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WITHHOLDING TAX REVOLUTION?

THE EFFECT OF THE BEPS MULTILATERAL CONVENTION ON CROSS-BORDER DEBT AND EQUITY INVESTMENTS

68 countries signed the BEPS multilateral convention on Wednesday 7 June. Its effect is to amend the hundreds of double tax treaties between those countries to introduce new anti-avoidance rules. After years of uncertainty we finally know which countries are opting for which variant of the proposed rules, and therefore which investments are likely to be adversely affected.

This briefing summarises the impact of the new rules on cross-border debt and equity investment and – in particular – withholding tax.

What is the overall effect of these changes?

The multilateral convention is complex, and it will be some time before its effects become entirely clear. However in summary:

- Most of the 68 jurisdictions are incorporating a "principal purpose test" (PPT) into their treaties. This will deny treaty relief where obtaining relief was one of the principal purposes of an arrangement or transaction. Some countries (such as the UK) have had a similar rule in most of their treaties for many years: if other countries follow that approach then the PPT should make little difference. The test, however, is by its nature subjective, and some countries may apply it more aggressively. We will refer to these jurisdictions as the "PPT states".
- Ten jurisdictions adopted a different approach; a "limitation on benefits" (LOB) article. This will deny treaty relief in a wide range of circumstances that, in particular, will make it difficult for many funds to access treaty relief. These jurisdictions are: Argentina, Armenia, Bulgaria, Chile, Colombia, India, Mexico, Russia, Slovak Republic and Uruguay – the "LOB states".
- Canada, Kuwait, Poland and Senegal have opted for the PPT for now, but say they intend to negotiate LOBs into their bilateral treaties.

- The US stands alone as a significant jurisdiction that has not signed the multilateral convention. However the US's existing treaties generally include LOBs.

We describe the PPT and LOB in more detail below, but we would say the overall outcome is:

- significantly increased tax risk on investment into the 14 LOB (and potential LOB) states, with some investors (particularly some types of fund and non-banks) excluded from treaty relief altogether, and
- somewhat increased tax risk for investments into the 54 PPT states (again particularly for funds and other non-banks), but quite how significant the risk is will depend upon how the PPT is applied in practice by different jurisdictions.

Those with current or proposed investments in LOB states may wish to consider their position carefully. Investors in PPT states can be more relaxed, at least until implementation is clarified.

In some markets (e.g. cross-border lending) transaction parties may wish to protect their position through risk allocation provisions in documentation.

What is BEPS?

The BEPS project was launched by the OECD and G20 in 2013 to tackle "base erosion and profit shifting" – tax planning strategies that shift profits from high tax jurisdictions to low tax/no-tax jurisdictions. The project is divided into fifteen "Actions" and it is Action 6 (treaty abuse) which is relevant to this briefing.

Action 6 was targeted at "treaty shopping" – where a person who is not entitled to the benefit of a tax treaty (usually located in a tax haven) invests/makes payments via an entity in another jurisdiction which is entitled to the benefit of a tax treaty.

In the example in Figure 1 opposite, a Cayman holding company wishes to lend to its subsidiary operating company. But the operating company's home jurisdiction will impose withholding tax on interest paid to the Caymans. The solution? Interpose a "conduit" special purpose vehicle (SPV) in an appropriate jurisdiction that has a double tax treaty with the operating company's jurisdiction but that itself has no withholding tax. The holding company lends to the conduit, and the conduit lends to the operating company. The operating company's payments are then relieved from withholding tax under the treaty, and the conduit company's payments aren't subject to withholding tax.

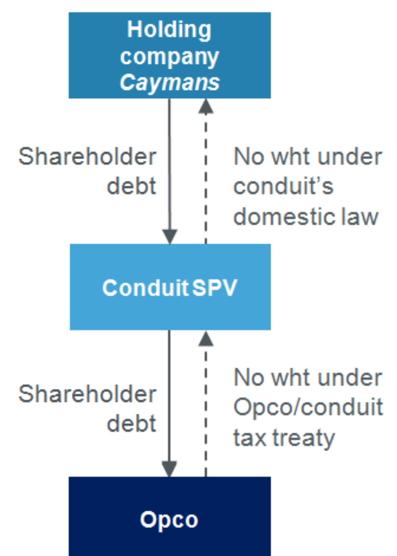

Figure 1

This kind of arrangement is often said to amount to "treaty shopping" or "treaty abuse" – the conduit SPV has been inserted solely to take advantage of a tax treaty. Similar arrangements can be used to mitigate dividend withholding and capital gains tax on equity investments, as well as interest withholding on debt.

