For the attention of the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA
By email: taxtreaties@OECD.org
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CREFC Europe response – OECD BEPS Action 6 Discussion Draft on non-CIV Examples

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 CRE businesses, as well as advisers, consultants and others with a stake in this sector.

Investment into CRE is critical for any economy. 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 as well as equity capital. This dependency is driven principally by the very different risk and return expectations (and hence cost) of different types of capital. By meeting that financing need, the CRE finance industry plays an important role in supporting CRE investment and, as a result, the wider economy.

We appreciate the efforts being made by the OECD to find a solution for non-CIVs, particularly given the challenges in crafting a single workable safe harbour for the numerous types of non-CIVs that exist. We are very encouraged by the OECD's willingness to include within the Commentary for the OECD Model Tax Convention on the principle purpose test (**PPT**) specific examples on non-CIVs. In particular, we are very pleased that one of examples being considered for inclusion specifically relates to securitisation. Much of this submission relates to the securitisation example.

However, for the reasons we set out below, we also urge you to consider adding an example for debt funds, which have emerged as a vitally important mechanism for the provision of credit to CRE markets. We attach a suggested draft example for debt funds at Appendix 2. If you are not willing to add such an example because of considerations of space (rather than on substantive grounds), please consider adding a statement that explicitly recognises that non-CIVs of certain types not covered in the examples, such as debt funds, should not, in the ordinary course, be denied treaty benefits.

Finally, we are aware of the submissions from INREV and the British Property Federation (BPF) in response to the Discussion Draft concerning the draft example relating to immovable property non-CIV funds. We support the comments INREV and the BPF make in their submissions.

Key points

1. **Certainty is key**: Securitisations require a high degree of certainty as to their tax position at day one. This is particularly important given rating requirements. Therefore, as far as the PPT rule is concerned,

we consider that a securitisation company example should be definitely be included as a non-CIV example within the OECD Commentary on the PPT rule.

2. **There is no "one-size fits all" approach for non-CIVs**: Similarly, there is no "one-size fits all" securitisation structure. Although that the rationale and basic securitisation model, will be the broadly the same regardless of where the securitisation company is located, differing regulatory and other requirements across jurisdictions (both at any specific point in time, but also over time as regulation evolves) means that a specific transaction may differ structurally from the base model.

   We recognise the need within the Commentary for a "universal" example: one that is neither too specific nor too complex. But if that example is construed by individual OECD member states too narrowly, bona fide commercial transactions risk being excluded from the treaty benefits for no good reason. ***We therefore strongly recommend that, in the Commentary accompanying these examples, the OECD clarify that not being able to match one or more particular features as set out in the examples does not preclude a non-CIV from accessing treaty benefits: i.e. that the examples included are illustrative and not limiting in nature***.

3. **Treaties must 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. A balance therefore needs to be struck between ensuring that treaties cannot be easily abused and facilitating commercial cross-border trade and investment.

   We recognise that it will not be possible to include non-CIV examples dealing with every possible fact-pattern, so that a limit has to be set somewhere - with the Commentary focusing on those situations identified as "common". However, we are disappointed that the limit has been set so low (i.e. "up to three", which means potentially that only one could be included). For the reasons set out in our response to the earlier OECD Discussion Draft: Treaty entitlement of non-CIV Funds (as summarised in "*Other non-CIV examples: debt fund example*?" below), ***we therefore ask the OECD to be open to including "more" examples of non-CIVs - with the "more" including a specific examples for debt funds***,

The Securitisation Example

1. Why include a securitisation company example

We are pleased that the OECD is considering a securitisation example for inclusion within its Commentary on the PPT rule. Securitisation can serve a particularly useful role within CRE finance. It facilitates the transfer of credit risk arising from CRE lending away from the banking sector whilst at the same time providing long-term investors with access to a diverse pool of assets in a form that is more liquid, and can be lower-risk, than the underlying loans. Given the importance of certainty within the securitisation market, we urge the OECD to include a securitisation company example as one of the (up to 3) examples of non-CIVs to be contained within paragraph 14 of the Commentary on the PPT rule.

As set out in our response to the 2016 OECD BEPS Action 6 discussion draft: Treaty entitlement of non-CIV Funds (the **2016 Response**), securitisation plays a key role in financial and capital markets. Although a lot of securitisation activity is domestic, cross-border securitisation does occur (for example, in relation to pan-European CRE loans).

