

**FIRST MEETING OF THE INFORMAL CONSULTATIVE GROUP ON THE
TAXATION OF COLLECTIVE INVESTMENT VEHICLES**

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ISSUES PRESENTED BY CIVS AND OTHER INTERMEDIATED FINANCIAL STRUCTURES

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I. INTRODUCTION

1. Most countries have dealt with the domestic tax issues arising from groups of small investors who pool their funds in collective investment vehicles (CIVs). In many cases, this is reflected in legislation that sets out specific tax treatment that may have significant conditions. The primary result is that most countries now have a tax system that provides for neutrality between direct investments and investments through a CIV, at least when the investors, the CIV, and the investment are all located in the same country

2. One of the primary purposes of tax treaties is to reduce tax barriers to cross-border trade and investment. At the same time, countries generally do not want those tax treaties to create instances of unanticipated double non-taxation. In particular, countries may want to ensure, either through explicit provisions in their double tax treaties, or by applying anti-abuse principles in their domestic laws, that only residents of the treaty partner are entitled to treaty benefits. With these objectives in mind, an increasing number of countries have begun specifically addressing at least some issues presented by CIVs in their bilateral tax treaties. These provisions, however, are by nature bilateral and may therefore not address the frequent situation where the investors, the investment and the CIV are located in three or more different countries.

3. This note provides a background discussion of the tax treaty issues that arise with respect to CIV and, more generally, with intermediated financial structures. Section II presents the general context of intermediated structures and the stakes involved for business and governments in dealing with tax treaty issues. Section III details the treaty issues that arise from the use of CIVs and intermediated financial structures. Section IV discusses the application of the general provisions of the OECD Model Tax Convention to CIVs (the Annex presents provisions from recent bilateral agreements that some countries have used to deal with these issues).

II. THE ROLE OF INTERMEDIARIES IN THE FINANCIAL MARKETS

4. Before addressing the treaty issues arising from CIVs, it is helpful to consider the role of CIVs in the financial markets, where CIVs act both as intermediaries and as issuers of securities.

5. It is hard now to imagine a financial system that does not rely heavily on financial intermediaries. Small investors deal with their local financial institutions, which may purchase and hold securities on their behalf. Those financial institutions may have accounts directly with the clearing organizations that clear those securities, or may have accounts with other financial institutions that are themselves members of the clearing organizations.

6. A small investor who tried to by-pass intermediaries and invest directly would incur substantial costs. Finance theory instructs the investor to diversify his risks between equity and debt securities, real estate, and other assets. Now investors are urged to diversify across international markets as well, in order to hedge currency and market risk. In addition, they are supposed to change their allocations of assets over time to ensure their risk profile matches their age and timeline to retirement, etc.

7. A small investor who tried to satisfy all of those demands through directing his own portfolio would spend substantial time and incur significant transaction costs that might be all out of proportion to the actual amount invested. Those who invest through intermediaries gain the benefits of economies of scale even if they have relatively little invested. Intermediaries save their clients money by executing transactions in large batches on behalf of a number of customers.

8. In addition, clients of financial institutions benefit from the market experience and insights of professional money managers. Moreover, a small investor who buys interests in a CIV can instantly achieve the benefits of diversification that otherwise would require much greater investment. An employee who puts \$100 into his employer's defined contribution plan or a personal savings plan that is invested in a broad market index has diversified his risk of loss as much as if he had bought a share of stock in each company in the index, at a substantially higher cost.

9. It is not surprising, therefore, that approximately US\$50 trillion currently is invested through financial intermediaries worldwide. This intermediation takes many forms, from global custodians, to omnibus accounts maintained by securities dealers, to pooled vehicles for pension funds, to classic, widely-held mutual funds. These figures do not take account of amounts held through private equity funds or hedge funds, although many of the principles could also be applied to them.

10. In all of these intermediated structures, there may be a number of layers between the issuer of a security and the beneficial owner. In many cases, those intermediaries will not be located in the country in which the issuer is located and may not be located in the country in which the investor is located.