Action 6 was intended to counter treaty shopping so that, in the example in Figure 1, the conduit SPV would not be able to claim treaty relief and the operating company's payments would be fully subject to withholding tax.

The Action 6 proposals were published in October 2015, together with the other fourteen BEPS Actions.

It was appreciated that implementing BEPS by individually amending each double tax treaty would be wildly impracticable – there are over 3,000 such treaties. Instead the OECD proposed a "multilateral convention" which would amend all the signatories' treaties at the same time. That is the convention that has just been signed, and Article 7 of the multilateral convention enacts the BEPS Action 6 proposals.

How do the new rules counter treaty shopping?

There are two separate rules proposed:

- a Principal Purpose Test; and
- a simplified Limitation on Benefits article.

Jurisdictions are free to choose either or both (but must include at least one).

An investor will be unable to claim relief under the treaty if they fail either provision. That will, for example, bar any claim for relief from withholding tax on interest, dividends or royalties, or from capital gains tax.

1. Principal Purpose Test ("PPT")

The proposed rule is simple in concept: "a benefit under this Convention shall not be granted... 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..."

This would seem to counteract simple conduit structures of the type in the example above, as well as more complex structures that are clearly largely tax-motivated. However other complex structures that have a tax effect but which are commercially motivated ought not to be caught. For example, a debt fund with multiple investors from around the world ought not to be impacted by the PPT even though its choice of jurisdiction for its lending entity will inevitably be influenced by tax treaty considerations (see e.g. Figure 2 opposite).

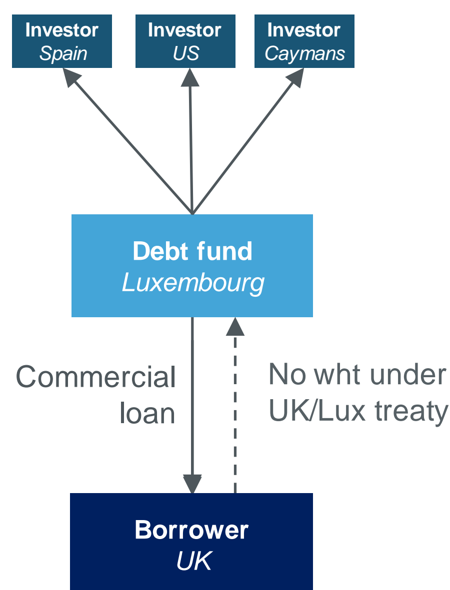

Figure 2

The UK has had a similar provision to the PPT (a "main purpose test") in most of its tax treaties for some time, and the approach outlined in the above paragraph is broadly reflective of HMRC's historical approach. That has been even in cases where (as in Figure 2) some of the investors could not have lent directly without suffering withholding tax (the Cayman investor in the example). HMRC have typically looked at the overall commercial objective of a structure.

The question is whether other jurisdictions will take a similar approach to the UK. It is possible some will not. A tax authority could, for example, look at an example like Figure 2 and assert that the effect is to facilitate tax avoidance by the Cayman investor. Such an authority might challenge the debt fund to show that its principal purpose was not to facilitate that avoidance. This has the potential to raise complicated issues about the motive of the parties and functions of SPVs (e.g. if the SPV in this example is making a significant profit and is not legally obliged to use receipts to pay investors will that evidence that the principal purpose is not avoidance?).

As we noted at the start of this briefing, most jurisdictions are adopting the PPT.

2. Limitation on Benefits ("LOB")

The LOB article will deny treaty relief to an SPV, fund or holding company unless it passes an essentially arithmetical test which looks to the ultimate beneficial owners of a payment, and asks whether at least 50% would themselves have been entitled to treaty relief.

Hence, in Figure 2, it is necessary to consider the identity of the investors in the debt fund and their respective holdings. The US and Spanish investors likely would themselves have been entitled to treaty relief; hence if they hold 2/3 of the fund interests then the LOB should not prevent the fund qualifying for relief. But if the Cayman investor holds more than half the fund interests then the LOB would deny treaty relief to the fund.

This kind of mechanism presents funds and some other non-banks with a significant problem: they need to determine who their ultimate investors are and, if those investors "trip" over the 50% threshold of an LOB, prevent all their other investors from suffering the consequences.

The LOB is a particular challenge for entities like CLOs which issue listed and cleared securities, as even in principle they are not able to say who their ultimate beneficial owners are. Hence the LOB would seem to exclude such entities from treaty relief entirely.

However the LOB should not in reality be relevant to the example in Figure 2, as most countries are not adopting the LOB. As we note at the start of the paper, only a small number of jurisdictions are, notably India, Russia, and much of South America (see Figure 3, below).