As we explained in our 2016 Response, both the loan and securitisation markets work on a presumption of gross payments. If a cross-border securitisation issuer (the **Issuer**) were not entitled to treaty benefits in respect of the underlying securitised loans, the additional tax cost could have a significant impact on the assumed cash flows within the securitisation (and as a result on the likely rating of the notes).

Similarly, any uncertainty as to an Issuer's ability to obtain treaty benefits, including where treaty relief is dependent on an application for discretionary relief, would have an adverse effect on the viability of that securitisation transaction. This is because the rating agencies will then 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 ultimately therefore the economics (and viability) of the transaction.

We therefore consider that the inclusion of a securitisation example in the Commentary will be very useful in clarifying the potential application of the PPT to securitisation transactions. The example published in the Discussion Draft is helpful because it:

(a) highlights the key features of a basic securitisation transaction;

(b) recognises and acknowledges the relevance of tax (as one of a number of factors) in structuring a securitisation transaction (in particular, in relation to locating the Issuer); and

(c) effectively confirms, in its conclusion (as set out in the final paragraph), that, absent unusual deal-specific facts, , treaty benefits should be provided.

We therefore urge the OECD to include a securitisation example in the Commentary.

2. Detail of securitisation company example

We appreciate that the examples included in the OECD Commentary need to be clear, concise and straightforward – and, so far as possible, universal. As a result, any example will inevitably be somewhat generic.

However, in reality there is no "one-size fits all" securitisation structure. Differing regulatory and other requirements across jurisdictions, as well as market developments and the features of different underlying asset classes, mean that a specific individual transaction may differ structurally from the "base" model reflected in any example.

In our 2016 Response, we summarised the common CMBS structure. We are pleased that many of the features we highlighted in the 2016 Response have been reflected in the draft securitisation example set out in the Discussion Draft. However, because of how the securitisation market works in practice, the example, if construed narrowly, means that bona fide commercial transactions risk being excluded from the treaty benefits because they are not on all fours with the example given.

By way of illustration, we set out in Appendix 1 some comments on the example. Not all our comments require drafting changes to be made to the example: we appreciate the need to avoid having an example that is "too long or too specific". But the comments highlight the need to ensure that divergence away from one or other of the listed features does not by itself risk treaty benefits – particularly as the divergence will generally be driven by commercial or regulatory factors.

Obviously the OECD Commentary is not law as such, and it will be down to individual OECD member states to determine how they apply the PPT in practice. However the Commentary is designed to – and will – influence how member states apply the PPT. ***We therefore strongly recommend that the OECD explicitly clarify that not being able to match one or more particular features as set out in the example does not preclude a securitisation from accessing treaty benefits: i.e. that the example is illustrative, and not limiting in nature***. Ultimately, regard must be had to all relevant facts and circumstances, with member states being encouraged to use the example in analogous, but not identical, situations: this point equally applies to each of the examples (see also the comments made by INREV and the BPF in their submissions). In this context, it may be helpful if the Commentary provides some background to the focus on particular features – emphasising that these are illustrative of approach rather than definitive detail, and that commercial or legal (non-tax) requirements may mean that a transaction has to be set up in a different way, but that in itself would not mean it was reasonable to deny treaty benefits.

Other non-CIV examples: debt fund example?

1. General

In its 2015 Final Report on BEP6 (in paragraph 14 of the Introduction), the OECD states:

> "*As regards the broader question of the treaty entitlement of non-CIV funds, the OECD recognises the economic importance of these funds and the need to ensure that treaty benefits be granted where appropriate [...] there is a need to continue to examine issues related to the treaty entitlement of non-CIV funds to ensure that the new treaty provisions that are being considered adequately address the treaty entitlement of non-CIVs*."

The Discussion Draft notes that the Working Group has decided that only a limited number of examples (up to 3) should be included in the Commentary on the PPT in relation to non-CIVs. The stated aim is to provide examples dealing with "common transactions".

The examples that have been publicly released for comment involve:

(a) an investment holding platform set up by a significant institutional investor (such as a pension fund or a sovereign immune entity);

(b) a securitisation company; and

(c) a real estate fund, marketed to institutional investors.

The Discussion Draft also notes the number of other examples proposed to be included in the Commentary on the PPT (ten). All the examples broadly serve the same purpose – illustrating how, on a specific (summarised) fact-pattern, all "relevant facts and circumstances" can result in a particular (reasonable) conclusion under the PPT. The inclusion of the proposed number of examples within the Final Report draft Commentary indicates the difficulties in explaining (within the text itself) how the PPT should apply, even to relatively straightforward fact patterns.

