

Report on the proceedings of Seminar F

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Subject II: Companion Seminar F – Treaty entitlement and collective investment vehicles (including trusts)

The chair introduced collective investment vehicles (CIVs) as means to allow portfolio investors to gain economies of scale and a diversification of their investments by bounding together with other portfolio investors. These vehicles follow closely the value of their investments and calculate their net asset value every day which represents the basis for subscription and redemption by investors. The legal forms and tax structures of CIVs may vary considerably from one jurisdiction to another. One of the purpose of this Seminar was to identify these diversities and to find out major trends and principles with regard to the tax treatment of CIVs.

It was pointed out that the activities of CIVs is growing much more rapidly than direct investments. Presently, asset management through CIVs represents around 20 trillion US dollars of assets worldwide, thus being the biggest industry in the world with a rate of growth in the last three years equal to 40%. The US market of CIVs manages around 40% of the worldwide assets that are managed through CIVs. Another 40% of the market is located in Europe and the rest is spread among Australia, Japan, Brasil and other jurisdictions.

For domestic tax purposes, CIVs are normally structured so to allow investors in being treated in the same way as if he/she had realized the income directly. In relation to CIVs which invested in foreign securities or CIVs with foreign investors, the main tax issues are related to the withholding tax in the source country, the tax treatment of the CIVs in the jurisdiction where it is organized and of the investor in his/her country of residence.

For treaty purposes, the main issues concern whether the treaty applies, how treaty benefits are extended to the CIVs or to their investors so to benefit of an exemption or a reduction of the withholding tax in the source country and how the investors may benefit of the credit relief mechanism.

The Chair pointed out that for CIVs very often the withholding tax in the country of the investment is a final cost; in many instances, treaty benefits imply high administrative burden or even administrative actions that may not be satisfied. Although many portfolio investors are tax exempt in their own country of residence, their part of CIVs income is often subject to final withholding taxes. It was also noted that derivatives and other financial instruments are widely used in the management of the CIVs and their development was considered as strictly dependent upon their tax regime (and in particular upon dividend stripping rules, GAARs or other anti-avoidance rules) and the tax authorities attitude towards these instruments.

The Seminar was structured in two Parts and some case studies. Part I was aimed at identifying the issues, Part II at looking for remedies while the case studies dealt more specifically with the tax treatment of dividends and capital gains from investments in stock.

Part I – Issues

It was pointed out that treaty entitlement for CIVs depends upon four basic requirements for treaty law purposes, namely the CIVs should be a “person”, a “resident”, the “beneficial owner” and, in some treaties, should comply with LOBs provisions.

For several CIVs it is difficult to fall within the OECD definition of “person” since the custodian arrangements or the *fond common de placement* are just contractual arrangements and are thus not considered as body of person under the treaty. In this respect, no problems arise for CIVs taking the form of corporation as it usually occurs in The Netherlands, in UK or in the US.

While the legal form is relevant to determine whether CIVs are persons under the treaty, the tax treatment is crucial to ascertain whether CIVs are treaty resident. In some jurisdictions CIVs are transparent for tax purposes and, based on the OECD partnership report, should thus not be considered as treaty resident. In other jurisdictions CIVs are not transparent but benefit of a full exemption for the income earned; in such a case it is questionable whether it might be considered as treaty resident. In some countries CIVs do not benefit of a full exemption but of an exemption for certain items of income; it was argued that in these cases it is more likely that CIVs are viewed as treaty residents. Another major form of tax exemption for CIVs is the dividends paid deduction so that CIVs paid income is not subject to tax in the hands of the CIVs.

Treaty issues may arise in relation to the definition of beneficial owner. The OECD MC requires that the recipient of income be the beneficial owner of the income in order to qualify for the withholding tax rate reduction provided by Arts. 10 and 11. It was argued that there are three schools of thoughts on whether CIVs are beneficial owners. According to some, CIVs are always to be considered as beneficial owners in light of the functions performed by the CIVs that exclude that they might be viewed as conduit. According to others, CIVs are never beneficial owners of the income since they have a legal or economic requirement to distribute their earnings each year. Some others are taking a different position depending on whether CIVs are formed as trusts or as corporations.

