***

Treaty abuse, and in particular treaty shopping, is one of the most important sources of concern in relation to BEPS. The key messages from the OECD discussion draft are:

- double non-taxation is to be countered by tight treaty anti-abuse clauses
- taxing rights under domestic laws aim to restore source country taxation (broadly meaning withholding taxes), where appropriate
- mechanics for relief of double taxation to be built into resident country taxation

The relevant part of the BEPS Action Plan reads as follows:

*Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be*

*used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.*

### **Limitation on benefits provision**

The discussion draft recommends the inclusion in tax treaties of a specific anti-abuse rule based on LoB provisions. The detailed proposals appear to be based on the approach currently adopted in a number of US treaties.

This provision would effectively restrict treaty benefits to certain residents being:

- individuals
- public companies
- pension funds
- entities qualified under a ownership/base erosion test
- those engaged in a relevant active trade or business in both countries or otherwise approved by the respective competent authorities

The draft does not include a recommendation for a 'derivative benefits' clause on the grounds that this provides an element of risk for treaty abuse. A derivative benefits provision would mean that if a non-qualifying treaty resident is owned by parties which would themselves be eligible to the benefits of the treaty or another treaty with no less favourable terms, then the treaty may still apply. However, the OECD does ask for comments and examples to help in arriving at a final decision on whether such a clause should be included.

### **Observations**

Restricting the qualification for treaty benefits to the list of residents on these objective ownership/activity conditions above would, as a practical matter, serve to exclude many private equity international holding companies. The ownership and active business tests are also open to differing interpretations and the Commentary promised in the OECD discussion draft will need to be crafted with some care to reduce the risk of widespread uncertainty leading to an adverse impact on international investment.

Whilst a competent authority process is one of the recommendations and so may theoretically be available to ultimately obtain treaty benefits, as a practical matter this is often a lengthy, time consuming process with uncertain outcomes. A derivative benefits clause, even if it were to be ultimately included, may also not provide significant assistance to many international private equity arrangements.

### **Main purpose or general anti-abuse rule**

To address other forms of treaty abuse, a further general anti-avoidance provision is recommended in addition to the entitlement to benefits clause. This would aim to capture avoidance arrangements that are unrelated to the ownership or activity of the resident, such as conduits. The overriding principle of such a provision is that tax benefits should not be available where one of the main purposes is securing a treaty benefit. The draft includes a limited number of examples and detailed Commentary will be produced on how such main purpose/ anti-abuse rule should operate. However, benefit is widely defined as including any limitation in the amount of tax due to one of the Contracting States.

### **Observations**

This test would appear to be more closely aligned to the main aims stated in the 2013 Action Plan. The concern relating to this new main purpose rule is the high degree of uncertainty due to its apparent breadth of its scope and it will be critical that future Commentary provides more clarity on the practical application of these proposals and the 'burden of proof' as to purpose.

It should also be noted that many countries already have a general anti-avoidance rule (GAAR) which often extends to nullify treaty benefits under domestic law. Further, such domestic law may have a 'dominant purpose' test, whereas the proposed rule simply has a 'one of the main purposes' test.

While we recognise there are reasons to support additional restrictions on the benefits available under tax treaties, the recommendations risk being overly protective and may go so far as to discourage legitimate commercial investment activity.

### **Targeted anti-avoidance rules**

In addition to the need for a general anti-abuse rule, the OECD sees the need for various targeted anti-abuse measures. Amongst the items listed are:

- cases where intermediate entities are established in the source country to reduce the rate of tax
- transfers which are designed to reduce dividend withholding tax
- transactions that circumvent a capital gains charge on immovable property
- changes are required to the tie-breaker rules for determining the treaty residence of a dual-resident person

- an anti-abuse rule for permanent establishments (PEs) in third country states to deal with cases of triangulation

### *Observations*

The range of specific provisions raises a wide variety of points and the OECD asks for comments. The scale and breadth of the items may create much more complexity than is perhaps required to achieve the overall aims of the OECD. There is also a concern that a mutual agreement based tie breaker procedure is unlikely to be an improvement. In the case of PEs and triangulation, the proposal to require a minimum effective tax rate before a PE in a third country can be afforded treaty benefits would represent a major departure from the existing operation of most tax treaties.

### ***Domestic tax law interaction with treaty benefits***

To avoid situations where treaties can be used to prevent the application of domestic anti-abuse rules the OECD suggests it may be necessary to change domestic law in some territories. Examples given include cases involving thin cap, dual residence, transfer pricing and anti-arbitrage rules.

### *Observations*

It is noted that this would be a significant change given that the Vienna Convention on the Law of Treaties typically require in such a situation that the treaty should prevail over domestic law. It will be important for the OECD to distinguish between domestic laws that are truly anti-abuse and those that are treaty overrides.

In addition, for EU entities the interaction of these recommendations with the multilateral EU Treaties (including the Parent/Subsidiary and Interest/Royalties Directives as enacted in the domestic law of EU

countries) is a complex area that may present significant challenges in practice.