Those difficulties apply equally (if not more so) to non-CIVs. Inclusion of examples within the Commentary on non-CIVs more generally would be helpful in ensuring that "the new treaty provisions [which include the PPT] [...] adequately address the treaty entitlement of non-CIVs". Each example helps provide certainty to taxpayers (and equally OECD member states) – and, as a result, ensures consistency in how the PPT is applied by different jurisdictions.

We are therefore disappointed that the limit on non-CIV examples has been set at "up to three" only. We note that the Discussion Draft acknowledges that agreement on the inclusion of any of these examples has not yet been reached: that in itself is telling of the need for more, rather than less, given that such divergence of opinion implies that, once the multilateral instrument takes effect, there will be an actual divergence in approach when granting/denying treaty benefits to non-CIVs in the future.

We therefore ask the OECD to be open to including more examples of non-CIVs in the Commentary, to facilitate consistency in approach between OECD member states in applying the PPT.

2. Why include a debt fund example?

As set out in our 2016 Response, we consider that an example relating specifically to the treatment of debt funds should be included in the OECD Commentary on the PPT.

Since the financial crisis – and in part because of the weakness of securitisation markets in Europe in recent years (with CRE debt securitisation through commercial mortgage-backed securities (**CMBS**) especially hard hit) – debt funds have emerged as a very important channel for debt finance to the CRE sector. CRE debt funds play an important part in the functioning of the CRE finance market. They help diversify CRE risk away from the banking system and therefore help promote financial system resilience. With many banks understandably taking a more conservative approach to lending than previously, CRE funds are able to "fill the gap" – providing borrowers with additional sources of capital for their business, and providing greater diversity of financing products than the banking sector alone provides. In common with the real estate fund example, the principal purpose of CRE debt funds is to allow investors, particularly major institutional investors, to benefit from the expertise of professional fund managers or advisors with specific experience of the CRE finance sector, in addition to the general benefits that arise from collective investment (namely, the ability to pool capital to diversify risk and access investment opportunities which may not otherwise be available).

In our 2016 Response, we summarised a common debt fund structure and commented generally on the importance to such funds of being able to access treaty benefits. As described in our 2016 Response, debt funds often set up a single purpose company to advance loans to borrowers – a Holdco. A Holdco, like a securitisation issuer, will hold one or more loans to unconnected borrowers and, using the funds received from those borrowers, make payments to the investors (via the debt fund, which will normally be a tax transparent vehicle).

Although there are similarities between such a Holdco and RCo in each of the regional investment platform and immovable property non-CIV examples[1], we are concerned that tax authorities tax authorities may regard the activity of acquiring loans (whether through origination or secondary market acquisition) as a fundamentally different investment activity to both securitisation and real estate investment, and so not covered, even by analogy, by the non-CIV example(s) included in the Commentary on the PPT.

In common with the investment holding platform and real estate fund examples, a debt fund aims to get as close as possible to the position that the ultimate investors are taxed as if they had directly made the relevant investments. For the reason, certainty as to the availability of treaty benefits is essential to minimise the risk of there being additional layers of tax due to investment through a fund.

But that certainty is not just important for the fund's investors: it also matters for the borrowers. As above, 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)). If interest payable to a particular lender is or could be subject to withholding, there are two potential outcomes.

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[1] For example, in the immovable property non-CIV example, reference is made to the possibility of RCo providing debt financing to the underlying investments – albeit this is a supplemental to RCo's "equity" investment in real estate assets, whereas for Holdco, the debt financing (of third parties) is the underlying investment.

- First, the loan may not be made between that lender and borrower (or, where a loan has already been originated, no assignment of that loan to that lender is allowed).

- Secondly, the loan may be made, but the borrower will have to pay additional amounts (by way of gross up) to (in effect) preserve the lender's return.

If the PPT leads to uncertainty as to whether withholding applies (for example, because a debt fund lender needs to apply to the competent authorities for discretionary relief), this could mean that the funding currently being provided by debt funds ceases to be viable economically. This risks reducing effective competition in the debt market by placing market-based finance provision (through such funds) at an unjustifiable tax disadvantage relative to more traditional sources of finance. Given the dynamics in the banking sector, overall credit supply to the CRE industry would likely fall and its cost increase, with undesirable (and surely unintended) consequences for ordinary businesses.

The inclusion of a specific example for debt funds would also help ensure consistency in the entitlement of such funds to treaty benefits. Debt funds tend to lend across multiple jurisdictions. The commercial rationale and structure will be broadly the same for each jurisdiction. Therefore, equity would suggest that each borrower jurisdiction should apply the PPT in the same way. A debt fund example within the Commentary on PPT would help ensure that equitable outcome.

