The OECD BEPS multilateral instrument: issues for the Asset Management industry

In brief

On 24 November 2016, the Organisation for Economic Cooperation and Development ("OECD") published the 49-page "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS", as well as an accompanying 86-page Explanatory Statement. The Convention (the "MLI") – referred to until now as the "multilateral instrument", and forming the subject of Action 15 of the OECD/G20 Base Erosion and Profit Shifting Project (the "BEPS Project") – has two main aims:

- To transpose a series of tax treaty measures, recommended in the October 2015 BEPS Project Final Reports, into existing bilateral and multilateral tax agreements.
- To set a new standard for mandatory binding arbitration for resolving double tax disputes.

The MLI aims to facilitate the process of implementing all the treaty-based measures of the October 2015 BEPS Project Final Report recommendations – both the "minimum standards" (treaty abuse, and basic dispute resolution/ compensating adjustment rules) which are mandatory (albeit with some optionality), and all other changes (including arbitration) which are essentially optional.

However, the flexibility included in the MLI suggests that some of the countries may not intend to implement (either fully, or even at all) some of the BEPS Project recommendations. While some options were included as BEPS Project alternatives and the MLI thus needed to reflect them, much of the flexibility is designed to enable parties to opt out of particular recommendations altogether, or to disapply them for individual treaties ("to accommodate specific tax treaty policies" per the OECD press release). Unfortunately the OECD could not ensure any greater level of uniformity of application, thus giving rise to greater uncertainty.

The MLI will be open for signature from 31 December 2016, and a major signing ceremony is scheduled to take place in Paris in June 2017. Countries' provisional notifications of their intentions when signing the MLI next year will better indicate the level of consistency in applying the BEPS measures that is ultimately likely to emerge, and whether the MLI will effectively achieve its goals. Most changes to tax treaties are likely to come into effect beginning in 2019.

For the asset management sector, the most significant issues are the absence of new provisions to clarify the treaty entitlement of funds, leading to greater concerns that the new treaty abuse measures could prove harmful, and tighter rules on defining a "tax footprint" causing fund managers to have unexpected tax liabilities in more countries.

In detail

Nature of the MLI

The MLI is 49 pages long and comprises seven parts:

Part I. Scope and Interpretation of Terms (Articles 1-2)
Part II. Hybrid Mismatches (Articles 3-5)
Part III. Treaty Abuse (Articles 6-11)
Part IV. Avoidance of Permanent Establishment Status (Articles 12-15)
Part V. Improving Dispute Resolution (Articles 16-17)
Part VI. Arbitration (Articles 18-26)
Part VII. Final Provisions (Articles 27-39)

The MLI does not override, nor substitute for, existing bilateral or multilateral tax conventions that countries signing the MLI have in place, and now wish to choose to have covered by the MLI (termed "Covered Tax Agreements"). Instead, the MLI supplements and "modifies" those agreements with the BEPS-related provisions, most of which each signatory can opt in or out of, in whole or in part.

Nevertheless, certain core provisions are obligatory, as they were agreed by consensus and reflected in the BEPS report as "minimum standards" – notably those on treaty abuse, and dispute resolution (but not binding arbitration that becomes mandatory where countries agree to it, nor on hybrids or PEs, which are optional inclusions).

A lot of the length and complexity of the MLI relates to the procedures for signatories to opt in or out of particular provisions. "Compatibility" provisions are included for each rule, addressing how the rule interacts with provisions in the existing agreements that the MLI will modify. There are also requirements that each signatory identify (by way of notification) the relevant provisions in each of their existing agreements that are impacted by those MLI options the signatory chooses to accept.

The OECD is to be the MLI's "Depositary", receiving notifications and providing "matching" services, as well as reporting events and making a lot of information publicly available, all as set out in the MLI.

Timing

- **Signature** – The MLI will be open for signature as from 31 December 2016, although there should be a major formal signing ceremony in Paris on 5 June 2017. Parties will need to provide a provisional list of their intended notifications and reservations at the time of signature. (It is, at present, unclear whether the US will be a signatory, this being complicated by the forthcoming change in Administration, the need for Senate approval, and the potential to implement the mandatory binding arbitration provisions in other ways.)