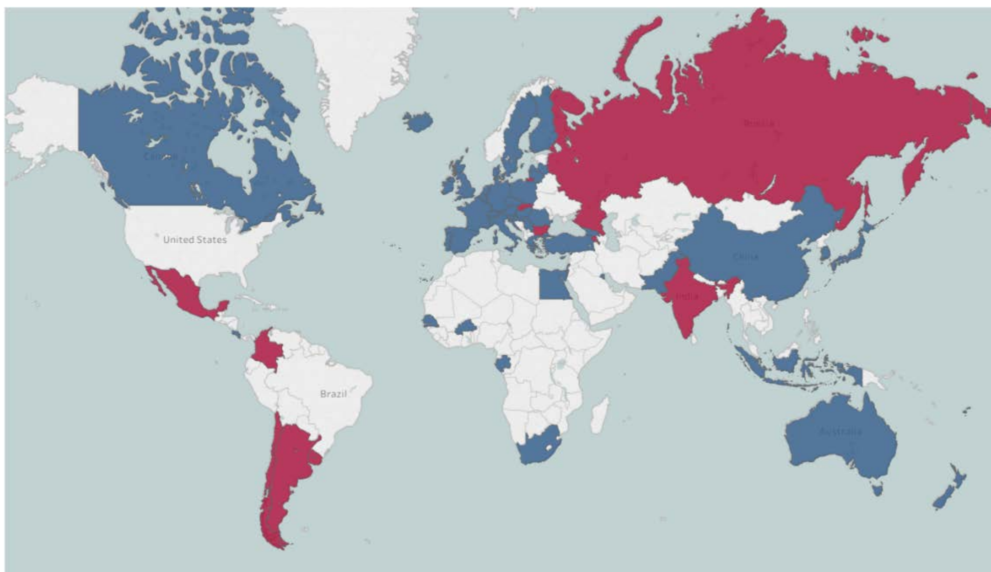

Figure 3 – PPT states (blue) and LOB states (red)

The LOB states generally have limited tax treaties, with only a fairly small class of investors able to currently claim relief from withholding tax. Hence the impact of the LOB is likely to be relatively limited (with Russia perhaps the most affected).

Those funds and other similar entities which do invest into the LOB jurisdictions are likely to be concerned that the multilateral convention will prevent them from accessing treaty relief.

How exactly are treaties amended?

There is a complex interaction between the multilateral convention, options and reservations made by different jurisdictions, and the provisions of existing treaties. But in short:

- Treaties between two LOB states will now include an LOB. For example, the Argentina/Chile tax treaty.
- Treaties between two PPT states will now include a PPT. For example the Germany/Luxembourg tax treaty.
- Treaties between a PPT state and an LOB state will generally now include a PPT and **not** an LOB. There are exceptions:
  - Denmark and Iceland are PPT states but have opted for an LOB where their treaty partner is an LOB state. So, for example, the Denmark/India tax treaty will now apply an LOB.
  - Greece is a PPT state, but has agreed that LOB state treaty partners may apply an LOB on payments out of the partner state. So, for example, the Greece/India tax treaty will apply an LOB to Indian payments, but a PPT to Greek payments.

  But in the other cases of treaties between a PPT state and an LOB state, there will simply be a PPT. So, for example, the India/France treaty will apply a PPT only. Some LOB states may be unhappy at this – and the multilateral convention envisages bilateral negotiations to try to resolve the situation. This creates an element of risk that these negotiations result in a treaty becoming fully subject to an LOB. Alternatively "frustrated" LOB states who have to fall back on the PPT may be tempted to apply the PPT in a manner akin to an LOB, i.e. by investigating the status of each ultimate beneficial owner.

When do the changes start to apply?

The treaty amendments effected by the multilateral convention relating to withholding tax will apply from the 1 January after both the treaty states in question have ratified the convention.

For some countries, ratification is typically fast and straightforward – where a treaty is between two such countries, the changes will therefore likely apply from 1 January 2018. For other countries ratification could take many months, or even years.

It's important to note there is no "grandfathering". Pre-existing investments will become fully subject to the new rules.

What should market participants do in practice?

Anyone with an existing financing or investment into an LOB state would be advised to consider whether in fact they are likely to qualify under the LOB. Similarly, anyone planning to lend/invest into an LOB state should consider their position carefully.

Other market participants should have no immediate cause for concern, other than to watch how the application of PPTs by tax authorities develops.

In some cases, particularly in the cross-border loan market, market participants may seek protection against the risk of the implementation of BEPS Action 6 causing treaty relief to be lost.

Further information

If you would like further details on any aspect of this briefing, or how it applies to your business, please speak to your usual Clifford Chance contact or any of those listed below.

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