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Our ref QIC and NZ Super Fund – OECD Submission non-CIVs Treaty Benefits

By email

22 April 2016

Dear Marlies

Comments on BEPS Action 6 - Treaty entitlement of non-CIV funds

Thank you for the opportunity to provide comments on the Public Discussion Draft entitled *"Treaty entitlement of non-CIV funds* which was released for comment on 24 March 2016 ("**Discussion Draft**").

This submission is made by the Queensland Investment Corporation (**QIC**) and the New Zealand Superannuation (**NZ Super Fund**).

For the purposes of this submission, institutional investors are considered to be widely held entities on the basis they are either pension funds, sovereign wealth funds (**SWFs**) or widely held unlisted funds. This submission does not consider the treatment of investments made by an individual or controlled entities of an individual.

1 Executive Summary

1. The Commentary to the OECD Model Tax Convention (Model DTA) should include comments confirming that the Principal Purpose Test (PPT) is a "purpose" test and not a "substance" test. It should also confirm that the PPT is an alternative test to the Limitation on Benefits (LOB).

2. If the principal purpose for establishing a non-CIV investment entity in its state of residence is a non-tax purpose, a non-CIV investment entity should be entitled to treaty benefits, even if the availability of treaty benefits was one of several considerations in determining the location to establish the non-CIV investment entity.

3. If a non-CIV investment entity fails the PPT, investors in the non-CIV investment entity, whether transparent or not, should be entitled to treaty benefits that would have been available if the investor had invested directly. If member states did not support this derivative benefits approach for all investors, at a minimum we submit that treaty benefits should be granted to pension funds and sovereign funds.

4. The Model DTA standard clauses in the dividends and interest articles should provide for the ability of contracting states to confer upon government investors (as appropriately

defined) an exemption from source country taxation for income derived by government investors.

In support of these submissions, we have provided below detailed submissions on the provision of treaty benefits for non-CIVs and a look-through approach to the ultimate institutional investors of the non-CIV investment entities. Furthermore, we have provided direct answers to selected questions in the Discussion Draft which are relevant to QIC and New Zealand Super Fund. We have also included appendices covering:

- The doctrine of sovereign immunity (Appendix One)
- Examples of the intended operation of the PPT (Appendix Two)

2 Introduction

The proposed amendments to the Model DTA and Commentary in respect of the LOB and PPT rules seek to ensure that taxpayers do not avail themselves of treaty relief in circumstances where it would be inappropriate for them to do so.

Institutional investors, in particular pension funds and SWFs are an increasingly important source of global investment capital.

In recent years institutional investors have diversified their portfolios beyond bonds and equities by adding allocations to alternative investments such as private equity, real estate, infrastructure, agricultural and hedge funds.

SWF and pension fund investors seek global efficiency from a taxation perspective as they are generally exempt or concessionary taxed in their home market and thus taxes in intermediate jurisdictions represent a real cost of making the investment.

Therefore, amendments in respect of the LOB and PPT rules should take into account substantial differences between the nature of investments made by non-CIVs into infrastructure and real estate, as compared to a corporate investor utilising wholly-owned subsidiaries to inappropriately access treaty benefits.

3 Treaty Benefits for non-CIVs

The structure of the CIV industry described in the CIV Report[1] focussed exclusively on portfolio equity and debt funds. In these funds the underlying investors have no direct rights over the assets in the fund and rely entirely upon the manager to make all decisions regarding the operation of the fund. This should be contrasted with another common type of investment

[1] http://www.oecd.org/tax/treaties/45359261.pdf

which is a consortium of institutional investors purchasing an infrastructure asset through a non-CIV created for the particular acquisition[2].

3.1 *Reasons for establishing a non-CIV investment entity*

The breadth of geographies and asset classes in which institutional investors participate means that it is necessary to establish non-CIV investment entities in jurisdictions outside their country of residence for many of their investments.

Whilst it is difficult to generalise, it is common for institutional investors from the southern hemisphere to co-invest in non-CIVs with other investors resident in either Europe or North America. Taking into account the residence of the local manager, the asset and time zone differences, it would not make commercial sense to set up a non-CIV in Australia or New Zealand to invest into an asset located in Europe, especially where other co-investors are North American or European.