- **Entry into force** – The MLI will enter into force for that party, generally three to four months after that party has ratified the MLI. However, for the first five parties, the ratification date is set by reference to the date of the fifth ratification. Notifications finalising the provisional list of options submitted on signature are required at ratification.

- Once ratified, the MLI provisions opted for can potentially apply to all the Covered Tax Agreements which that party has notified, although initially the provisions will only to apply the extent that counterparties involved have also already ratified the MLI. As further ratifications occur, the MLI provisions mutually opted for will then come into force automatically (after the three to four month period) between the parties that have both then ratified, so long as both these parties have each listed that treaty as being a Covered Tax Agreement. Under this "matching" mechanism, the OECD as Depositary will publicise the dates on which each individual Covered Tax Agreement, with the particular MLI provisions that have been opted for, come into force.

- **Entry into effect** –The MLI comes into effect for Mutual Agreement Procedure ("MAP") and Arbitration cases normally from the date of entry into force as outlined above. More generally, measures will take effect thereafter, according to the following rules

  - Withholding tax ("WHT") – on amounts due from the next 1 January (or at the start of the tax year if a party so elects, even if the other does not), and

  - Other taxes – unless both parties elect for a shorter delay, in respect of taxable periods beginning on or after six months later (or the following 1 January, if a party elects even if the other does not).

Further details on the background to the MLI, and its elements that do not affect the Asset Management industry as directly, can be found in PwC's Tax Policy Bulletin of 5 December 2016 "OECD publishes multilateral instrument for implementing BEPS in double tax treaties" http://www.pwc.com/gx/en/services/tax/newsletters/tax-policy-bulletin/oecd-publishes-multilateral-instrument-for-implementing-beps.html

Treaty abuse provisions

The MLI text

All parties that become signatories to the MLI are committing to implementing the OECD's "minimum standard" on treaty abuse. This means that some form of anti-treaty abuse measures will have to be adopted under the MLI, unless countries have or put equivalent bilateral measures in place.

The BEPS Action 6 Final Report on Treaty Abuse recommended that parties choose from three alternative approaches – a Principal Purpose Test ("PPT"), a Simplified Limitation on Benefits ("LoB") article combined with a PPT, or a more Complex LoB accompanied by either an "anti-conduit" rule or a PPT.

However, unlike the BEPS Action 6 Final Report, the MLI does not provide any Complex LoB text, but rather (as the third option) allows countries to negotiate a Complex LoB on a bilateral basis. Parties preferring a Complex LoB provision may accept the PPT as an interim measure, but express the intent to change in a notification.

While it is premature to predict precisely which options individual countries will select, most non-US jurisdictions seem likely to opt for the PPT, which is in any case effectively the default. Also, if the US does become a signatory to the MLI, it will be likely to opt for the "separately negotiated" Complex LoB third option. So, at this stage it looks unlikely that the Simplified LoB text will end up applying to particularly many treaties.

If one counterparty under the MLI opts to accept the PPT only, and the other party to a bilateral agreement being "matched" under the MLI opts for a Simplified LoB, the PPT will then apply, unless:

- the Simplified LoB party opts out altogether (but it then must endeavour with the other party to get to a mutually satisfactory way of satisfying the "minimum standard"), or
- the PPT party opts to allow a "symmetrical" Simplified LoB approach (i.e. both parties apply a Simplified LoB in addition to first including PPT), or an "asymmetrical approach (i.e. one party applies a PPT alone, and the other party applies a Simplified LoB together with the PPT).

The PPT as expressed in the BEPS Action 6 Final Report, and effectively replicated in the MLI, is worded as follows:

> "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."

Notably, the European Commission's January 2016 recommendation on measures against tax treaty abuse stated that "with a view to ensuring compliance with EU law, the GAAR based on a PPT as suggested in the final report on Action 6 needs to be aligned with the case law of the CJEU as regards the abuse of law". This meant essentially that where the PPT might have otherwise been in point, but where there was also "genuine economic activity", it would not apply. The PPT in the MLI does not follow the EU in offering any "genuine economic activity" let-out.

Another significant feature of the text of the MLI is that there is **no mention**, at any point in the text, **of** how **collective investment vehicles** ("CIVs") are to be treated. This is consistent with the manner in which the BEPS Action 6 Final Report has been applied in developing the text of the MLI, as it was only the Final Report recommended wording for a "detailed" or Complex version of an LoB which contained CIV-related wording. As the MLI *ad hoc* drafting group has chosen not to have a "detailed" version of an

LoB, the MLI did not have to contain any CIV-related wording.

