

Follow up work on BEPS Action 6 : Preventing Treaty Abuse



9 January 2015

INREV response to OECD Public Discussion Draft “Follow Up Work on BEPS Action 6: Preventing Treaty Abuse”, dated 21 November 2014

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide guidance and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe. In addition, INREV undertakes research and surveys of the industry and constructs the INREV Index which covers the performance of institutional non-listed real estate funds investing in Europe.

INREV currently has 344 members. Our member base includes institutional investors from around the globe such as pension funds, insurance companies and sovereign wealth funds, as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into non-listed real estate vehicles in Europe.

Our fund manager members manage more than 500 European non-listed real estate investment funds, as well as joint ventures, club deals and separate accounts for institutional investors. INREV's members represent almost all jurisdictions of the European Union's internal market and a range of underlying long-term investment vehicle structures, both CIVs and other non-listed real estate investment vehicles, the vast majority of which are Alternative Investment Funds (“AIFs”) subject to regulation under the European Alternative Investment Fund Directive (“AIFMD”).

Concerns regarding the Discussion Draft on Treaty Abuse

As we have publically stated before, INREV shares the concerns of the G20 and the OECD that action is needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it. INREV also supports a coordinated and comprehensive international approach to tackle these important issues.

As we stated in earlier submissions, including our response dated 7 April 2014 and the comments we made jointly with a large number of European real estate associations on 23 May 2014, the BEPS Action 6 discussion draft proposes measures that could inadvertently have a significant negative impact on the future development of institutional real estate investment and institutional investment in related sectors such as infrastructure that generally use the same or very similar investment fund structures. The potential loss to the European economy of the benefits of investment in real estate and infrastructure funds, in terms of economic stimulation, job creation and growth, would be incalculable.

Public Discussion Draft Follow Up Work on BEPS Action 6

INREV welcomes the opportunity to comment on the recent OECD Public Discussion Draft: follow up work on BEPS Action 6 – preventing treaty abuse (the “Follow Up Discussion Draft”). We are very pleased that the OECD seeks the view of the stakeholders in the investment management industry in order to find appropriate solutions for CIVs and non-CIVs in connection with the work on BEPS Action 6 – Treaty Abuse.

The Follow Up Discussion Draft accurately highlights on page 6, paragraph 16:

The problems that the LOB rule creates for CIVs may also be encountered by private equity funds/alternative funds (i.e., since their investor base is not restricted to a single country, they would be denied benefits under the LOB rule and would probably not get the active business exception; any provision dealing expressly with CIVs would not apply to them). Also, these funds face many of the

treaty issues that were addressed in the 2010 OECD Report on CIVs (e.g., whether they qualify as residents).

Indeed, the currently proposed LOB rule basically only allows treaty entitlement to extend to shareholders in the same country of residence as the fund claiming treaty benefits; it is also true that the active business exception would not apply to them. The proposed standard for eligibility of the LOB rule is therefore very narrow in that it is not possible for most European non-listed real estate funds and other investment vehicles to meet the requirements as currently structured, as most of them are “non-CIVs” in OECD terminology (even though, confusingly, most are considered “CIVs” under the EU’s AIFMD). This result follows because they typically have an institutional investor base with diverse countries of residence. Ironically, this is true even though it is safe to say that each of their institutional investors, if investing directly in the real estate rather than investing indirectly through non-listed real estate investment vehicles, would be entitled to the benefits of double tax treaties.

These non-listed real estate investment vehicles are employed for numerous, quite legitimate financial and operational purposes, and not for the inappropriate purpose of taking advantage of treaty shopping opportunities. More importantly, however, these structures do pay a fair share of tax in the relevant country, not only on the fund profits in the form of rental income and gains, but also in the form of real estate transfer tax, property tax and payroll tax. The investors in these structures are typically either subject to corporate income tax in their country of residence (insurance companies), or are by nature exempt (pension funds) but regularly pay pension benefits that are fully subject to tax in the hands of the recipients of the payments (retired workers).

The structures and their underlying investors take advantage of the double taxation treaties only in order not to be subject to double or even triple taxation. We provided a number of real-world examples in our previous submissions of fund structures that would not be able to claim treaty benefits under the current proposal.

