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Treatment of collective investment vehicles*

Summary

The current Model contains no specific provisions and very limited commentaries concerning the tax treatment of collective investment vehicles (CIVs).

Committee member Mr. Christoph Schelling prepared a paper outlining the key issues related to the applicability of treaty provisions to income deriving from investments made through CIVs. In addition, the paper touches on the following issues: 1) application of Article 29 of the Model to CIVs; 2) treatment of non-CIVs; and 3) treatment of the remuneration of CIVs' management.

The paper, which has been already shared with the Subcommittee responsible for the update of the Model, is presented at the 17th session of the Committee, with a view to determining if the above-mentioned issues need to be addressed in the next update of the Model.

* Prepared by Christoph Schelling in cooperation with Gian Sandri, Basil Peyer, and Nereida Jäggi

I. INTRODUCTION

The aim of the present note is to outline the issues raised by the treaty entitlements for investments made through collective investment vehicles (CIVs) on dividend and interest income, as a basis for discussion during the sixteenth session of the Committee.

The economic importance of CIVs (and the relevance of taxation in attracting and providing access to such investment) makes the tax treatment of collective investment vehicles an important question for both developed and developing countries.

Given the economic benefits of CIVs, most countries try to put into place a tax system that provides neutrality between direct investments and investments through a CIV. However, in cross-border situations, investment through a CIV can produce over-, under-, or double taxation for two main reasons: First, two or more States can have differing tax qualifications of the CIVs in their domestic laws, which affects the application of double taxation treaties. Second, from a more practical point of view, it can be very difficult to identify the specific investors in CIV structures or the respective type of income concerned, which can limit substantially the access to the benefits of a tax treaty.

The UN Model at present contains no specific provisions and very limited Commentary concerning CIVs. The Committee will have to consider the issues related to the tax treatment of CIVs, and to determine if these issues need to be addressed in its upcoming work.

II. COLLECTIVE INVESTMENT VEHICLES ("CIVS")

1. Definition

The term "CIV" can be defined as funds that are **widely-held** by investors, that are invested in a **diversified portfolio** of securities, and are subject to **investor-protection regulation** in the country where they are established[1]. The term also includes "funds of funds" structures, where the master fund holds a diversified portfolio of investments through feeder funds.

2. Importance of CIVs

In 2016, it is estimated that the total worldwide assets invested through open-ended funds amounted to over US$40 trillion.[2] Since 2009 this figure has more than doubled.

There are multiple reasons for an investor to invest through a CIV rather than directly: cost efficiency, diversification of risk, economies of scale, liquidity of investment (as securities issued by CIVs may be redeemed), efficient reinvestment of income (taking advantage of

[1] Report THE GRANTING OF TREATY BENEFITS WITH RESPECT TO THE INCOME OF COLLECTIVE INVESTMENT VEHICLES, Adopted by the OECD's Committee on Fiscal Affairs in 2010

[2] http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2017/2017_factbook.pdf, visited 26 March 2018

market experience and insights of professional managers). The advantages of a diversified and professionally managed portfolio at reasonable cost are in particular beneficial to small investors. However, institutional investors, such as pension or state funds, also increasingly use CIVs. In particular, the recent strong growth of passive investment strategies, i.e. the replication of the performance of a defined basket of assets (such as an index), boosted the use of CIVs by institutional investors, due to competitive cost-performance profiles.

It is to be expected that the importance of CIVs will continue to grow, and that this growth will also focus on developing countries for the management of the savings and retirement benefits of expanding middle-classes and increasingly ageing populations.

3. Structure

CIVs are typically organised by financial services providers (securities firms, banks, or insurance companies), which are referred to as the CIV's "manager". The manager can provide a variety of services such as portfolio management or investor recordkeeping but can also outsource a CIV's administration and organization.

Investment through CIVs is highly regulated. Direct purchases of shares or units can be affected between the ultimate investor and the CIV or its agent. However, in many financial services markets, direct purchases (and holdings) typically only form a part of the investment in CIVs. Also common are indirect share purchases though one or more intermediaries (e.g. securities firms, banks, insurance companies, independent financial advisers).

Interests in the CIVs are distributed through affiliated and/or unaffiliated firms. Distributors will enter into distribution arrangements with other firms that will distribute CIV shares or units. As a result, there may be layers of intermediaries between the CIV and the beneficial owner of the interests in the CIV. In many cases, these intermediaries will be located in a different country than the issuer, the CIV, and/or the investor.

Furthermore, interests in CIVs acquired through intermediaries are often registered at the CIV level only through nominee/street name accounts for two main reasons: competition concerns (customers' identities are highly valuable), and efficiency (CIV holders of shares or units can change daily). As a result, it will often be difficult to identify the final investor by the CIVs themselves, which can constitute a barrier to the granting of any treaty benefits.

Finally, it can be observed that international diversification of investments is becoming more widespread in a globalised economy. In this context, the practical difficulties in claiming treaty benefits for CIV investors are only increasing.