Asset management takeaway
Despite three rounds of public consultation (in autumn 2014, in summer 2015, and again in spring 2016 focusing on non-CIVs) based on the premise that the BEPS Project did need to make specific provision for fund vehicles in the area of treaty entitlement, the outcome at this advanced stage appears to be that these needs have largely failed to be addressed.

CIVs

How will the PPT apply? The only guidance that funds now have on how the MLI provisions will affect them – assuming that the PPT approach becomes the norm, as seems likely – is within the commentary on the PPT text within the BEPS Action 6 Final Report. This commentary is of course expected in due course to become part of the OECD Model Tax Convention Commentary.

One of the examples ("Example D"), outlining the practical application of the PPT, describes a CIV, and confirms that based on the fact pattern set out, it would not be reasonable to apply the PPT to deny treaty benefits. However, the example does pre-suppose that the CIV has a corporate form, pursues a full distribution policy, and is taxable on non-distributed income, and thus the Example may only narrowly be of direct application. (The OECD's concern that CIVs might be abusive, because they could allow investors to defer taxation, thus remains prominent.)

However the Example D text does state the clear principle that "the intent of tax treaties is to provide benefits to encourage cross-border investment".

This guidance is certainly of some help, and does suggest that the OECD tends to see CIVs generally as relatively benign arrangements from a tax treaty abuse perspective. However, the little that is written is arguably at present just a few grains of sand in a dune of subjectivity.

Could more have been done? Undoubtedly, yes. The BEPS Project output did formally record general support for the previous work done by the OECD on funds, including the conclusions of the OECD's 2010 CIV Report.

However, despite the conclusions of the 2010 CIV Report having meanwhile been included within the OECD Model Tax Convention Commentary (July 2014 edition) (see paragraphs 6.8 to 6.34 of the Commentary on Article 1) this reiteration of support has not so far led to many instances of the key recommendations made in 2010 being implemented bilaterally. Indeed this lack of acceptance of the recommendations was flagged by the OECD in the summer 2015 consultation discussion draft.

It is thus disappointing that the MLI has not been grasped as a major "once in a generation" opportunity to follow through on the OECD's 2010 CIV Report recommendations.

What could have been done? At the least, a basic approach as outlined below could have been adopted.

Importantly, the way in which the MLI text addresses the issue of the PPT/LoB dichotomy could have been seen as a helpful model for progressing to solve the main problem identified in the 2010 CIV Report, that being the need to resolve countries' differing tax policy goals and levels of concern on specific issues.

Firstly, explicit MLI text, using the July 2014 Commentary wording for stipulating **which types of fund are in scope**, could have been used. Signatories could then each have listed as part of the notification process which precise legal forms and regulatory regimes in their own jurisdiction were proposed to be recognised as CIVs for treaty purposes. (A further reservation, emphasising that a fund must be "widely held", might reasonably have been applied.) The "matching" process would then have allowed counter-parties to opt for all, some, or none of these forms/regimes to be confirmed as treaty entitled.

Secondly, the signatories could each have **opted for** notification as to which of the **variants** of the July 2014 Commentary **suggested treaty wording** (set out in paragraphs 6.17, 6.21, 6.26. 6.27, and 6.34, or 6.28 of the July 2014 Commentary), would be acceptable. Again, the "matching" process would then have confirmed the mutually acceptable position.

Ideally, more encouragement would now have been given to countries to go for the **simple** paragraph 6.17 **option** – i.e. for the CIVs agreed as being covered to be treated as individuals (i.e. physical persons) for the purposes of treaty application, without any further provisos or conditions being imposed as to the status of investors in the fund.

One of the reasons why the 2010 CIV Report offered a "buffet" of solutions rather than a single "menu du jour" was continuing concern over treaty shopping – i.e. that residents of third countries could, under the paragraph 6.17

option alone, potentially receive treaty benefits that would not have been available had they invested directly. Disappointingly, the OECD's response during public consultation on the issue during the BEPS Project was unable to progress from this position, noting that "a single approach ... was not feasible or advisable".