As SWFs and pension funds have mandates to invest prudently to ensure that they can meet future obligations, their investment decisions take into account many factors which affect their return on investment, including any tax burden. Institutional investors therefore consider a wide variety of issues when evaluating an investment and the investment structure. Given the investment of institutional investors across a wide portfolio of assets in various global markets, they are generally likely to employ regional offices and/or external managers to administer and manage their investments.

Institutional investors also invest as part of consortia to gain exposure to large, illiquid assets i.e. real estate and infrastructure investments.

Unlike multinational corporates which often operate in a single industry with branches in multiple countries, institutional investors are likely to use specialist external managers or regional offices to manage their investments (particularly when investing into highly specialised assets subject to local regulation such as infrastructure projects). Often the external managers and regional offices are resident in a jurisdiction other than where the institutional investor is resident.

The use of a regional office or manager in a third state is one of the most common structuring options used by institutional investors for their investments and may have a number of advantages over direct investment:

- Economies of scale through pooling of capital - investment exposure to larger assets;
- Geographical proximity to the intermediary jurisdiction, which may assist in exercising governance rights over the asset;

[2] http://www.sovereignwealthcenter.com/Article/3205798/real-estate-and-infrastructure/Powering-Up-Sovereign-Fund-Investment-in-Infrastructure.html#.VKnlLdgcR3Y

- Better investment risk management through portfolio diversification; and
- Access to specialist manager expertise.

In addition, we note that institutional investors are experienced in selecting and administering their investment portfolio, but are unlikely to be directly involved in the day-to-day operation of the assets they acquire as, they may lack the necessary expertise. In the case of some institutional investors, their constituent documents may prohibit direct investment in non-financial assets. Accordingly, for assets like infrastructure and real estate, minority stakes in CIVs may be the only permissible way to invest.

To overcome this, it is common practice for institutional investors to appoint a manager, who has experience in operating the assets which they have acquired. This has resulted in the rise in popularity of non-CIVs situated in the jurisdiction where the fund manager is based as opposed to investment vehicles situated in the State in which the asset is located.

3.2 Principal purpose test

Based on the comments at section 3.1, we support the suggestion that if the principal purpose for establishing a non-CIV investment entity in its State of residence is a non-tax purpose, a non-CIV investment entity should not be denied treaty benefits, even if the availability of treaty benefits was one of several considerations in determining the location of the non-CIV investment entity.

We also support the approach adopted by the OECD that the PPT should be undertaken objectively, having regard to all of the relevant facts and circumstances of the establishment of the non-CIV investment entity.

Any commentary supporting the Model DTA which deals with the PPT should make it clear that obtaining a benefit under a DTA does not prima facie mean that that outcome was one of the principal purposes of an arrangement or transaction. Furthermore, the commentary should emphasise that determining the purpose of establishing a non-CIV investment will require more than merely reviewing the tax effects of an arrangement.

Where, however, an arrangement can only reasonably be explained by a benefit that arises under the DTA, then the commentary should make it clear that the principal purpose of the arrangement would be to obtain the benefit.

If the non-CIV investment entity was formed for valid commercial purposes and the activities of that entity establish a substantial connection with the state of residence, these purposes and activities should be sufficient evidence that obtaining treaty benefits was not one of the principal purposes for using the non-CIV investment entity.

4 Treaty benefit if the institutional investor had invested directly

If a non-CIV investment entity fails the PPT, investors, regardless of whether the non-CIV investment entity is transparent or not, should be entitled to treaty benefits that would have been

available if the institutional investor had invested directly. If member states feel that extending this approach to all investors in a non-CIV imports an unworkable level of complexity between states, this could be applied solely in respect of institutional investors in the non-CIV.

4.1 *Operation of look-through approach*

Under this approach, an investor resident in Country A, who participates in the non-CIV investment entity (which is resident in Country B) will be eligible for treaty benefits in respect of items of income (including profits or gains) derived from the source country (Country C) through the entity established in Country B, to the extent that Country A treats the income as beneficially owned by the resident of Country A. Resident participants in the entity will be treated as having derived the income directly and may be entitled to treaty benefits. Treaty benefits in respect of such items of income (including profits or gains) will be granted where:

- The beneficiaries, members or participants of the non-CIV are considered residents of Country A under the relevant DTA; and
- Other conditions in the DTA are satisfied.