### ***Hybrid arrangements***

OECD issued two papers on March 19, 2014: (1) a shorter report on treaty issues that largely covers gaps where Action Point 6 and Action Point 2 overlap, and (2) a much longer draft Consultation Document on domestic anti-hybrid rules. [Click here for a PwC Tax Policy Bulletin](#) covering these drafts in more detail.

In this Insight we aim to add to the PwC Tax Policy Bulletin by drawing out items that may be of specific interest to arrangements that are described by OECD as ‘widely-held investment vehicles that admit offshore investors’ – which may be taken as a generic term for private equity and similar collective investment type arrangements.

It is worth noting that the definitions of hybrid arrangements as and when enacted by individual countries will be extremely important. In many instances, private equity arrangements may be considered to be dealing with timing differences (to avoid ‘dry’ income and gains) and the efficient return of funds to a broad mix of investors, rather than to create true hybrid arrangements of the sort that are the primary target of the OECD proposals. In this regard the OECD recommendation on reverse hybrids and imported mismatches are highly relevant. The discussion draft acknowledges the complex nature of such arrangements; not least the operational challenges in connection with obtaining sufficient information that would be required to operate the anti-hybrid provisions.

### ***Reverse hybrids and imported mismatches***

Imported mismatch arrangements are stated to be hybrid (entity or financing) structures created under

the laws of two jurisdictions where the effects of the hybrid mismatch are imported into a third jurisdiction. Reverse hybrids are treated as a subset of this category.

An ‘imported mismatch’ is effectively a hybrid created using intermediate holding and/or financing companies. For example, a simple non hybrid loan instrument may be used by Country B to fund an investment in Country C, and so this would not look to be a hybrid financial instrument or entity from Country C’s standpoint. However, a hybrid arrangement may be created indirectly by issuing a tax deductible instrument out of Country B to an entity in Country A that is tax exempt in Country A. Alternatively, a reverse hybrid may be created – as above, Country A establishes an apparently plain company in Country B to make a loan to Country C that would create a deduction. If Company B is considered fiscally transparent in its home country and not taxed on the income arising from the loan, then a hybrid arrangement would be created if Country A does not tax the income of Company B. The analysis of CFC and other indirect income taxation would, of course, be an added complication to this example.

### ***Information requirements***

Notwithstanding the technical discussion, recommendations are also made in the draft report that intermediary countries introduce revised tax filing and reporting requirements such that tax authorities are able to determine the income and gains allocated to each investor. Although this appears to be restricted to cases of reverse hybrids, the implementation of such requirements in practice may go much further. No reference is made to the other regulatory and information gathering requirements of AIFMD or FATCA etc.

***Defensive mechanisms***

The draft report recommends a defensive mechanism can be employed by the source country to deny a deduction for a payment made under an imported mismatch arrangement to the extent the payment results in a double non taxation or no income inclusion result. However, it is also noted that the information required is often extremely detailed and there are a number of tax policy and detection challenges presented by reverse hybrid mismatches that point towards a more limited scope when denying the deduction. All in all it is a highly complicated area that will depend very substantially on how more detailed guidance is developed.

***Third party and avoidance arrangements***

Although the draft report is substantially concerned with intra-group or related party financing, there are provisions that would be triggered in respect of avoidance arrangements.

***The takeaway***

Tax treaties play a critical role in removing barriers to cross-border

trade and investment. The BEPS Action Plan recognises this and underscores the importance of establishing 'agreed international rules which are clear and predictable, giving certainty to both governments and businesses'. The focus of the discussion draft on combating treaty shopping must be appropriately balanced with regard for the potential impact on cross border investment and the drag on returns that layers of taxes can create for commercial investors.

Aside from the specific provisions on treaty changes in the draft report, there is also an apparent endorsement of unilateral changes to domestic law and to certain treaty arrangements. The risk is that this may open the door to uncoordinated action.

Outside the terms of reference of this draft, there is also work on clarifying the beneficial ownership concept. The beneficial ownership concept has caused confusion for some time due to (1) its use by some tax authorities as a quasi anti-abuse measure, notwithstanding that it is arguably not intended to fulfil that function; and (2) the difference in interpretation as between Civil Law countries and

Common Law countries has led to a wide range of contradictory case law. It remains to be seen how this can be reconciled with the beneficial ownership concept in the context of EU Directives, for example as followed by Germany and Austria who have recently applied the concept strictly to address treaty shopping.

The OECD recommendations to combat the use of hybrids are highly complex and are likely to create substantial uncertainty in respect of investment and financing arrangements. Considerable resources may be required to evaluate the impact of the recommendations, and domestic laws as they are introduced, both in respect of countries where current and/or potential investments are located, but also where intermediate holding and financing entities are established. In particular, the OECD appears to place burden of proof that no hybrids are created by intermediate entities / conduits on the taxpayer. At the very least this is likely to create substantial additional information and reporting requirement.



## ***Let's talk***

For a deeper discussion of how this issue might affect your business, please contact:

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