III. THE TREATY ISSUES THAT ARISE FROM THE USE OF CIVS AND INTERMEDIATED FINANCIAL STRUCTURES

11. The existence of a number of intermediaries, the fact that they are often located in different countries and that they may act both as intermediaries and as issuers of securities present issues as regards what these intermediaries can and should accept from other intermediaries in order to comply with their own withholding tax obligations, and what they can and should provide to withholding agents in order to claim the benefits of tax treaties. These issues are not restricted to CIVs and arise from the fact that financial markets are largely intermediated markets, particularly in the cross-border context. These issues have an important practical impact as they result in significant amounts of withholding taxes paid in excess of the amounts payable pursuant to tax treaties and in significant, sometimes deterrent, compliance costs involved in obtaining the applicable treaty relief.

12. In 1995, the OECD Model Convention was modified to deal with one treaty issue related to intermediated structures. Before 1995, reduced rates of withholding under Articles 10 and 11 were available for dividends and interest arising in one Contracting State and paid to a resident of the other Contracting State "if the recipient is the beneficial owner" of the dividends or interest. Post-1995, the reduced rates are available if the beneficial owner is a resident of the other Contracting State. Paragraph 12.2 of the Commentary to Article 10 describes the change:

"12.2 Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a

third State, is interposed between the beneficiary and the payer, but the beneficial owner is a resident of the other Contracting State. (The text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries.) States which wish to make this more explicit are free to do so during bilateral negotiations.”

13. Many of the issues involved, however, do not result from the wording of tax treaties but, rather, from the fact that treaties based on the OECD Model Convention do not set out procedures for claiming the benefits of the Convention. In fact, Paragraphs 18 and 19 of the Commentary to Article 10 of the OECD Model Tax Convention specifically acknowledge the issue:

“18. Paragraph 2 lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment.

19. The paragraph does not settle procedural questions. Each State should be able to use the procedure provided in its own laws. It can either forthwith limit its tax to the rates given in the Article or tax in full and make a refund (see, however, paragraph 26.2 of the Commentary on Article 1)...”

14. The cross-referenced paragraph in the Commentary on Article 1 was added in 2003 in response to concerns that refunds were taking an inordinately long time to materialize in some cases. It recommends providing the benefits of the treaty at the time payment is made, rather than requiring claims for refund. Specifically, Paragraph 26.2 of the Commentary on Article 1 reads as follows:

“26.2 A number of Articles of the Convention limit the right of a State to tax income derived from its territory. As noted in paragraph 19 of the Commentary on Article 10 as concerns the taxation of dividends, the Convention does not settle procedural questions and each State is free to use the procedure provided in its domestic law in order to apply the limits provided by the Convention. A State can therefore automatically limit the tax that it levies in accordance with the relevant provisions of the Convention, subject to possible prior verification of treaty entitlement, or it can impose the tax provided for under its domestic law and subsequently refund the part of that tax that exceeds the amount that it can levy under the provisions of the Convention. As a general rule, in order to ensure expeditious implementation of taxpayers’ benefits under a treaty, the first approach is the highly preferable method. If a refund system is needed, it should be based on observable difficulties in identifying entitlement to treaty benefits. Also, where the second approach is adopted, it is extremely important that the refund be made expeditiously, especially if no interest is paid on the amount of the refund, as any undue delay in making that refund is a direct cost to the taxpayer.”

15. Such delays reduce the return to any investor unless the refund is accompanied by interest to compensate for the delay. There is an added dimension to such delays when the investor is a CIV, however, because investors in CIVs may change daily. Accordingly, a refund that is delayed may never benefit the investors on whose behalf the claim was made. Those investors that have sold or redeemed their interests in the CIV in the interim will have gotten a benefit only if the net asset value reflected the potential refund.