We are concerned that any denial of treaty benefits would result in high domestic withholding rates applying to distributions from the state of source, notwithstanding the ultimate owner of the income (i.e. the institutional investor) would have been entitled to a lower rate of tax had it invested directly. As has been mentioned earlier in this paper, institutional investors will often make investments via a non-CIV for a number of non-tax reasons and therefore should not be penalised for investing via a non-CIV where direct investment would have resulted in a more favourable tax outcome, but was not possible for non-tax commercial reasons.

We acknowledge the "look-through" approach involves practical complexities which include:

- The mechanics of three jurisdictions being required to treat the non-CIV as fiscally transparent (i.e. the countries of source, residence of the intermediate entity and the country of residence of the institutional investor); and
- Confirmation of the residency of the institutional investor (and its entitlement to treaty benefits) by the source state and withholding agents in that state.

However, given the nature of the institutional investors who invest via a non-CIV, we submit that there are simple practical solutions to these complexities.

In respect of the first complexity, this can be addressed if the Model DTA and its accompanying commentary required jurisdictions to treat entities which meet a standard definition of a non-CIV investment entity as fiscally transparent. This would lead to an outcome which is consistent with established OECD practice relating to investment via transparent intermediate entities, and would enable the institutional investor to look-through the intermediate entity and apply the Country A-Country C DTA.

In relation to the second complexity, a streamlined approach can be developed based upon a common standard to enable institutional investors to confirm to the state of source their residency status and their entitlement to tax treaty benefits in their jurisdiction of residence. Given that most institutional investors such as pension funds and sovereign investors are tied to a specific jurisdiction either through enabling legislation or their state-sanctioned role, they will be able to confirm their residence and entitlement to tax treaty benefits under existing integrity measures. Self-certifications, such as those used under the OECD's Standard for the Automatic Exchange of Financial Account Information in Tax Matters (commonly referred to as the "CRS") or the U.S. qualified intermediary ("QI") regime, could be preferable ways to confirm the residence of the institutional investor within currently accepted frameworks.

Source countries would need to provide clear guidance as to whether and in what circumstances that documentation would need to be provided to a withholding agent and/or the source country government.

Our experience is the "know your client", FATCA and anti-money laundering requirements being imposed by most jurisdictions mean that tracing the ultimate ownership of non-CIV investment entities can be undertaken within existing frameworks.

If governments provide clear rules regarding the documentation that non-CIV investment entities must collect regarding treaty entitlement, non-CIV investment entities could collect that documentation as part of their on-boarding of investor processes.

Where a non-CIV investment entity cannot identify its investors, or cannot identify all of its investors, we suggest unidentifiable investors be treated as not eligible for treaty benefits.

5 Direct responses to selected questions in the Discussion Draft

Question One

"What would be the threshold for determining that a fund is "widely-held for the purpose of such a proposal?"

A definition of a "widely-held" fund, should include (but not necessarily be limited to), non-CIV funds that are predominantly owned directly or indirectly by SWFs, recognised pension funds, public reserve fund or a combination of these funds.

We note that institutional investors such as SWFs, pension funds and life insurance companies are not established to generate wealth or profit for a small group of people as in the case of a corporate. Rather, they are established as a matter of government policy to meet intergenerational or contractual commitments relating to ongoing retirement or other welfare obligations of its citizens.

Question Four

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?

Granting tax benefits at the level of the non-CIV investment entity should not raise concerns about deferral, when the non-CIV investment entity is owned predominantly by institutional investors or tax-exempt entities. Tax deferral is generally not an issue in the context of investments by institutional investors in non-CIV investment entities because these investors are often tax exempt in their local jurisdictions. We also note that many jurisdictions' domestic law includes anti-deferral legislation that would apply to taxable investors in non-CIV investment entities. In any event institutional investors would as a rule prefer to repatriate cash when it is available so as to ensure that these funds can be deployed more efficiently into other investment activities.

Whilst the Base Erosion and Profit Shifting (**BEPS**) project remains relevant to institutional investors, it should be acknowledged that institutional investors themselves are predominantly government owned or regulated and they operate in a different manner to multinational corporates. As a result, the BEPS issues arising in the context of multinational corporates such as excessive debt financing, shifting of profits to low-tax jurisdictions and participation in aggressive transfer pricing arrangements are not pertinent to institutional investors.