LOBs or other specific provisions on CIVs are often limiting treaty entitlement to CIVs with investors or with a certain percentage of investors that are resident of treaty countries.

It was then argued that there is rarely a direct relationship between portfolio investors and the issuers of the securities. There are often several intermediaries in between, such as a global custodian, a custodian and a central security depository in the source country, and brokers and investment managers. Income normally flows from the issuer to the investors through all these intermediaries.

Investors are often denied treaty benefits or are suffering disproportionate administrative costs in order to secure treaty benefits because of the excessive documentation requirements, of the unreasonable time to provide information and documentation of investors, of the necessity of local advices to calculate and to settle tax liabilities or of the difficulties in obtaining tax relief. With respect to the latter, it was noted the proliferation of different tax relief systems, which are sometimes also differentiated depending on the types of income (e.g. dividends, remuneration from corporate or government bond, etc.).

In relation to EU law, the panel pointed out that the EU non discrimination principle and the fundamental freedoms may have an impact on the tax treatment of CIVs also in relation to the EEA countries (Norway, Iceland and Liechtenstein), and, as far as the free movement of capital is concerned, also in the relationships with third countries. Under the consolidated ECJ case law, EU law could override tax treaties, even if concluded with third countries. In order to test the EU

compatibility of domestic or treaty restrictions to the EU fundamental freedoms the ECJ traditionally applies a proportionality test by looking at the objectives of the measures. It was noted that the most relevant EU freedom in relation to CIVs is the free movement of capital provided that the focus of the panel was on portfolio investments. It was argued that, although there is not yet settled case law by the ECJ, the free movement of capital should be applied differently in the EU and in the relationship with non EU countries. This is due to the different legislative framework, such as the existence of the mutual assistance in exchange of information and in tax recovery claims directives that are only applied within the EU. Obviously, the freedom to provide services and the right of establishment may also play a role in a pure EU context for the tax treatment of CIVs.

Finally, the impact of the Savings Directive on the tax treatment of CIVs was highlighted. The purpose of the Savings Directive is to allow Member States to tax their own individual tax residents on interest payments made from another Member State. This Directive, which is applied only to individuals, eliminates withholding taxes on eligible interest payments by adopting the method of exchange of information (apart from transitional periods agreed with three EU Member States). It was pointed out that with respect to the chain of intermediaries the focus of the Directive is on the last intermediary, i.e. the so-called last paying agent. Thus, it was concluded that the Savings Directive plays a relatively minor role in relation to CIVs.

Case studies

The case studies concerned CIVs with several investors from different jurisdictions (mainly US, Japan, France) investing in various countries and focused on some specific issues such as:

- a) dividend withholding tax in the source country, including the domestic and treaty tax rate; the main issues regard the treaty to be applied (the investors' versus the CIVs' treaties) and whether the CIVs may apply treaties on behalf of their investors;
- b) the tax treatment of the investor, and in particular the credit relief in his/her country of residence, especially where the investor is tax exempt so that the foreign withholding tax represents a pure cost;
- c) the alternatives to dividend withholding tax such as stock lending or equity swaps where the related payment is not subject to withholding tax.

The first case study dealt with *Fonds Commun de Placement* (FCP) which are a sort of contractual arrangements, rather common in France and Luxembourg, where the assets are jointly owned by the investors. FCP is not a taxable entity and taxes are levied on income distributed to investors. In a pure domestic context, no dividend withholding tax, no tax at FCP and the investors are taxed as if the income would have been realized directly. A French FCP with foreign investors is subject to dividend withholding tax but might benefit of treaty reduced rates. In such a case, a US investor for example may normally benefit of the withholding tax credit; under Art. 29 of the France-Japan tax treaty concluded in 2007, the French FCP might claim treaty benefits on behalf of the Japanese investors and thus being subject to a 10% withholding tax. Whereas a Japanese individual might benefit of the tax credit, tax withheld by the French FCP for tax exempt investors (such as pension funds) is final and does not give right to any credit. Then, the panel discussed the case in which the French FCP with foreign investors has invested in foreign stocks (US, Japanese and Swiss stocks). Assuming the US as country of investment, under France-US tax treaty, the French FCP would be treated as transparent; thus, treaty relief is available to French investors. Treaty entitlement for third country investors depends upon the US treaty with the country of residence of the investor and if that the latter country treats the FCP as transparent; in this case treaty relief should be normally given. A French investor would be entitled to a tax credit for the withholding tax levied in the US.

