To: Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

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CREFC Europe response – OECD BEPS Action 6 discussion draft: Treaty Entitlement of Non-CIV Funds

Introduction

The Commercial Real Estate Finance Council (**CREFC**) Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) debt market in Europe that can support the real economy without threatening financial stability.

CREFC Europe is the voice of the CRE finance industry in Europe, representing banks, insurance companies, fund managers, and others who provide or intermediate the provision of debt to real estate businesses, as well as advisers, consultants and others with a stake in this sector.

Investment into CRE is critical for any economy. Such investment provides accommodation for businesses and other occupiers that is fit for purpose, offering them the flexibility to suit their premises to their changing needs and changing economic conditions. By providing much of our built environment, the CRE industry represents a critical component of the real economy, delivering important socio-economic benefits to communities as well as opportunities for productivity gains for business.

As a capital intensive and long-term business often involving very large, valuable and illiquid assets, CRE is dependent on the ready availability of credit. This dependency is driven principally by the very different risk and return expectations (and hence cost) of different types of capital. The capacity of CRE to generate long-term, stable cash flows in the form of rental income is well suited to the use of debt. Accordingly, the CRE finance industry plays an important role in supporting CRE investment and the wider economy, by providing the debt that helps fund investment in the built environment.

We are aware of the submission of the British Property Federation (**BPF**) in response to the Discussion Draft which highlights concerns as to the potential adverse impact of the current proposals on investment in CRE. We generally support the BPF's comments regarding the limitation on benefits (**LoB**) and principal purpose test (**PPT**) approaches.

However, the current proposals are also of direct relevance to many CRE debt providers, particularly given the recent – and rapid – diversification in CRE debt markets, with new lenders, principally CRE debt funds, emerging. This diversification is to be welcomed from a policy as well as market perspective, and should be protected: excessive CRE debt exposures concentrated in the banking system has been a significant problem for many countries in recent years.

Although many of the points made by the BPF are equally relevant to such non-bank CRE lenders, we set out below some additional comments relating specifically to (i) CRE debt funds and (ii) securitisations of commercial mortgages (commercial mortgaged-backed securities or **CMBS**), particularly in relation to the PPT (question 25).

Key points

1. ***Treaties must continue to support cross-border investment***: A well-functioning tax treaty regime is critical in ensuring that capital can flow cross-border efficiently to suitable investment opportunities. That is good both for savers all over the world, and to support productive investment. A balance therefore needs to be struck between ensuring that treaties cannot be easily abused and facilitating commercial cross-border trade and investment. However, on the basis of the current drafting of the LoB and PPT provisions, and related commentary, we are concerned that the rights of bona fide non-CIV funds to treaty benefits could be adversely affected.

2. ***Tax neutrality is not the same as tax abuse***: For both CRE debt funds and securitisations, tax neutrality is a necessary feature of their structure. For debt funds, this is because investors expect to be in no worse a position through investing in a fund that they would be had they invested directly. For securitisations, the objective is to ensure that cash receipts from investments are available to investors (the bondholders) to the maximum extent possible. Where such non-CIVs operate cross-border, the availability of treaty benefits can be an important element of achieving that tax neutrality – and will therefore influence the decision as to where to locate an asset-holding company. Seeking tax neutrality in this context is consistent with, and not an abuse of, OECD tax treaty principles.

3. ***Very low risk of tax deferral for CRE debt funds and CMBS***: In relation to both debt funds and securitisation, the risk of tax deferral is very low. This is because for both types of entity there is a commercial imperative to pass on income and gains to investors within a short time frame. For debt funds, this is because of the importance of achieving the internal rate of return (**IRR**) promised to investors; for securitisations, timely payment to noteholders is important to support the ratings required for the notes.

4. ***Certainty is key***: Both debt funds and securitisation require certainty as to their tax position at day one. For securitisations, this is particularly important given rating requirements and the deliberately inflexible and 'automated' structure on which they rely. As far as the PPT rule is concerned, the OECD commentary needs to include clear, straightforward, unequivocal guidance as to the application of the rule to non-CIVs, accompanied by realistic examples to provide taxpayers and their advisers with the required certainty.