16. Despite this recommendation, there are still substantial barriers to receiving benefits of tax treaties. In some cases, as discussed below regarding CIVs, these problems arise from disagreements between governments regarding the appropriate treatment of CIVs, pension funds and other entities. In other cases, the problems are procedural. In its first report, the Fiscal Compliance Experts’ Group (FISCO) organized by the European Commission identified a number of such procedural barriers. These include onerous documentation requirements, the use of local securities depositories or other intermediaries,

extremely short statutes of limitation for refund claims, and requirements that refund claims must be made at a local tax office.

17. Some of the most common problems arise because some systems are based on the implicit assumption that there is a direct relationship between the issuer (or its local paying agent) and the beneficial owner of income and these systems may be difficult to apply to the reality of intermediated financial structures. The financial institution that has information regarding the beneficial owner may be several layers away from the paying agent. A fundamental problem with any requirement that beneficial ownership information be passed up through layers of intermediaries is that it is inconsistent with business reality. Businesses do not pass their customer lists to their competitors, much less let their competitors know the investment preferences of those customers.

18. There are, however, systems that seek to address these issues. In examining these systems, and their possible application to CIVs, it will be useful to keep in mind the stakes for the business and governments. The governments' interests can also be broken down between the interests of a country in its capacity as the source country, and its interests as the residence country. A system will only be successful if it provides the information that the governments need in both of these capacities, and if it is administrable.

19. The source country has a strong interest in ensuring that its treaties are not used by residents of third countries that are not themselves entitled to treaty benefits. That is, treaties are, with few exceptions, bilateral in nature, with each of the Contracting States giving up taxing rights in exchange for reciprocal benefits in the other Contracting States. This basic bargain is violated when a treaty is used by residents of a third State, which may not provide benefits to residents of the source State. Moreover, a resident of a third State that inappropriately derives benefits of a bilateral treaty has no incentive to encourage its own government to enter into a treaty with the source State, thereby reducing the chances that residents of that source State would receive reciprocal benefits in the future.

20. The practical implications of the source country's interest in ensuring that its treaties are not used by residents of third countries that are not themselves entitled to treaty benefits can be different depending on the type of income involved. For example, even though many treaties between OECD countries provide for taxation of interest only in the residence country, investors in the debt markets have generally not relied on such treaty exemptions in order to obtain interest at a zero withholding rate. That is because most major debtor countries have recognised that such investors want a fixed and predictable return that will not be threatened by the potential difficulties of claiming treaty benefits and have therefore provided in their domestic law for an exemption from withholding tax for publicly issued or publicly traded securities. These source countries are generally only concerned that the interest is beneficially owned by a non-resident of the source country and are often willing to provide the exemption upon receipt of a certification to that effect, without needing to know more about the identity or specific country of residence of the investor.

21. Even in situations involving dividends, where entitlement to reduced rates of withholding is based squarely on bilateral tax treaties, it is unclear that the source country needs to know very much, if anything, about the identity of specific investors or even about their countries of residence, provided it knows the investors are resident in one of the countries with which it has a treaty relationship. That is because the treatment of these types of income is reasonably uniform across tax treaties. In most tax treaties between developed countries, the withholding rate on portfolio dividends is 15%, although it is lowered in some treaties to 10%. Although there is more variation in treaties with developing countries, the UN Model treaty also provides for a 15% rate on portfolio dividends and many developing countries follow suit.

22. The stakes surrounding access to information about the identity of the specific investor are significantly different, and arguably higher, for the country of residence of the investor, whether that country is also the country of source or a different country. The country of residence of the investor is deeply interested in receiving information regarding the names of the investors and the types and amount of income earned by such investors. In many cases, it also needs to have that information sorted by taxpayer identification number (i.e. the identification number recognizable in the residence country's tax system) in order for the information to be useful to it. Where that information becomes available to the source country in the process of applying treaty benefits to income arising in the source country, the exchange of information provisions of tax treaties typically provide a mechanism by which such information can be shared with the investor's country of residence. But where intermediated financial structures make it difficult for that information to make its way into the hands of the source country, the residence country may have a heightened concern that its resident investors may be receiving low taxed income from the source country without the knowledge of the residence country.