The second case involved an offshore corporation not subject to any tax in its country of residence and whose distributed income is not subject to any withholding tax. In this case, the major issue is source taxation. In the US there would be a 30% withholding tax on dividends distributed to the offshore corporation. Treaty relief might be available if the investor in his/her country of residence treats the offshore corporation as a transparent entity and the offshore corporation is organized as a partnership. In Japan there would be a 20% withholding tax on dividends distributed to the offshore corporation and no credit would be available for Japanese investors. In some jurisdictions, such as in France, withholding taxes at source (equal to 25% in France) may be avoided by entering into stock lending or equity swap transactions; however, GAARs may play a fundamental role in structuring the transactions. For the investor country taxation, normally only distribution would be taxable as dividend income with the possibility of benefiting of the Parent-Subsidiary tax treatment; however, anti-avoidance rules such as a market evaluation of the securities held or CFC rules might apply.

The third case concerned an instrument which is not in itself a collective investment vehicle but is a general contract provided for by Art. 535 Japanese commercial law called Tokumei Kumiai (TK). The issue was addressed by resuming a famous case law with a Japanese company which distributes profits to a Dutch company. The latter claimed that according to the existing contract with the Japanese party, to be qualified as a TK contract, there was no PE in Japan. The qualification of the contract as a TK contract would have rendered applicable Art. 23 of the Netherlands-Japan tax treaty (other income) under which exclusive taxing rights were granted to the country of residence (i.e. Netherlands). Due to the Dutch participation exemption regime, the profits were not taxable in the Netherlands. Japanese tax authorities argued that there was a PE in Japan since the contract was identifiable in a partnership contract under Art. 667 of the Japanese civil law. Pursuant Art. 8 of the Netherlands-Japan tax treaty, Japan was therefore allowed to tax the business income attributable to the PE. To the contrary, the Japanese court ruled that the contract at stake was to be qualified as a TK contract. For this reason, the 2003 Japan-US tax treaty provides for a 20% withholding tax on these kind of payments. After this case, changes in Japanese law occurred and now TK remunerations are subject to 20% withholding tax in any situation, also for domestic distributions. Accordingly, specific provisions were concluded in other recent Japanese tax treaties (e.g. with UK and France).

Part II - Remedies

This part of the seminar addressed the various possible remedies to the issues discussed in Part I. The panellist from the OECD briefly described the composition and function of the informal consultative group by pointing out the intensive dialogue between the governments and the business community. By November 2008 the group is supposed to deliver a report to the CFA. The focus is on three major areas, namely (i) to clarify the tax treatment of CIVs under the existing treaties, (ii) to consider new possible treaty provisions to expand CIVs entitled to treaty benefits, and (iii) to identify treaty entitled entities also with reference to other structures including custodians and other intermediaries. The possible approaches range from the one recognizing all CIVs as treaty entitled regardless of who are the investors and the other denying treaty benefits to all CIVs that are to be considered as transparent. The first approach was criticized because it may create treaty shopping opportunities.