5. ***There is no "one-size fits all" approach for non-CIVs***: The number and nature of the questions included in the Discussion Draft highlight the challenges in crafting a single workable safe harbour for a "good" non-CIV. In relation to the PPT rule, we welcome the OECD's willingness to consider adding "one or more examples" to the Commentary: given the different features of particular types of non-CIV, we would recommend that the OECD include specific examples for debt funds and securitisations, as well as for real estate funds.

   A similar point arises in relation to the proposed LoB provision: it may be that more than one non-CIV carve-out is needed, given the differences between particular types of investment vehicle. This is particularly the case for securitisation, where a derivative benefits test would be impossible to meet as a practical matter, because of the listed and traded nature of securitisation bonds.

6. ***Safe harbour for "widely held" funds***: We agree with the BPF that an investor in a widely held fund will not have the power to influence the structure or investment of a fund for their own tax advantage – so the risk of treaty abuse in a widely held fund is negligible. However, it is important that any "widely held" test is not simply a matter of counting the number of investors. This is particularly important for funds that invest in CRE debt – such funds tend to have a small number of (typically institutional) investors, owing not to tax considerations but to the newness, limited

scale and specialized nature of the asset class. Any test based on wide ownership should recognise the nature of the investors (are they themselves widely held?) and consider their ability to influence fund strategy (through control rights).

The PPT Rule - Private equity debt funds

An example relating specifically to the treatment of debt funds should be included in the commentary on the OECD. In response to question 25, we attach a proposed example at Appendix 1, and set out below the rationale underlying it.

1. Role of private equity debt funds

Until the financial crisis, the European CRE debt market was overwhelmingly dominated by banks. This led to concentration risk and a lack of transparency or liquidity that continues to afflict Europe's financial system and economy. However, since the crisis, various kinds of CRE debt funds have emerged. Most originate or participate in new CRE loans, helping diversify CRE risk away from the banking system and providing a mechanism for non-originating capital to gain CRE debt exposure. Some specialise in junior or mezzanine debt, filling a gap in the higher-risk part of the market no longer attractive to banks that are (quite rightly) adopting a more conservative approach than they did before the crisis. Others tend to focus their lending activities on senior loans only. A small number have played an essential role in helping to resolve the pre-crisis legacy by acquiring portfolios of sub-performing or non-performing loans (**NPLs**) from banks or national asset management agencies.

The result of this rapid diversification is that the CRE industry is now able to access finance not only from the banks, but also from a range of new lenders and new vehicles for non-originating capital providers (including institutional and private equity debt funds). The existence of such debt funds complements bank credit for business and also helps to promote system resilience through diversification of lending sources.

For non-originating investors, the appeal of debt secured on real estate has long been recognised. Debt funds can be seen by investors, particularly institutional investors such as insurance companies and pension funds, as offering a competitive risk-adjusted return.

As is the case for private equity funds that invest in companies or real estate, the principal purpose of CRE debt funds is to allow investors, including major institutional investors, to benefit from the expertise of professional fund managers with significant experience of the CRE finance sector, in addition to the general benefits that arise from collective investment (namely, the ability to pool capital and thereby access investment opportunities which may not otherwise be available, as well as achieve risk diversification).

2. Common structure of private equity debt fund

By way of example, we summarise below a common structure used by debt funds. In many ways, it is not dissimilar to the structure of other forms of private equity or alternative fund.

Nature of fund: The fund itself will normally be constituted as a fiscally transparent partnership, as is common in the funds industry generally. Its investors will normally be a mix of institutions (insurance companies and pensions funds), sovereign wealth funds and high net wealth individuals.

Nature of Investors: Institutional and sovereign wealth fund investors may invest directly in the fund, or through intermediate companies (depending on their preferred investment strategy). In general, most debt funds currently have a small number of such investors (usually less than ten) and there is limited trading of fund interests: generally, the investor base of a particular fund is stable.

The nature of these types of investors is such that they would, were they to lend directly, generally be eligible for treaty benefits, or tax exempt (such as pension funds or sovereign wealth funds). However, given that investors are likely to be from a number of different jurisdictions, it is likely that each would be eligible under a different treaty.