III. ISSUES TO ADDRESS

There are two main categories of difficulties related to the tax treatment of CIVs. First, is the question, whether a CIV qualifies or not to claim benefits of tax treaties, and second, if that is not the case, whether and how investors can get relief from double taxation for income received through a CIV.

1. Can a CIV claim the benefits of tax treaties on its own behalf?

A CIV can in principle claim the benefits of tax treaties if the following conditions are fulfilled:

1. The CIV is a person.
2. The CIV is a "resident of a Contracting state".
3. The income can be attributed to the CIV for the purpose of the treaty.
4. The CIV is the beneficial owner of income it receives.
5. There is no situation of abuse, such as treaty-shopping and in case of a "limitation on benefits" clause, the CIV is entitled to treaty benefits pursuant to such provision.

A risk of double taxation will occur if the states involved do not agree that these conditions are met. This may often be the case for various reasons. First, CIVs can take different legal forms. In common law countries, both companies and trusts are habitually used. In many civil law countries, ownership vehicles (such as contractual arrangements) as well as companies are common. Due to the diversity of vehicles, legal structures, and domestic regulations governing CIVs, approaches differ widely between jurisdictions. Second, the tax treatment of CIVs varies considerably from one jurisdiction to another, even though there seems to be a general policy goal to ensure that investing through a CIV should result in a tax burden that is equal to the one that applies in the case of a direct investment. In some jurisdictions, a CIV is treated as fiscally transparent, and the holder of the interest in the CIV is held liable to tax. Other jurisdictions consider the CIV to be an entity interposed between the investor and its investments, and thus tax the CIV while exempting the investor, or grant a credit for the tax levied at the level of the CIV or apply a reduction of the CIV's base of taxation by a reference to distributions of income made to investors.

The different legal forms of CIVs and the various domestic tax systems can make it difficult to determine whether a CIV is a company, or respectively, a person, and a resident, as the legal personality and the liability to tax are relevant for the treatment as a resident for the purpose of applying the UN Model Double Taxation Convention. The new paragraph 2 of Article 1 of the revised UN Model Double Taxation Convention does address the situation of the attribution of income to an entity that one or both Contracting States treat as wholly or partially fiscally transparent for tax purposes, but does not solve other issues that may arise, such as the question of liability to tax.

Another question raised in that context concerns the qualification of a CIV as the beneficial owner of received income. Circumstances that give rise to doubt in this respect can for instance lie in the fact that some CIVs are, for regulatory reasons, obliged to distribute their profits (or parts of it) to their investors, or that a given CIV's manager rather than the CIV itself is the legal owner of the income, which is often the case with contractual CIVs.

A further issue frequently raised by governments is the concern that CIVs may be used for treaty-shopping. In some cases, this leads to a refusal of treaty benefits. At the origin of this concern lies the perception that CIVs are generally not subject to substantial taxation in the jurisdiction where they are established and may therefore easily serve as a vehicle for treaty-shopping. On the other hand, CIVs and their investors are naturally sensitive to their tax treatment. Taxation strongly affects the performance of a CIV and is, thus, for a CIV and its investors, a crucial issue. Regarding the application of the "principle purpose test" introduced with the 2017 updates in Article 29 ("Entitlement to benefits") to the UN and the OECD Model Double Taxation Conventions, the Commentaries to both provisions provide guidance by describing an example regarding a CIV.

In this context, it is necessary for treaty negotiators to determine, in view of the various characteristics of the different types of CIVs, if the generally applicable anti-abuse rules are sufficiently robust to avoid the use of CIVs as vehicles for treaty shopping, or if it is necessary to draft specific provisions dealing with CIVs. In fact, Article 29 of both the OECD and the UN Model Double Taxation Convention suggest to determine explicitly the conditions under which a CIV is considered as a "qualified person" and can claim treaty benefits in the case that a "limitation on benefits" provision is used in a treaty. The need to establish conditions for the entitlement of CIVs to treaty benefits is due to the fact that CIVs will very often not fulfill the criteria of the other tests mentioned in Article 29, e.g. because the interests are not publicly traded, they do not qualify as a "headquarters company", or they do not engage in the "active conduct of a business". Whereas the Commentary to Article 29 of the OECD Model Double Taxation Convention provides detailed guidance for the drafting of a provision regarding the entitlement of treaty benefits of CIVs, the Commentary to the UN Model Double Taxation Convention only states the importance of such a rule for foreign portfolio investment and advises to make sure that such a rule does not enable treaty shopping through CIVs.

2. If one jurisdiction considers the CIV as fiscally transparent, how can the investors get relief from double taxation?

In view of the diversity and complexity of CIV structures and for reasons of operational and administrative difficulties linked to this feature, it appears very difficult for a CIV's investors to effectively claim treaty benefits directly in the source jurisdiction. It is often challenging or may even be virtually impossible for investors to prove that withholding taxes were levied on the income they received through a CIV, or they may not have the information that withholding taxes were paid at all. Furthermore, individual claims for refund by individual investors typically pertain to relatively small amounts and may generate high operational costs when compared to the amount that has to be finally refunded. Also, processing high numbers of individual claims may be a considerable administrative burden for tax administrations.