We therefore ask the OECD to consider including an additional example in the Commentary on PPT that addresses the position of debt funds specifically. Such an example is needed to provide certainty (for the fund and – as importantly – for the benefit of businesses seeking finance).

Alternatively, if the OECD is not willing to countenance the addition of another example, ***we would encourage the inclusion of a statement to clarify explicitly – and with specific reference to specific examples that were rejected for reasons of space rather than on substantive grounds – that there are many other cases where non-CIV funds should not be denied treaty benefits.***

Please see Appendix 2 to this submission for a draft example relating to debt funds for the Working Group to consider.

Yours sincerely

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Appendix 1: Comments on the securitisation company example

The following sets out some specific comments on the securitisation company example, linked to the universality of the features listed in the example.

1. Identity of originator

"RCo, a securitisation company resident of State R, was established by a bank"

Comment*: The originator of a securitisation is commonly, but not necessarily, a bank. Securitisations can be originated by non-bank lenders (including other forms of financial institution). If a securitisation is a bona fide commercial transaction – i.e. shares the other features listed, and is not part of any other transaction undertaken for a principal purpose of obtaining the benefit of the Convention, the status of the originator as a bank or otherwise should not, in our view, be determinative of treaty entitlement.*

2. Issuer share capital

"RCo is fully debt-funded. RCo has ~~issued a single~~ THE MINIMUM AMOUNT OF ISSUED share CAPITAL REQUIRED which is NORMALLY held on trust and has ~~no~~ NEGLIGIBLE economic value." [Amendments added]

Comment*: The amount of share capital in RCo will depend on local law requirements. For example, within the UK, a securitisation issuer must have a minimum £50,000 share capital as a public listed company (or plc): it has to be a plc to issue debt securities to investors. However, what is common, is that the share capital will generally be maintained at no more than the legally required minimum.*

Depending on the local law, the share capital will therefore have some, albeit limited, economic value: however that value is irrelevant in the context of the investors, whose return is funded by the loans held by the issuer.

Reference to a "single share" is misleading. The minimum requirement may be met by multiple shares of low nominal value, rather than a single share. Hence the focus should be on overall share capital in issue.

The shares are usually held on trust (or a similar arrangement) in order to ensure that the issuer is not affected by the bankruptcy of the originator: query if adding a reference to the purpose here would be useful to explain the key feature, to deal with those situations where a trust is not or cannot be used.

An alternative phrasing (as we included in the example appended to our 2016 Response) would be:

> "*As is common for securitisations, the issued share capital of RCo is held by independent shareholders, whether directly or via a trust, to ensure that RCo's solvency would not be affected by the bankruptcy of the bank.*"

3. Ownership of notes

"RCo's debt finance was raised through the issuance of notes that are widely-held by third-party investors. [...] To comply with regulatory requirements, the bank also retained a small percentage of the listed, widely-held debt securities"

Comment*: It is helpful to refer to the bank holding some notes: to make it clear that the originator owing notes does not preclude treaty entitlement.*

Regulatory requirements impose retention requirements, which can be met by holding notes or underlying loans: in the latter case, the bank may not hold notes.

A securitisation often involves more than one class of notes. The capital structure will rank notes in terms of seniority (and priority of payment). The transaction may involve over-collateralisation to mitigate the impact of borrower default on investors. As a corollary, the capital structure may include a junior class that entitles the holder to what is commonly referred to as "excess spread": the right (in substance) to any interest and principal remaining after the notes have been serviced in full. This class will often be held by the originator alone: we assume that this is not itself a concern, given it is a standard feature of many securitisations – although it may be expressed in different ways.

Will the Commentary indicate what "widely-held" means in this context: the issuer will not necessarily know how many investors hold its notes. The key factor should be the issue to third parties.

4. Listing on stock exchange

".....the notes are listed on a recognised stock exchange'

***Comment**: As above, the capital structure will rank notes in terms of seniority (and priority of payment) and may include a junior class that entitles the holder to what is commonly referred to as "excess spread". That junior class may be a conventional note or – again depending on local law requirements – a slightly different form of instrument (given that it does not necessarily have a clearly definable principal amount). Given its characteristics, it may or may not be listed.*

5. Identity of borrower

"RCo currently holds 60 per cent of its portfolio in receivables of ~~small and medium sized~~ enterprises resident in State S" [Amendments added]

***Comment**: We are unclear why the status of the borrowers as SME is seen a relevant: the loans could be made to a range of borrowers, which may be SMEs or subsidiaries of larger groups.*