Investment Decisions: The fund's investment strategy - the type and nature of loans it intends to make (including any geographical and/or sector restrictions) – will be set out in the fund's prospectus (and detailed in the partnership agreement). The investors and the fund adviser/manager will be unrelated (save to the extent the adviser/manager or its staff co-invest in the fund to align interests), and the adviser/manager will have discretion in selecting suitable investments within those restrictions.

The fund will invest in loans – either through originating loans to CRE borrowers, or acquiring loans from existing lenders (either as part of primary syndication or subsequently in the secondary market). These loans are generally acquired to hold to maturity (although certain strategies, including NPL investment, where active management, restructuring, enforcement or disposal may be likely). Its investment strategy, as detailed in the fund's partnership agreement, will be outlined in the fund prospectus.

*Making investments – use of SPV*s: In general, loans will be made not by the fund itself, but by one or more corporate special purpose vehicles set up by the fund. This in part reflects how the underlying CRE debt market works. Borrowers typically expect to deal with corporate lenders (and this is reflected in market-standard loan documents). Using a corporate vehicle (**Holdco**) means that investors can be insulated from certain legal risks by virtue of the resulting "corporate veil". Certain jurisdictions may have specific regulatory requirements which need to be met for an entity to be allowed to lend into the jurisdiction. Setting up a Holdco as lender therefore offers significant commercial benefits, as it is that company (not the fund - and accordingly not the (passive) investors) that will apply for all relevant regulatory consents and licences.

In addition, some, but not all, debt funds may wish to enter into joint ventures or use leverage as part of their investment strategy in respect of some or all of their loan investments – linked to achieving a particular IRR for investors. Where leverage is used, the lender providing that financing will generally want specific security over both the underlying (loan) asset being financed, and the entity that holds it. Using a Holdco facilitates the provision of acceptable security by providing an effective ring-fencing around the relevant asset.

Where a debt fund sets up a Holdco, it is common for the Holdco to be funded by a loan from the debt fund.

Returns on capital invested: The investments made by the fund will generate income for investors (primarily in the form of interest on the underlying loans and any fees). The capital provided by investors, which will be used to make loans to borrowers, will be repaid out of the repayment proceeds paid by borrowers (although where a borrower prepays a loan, the principal received may be reinvested, if the prepayment is in the first couple of years of the fund).

Fund performance, as is the case for other non-CIV private equity funds, is driven by financial performance, measured by the IRR, which looks to both the timing and amount of investor cash receipts. Fund advisers/managers receive a fee that will generally include a performance-linked element (which is triggered once investors have received a specified IRR – a so-called hurdle). As a result, there is a clear and strong commercial incentive for funds (far outweighing any possible tax deferral benefit of retaining cash in the structure) to pass investment profits to investors when they arise – to meet IRR targets and as a result for managers to be in a position to be able to start accruing the performance element of their fee.

3. Importance of treaty benefits

In common with other collective investment vehicles, a debt fund will look to use, so far as reasonable, a tax efficient structure to holding its investments, so as to optimise returns to investors. In some ways, the aim is to get as close as possible to the tax position that the ultimate investors would have been in if they had directly made the relevant investments. As a result, treaty benefits are needed to ensure that an additional layer of taxation does not arise merely because the investment is through a fund.

The availability of treaty benefits is important to the fund in relation to its investment holding structure in two specific ways:

(a) interest payments from borrowers to Holdco; and

(b) dividends and interest payments made by Holdco to the fund itself.

Treaty benefits re investments: Looking first at interest payments from borrowers to HoldCo, the loan market works on a presumption of gross payments (in that lenders expect to receive interest free of withholding, and borrowers expect to pay the net interest only (i.e. without having to "gross up" for any shortfall resulting from withholding tax). As a result, loan documentation generally contains market-standard provisions designed to allocate the risk of withholding tax as between (different types of) lender and borrower, with some loans prohibiting assignment to a new lender who would trigger a withholding obligation.