In principle, if an investor in a CIV cannot enjoy the application of relevant treaty benefits for the income of which he or she is the ultimate beneficiary, and the income thereby becomes subject to double or over-taxation, the relevant treaty network will have failed its purpose of eliminating double taxation in the particular circumstances. Investors who invest through a CIV will in this situation be treated less favourably than if they had invested directly.

With this in view, a solution might be found in the development of systems that would allow CIVs to make claims on behalf of all, or certain categories, of their investors.

More questions arise if the investor is located in a third jurisdiction. If the investor resides in a third jurisdiction that has a treaty with the source jurisdiction providing for residual rates equivalent to or lower than the ones that apply under the treaty between the source jurisdiction and the jurisdiction where the CIV is established, he or she could be considered an "equivalent beneficiary" under the last-mentioned treaty, and thereby be awarded the reduced tax rate when investing through a CIV, equivalent to the rate that would apply under the first-mentioned treaty if he or she had invested directly.

3. How is the remuneration of the fund manager treated?

Depending on the legal relationship between the fund and its managers, the remuneration of the management may be treated according to the Articles 7, 14, 15 or 16 of the UN Model Double Taxation Convention.

4. How are double taxation treaties applied to non-CIV funds?

Non-CIV funds are funds that do not meet the criteria of the above-mentioned definition of CIVs. One reason for that can be that the fund is not widely held, for instance that the fund is held by one or a few institutional investors, such as pension funds or insurance companies, to pool investments. Another reason could be that the fund does not invest in a diversified portfolio, for example that the fund holds only a few private equity participations.

As regards the claim of tax treaty benefits on its own behalf, non-CIV funds raise particular issues where a "limitation on benefits" provision in terms of Article 29 UN or OECD Model Double Taxation Convention applies. Concerning the "principle purpose test", the Commentaries to both provisions provide three examples regarding the application to non-CIV funds. The difficulty with the application of the said provision is that non-CIVs are not considered in the models for the "limitations on benefits" part and if they are not covered by the clause establishing the conditions for CIVs to claim the benefits of the treaty and if the "equivalent beneficiary" test is not fulfilled, treaty benefits will be denied to non-CIV funds under this provision.

IV. CIVs IN THE CONTEXT OF DEVELOPING COUNTRIES

Taxation is an important issue for CIVs since their performance and their market position are affected by tax issues. When organising their business CIVs seem to apply a holistic approach taking into account not only taxes payable by the CIV itself on income received, but also taxes owed by investors for income received through the CIV. If over- or double taxation results on an investment through a CIV, the investor or the CIV may need to reconsider the investment.

For tax policy of developing countries, the tax sensitivity of CIVs has several implications. In order to attract investment by CIVs, a country has an interest to ensure that double taxation is normally relieved under its double tax treaties. In this context, it needs to be considered that CIVs usually engage in portfolio-type investments, which considerably reduces the risk of BEPS and also means that under many double tax treaties a higher portfolio rate of residual taxes will result on dividends in the source State. Developing countries may thus wish to take the special situation of CIVs into account when considering treaty policy and practices with a view to attract investment by CIVs.

V. DECISION ON THE WAY FORWARD AND POSSIBLE OUTPUTS

The UN Model Double Taxation Convention and its Commentary do not at present contain any specific provisions on collective investment vehicles.

In view of the multiple issues linked to the treatment of income generated through CIVs under double tax treaties, the Committee is hereby invited to discuss if there is a need to further address this topic in its upcoming work.

If the Committee should decide to include this topic in its future work, a possible output could consist of the inclusion of additional language in the Commentary that could assist jurisdictions when negotiating double tax treaties or applying negotiated treaties to CIVs.

In this context, it might be considered to introduce in the Commentary possible provisions regarding the treatment of CIVs, in particular for the following situations (as is, by comparison, the case for the OECD Model Commentary):

- A CIV is treated as a resident and can claim treaty benefits to the extent that beneficial interests in the CIV are owned by residents of the jurisdiction where the CIV is established.
- A CIV is not treated as a resident but can claim treaty benefits on behalf of the owners of the beneficial interests that are residents of the jurisdiction where the CIV is established.
- A CIV is treated as a resident and can claim treaty benefits to the extent that beneficial interests in the CIV are owned by residents or equivalent beneficiaries (i.e. residents of the jurisdiction where the CIV is established or of a third jurisdiction which has a double tax treaty with the source state providing for the same or a lower rate of tax at source as compared to the treaty between the state where the CIV is established and the source state).
- A specific provision dealing with publicly traded CIVs.
- Commentary with guidance on the drafting of a provision concerning the entitlement of CIVs to treaty benefits in terms of Article 29 UN Model Double Taxation Convention.