This conclusion should certainly now be challenged. The MLI has clearly shown that a solution is at least feasible.

Furthermore, the inclusion as a "minimum standard" of the PPT in all treaties, taken together with some further work on emphasising the "widely held" requirement as essential for treaty access, and greater recognition (reiterated frequently during the BEPS Project consultation process) that investment in CIVs is simply not motivated by tax treaty shopping, are all factors that should greatly reduce the "not advisable" concerns noted by the OECD Working Party.

In conclusion, this failure of the BEPS Project to give clearer tax treaty entitlement to CIV-type funds should certainly be seen as an opportunity missed. It would have been a good way for the OECD to demonstrate that the BEPS Project was being undertaken in a way that promotes investment and trade.

What now? It is to be hoped that fund managers will now redouble their efforts to lobby governments to make progress in this area.

One way in which this might happen in the short term is for fund managers to respond to current OECD requests for input. The OECD has during 2016 been encouraged by the G20 to find more solutions supporting certainty in the tax system. To progress this, the OECD has launched a Business Survey on Taxation (closing on 16 December 2016), seeking views from business on where such solutions might be found. Clearly fund managers urging greater certainty for the tax treaty entitlement for their funds is one such area, pressing the point that the OECD itself has already recognised for some years that there is an issue here.

Another reason why progress in this area, at least within the EU, is important is that the current situation is seen by the Capital Markets Union project as presenting barriers to the development of cross border capital markets. The EU Commission is said to be already taking action to encourage Member States to address withholding tax refund procedures.

Non-CIVs

The most recent round of public consultation by the OECD on the final form of the BEPS work on tax treaty abuse came in spring 2016, after the BEPS Project Action 6 Final Report had been published. This was as a follow-up topic, with the stated aim of ensuring that new treaty provisions adequately address the treaty entitlement of non-CIV funds (i.e. alternative investment funds). The OECD also noted that in this area, governments had concerns that (i) non-CIV funds could be used to provide treaty benefits to investors not themselves entitled, and (ii) investors could defer recognition of income.

Most of the consultation looked at whether specific wording should be added to the recommended wording for the LoB rules to cover non-CIVs more explicitly, and if so what its form should take. The consultation also sought input on the PPT. Here suggestions for new examples to be added to the Commentary on the Model Treaty were sought, to show how the PPT might apply to arrangements made by non-CIV funds.

The LoB text in the MLI does not differ markedly from that in the Action 6 Final Report in its application to non-CIVs, suggesting that representations made on behalf of non-CIVs during the spring 2016 consultation have not been heeded.

This means that non-CIV holding and financing activities are in the majority of cases are going to be excluded from treaty benefits in any situation where a *Simplified LoB* clause is relevant – the mix of investors in the fund will only seldom allow the "at least 75% equivalent beneficiaries" route for qualifying for benefits to operate. Nor are the "active conduct of a business rules" likely to help.

As regards the *PPT*, following the consultation, no further guidance on how the PPT might apply to non-CIVs has yet been published by the OECD. This is of increased importance now that it is clear that the PPT is the default "minimum standard" wording for treaties to be covered by the MLI.

It is to be hoped that this guidance will emerge shortly, although there have been no indications of this from the OECD. Otherwise, alternative investment fund managers face seeing countries in which their funds operate committing to the PPT, without knowing how their investors, or themselves as fund managers, will be affected.

In conclusion, the outlook for non-CIVs concerned by the BEPS treaty abuse measures remains gloomy and unclear following the publication of the MLI.

Action 7: Artificial avoidance of permanent establishments

Summary

Unlike the treaty abuse measures reviewed above, the MLI offers its signatories the option of NOT amending existing treaties to in effect extend the scope of activities or levels of presence that give rise to a permanent establishment ("PE") – often described as a "tax footprint".

However, many countries are still likely to want to accept the MLI measures. Notably, the European Commission's January 2016 recommendation to Member States on tax treaties unreservedly endorsed the OECD revisions to the PE article of its Model treaty set out in the BEPS Action 7 Final Report. Hence, at least within the EU, the new provisions in the MLI are likely to become effective in their entirety.

The MLI contains three articles revising the rules on PEs. These generally but not precisely follow the BEPS Action 7 Final Report text, which in broad terms introduces measures as follows.