Where loans are cross-border, the treaty status of both the current lender and any potential future lender in respect of the loan is therefore of direct relevance to the parties when deciding to transact. If withholding tax were to apply to interest payable to Holdco, then, unless the borrower is required to gross-up its interest payments, investors would incur an additional level of tax which would not apply if they lent directly. If the borrower is required to gross-up, then the borrower's effective cost of funds increases, as compared to the position under a direct loan made by a treaty-protected lender. Further, where Holdco is looking to buy (rather than originate) its interest in the loan, the fact that the borrower may have to gross-up payments to Holdco could preclude Holdco from making that investment in any event.

Similarly, if there is uncertainty as to whether withholding applies (for example, because a debt fund lender needs to apply to the competent authorities for discretionary relief), the allocation of risk between lender and borrower whilst that application is pending could also impact the economics of the loan.

Ultimately this could mean that the funding currently being provided by debt funds ceases to be viable economically, impacting the availability of finance from this increasingly significant sector of the CRE finance market and reducing effective competition in the debt market by placing market-based finance provision (through such funds) at a tax disadvantage relative to more traditional sources of finance. We can see no policy justification for such an outcome.

Importance of avoiding double taxation: The availability of treaty benefits means that the likelihood of investors suffering additional levels of tax to that which would have been payable had they invested directly is reduced: the availability of treaty benefits is therefore important in ensuring tax neutrality of funds. As a result, although a number of factors will influence the choice of jurisdiction of Holdco (such as the legal regime, political stability, investor familiarity, flexibility to extract proceeds from piecemeal realisations of the portfolio), it is extremely unlikely in practice that, where a fund has a number of possible jurisdictions to choose between, it would locate Holdco in a jurisdiction that was not suitably treaty-protected.

In addition, as highlighted above, the availability of treaty benefits is also important for the fund to be able to lend in the first place.

Tax is thus a factor that is considered when the fund sets up its investment holding structure. That is not to say that access to treaty benefits is a principal purpose of non-CIV funds. Rather, treaty benefits are a necessary condition for allowing investors to access the investment opportunity offered by CRE debt funds without suffering an additional layer of tax. The need for tax neutrality is a requirement arising from the use of a non-CIV fund and its underlying investment strategy, not a main purpose of the arrangement; this is not a case involving treaty shopping. The fact that the availability of treaty benefits is considered by the fund, among other factors, does not render its behaviour abusive.

The PPT Rule – Securitisation

We consider that the OECD should include within its guidance on the PPT an example relating specifically to the treatment of debt funds. In response to question 25, we attach a proposed example at Appendix 2, and set out below the rationale underlying the drafting of that example.

1. Role of securitisation

Securitisation companies are recognised by regulators as an essential part of well-functioning capital markets. Encouraging the re-emergence of a European securitisation market is a key aspect of the European Commission's Capital Markets Union Action Plan.[1] In particular, the European Commission has stated that it sees securitisation as "an important channel for diversifying funding sources and enabling a broader distribution of risk by allowing banks to transfer the risk of some exposures to other banks, or long-term investors such as insurance companies and asset managers".

In the context of CRE debt, securitisation serves a useful role, both in terms of transferring credit risk arising from CRE lending away from the banking sector; and also in providing long-term investors with the opportunity to have access to a diverse pool of assets in a form which can be lower-risk than the underlying loans. Various post-crisis challenges have limited the growth of a significant, sustainable CMBS market in Europe, but it is important to ensure that the regulatory and tax environment does not unnecessarily create additional barriers to the evolution of such a market.

2. Common structure of CMBS

By way of general background, a bank or other originating lender may make use of securitisation after making various loans to third party borrowers, based in a number of different jurisdictions.

The Issuer: At a certain point, the origination lender determines to securitise the loans. A securitisation company (**Issuer**) is established by a corporate services provider as an "orphan" on terms that the shares are held on a charitable trust. The directors of the Issuer will in many cases be provided by that corporate services provider. The orphan nature of the Issuer is effectively a rating agency requirement,

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[1] See the European Commission Press Release on CMU of 30 September 2015 at http://europa.eu/rapid/press-release_IP-15-5731_en.htm?locale=en and associated materials.

as it supports the "insolvency remoteness" of the Issuer (i.e. the Issuer will not be affected should the originator become bankrupt).

