Choose your location carefully

By David Klass
Published in *FT Advisor*, July 25, 2019

The OECD’s drive to counter perceived base erosion and profit shifting globally (known as the BEPS Project) has as one of its fundamental aims the prevention of ‘treaty abuse’: where taxpayers claim the benefit of tax treaties in circumstances where – it is alleged – it was not intended those benefits should be available.

This is potentially of direct relevance to financial institutions operating cross-border, as they will typically rely on tax treaties to reduce, or wholly eliminate, withholding taxes that would otherwise apply to cash flows from the jurisdiction in which the underlying investment is located.

This could have a particularly pronounced effect on fund managers and other financial institutions post-Brexit, when it is likely greater reliance will need to be placed on tax treaties, as EU directives restricting the application of withholding taxes cease to apply to UK entities.

But the problem is they may now face greater scrutiny as to why they are resorting to tax treaties when dealing with dividends and other cross-border payments, and may not be able to benefit from them in as straightforward a manner as in the past.

Specifically, countries have been offered the choice by the OECD of adopting a principal purpose test or a limitation of benefits test (or a combination of the two), to limit the availability of tax treaty benefits where it is considered that ‘abuse’ of the treaty would otherwise arise.

These recommendations are currently being implemented by a significant and increasing number of countries.

Special purpose vehicles are typically used in cross-border investment structures since, if investments were made and held directly by a limited partnership fund vehicle, the fund would often suffer withholding tax, by way of example on credit investments in countries such as the UK, as the provisions of the relevant treaty reducing or eliminating withholding tax may not be granted to the fund or its limited partner investors.

It is therefore common to invest via an intermediate SPV, with the intention that the vehicle should be capable of accessing the benefits of the relevant tax treaty; therefore the OECD-derived changes are particularly important in the investment fund and asset management context, with the potential to deny an SPV currently sitting in the structure beneath the main fund access to treaty benefits.

This article presents the views of the authors, which do not necessarily reflect those of Hunton Andrews Kurth LLP or its clients. The information presented is for general information and education purposes. No legal advice is intended to be conveyed; readers should consult with legal counsel with respect to any legal advice they require related to the subject matter of the article. Receipt of this article does not constitute an attorney-client relationship. Prior results do not guarantee a similar outcome. Attorney advertising.

These developments would in themselves have been enough to warrant financial institutions' keen attention so far as future structuring is concerned; but with Brexit around the corner, there is a double whammy of not only future investments, but existing structures being potentially affected.

The upshot is that institutions are faced with the prospect of having to make greater use of tax treaties, precisely at a time when their use is being reined in.

The ability to continue to rely on tax treaties in the context of such structures is therefore key.

The principal purpose test

The PPT provides that a benefit under a treaty is not to be granted if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of the arrangement or transaction giving rise to the benefit.

This is unless the taxpayer can show that granting that benefit in the circumstances "would be in accordance with the object and purpose" of the relevant provisions of the treaty.

The key issue here is that the PPT introduces an additional element of subjectivity.

Further, a provision such as the PPT is likely to be interpreted differently by different tax authorities, increasing uncertainty in the use of, and consequently financial institutions' ability to rely on, tax treaties.

The OECD has published guidance as to its interpretation of the PPT in an investment fund context by means of certain examples, but the specificity of the examples means it is difficult to extract many principles on which to place more general reliance and so the guidance, at least in its current form, is of limited value.

Key Points

- Fund managers' use of tax treaties when dealing with dividends is coming under greater scrutiny
- Institutions are making greater use of tax treaties, just as Brexit is reining in their usage
- A principal purpose test which examines the use of tax treaties will be interpreted differently by different tax authorities

What can nevertheless be taken from the examples is that they display a number of non-tax attributes, evidencing robust commercial motivation for locating the fund in the jurisdiction concerned, not merely that jurisdiction's network of tax treaties.

These include a link between the fund's location and that of the underlying investments, and the availability of directors familiar with local requirements.

The existence of a favourable tax treaty network is considered an acceptable factor, provided, however, it is not the only one.

Limitation on benefits provision

By way of alternative approach to the PPT, the OECD has proposed a so-called "limitation on benefits" provision (these are commonly present in treaties to which the US is party).

This limits the benefits of a treaty to persons the shares of which are held by, or the investors in which are, "qualifying" persons, for example entities owned at least 50 per cent by persons themselves entitled to treaty benefits: so a fund may wish to separate investors with differing tax attributes into different fund vehicles, such that an SPV below at least one such fund vehicle (containing qualifying investors) continues to access treaty benefits.

It is, consequently, becoming common for funds to amend the 'alternative investment vehicle' language in their fund documentation to ensure that this permits reorganisations of the fund structure to respond toBEPS-related developments, including grouping investors having 'good' tax attributes separately from those which do not.

What are the consequences?

A consequence of these developments, particularly where the PPT approach is adopted, is an increased risk of challenge by the tax authorities of the jurisdiction in which the investment is located, if they consider that the tax relief sought is a "main purpose" of having established the SPV in its jurisdiction of residence.

The take away for funds and asset managers is that a greater amount of forethought now needs to be given to the non-tax related reasoning behind the choice of location of the SPV, as opposed merely to its appeal from a treaty perspective.

Structures involving UK entities may be particularly affected in the light of Brexit, and the consequential inability of UK companies to rely on EU directives preventing the imposition of withholding taxes on payments of interest and dividends between EU-resident companies.

In view of this, increased reliance may need to be placed on tax treaties (which will remain unaffected by Brexit), precisely at a time when the ability to rely on them is becoming more restricted.

A timely review of existing structures in light of this is advisable.

David Klass *is a partner in the Tax group in the London office of Hunton Andrews Kurth LLP. David advises on a wide range of corporate tax issues and transactions, in particular those with an international element. He can be reached at +44 (0)20 7220 5627 or dklass@HuntonAK.com.*

© 2019 Hunton Andrews Kurth LLP