Question 8

The rationale that was given for the above proposal refers to the fact that "investors in Alternative Funds are primarily institutional investors, and are often entitled to benefits that are at least as good as the benefits that might be claimed by the Alternative Fund". What is the meaning of "institutional investors" in that context? In particular, does it include taxable entities or other non-CIVs? Absent a clear definition of "institutional investors", how can it be concluded that institutional investors "are often entitled to benefits that are at least as good as the benefits that might be claimed by the Alternative Fund"? Also, is it suggested that "institutional investors" are less likely to engage in treaty-shopping and, if yes, why?

We suggest that the definition of "institutional investors" should be wide enough to cover recognised SWFs, recognised pension funds and life insurance companies.

In this context, SWFs should be defined to cover globally recognised government sponsored investment entities which invest funds for the benefit of the citizens of that government rather than any individual. Consistent with established approaches to sovereign immunity in most

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OECD countries[3], the definition of a SWF should exclude government owned trading entities and state-owned enterprises which undertake commercial activities. A government owned trading entity which is not generally entitled to sovereign immunity includes companies such as government owned broadcasters, electricity suppliers and telecommunications companies. By way of distinction, SWFs are special purpose investment funds set up by a state or political subdivision of the state for macroeconomic reasons such as meeting a future government liability (e.g. pensions) or as a mechanism for intergenerational funds transfer. Investment entities generally do not take majority interests in underlying businesses and do not participate in the day-to-day management or operation of the investee entity.

We refer to the OECD's Public Discussion Draft – "Treaty Residence of Pension Funds" concerning the definition of "recognised pension fund" and submit that the meaning of pension fund should take into consideration the public submissions made in that work stream. We also refer to the previous Discussion draft on the application of tax treaties to SWFs in 2010[4] and submit that the consultation on that definition should be taken into consideration when defining an institutional investor.

With respect to the PPT, we support the suggestion that under the PPT, if the principal purpose for establishing a non-CIV investment entity in its state of residence is a non-tax commercial purpose, a non-CIV investment entity should not be denied treaty benefits, even if the availability of treaty benefits was one of several considerations in determining the location to establish the non-CIV investment entity.

Question 25

Commentators wishing to suggest new examples related to the application of the PPT rule to common types of legitimate arrangements that are commonly entered into by non-CIV funds are invited to do so. These examples should be brief and should focus on common transactions that do not raise concerns related to treaty-shopping or inappropriate granting of treaty benefits.

With respect to Question 25 of the Discussion Draft, we have participated in public consultation with HM Treasury, UK and support the Examples drafted by their office as attached in Appendix Two. We have also provided a third example to demonstrate an example of when the PPT is failed how the look through approach should be applied. This will provide institutional investors with a degree of certainty as to the operation of the PPT.

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[3] Please refer to Appendix 1 for a discussion of approaches to sovereign immunity..

[4] Discussion Draft on the Application of Tax Treaties to State-Owned Entities, Including Sovereign Wealth Funds, November 2009 to 31 January 2010.

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Foreign Governments should also be encouraged to rule or give a view on the application of the PPT in relation to specific investment structures established or to be established by widely held institutional investors.

If you have any questions in relation to our submission, we would be pleased to discuss further.

Yours faithfully

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QIC

Appendix 1 – Sovereign immunity

A number of States provide concessionary tax treatment for pension and SWFs and their subsidiaries, usually in the form of an exemption from withholding taxes.

These jurisdictions include Australia, Canada, USA, UK, France and Korea[5].

Suggested parameters of activities qualifying for sovereign immunity:

Given the broad range of investments made by government-supported non-CIVs, it is important to ensure that any exemption is based upon a concept of eligible sovereign investment activities that accommodate passive investment by foreign governments, without providing an effective tax subsidy to foreign state-owned commercial enterprises. The doctrine of sovereign immunity should apply to income which is beneficially owned by a state, or political subdivision or a local authority (including a government investment fund) in the performance of governmental functions where the following criteria are satisfied:

- the person making the investment (and therefore deriving the income) is a foreign government or an agency of a foreign government performing governmental functions;
- the moneys being invested are and will remain government moneys and will not be distributed to any entities other than the government itself; and
- the income is being derived from a non-commercial activity.