The Issuer issues notes through the capital markets to a wide pool of third party investors including asset management firms, hedge funds and institutions. There are likely to be a number of different classes of notes (i.e. senior and more junior tranches), most or all of them rated, with the most senior class typically being rated AAA.

Most if not all of the notes are listed on a stock exchange, allowing them to be traded on the secondary market. As the notes are held through a clearing system, the Issuer is unlikely to have any actual knowledge of the identity of its investors.

The pool of loans: The proceeds of the notes issue will be used by the Issuer to acquire the relevant pool of loans from the originating lender. The loans to be acquired will have been determined by the originating lender having regard to rating criteria, so that the notes can get the desired ratings. Certain details of the loans to be acquired by the Issuer will be made available to prospective note-holders in a prospectus.

The cash flows: Interest and principal received from borrowers will be applied in paying interest, and repaying capital, on the notes in accordance with a pre-agreed contractual priority of payments. In general any money received by the Issuer from its investments will be paid out within a short period to noteholders, after meeting expenses (in practice this is usually within 14 days and almost invariably within the same quarter (i.e. 90 days)) – although the Issuer may be required under the securitisation arrangements to retain an amount by way of profit and/or for reserves against specific credit-related risks (again, to satisfy rating agency requirements). In some jurisdictions (including the UK), the ability of the Issuer to qualify as a securitisation company is dependent on all cash receipts being paid out within a particular period of receipt.

The principal activities of the Issuer: Activities such as collecting payments from borrowers, making payments on the notes and any related administration are delegated to agents, and a loan servicer is appointed to act on the Issuer's behalf in respect of loan portfolio surveillance and dealings with borrowers. The Issuer itself is designed to be passive, with all its principal activities contracted out to third party service providers. Further, the parameters within which the Issuer (and its agents) can act will be prescribed by contracts entered into on day one – the arrangements that support the structure are in effect regulated by the requirements of the rating agencies and as a result the Issuer has very limited discretion in relation to managing its assets.

3. Importance of treaty benefits

Although many securitisations are domestic (i.e. originating lender, Issuer and borrowers are all resident in the same jurisdiction), cross-border securitisation can and does also occur – and it can be a policy goal to promote it, as for example in the context of European Capital Markets Union.

As stated above, the loan market works on a presumption of gross payments. As a result, none of the loans would be subject to withholding tax when made, either by virtue of a specific domestic withholding exemption or because of a treaty claim by the lender.

As is the case with debt funds, when structuring a securitisation, the focus is on achieving tax neutrality so that interest and principal received on the underlying loans are available to the fullest extent possible to service the notes (after meeting known third party expenses). By buying notes issued by the Issuer, investors acquire an interest in the cash flows generated by the underlying loan pool.

If the Issuer were not entitled to treaty benefits in respect of the acquired loans and borrowers applied withholding tax, the additional cost would impact the assumed securitisation cash flows and thus also the rating of the notes and ultimately the viability of the securitisation itself. Even material uncertainty at the outset of a securitisation regarding the Issuer's ability to obtain treaty benefits in respect of a particular loan would probably prevent the loan from being securitisable. Uncertainty in this context would include the situation where the Issuer would need to apply for discretionary relief under a treaty.

The reason why certainty on tax is needed is because the rating process involves the Issuer receiving legal opinions on certain matters, including tax. The tax opinion would address the ability of the Issuer to receive interest on the securitised loans free of withholding. If the opinion is qualified in any way because of any uncertainty as to, say, the Issuer's entitlement to treaty benefits, the rating agencies will in effect assume interest is received net of withholding. The cost of that withholding has a direct impact on the cash assumed to be available to service the notes, and so affects the ratings – and ultimately therefore the economics (and viability) of the transaction.