- The scope of the "dependent agent" test may be expanded, to include situations where an agent **habitually plays the principal role leading to the conclusion of contracts** that are routinely concluded without modification by the enterprise.
- The independent agent exemption may be narrowed, such that where a person **acts exclusively** or almost exclusively **on behalf of** one or more **'closely related businesses'**, that person shall **not** be considered to be **an independent agent**.
- Finally, the "specific activity" exemptions may be restricted to activities that are of a **preparatory or auxiliary** nature. In deciding whether the preparatory or auxiliary exemption can apply, all activities that a group undertakes at the same premises must be looked at together.

Asset management takeaway

The new treaty provisions aim to make it much less easy for businesses that have only a light "footprint" in a jurisdiction to be able to use the wording of a tax treaty as the reason for not having to file tax returns or pay tax in that jurisdiction.

Although these new measures are aimed principally at businesses that use the internet as their primary sales medium, or that have strongly international and centralised value chains distributing consumer goods or industrial products, their wide scope means that the asset management industry will certainly be affected.

Given the very wide variety of business models under which fund managers invest and distribute products internationally, and the multitude of ways in which these have evolved differently within fund management groups, the most acute problem areas will differ for each organisation.

One growing overall trend is pressure from regulators causing greater levels of activity to be needed, often geographically located at the point where a function must be delivered. Clearly, when reporting on such activity to regulators, the fact pattern notified must also be looked at from a "tax footprint" perspective – one story for the regulator, and another story for the tax authorities (whether for direct or indirect taxes), is obviously going to be an unsustainable position.

Some specific areas, already seen as problematic in practice, are outlined below. Here the new MLI treaty wording will act to make many existing situations even more difficult.

For fund managers, the MLI provisions are firstly likely to concern *distribution activity* by a local support organisation. Under the new MLI wording, "habitually playing the principal role leading to the conclusion of contracts" (e.g. those under which an investor commits funds) will be a critical issue.

If this is the operational norm, once the MLI text comes into force, it is likely that a local support organisation will then be seen as causing the fund manager (earning the fee from the fund being sold) to have a taxable presence locally.

Furthermore, until now the use of "commissionaire" contractual arrangements, or arrangements which had local affiliates operating as if they were independent agents for the fund manager, have usually been sufficient to allow the principal to be protected by a treaty from having a taxable presence. This "safety net" will disappear as the MLI comes into effect.

Information gathering is another activity that might also be more likely to give rise to a taxable footprint than hitherto. While the MLI should continue to protect in cases where this is the only activity undertaken in a territory, this will not be the case if there are also other activities going on that, overall, go beyond being purely "auxiliary" in nature.

Notably, if the fund manager has more than one entity in the local territory, the new measures will require the overall activity of all the affiliates to be looked at in aggregate.

For alternative investment funds, *capital raising and deal sourcing* activities, whether through representative offices or "fly-in" teams, will also be at much greater risk of giving rise to PEs. Existing "safe harbour" practices of some tax authorities may also have to be modified, and would then offer less protection. Given the high value-adding nature of these deal-driven activities, the amounts of income then attributable (and taxable) could turn out to be very significant.

How and where contracts are concluded becomes a critical aspect once any tax authority challenge arises. Having systems and control procedures in place that track the travel records of senior personnel, and set out limits to their authority to act, will be increasingly important operational requirements.

Lastly, it should by no means be assumed that these issues only become important once any MLI provisions come into force. The tax-motivated activities of major MNEs with internet-based core businesses have attracted considerable adverse publicity. This was one of the main factors that led to the launch of the BEPS project.

Tax authorities are thus already far more sensitive than they were five years ago in this area, and challenges that result in unexpected "tax footprints" for fund managers already are beginning to be reported. A recent PwC survey of mainstream asset managers across Europe suggested that around a quarter of fund managers have already met some form of "permanent establishment" challenge from a tax authority. Also, many fund managers are not fully aware of whether the existing rules that delineate PEs are currently being correctly observed within their organisations.

Although the MLI is likely to lead to more challenges in this area, many fund managers already – knowingly or not – face significant PE-linked exposures. Careful and rigorous reviews of operational methods should thus already be seen as best practice.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your usual PwC contact or one of the following:

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