

## Tax treaty benefits for funds: OECD proposals

The OECD has recently published proposals for the granting of tax treaty benefits to funds. The proposals will form part of the Commentary on the OECD Model Tax Convention, a revised version of which is due for publication later this year. A Pilot Group of industry representatives and OECD country members was set up to consider the practical implications and to propose measures to improve international withholding and investor reporting procedures. The Pilot Group has now almost completed its work and the OECD is expected to release a draft implementation package for public comment in the next few months. This will include a model memorandum of understanding and generic documentation and contracts. It is intended that the proposed procedures will cover all intermediaries, not just funds.

### Scope of the CIV Report

The recently published OECD Report is intended to clarify the circumstances in which certain funds, described as a Collective Investment Vehicles (CIV), are entitled to treaty benefits. CIVs are defined as funds that are "widely held, hold a diversified portfolio of securities and are subject to investor-protection regulation" including "funds of funds". However, the Report does not cover investment through private equity funds or hedge funds and its recommendations do not interfere with tax transparent asset pooling arrangements.

### Background

The Report recognizes that the CIV industry fulfils an important economic purpose and supports the principle that investment through a CIV should be tax neutral as compared to direct investment in an underlying security. It notes that the international CIV industry accounts for about US\$20 trillion in assets and plays a vital role in personal savings and retirement provision. In an increasingly globalised investment market there are significant tax problems for CIV operators who have a fiduciary responsibility to ensure that investors are not disadvantaged and that fund tax liabilities are correct.

### Can a CIV claim treaty benefits in its own right?

The Report sets out to answer this question by providing guidance to treaty negotiators and industry. Currently, the OECD Model Tax Convention, which forms the basis for about 3,000 tax treaties, contains no guidance on how a CIV should be treated. The Report addresses the issues that have traditionally been the source of most disagreement.

### Is a CIV a "person"?

A CIV can take any one of a number of legal forms. It can be a company, trust, partnership or contractual arrangement. As a general view, a CIV structured as a company clearly constitutes a person, a contractual arrangement is not and a trust can be either. The Report concludes that CIVs that serve the same economic purpose should in principle receive the same benefits and that as far as possible contracting states should treat a CIV as a person for the purpose of treaties.

### Is a CIV a "resident" of a Contracting State?

The Report concludes that for the most part CIVs pay very little if any tax in any OECD country. This is achieved either by exemption, deduction of distributions or a very low statutory rate. It concludes that the "liable to tax" test should not preclude a CIV from being treated as a resident but where a CIV is intended to be fiscally transparent it should not be regarded as resident in the country of establishment.

### Is a CIV the "beneficial owner" of the income?

Some OECD countries have taken the view that a CIV cannot be the beneficial owner of its income as it is holding the investment portfolio collectively on behalf of its investors. The Report questions this view and concludes that a CIV can be treated as the beneficial owner. So long as the managers of the CIV have discretionary powers over the investment portfolio, the CIV can be regarded as the beneficial owner.

### Who should claim treaty benefits?

In most circumstances a CIV should be able to claim treaty benefits in its own right particularly in the case of CIVs constituted as companies (e.g. UK OEIC, US RIC, Irish VCC or Luxemburg SICAV) but also in the case of trusts (e.g. Unit trusts in UK, Japan, Ireland, Australia, New Zealand). However, the Report recognises that not all contracting states will take this view especially where the CIV is constituted as a contractual or common ownership arrangement (e.g. Luxemburg, French or Belgian FCP, Irish CCF). In those circumstances it concludes that the CIV manager should be able to claim treaty benefits on behalf of the investors.

### Should CIV investors get credit for unrelieved withholding taxes?

If tax neutrality is to be maintained investors ought to be able to get credit for any unrelieved withholding taxes in the investment portfolio of a CIV. The Report supports the principle of granting credits but recognises that in practice it would be difficult to achieve in the case of a widely held CIV.

## Is there double taxation of CIV Investors?

The Report notes that some countries may be reluctant to grant treaty benefits at the CIV level where investors are not currently taxed on rolled-up income and gains.

However, it concludes that this should not be a hindrance to granting treaty relief at the CIV level. Most countries either have forced distribution rules (e.g. the US and the old UK system) or impute income to investors (e.g. the US PFIC regime, the new UK reporting regime and the existing German system). In addition most countries penalise taxpayers who accumulate income in offshore funds and the tax deferred is often not significantly more than the unrelieved withholding taxed within the CIV portfolio.

## Preventing treaty shopping

The Report recognises that there are risks to source countries which grant treaty benefits at the CIV level in that CIVs usually pay little or no tax and shares or units in CIVs are increasingly distributed across borders. This can be addressed by inserting appropriate limitation on benefits (LOB) clauses into treaties. In its severest form, LOB provisions would limit benefits to a CIV to the extent that its investors are resident in the country of establishment of the CIV. The Report recognises that this would be an overly restrictive approach. For example, it would discriminate against UCITS which are designed for distribution in multiple markets. It recommends that LOB clauses should be extended to include "equivalent beneficiaries" i.e. CIV investors in third countries that have a tax treaty with the source country. The Report notes that in practice this should not lead to distortions as the withholding tax rate on portfolio income is typically 15% or 10% in the vast majority of treaties. The Report also concludes that a CIV that is organised as a company with shares actively traded on a stock exchange (e.g. an ETF) should not be subject to LOB provisions but should benefit in its own right.

## Proportionate treaty benefits

Whether a CIV benefits in its own right or by making claims on behalf of investors treaty relief would normally be limited to the proportion of "good" investors i.e. residents of countries which have a tax treaty with the source country. In practice, it would be difficult to maintain a precise measure of "good" investors and the Report suggests mechanisms that could be used to establish the relevant proportion, perhaps on a quarterly basis. It also suggests that contracting states should take into account factors such as where the CIV is distributed and envisages the possibility of creating special classes of shares/units in the CIV that would be distributed to treaty entitled investors only. None of this would preclude countries from granting 100% treaty benefits to a CIV that has a certain (unspecified) threshold of "good" investors.

## Asset pooling and tax transparent arrangements

Nothing in the CIV proposals should militate against situations where the investor base is sufficiently stable to allow the scheme managers to correctly align treaty benefits with identifiable investors. Asset pooling schemes using tax transparent structures such as limited partnerships or common ownership arrangements (e.g. CCF, FCP or FGR) should not be impacted by the CIV proposals.

## Implementation Pilot Group

The Pilot Group consisting of OECD country members and industry representatives was mandated to produce an implementation package to give effect to the CIV Report and to improve current withholding procedures.

The proposals on procedures will not be confined to the CIV industry but will not be confined to the CIV industry but will address the issues faced by all market intermediaries and will cover liability, risk, independent review (audit) and reporting of beneficial ownership information. The Pilot Group has almost completed its work and a draft implementation package is likely to be published in the next few months.

## How can PwC help?

PwC has an international network of tax specialists who have been closely involved with this project. PwC has relationships at different levels of the OECD and can provide insights and guidance on how these projects affect the financial services sector.

## Contacts

If you would like further advice in relation to the issues outlined above, please call your local PwC contact or alternatively any member of the PwC Tax Policy Forum or the Asset Management Group listed below:

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