The purpose of securitisation is a commercial one: the transfer of risk to non-originating investors and the recycling of capital by the originating lender. In structuring the securitisation, tax is an important consideration, both at entity level (i.e. the tax treatment of the Issuer itself) and in terms of withholding tax. Tax neutrality is an essential element of the rating analysis and therefore of the structuring of the deal, not a main purpose of it. Similarly, investors expect limited (and known) tax leakage within the structure, and that the Issuer will be entitled to receive interest gross. Again, this does not mean that obtaining treaty benefits at Issuer level is a principal purpose of the arrangement.

Many jurisdictions provide a specific exemption from withholding tax for listed securities (for example, the quoted Eurobond exemption within the UK tax code), to encourage capital market financings. Given that withholding is generally disapplied in relation to both interest on CRE loans and interest on securitisation bonds, it is hard to see any policy rationale for denying treaty relief to securitisation Issuers. The effect would simply be to make securitisation very difficult, contrary to policy objectives in many countries.

We would ask that the OECD provide a clear example of the application of the PPT rule to securitisations to provide the certainty required (including by rating agencies) to enable the securitisation market to function as intended.

The LoB Rule

We generally agree with the comments made by the BPF in its responses to the questions raised in the Discussion Draft. We have the following additional comments, reflecting specific concerns relating to debt funds and securitisation.

Questions 1 and 2: What would be the threshold for determining that a fund is "widely held" for the purpose of such a proposal? What types of regulatory frameworks would be acceptable in order to conclude that a fund is "regulated" for the purposes of such a proposal?

CRE debt funds (in common with many real estate funds) typically have a small number of (mainly institutional) investors, often less than ten. That is a function of the newness, modest scale and specialised nature of the asset class, and has nothing to do with tax.

Any "widely held" test must take account of the nature of the investors (and not just the number), and "cliff-edges" should be avoided as regards any minimum. In particular, where investors would themselves be regarded as widely held, the fund should also be considered to have met the test.

We also agree with the BPF that regulation should not be a condition to treaty access.

Question 4: Is it correct that investors in a non-CIV are typically taxable only when they receive a distribution? Would there be mandatory distribution requirements for a fund to be eligible for the proposed exception and if yes, would intermediate entities be required to distribute earnings up the chain of ownership on a mandatory basis? If not, how would concerns about deferral of tax be addressed.

As explained above, the risk of tax deferral is very low in relation to both CRE debt funds and securitisations, given the commercial imperative to pass money to investors promptly. In any event, the concerns about deferral may be best tackled through domestic rules enacted by individual states to address deferral by their residents (by taxing on a current basis (undistributed) income earned through an investment fund), that take account of the operation of their domestic tax framework and policy objectives (particularly if it is the case that member states take different views as to the risks from potential for deferral, which was suggested in relation to the 2010 OECD Report on granting treaty benefits to CIVs).

Question 9: Unlike CIVs, which are defined in paragraph 6.8 of the 2010 Report on CIVs, the term "non-CIV" has no established definition. What would be the main types of investment vehicles to which the proposal could apply?

There is no "one-size fits all" definition of a non-CIV. There is a wide spectrum of funds that could be excluded from being able to benefit from tax treaties under the current proposed form of LoB in circumstances where there is no tax abuse. Therefore, we would ask the OECD to consider including within its non-CIV safe harbour different criteria or regimes, enabling different types of non-CIV fund to access treaty benefits.

This is particularly important for securitisations. Securitisations would be very unlikely to qualify for treaty benefits under the type of non-CIV provision being contemplated in the Discussion Draft, particularly as a securitisation company will generally have no information about its investors. In particular, as investors in a securitisation hold their economic interest by way of debt securities, the base erosion test is unlikely to be met; and any derivative benefits related criteria would be impossible to meet (the subject of question 8).

This would suggest that either securitisation companies are carved out specifically (in a way similar to that suggested for CIVs at paragraphs 35 or 42 of the draft commentary in Section A of the OECD's Action 6 Final Report, subject to appropriate modifications reflecting the structure of such transactions (for example, the listing of its bonds and/or the existence of a particular securitisation regime within one of the Treaty States).

Question 14: How would the proposal address the concern, expressed by some commentators, that many non-CIV funds would be unable to determine who their ultimate beneficial owners are and, therefore, would not know the treaty residence and tax status of these beneficial owners?