An activity undertaken by a foreign state or governmental agency should generally be accepted as the performance of governmental functions provided that the agencies are wholly owned and controlled by the government and do not engage in ordinary commercial activities. This approach is consistent with the decision of the British House of Lords in the case *I Congreso del Partido* [1981] 2 All ER 1064 which held that activities of a trading, commercial or other private law character were not governmental functions.

Extension of doctrine of sovereign immunity through the Model DTA

The availability of sovereign immunity varies between jurisdictions. Whilst common law countries such as Australia, the United States and the United Kingdom do recognize and apply a doctrine of sovereign immunity, several European nations such as Poland, Norway and Switzerland do not recognize this principle in their domestic laws and therefore do not grant a specific exemption for foreign government investors[6].

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[5] For a more detailed listing see www.law.wisc.edu/m/y2njd/swfs_taxation_arial_717_08.doc - accessed 29 December 2014

[6] Janssen, S, "How to Treat(y) Sovereign Wealth Funds? The Application of Tax Treaties to State Owned Entities, Including Sovereign Wealth Funds", in Webber, D & van Weeghel, S (eds), *The 2010 OECD Updates: Model Tax Convention & Transfer Pricing Guidelines,* Kluwer Law International, 2011

The doctrine of sovereign immunity has been specifically negotiated into existing bilateral DTAs based upon the mutual agreement of the contracting states[7]. Whilst the incorporation of sovereign immunity into individual tax treaties has so far depended on negotiations between individual states, the certainty that this offers makes this option the preferred route to providing certainty for foreign government investors.

The inclusion of sovereign immunity in the Model DTA dividends and interest articles allows the contracting states to confer an exemption from source country taxation provided key criteria outlined above have been met.

One of the key challenges states face when dealing with claims for sovereign immunity is the commercial and political intentions of foreign governments. As such, there may be a reluctance to grant a foreign government preferential tax treatment for income derived from an investment in an industry or business which is regarded as being a commercial venture by a state owned enterprise of the other contracting state. However, these concerns can be mitigated by limiting the availability of the sovereign immunity exemption to portfolio investments made by specifically named sovereign investors (or investors which are a government of the other contracting state) which do not involve the investor taking a role in the operation or control of the target investment, consistent with the indicia of sovereign immunity set out above. Guidance could be provided in the Commentary to clarify when the granting of sovereign immunity would be appropriate, setting clear parameters on when the exemption could be provided.

As the example of the Australia-New Zealand DTA shows[8], states can be free to negotiate the entities upon which sovereign immunity is conferred. In this DTA, the Australian Government has specifically confirmed in the accompanying Explanatory Memorandum it prepares which government investment entities in Australia and New Zealand the contracting states agreed to cover in Articles 10(4) and 11(3)(a). We have extracted the relevant sections of the Dividend Article (Article 10(4)) and Explanatory Memorandum to the Australia-New Zealand DTA below.

Dividends article – Article 10(4)

Notwithstanding the provisions of paragraph 2, dividends shall not be taxed in the Contracting State of which the company paying the dividends is a resident if the beneficial owner of the dividends holds directly no more than 10 per cent of the voting power of the company paying the dividends, and the beneficial owner is a Contracting State, or political subdivision or a local authority thereof (including a government investment fund).

Commentary from Explanatory Memorandum

Dividends which are beneficially owned by a State, or political subdivision or a local authority (including a government investment fund) will be exempt from tax in the source country if they

[7] See, for example, the Australia-New Zealand Double Tax Agreement

[8] See Articles 10(4) and 11(3)(a).

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hold no more than 10 per cent of the voting power in the company paying the dividends. This exemption complements that provided in respect of interest derived by States, their political subdivisions and local authorities (including government investment funds) under Article 11 (Interest). In the course of negotiations, the two delegations agreed:

'...that dividends and interest will be regarded as being derived by a Contracting State, political subdivision, local authority or government investment fund where the investment is made by the Government and the funds are and remain government monies.

The delegations also agreed that this would include dividends and interest paid to, in the case of New Zealand, the New Zealand Superannuation Fund, the Government Superannuation Fund, and in the case of Australia, the Future Fund, the Building Australia Fund, the Education Fund and the Health and Hospital Fund, as well as any similar fund the purpose of which is to pre-fund future government liabilities.'[9]

[9] Explanatory Memorandum, to the *International Tax Agreements Amendment Bill (No. 2)* 2009, Paragraph 2.184.