The panel pointed out the difficult administrative issues to obtain treaty benefits for investors should a CIV be considered as transparent. There are basically two possibilities: relief at source or withholding tax refund; in this respect, treaty relief might be claim by the individual investor or through consolidated claims by the CIV as agent for all eligible investors. The submission of individual claims by the investors generally would not be possible for many reasons. First, investors

might not be aware of the income received by the CIV and not know their share of that income. Second, there is normally a difference in timing when the income is received by the CIV and when that income is distributed (or if not distributed at all). Third, the high number of claims which should be claimed by the investors. Strong preference was therefore expressed in favour of consolidated claims by the CIV acting as agent for all eligible investors. It was argued to give treaty benefits in proportion to the eligible investors and if the latter exceeds a certain threshold to give a full treaty entitlement to the CIV. However, in many cases the CIV does not have a direct relationship with the end investor and does not have information about the investor. Other intermediaries are normally interposed between the CIV and the investors. At the beginning of 2003, the group called G30 issued a report on “*Global Clearing and Settlement – Plan of Action*” focusing on many aspects of global clearance and settlements among which a recommendation dealing specifically with tax treaty arrangements. It was pointed out the need to automate and standardize tax relief arrangements for cross-border investors. As a possible solution, it was mentioned the proposed tax relief model which might be adopted for all CIVs developed by the International Securities Services Association. Key principles of the tax relief model are that investor information remains with the intermediary acting directly for the investor, some tax rate information is passed up the intermediary chain and ends up with the intermediary acting as withholding agent, and intermediaries would be subject to local authorization and periodic review by the tax authorities.

Not only the OECD but also the European Commission has been looking into these remedies and set up two years ago the group called FISCO (EU Clearing and Settlement Fiscal Compliance Experts’ Group). The main task is to look at two major tax issues of clearing and settlement of securities transactions within the EU, namely transaction tax and withholding tax procedures. A first fact finding study by FISCO, which was published in 2006, showed that withholding tax collection and relief procedures vary considerably among Member States and also between different categories of securities within the same Member State. It was announced that the final report containing possible solutions would have been presented in a conference in Brussels on 23 October 2007. Very recently, the Commission has also set up an expert group on removal of obstacles to cross-border venture capital investments and a report is expected in 2008.

Few remarks were made by the Japanese panellist in relation to the Japanese tax treaties practice for CIVs. Apart from the tax treaties with France and UK, not many other Japanese treaties contain specific clauses for CIVs. The new Japan-US tax treaty introduced a qualified resident test which requires all investors to submit forms to apply the treaty and documents to disclose investors behind a CIV.

Then, the panel discussed the tax treatment of CIVs in light of the EU non discrimination principle. First, it was pointed out that the European principle of non discrimination is different from the treaty non discrimination; the first prohibits not only discrimination based on nationality but also that based on residence. Although no ECJ judgement is related to CIVs, it was argued that some significant guidance about the tax treatment of CIVs may derive from the *Denkavit* case and that the same principles followed in this case in relation to the right of establishment should be applied for the free movement of capital. Mention was made of the letter of formal notice (the first step of an infringement procedure) that the Commission sent to nine Member States for heavier taxation on outbound dividends paid to foreign pension funds which are normally tax exempt under domestic laws. There are two cases pending before the ECJ related to CIVs, namely the *Orange European Smallcap Fund NV* case, for which the AG opinion was delivered in July 2007, and the new *Aberdeen Property Fininvest Alpha Oy* case (C-303/07).

The Chair pointed out that based on EU law many claims were filed by CIVs to obtain refunds of withholding taxes either because the CIV was exempt and should have been treated as exempt in the source country or because the final investor did not get the tax credit.

Moving then to treaty non discrimination, one of the panellists highlighted that the treaty provisions are much more specific compared to the European rules and cannot be considered as a broad non discrimination principle. However, the issue has not yet been discussed at the informal consultative group of the OECD.

The panel closed with some concluding remarks from the Chair who observed the wide diversity of CIVs' structures and of tax treaty treatments. It would be welcome a solution ensuring treaty entitlement to portfolio investors and able to restrict treaty shopping. It was finally argued that there are substantial opportunities to reduce costs and increase efficiency for both investors and governments. Two factors were mentioned as key factors of the future developments of the matter: the increased progress of technology providing new opportunities and the existing network of highly regulated financial intermediaries which may represent the basis for certification and circulation of information.