The comments made by the BPF in relation to question 14 (and also questions 15 and 16) apply equally to debt funds. We concur that a pragmatic approach needs to be taken here.

However, as stated above, securitisation Issuers and sponsors are generally unaware of the identity of their investors (who can change as notes are traded), and so would not be able to determine the tax status of noteholders. It is for that reason that exemption from withholding tax on interest on bonds issued on the capital markets is generally conferred by a specific domestic exemption (as is the case in the UK) such that treaty entitlement of noteholders is irrelevant in practice. It would seem both odd and inequitable for the ability of a securitisation entity to claim treaty benefits to be dependent on noteholders' tax status.

Question 17: Since beneficial interests in non-CIV funds are frequently held through a chain of intermediaries, including multiple subsidiary entities (which is not the case of typical CIVs), how would the proposal overcome the difficulties derived from such complex investment structures with multiple layers and ensure that a fund is not used to provide treaty benefits to investors that are not themselves entitled to treaty benefits?

Any intermediary entity should be able to claim treaty access if it is owned by a non-CIV which itself could claim treaty relief: i.e. the treaty eligibility of the fund itself would allow any intermediary entities which are controlled by it to access treaty benefits.

Question 24: Although the above proposal for a "Global Streamed Fund" regime is very recent and has not yet been examined by Working Party 1, the Working Party wishes to invite commentators to offer their views on its different features. In particular, the Working Party invites comments on [it].

We agree with the BPF that a GSF regime should be an elective one, and that introducing such a regime could raise significant transitional issues for existing funds (and tax authorities).

We would be happy to discuss any of the points made above, or any queries relating to the examples below, at your convenience.

Yours sincerely

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Appendix 1: Debt Fund example

A non-CIV fund, structured as a fiscally transparent partnership, is established to invest in a portfolio of loans. The fund may invest in loans in order to benefit from a regular income stream in the form of interest receipts (whether by originating such loans or acquiring existing performing loans), or it may seek to invest in distressed or otherwise underperforming loans, in the hope of achieving a profit from a future repayment, restructuring or disposal of the loans.

The fund is marketed to pension schemes, sovereign wealth funds, other institutional investors and high net worth individuals, on the basis of a prospectus that will become the investment mandate of the fund. A variety of investors unrelated to the manager, and who may be resident in different jurisdictions, commit funds to the partnership without then knowing either the identity of the target investments or the specific jurisdictions in which the investments will be made (although the prospectus will set out the fund's investment strategy and may therefore indicate a particular geographical, sector-based or other investment focus for the fund). The investment strategy of the fund is not driven by the tax position of the investors, but on the basis that it will seek to invest in a range of debt obligations offering a suitable return on capital. The fund manager (and its staff) may co-invest alongside third party investors to provide alignment of interests.

Debt investments are made through a holding company, RCo, established in State R. It is likely that the investments held through RCo will include debt investments from different jurisdictions, some of which may not impose withholding taxes in respect of income and gains arising from debt investments, as well investments in jurisdictions that do impose such withholding taxes.

There are a number of reasons for the fund to establish a holding company in order to make debt investments.

By establishing a corporate holding company to make investments, investors in the fund will benefit from the protection provided the limited liability afforded to the fund as shareholder in RCo. There may, for example, be regulatory requirements arising in the jurisdiction(s) in which loans will be made that make a corporate holding vehicle desirable.

In addition, borrowers typically expect to deal with corporate lenders. This is reflected in market-standard finance documents. Accordingly, the use of a corporate holding company facilitates both negotiations with new borrowers and the transfer of existing loans originated by other lenders on normal market terms.

In some cases, a fund may wish to leverage the investors' capital in relation to all or some of its investments to enhance the return on capital (either at the outset of the fund or at a later stage to be determined). The use of a corporate holding vehicle provides the fund with increased flexibility to utilise external leverage as a component of its investment strategy. This is because a lender to the fund will typically prefer to lend to a holding company, as this facilitates the taking of security over both the investment portfolio and the share capital of the holding company itself. If the fund wants to retain the flexibility to use external leverage for some, but not all, of its investments, the fund may set up a series of investment-specific holding companies, each of which would hold separate investment portfolios, to simplify any such financing arrangements.