Appendix 2 – PPT Examples

Example 1: Sovereign Wealth Fund (or Pension Fund)

RCo, a company resident in State R, is a wholly owned subsidiary of a recognised sovereign wealth fund (the "Fund") resident in State T. RCo operates exclusively to earn income for the benefit of the Fund and acquires and manages a diversified portfolio of private market investments located in countries neighbouring State R to generate a long-term investment return. The commercial reasons for RCo being established in State R include:

- greater connectivity with local markets and underlying investments in nearby jurisdictions;
- access to appropriately qualified personnel;
- its economic, legal and political stability; and
- time zone efficiencies.

RCo's personnel have responsibilities including the following:

- reviewing investment recommendations from the Fund's global investment teams;
- making investment decisions and monitoring investments' performance;
- undertaking treasury functions;
- acting as board directors for entities in which RCo has invested;
- maintaining RCo's books and records;
- ensuring compliance with regional regulatory requirements; and
- providing services to any additional subsidiaries in State R.

One of RCo's portfolios of investment holds a 40% interest in a company resident in State S, in respect of which it receives annual dividends. Under the convention between State R and State S, the withholding tax rate on dividends is reduced from 30% to 5%. Under the convention between State T and State S, the withholding tax rate on dividends is reduced to 10%.

In deciding to invest in the company resident in State S, RCo took into account the benefits of State R-State S tax convention on dividends, but this is not sufficient to trigger application of paragraph 7. The purpose of tax treaties includes providing 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, having regard to all facts, it is not reasonable to deny RCo the benefit of the State R-State S tax treaty.

Example 2: Infrastructure Investment

RCo also holds an investment in an infrastructure project in State S, where it co-invests with other institutional investors (e.g, an infrastructure fund comprised predominantly of institutional investors). These investors provide both equity and debt finance to the project through an intermediate vehicle (resident in State R) in which RCo holds a 20% interest. Under the convention between State R and State S, the withholding tax rate on dividends is reduced from 30% to 5%. Under the convention between State T and State S, the withholding tax rate on dividends is reduced to 10%. RCo pays tax and files tax returns in State R.

In determining which jurisdiction to locate the intermediate vehicle, the investors took into account a range of factors including State R's tax convention network, and the certainty with regard to the tax treatment of interest and dividends, which is a commercial consideration given the scale and long term nature of these investments.

The Fund considered the existence of a benefit under the State R-State S tax convention with respect to interest and dividends, but this alone would not be sufficient to trigger the application of paragraph 7. The intention of tax treaties includes providing benefits to encourage cross-border investment. 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. If a vehicle is established for purposes of providing finance for an infrastructure investment project, then after consideration of the facts and circumstances, it would not be reasonable to deny treaty benefits to the intermediate vehicle.

The conclusions of this example would apply equally if a fund invested through a series of separate entities as a regional platform. The principal purpose for the establishment of the regional platform should be considered with reference to the Fund's economic and commercial nexus to the jurisdiction as a whole, rather than only on an 'isolated' entity-by-entity basis.