6. Residence of bank

"The bank is a resident of a State T"

***Comment**: The bank's residence in State T, a different state to RCo, is clearly material to the purpose of the example. But similar considerations would apply if (a) the bank is resident in RCo, given that RCo is a different entity to the originator, and treaty considerations would apply equally to the choice of jurisdiction (though clearly there should be no differentiation in treaty rate in practice – so the "equivalent benefit" condition would be met) and (b) if the bank is resident in State S, yet sets up RCo in state R: a different withholding comparable will apply as the equivalent treaty benefits condition would not be relevant.*

7. Factors affecting choice of State R

"… availability of skilled and experienced personnel and support services in State R"

***Comment**: A cross-border securitisation involves RCo as lender to borrowers in multiple jurisdictions. Those loans may not necessarily include loans to borrowers in State R.*

As a general rule, for loans secured on real estate (both commercial and residential) loan servicing takes place in the borrower's jurisdiction – the servicer will have "local knowledge" as to both the market and *market practice in that jurisdiction, and is well-placed to maintain the on-going relationship with the borrower during the loan term. The loan servicer can be the originator, or a local agent appointed by the originator when the loan was advanced: RCo in effect "steps into" these relationships.*

In addition, the originator bank may provide certain capital market related support services to RCo out of State T. Other services – like paying and calculation agents – may be provided in the jurisdiction of the stock exchange on which the notes are listed (which again may not be State R).

This means that not all the services that support the securitisation will be necessarily carried out in State R: it could be that, other than general corporate support, and legal and audit support, many of the specific capital market and loan related support services are carried out in other jurisdictions (i.e. State T (in relation to originator provided services: borrower jurisdictions (in relation to loan related services) and the listing jurisdiction). It was in connection with this issue that we included in the draft example on securitisation appended to our 2016 Response referred instead to the existence of a "skilled and knowledgeable professional services market" as a relevant fact.

*Given that this is a function of the commercial context in which securitisation works, we assume that this would not impact RCo's ability to access treaty benefits. It would be helpful if what "*availability of skilled and experienced personnel and support services in State R*" means in practice could be clarified – whether in the Commentary or through an amendment to the example.*

Appendix 2: Draft debt fund example

Debt Fund, a State C partnership treated as fiscally transparent, is established to invest in a portfolio of debt obligations. The fund invests in debts in order to benefit from a regular income stream in the form of interest receipts (whether by originating such debts or acquiring existing performing debts), typically with the general intention of holding such loans to maturity.

The fund is marketed primarily to institutional investors such as pension schemes, and sovereign wealth funds on the basis of a prospectus that will become the investment mandate of the fund. A range 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.

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.

RCo is established for a number of commercial and legal reasons, such as to protect the Debt fund (and its investors) from the liabilities of and potential claims, to meet any jurisdiction-specific regulatory requirements and to make and management of investments. Furthermore, borrowers typically expect to deal with lenders in corporate form. This is reflected in market-standard finance documents. RCo therefore facilitates negotiations with new borrowers as well as the transfer of existing loans originated by other lenders on normal market terms.

Further, as a fund may wish to leverage the investors' capital in relation to certain investments to enhance its return on capital (either at the outset of the fund or at a later stage to be determined), the use of RCo (or, subject to Debt Fund's investment strategy relating to leverage and/or third party lender requirements) a newly formed subsidiary of RCo) will facilitate any debt financing from third party lenders.. It is also established for the purposes of administering the claims for relief of withholding tax under any applicable tax treaty. This is an important function of RCo as it is administratively simpler for one company to get treaty relief rather than every qualifying investor being required to process its own claim for relief, especially if the treaty relief to which an individual investor would be entitled as regards a specific item of income is a small amount.

After a review of possible locations, Debt Fund decided to establish RCo in State R. This decision was mainly driven by the political stability of State R, its regulatory and legal systems, investor familiarity, access to appropriately qualified personnel, tax considerations such as certainty around the taxation position of the holding company in respect of its returns from its investments and the extensive tax convention network of State R, including its treaties with other States within the specific geographic area targeted for investment. These tax considerations are taken into account as part of the decision but are one factor in a range of considerations.

In this example, whilst the decision to locate the holding company in State R is taken in light of the existence of benefits under the tax conventions between State R and the states of residence of potential borrowers (within the specific geographical area targeted for investment), it is clear that RCo's immovable property investments are made for commercial purposes consistent with the investment mandate of the fund. 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, it should receive treaty benefits. Therefore, 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 State which may seek to impose tax in respect of income or profits arising from RCo’s investments.