These non-listed real estate investment structures are important vehicles for pension funds, insurance companies and other institutional investors to invest in real estate and thereby generate returns needed to meet their obligations to pensioners and policyholders. They invest via funds or other similar investment vehicles in a portfolio of real estate situated in various countries in order to diversify their investment portfolios while funding their long-term obligations.

Comments and recommendations regarding BEPS Action 6

INREV offers the following comments and recommendations on the Follow Up Discussion Draft as it applies to non-CIVs (private equity/alternative investment funds), in particular regarding the application of the proposed LOB rule and Principal Purpose Test.

Premises

In developing our recommendations, we have built on the following premises, supported in some parts by the comments made in the sections above:

- Non-CIVs, such as non-listed real estate funds and other investment vehicles, are not established with the purpose of achieving double non-taxation, which is the legitimate target of the various BEPS actions. Rather, these vehicles, which play an increasingly important role in matching capital flows in the global economy and the capital markets, are structured as they are for many other legitimate commercial reasons, only in part including not having to pay double or potentially even triple taxation in separate jurisdictions on the same income.

- The policy defined by the OECD in the 2010 CIV report should be upheld: the goal should be to put the investors in non-listed real estate vehicles in the same tax position that they would be if they invested directly in the underlying assets. In other words, there should be tax neutrality between direct investments and investments via a non-listed real estate fund or other investment vehicle, whether it is a CIV or a non-CIV.
- Moreover, in many jurisdictions non-listed real estate vehicles are structured as partnerships, which are typically tax transparent, mostly with limited liability. OECD has addressed treaty issues of partnerships and partners in separate reports and guidance. New proposals under the BEPS initiative should be consistent with those guidelines, so in situations where partners to a qualifying partnership can claim treaty entitlement because of the partnership's transparent tax treatment, it should not be lost or unduly complicated by the new proposals.
- Application of tax treaties by non-listed real estate vehicles should be straightforward. The anti-abuse solutions should not render the application of tax treaties significantly more complex, legally uncertain and costly, thereby hindering cross-border flows of capital and global economic development as a result. For example, a "derivative benefits test" would still create uncertainty in many cases regarding the circumstances in which an investment vehicle would qualify.
- The various developments in the field of international transparency, including FATCA, CRS, EU Savings Directive, as well as the EU AIFM Directive, significantly mitigate the risk of non-listed real estate funds and other investment vehicles being used for inappropriate reasons including tax avoidance; most of these vehicles are entities with regulatory reporting obligations under the recently enacted transparency and regulatory supervision regimes.
- For a variety of legitimate legal, practical and business reasons, real estate investment funds and other investment vehicles structure their investments via investment holding and real estate operating companies (i.e., via subsidiaries); these subsidiaries should also be able to benefit from tax treaty access. The use of investment holding and real estate operating companies should not prevent non-listed real estate funds and other investment vehicles from making use of treaty benefits, as these structures are extremely useful, but are not designed to facilitate tax avoidance.

Proposed solutions

Based on the above, INREV proposes that treaty benefits should continue to be available to non-listed real estate funds and other investment vehicles because, like public companies, they are either widely held, or in many instances are held by investors that would be entitled to similar treaty benefits if they owned the underlying assets directly. This can be achieved by defining CIVs and non-CIVs as "qualified persons" under the LOB. In this respect, we would like to draw your attention to paragraph 56 of the 2010 CIV report, where a simple solution is considered in order to grant treaty access to CIVs taking into account the objective of fighting abuse (treaty shopping):

Such a provision could be structured in various ways. The simplest would provide a binary application; an entity should either receive 1) full treaty benefits if the requirements for benefits are satisfied, or 2) no treaty benefits if the requirements are not satisfied. This is the standard approach under many anti-treaty shopping provisions. However, that approach would create a pure "cliff", which effectively would deny benefits to investors who otherwise would be entitled to treaty benefits. For that reason, those countries that have developed provisions to specifically address the treatment of CIVs generally have allowed a CIV to make claims in proportion to its "good" ownership, whether defined to include only residents of the same State or other treaty-entitled investors as well. Procedures could be further

simplified, without significantly increasing the risk of treaty shopping, by providing that, once the CIV has passed some threshold of “good” ownership, the CIV would be entitled to benefits with respect to 100% of the income it receives. This dual approach would avoid the “cliff” effect described above. On the other hand, the “cliff” effect applies equally above the threshold, in that some investors who might not have been entitled to benefits nevertheless would benefit. This might argue for the adoption of a high threshold. A higher threshold might also be justified if a broader class of investors, such as all treaty-entitled investors, were treated as “good” owners. Because of these variables, the choice of threshold is best left to bilateral negotiations.