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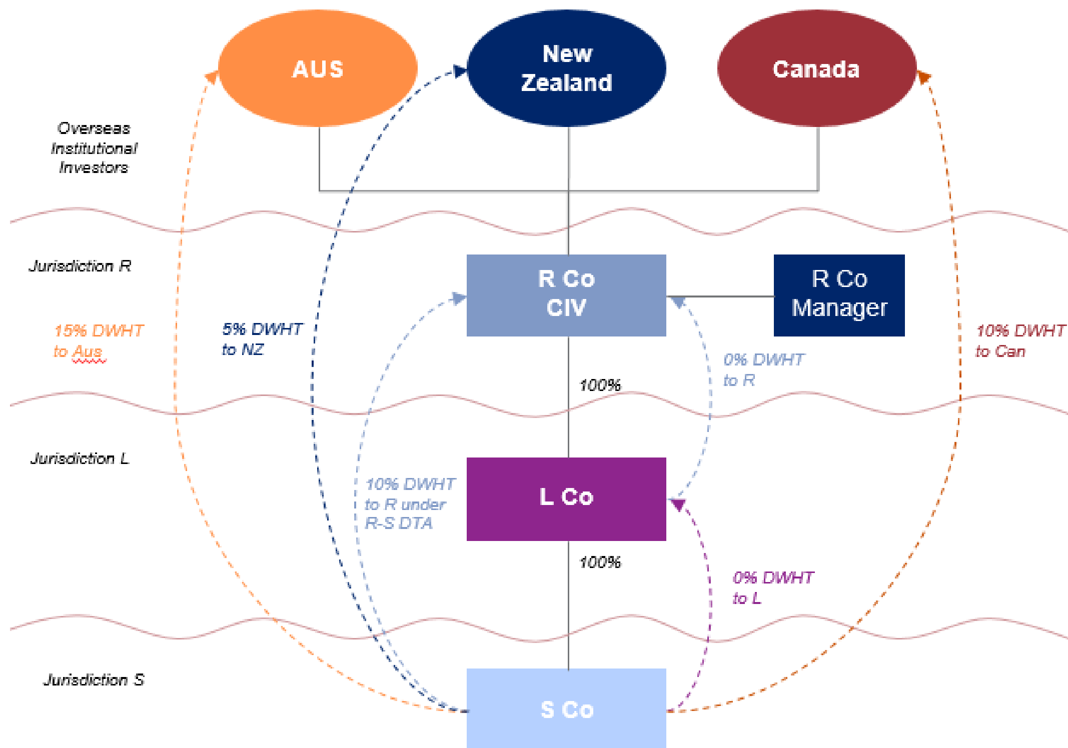
Example 3: Principal purpose to obtain treaty benefit: PPT not satisfied

The diagram below depicts an arrangement which we submit would not satisfy the PPT.



Background facts

- Three institutional investors, resident in Australia, New Zealand and Canada invest into R Co, located in State R.
- Collectively the three investors hold less than 60% and no one investor controls R Co. The remaining investors are also institutional investors.
- R Co is established to acquire an interest in an asset located in State S, which is held through an entity established in State S ("S Co"). R Co will co-invest with other investors into S Co.
- The commercial reasons for establishing R Co are the same as those set out in Example 1. In particular, a manager with specific expertise in managing the asset is located in State R, and the management team who work on the investment are all located in State R.
- State R is located in the same time zone as State S.

- The rate of dividend withholding tax between State S and State R under the DTA between these states is 10%.
- The domestic law of State S imposes a dividend withholding tax rate of 30% on dividends from S Co in the absence of a DTA.
- In order to mitigate this withholding tax leakage, R Co establishes a wholly-owned subsidiary in State L (L Co). The DTA between State S and State L provides a nil rate of dividend withholding tax. The rate of withholding tax on a dividend between State L and State R is also nil.
- Whilst L Co's directors hold Board meetings in State L, none of the directors of L Co reside in State L. Furthermore, the management company in State R does not have any employees or presence in State L.

PPT analysis: DTA between State S and State L

Applying the PPT, it is clear on an objective analysis of all the facts of the arrangement that the principal purpose of establishing L Co was to enable R Co to obtain a lower rate of dividend withholding tax than would be available if it had made a direct investment into S Co from State R.

Based on the fact pattern set out above, an objective consideration of this arrangement leads to a conclusion that the establishment of L Co to invest into S Co can only be reasonably explained by a benefit which arises under the DTA between State S and State L. As such, we submit that the PPT would be failed in these circumstances.

Look-through analysis

Based on the facts above, we submit that an objective analysis of the facts surrounding the establishment of R Co leads to a conclusion that R Co was not established for a principal purpose of obtaining benefits under the State S-State R DTA.

Since the interposition of L Co fails the PPT, but the establishment of R Co does not fail the PPT, a "look-through" approach should be taken so that the treaty between State S and State R will apply to any distribution from S Co to R Co. As such, the prima facie rate of dividend withholding tax under the domestic tax law of State S (being 30%), should be reduced to 10%.

By way of illustration of the look-through principle, we submit that if a view was adopted that the establishment of R Co also failed the PPT (which is a position with which we disagree), then the look-through approach should be applied to the ultimate institutional investors, so that the DTA between S Co and Australia, New Zealand and Canada would be applied to the institutional investors resident in these jurisdictions.