In deciding on the location of RCo the fund manager considers the legal regime, political stability, investor familiarity, flexibility to extract proceeds from realisations of the portfolio and tax considerations such as certainty around the taxation position of the holding company in respect of income from the portfolio and proceeds from the disposal of its investments (which includes considering the treaty position of RCo in relation to a likely range of borrower jurisdictions). These tax considerations are taken into account as part of the decision but are one factor in a range of considerations.

In making the decision to locate the holding company in State R, the fund manager will have considered the availability of benefits under the tax conventions between State R and the states of residence of potential borrowers, but that alone would not be sufficient to trigger the application of [paragraph 7]. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not [paragraph 7] applies to an investment, it is necessary to consider the context in which the investment was made. In this example, in the absence of other facts and circumstances showing otherwise, RCo's investments are made for commercial purposes consistent with the investment mandate of the fund, so it should receive treaty benefits. In summary, unless RCo's investments are part of an arrangement, or relate to another transaction, undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the tax treaties between State R and any states which may seek to impose tax in respect of income or profits arising from RCo's investments.

Appendix 2: Securitisation Example

LenderCo makes loans to unconnected borrowers located in one or more jurisdictions. LenderCo may be a bank or a non-bank lender. To remove risk from its balance sheet and recycle its capital, LenderCo wishes to securitise a portfolio of loans which it has originated. To facilitate the securitsiation, a special purpose vehicle, SCo, is set up. As is common for securitisations, the issued share capital of SCo is held by independent shareholders to ensure that SCo's solvency would not be affected by the bankruptcy of LenderCo. SCo is a resident of State S. LenderCo may be resident in State S or in a different state.

The decision as to where SCo should be resident is driven by State R's securitisation and other relevant legislation, established credentials as a location for establishing securitisation companies, skilled and knowledgeable professional services market and tax considerations relating to obtaining certainty as to the tax treatment of SCo. These tax considerations include the comprehensive double taxation treaty network of State S, including its tax treaty with any state in which borrowers under LenderCo's loans are resident.

SCo raises debt finance to fund its acquisition of loans from LenderCo by issuing bonds to third party investors in the capital markets. LenderCo may be required to hold a proportion of the bonds issued by SCo for regulatory reasons. The bonds are rated and listed on a recognised stock exchange. Investors' decisions to acquire the bonds issued by SCo are not driven by the location of any particular investment made by SCo and SCo's investment strategy is not driven by the tax position of investors (in fact, SCo has limited or no information about its investors, which will change as the bonds are traded). Subject to any special regime applicable for securitisation companies, SCo is taxed in State S on income earned and is entitled to a full deduction for interest payments made to investors. In addition, payments of interest on the bonds to investors by SCo can be made free of withholding tax under the tax laws of State S.

SCo uses the proceeds of the bond issuance to acquire the portfolio of loans from LenderCo. The portfolio includes loans made to borrowers resident in State R – these loans may in aggregate represent a significant proportion by value of the portfolio. SCo receives regular interest payments on these loans. Under the tax treaty between State R and State S, the withholding tax rate on interest is reduced from 30% to 0%: had LenderCo retained the loans, LenderCo would have been entitled to an equivalent reduction in withholding, whether under the applicable treaty with State R or under some other exemption.

In this example, merely reviewing the effects of State R's tax treaty with State S on interest payments by the borrowers located in State R to RCo, or the fact that State S has a comprehensive double tax treaty network, would not enable a conclusion to be drawn about the purpose of the establishment of SCo by LenderCo.

The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, in order to determine whether or not [paragraph 7] applies to an investment, it is necessary to consider the context in which the investment is made. Assuming that SCo was established in connection with a genuine commercial decision made and implemented by LenderCo to securitise certain assets, and unless SCo's investment in the loan portfolio is part of an arrangement, or relates to another transaction, undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R / State S tax convention to SCo.