In summary, if it can be demonstrated that a CIV or non-CIV has a certain percentage of “good” owners (equivalent beneficiaries), such CIV or non-CIV and its subsidiary investment vehicles should be entitled to full treaty benefits.

With respect to the topic of a “principal purpose test”, our view is that it should not be applied to qualifying non-listed real estate funds or other investment vehicles. From the examples given in the OECD publications on Action 6, it seems that conduit companies inappropriately taking advantage of treaty entitlement are an important reason to propose a principal purpose test. However, as explained above, qualifying real estate funds and other investment vehicles are not in the business of treaty shopping. We believe that the goal of the principal purpose test can be more effectively achieved by anti-conduit measures, along with beneficial ownership requirements (SAARs instead of GAARs).

We agree with the point made in section A.2. of the Follow Up Discussion Draft that a solution should be sought for all CIVs and non-CIVs; that is, for all types of alternative investment funds (non-listed real estate funds, private equity funds, infrastructure funds, etc.).

Based on the above considerations, we would propose the following amendments to the current draft BEPS Action 6 model tax treaty provisions:

- CIVs and non-CIVs should be considered “qualified persons” under Article X, paragraph 2, f) of the proposed LOB provision, using an “equivalent beneficiary” approach, meaning that if on at least half the days of the taxable period, at least 50 per cent of the aggregate voting power and value of the interest in the CIV or non-CIV fund is owned by persons that are resident of any other State with which the State of source has concluded a convention for the avoidance of double taxation.
- The terms “collective investment vehicle” (CIV) and non-CIV should include:
 - any entity that is subject to investor protection regulations, or whose manager is subject to such regulations, in its country of residence; and
 - any entity that is either directly or indirectly controlled by a CIV or non-CIV established in a State with which the State of source has concluded a convention for the avoidance of double taxation, including a vehicle that is considered tax transparent in the country where it is established and, either directly or through its manager, is subject to investor-protection regulations.

It should be expressly stated that the “principal purpose test” does not apply to qualifying CIVs or non-CIV.

INREV understands that these recommendations effectively carve out qualifying alternative investment funds and other investment vehicles from running through the set of tests included in the proposed LOB provision (article X). The alternative is to amend the proposed LOB rules to make sure that alternative investment vehicles can qualify under one or more of the tests (most likely the derivative benefits test). However, this approach is more complicated and would require a very

substantial amendment of the LOB tests, as the tests, as currently proposed, contain many elements such as the intermediate entity condition that give rise to undesired complications and uncertainties if applied to alternative investment funds and other vehicles with an internationally spread investor base.

Furthermore, as mentioned above, the new rules under BEPS Action 6 should be consistent with the existing OECD guidance and reports on treaty issues of partnerships and partners, and should provide clear guidance regarding investment vehicles that are partnerships or tax transparent trusts. This could, for example, be achieved by clarifying that a tax transparent non - CIV is deemed to be an equivalent beneficiary of real estate investment vehicles of which it owns the shares/interests.

Given the potentially significant and far-reaching adverse impact that the current OECD proposals on Treaty Abuse could have on non-listed real estate investment funds and other investment vehicles, INREV urges the OECD to carefully consider the treaty entitlement of non- listed real estate investment vehicles, along with other alternative investment funds, taking into account both our premises and recommendations.

We believe our recommendations are fully in line with the recommendations made by the OECD in various earlier reports and guidelines and appreciate very much being given the opportunity to submit comments as part of the public consultation process. We plan to attend the public consultation meeting in Paris on 22 January 2015; however, we do not wish to speak in support of our comments at that meeting. Of course, we remain available should you desire any further explanation or input regarding our comments.