IV. APPLICATION OF CURRENT TREATY RULES TO CIVS

23. In the absence of specific rules applicable to CIVs, a CIV will be entitled to the benefits of a convention in its own right only if it is a person that is a resident of a Contracting State and that is the beneficial owner of the relevant income. In practice, issues have arisen with respect to each of these requirements, which are addressed in turn below.

Is a CIV a "person"?

24. CIVs take different legal forms in Member States. In Canada and the United States, both corporations (such as "mutual funds") and trusts are commonly used. In Australia, Japan, New Zealand and the United Kingdom, the trust is the predominant form. Japan has increased the possible forms for CIVs in the last few years. In many European countries, both joint ownership vehicles (such as fonds communs de placemen) and corporations (such as beleggingsinstellingen) are commonly used. In all of these countries, of course, there are also forms of custodianship arrangements that are purely contractual in nature.

25. These different forms must be taken into account when determining whether a CIV qualifies as a "person" within the meaning of the Convention. Subparagraph 1 a) of Article 3 of the Model defines a "person" for purposes of the Convention as "an individual, a company and any other body of persons". Paragraph 2 of the Commentary to Article 3 provides:

"2. The definition of the term "person" given in subparagraph a) is not exhaustive and should be read as indicating that the term "person" is used in a very wide sense (cf. especially Articles 1 and 4). The definition explicitly mentions individuals, companies and other bodies of persons. From the meaning assigned to the term "company" by the definition contained in subparagraph b) it follows that, in addition, the term "person" includes any entity which, although itself not a body of persons, is treated as a body corporate for tax purposes. Thus, e.g. a foundation (fondation, Stiftung) may fall within the meaning of the term "person". Partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons."

26. Under the definition provided in paragraph 2 of the Commentary, a CIV that has the legal form of a corporation clearly would be treated as a "person". A pure contractual arrangement clearly would not be a "person". Opinion appears divided, however, on whether a trust is a "body of persons".

27. The affirmative view relies on the wide meaning intended for the definition of the term "person". Under that view, a trust is an entity composed of some combination of trustees, settlor/grantor and

beneficiaries and, therefore, even though there is a relationship which serves as the cement for this “body” it is nonetheless a body of persons. Moreover, paragraph 8.2 of the Commentary to Article 4 states that pension funds generally are viewed as residents. Many, if not most, pension funds are organized as trusts. If they are viewed as residents then they must also be viewed as persons.

28. On the contrary view, a trust is purely a relationship, and is the very opposite of the unity that is contemplated by the concept of a “person” as is obvious from the examples given in the definition of the term “person”. In general, those holding this view are from countries where trusts are not in general use.

29. In practice, it seems that few countries have denied benefits to CIVs in the form of trusts solely on the grounds that the trust is not a person. This may be because those countries in which trusts are common make it a point to resolve this question by modifying the definition of “person” to specifically include trusts. In any event, real difficulties tend to arise with respect to other aspects of the definition of “resident”.

Is a CIV that is a “person” a “resident of a Contracting State”?

30. States take different approaches to achieving the tax neutrality (i.e. the neutrality with directly held investments) that is crucial to CIVs. In some States, CIVs are treated as fully transparent (“flow-through”). Other States regard the CIV to a greater or lesser degree as an entity interposed between investor and investments (“opaque”). In some States, a CIV is in principle subject to tax but is exempt if it fulfils certain criteria with regard to its activities, which may involve looking at its distribution practice, its sources of income, and sometimes its sectors of operation. More frequently, CIVs are subject to tax but the base for taxation is reduced, in a variety of different ways, by reference to distributions paid to investors. Deductions for distributions will usually mean that no tax is in fact paid. Other States tax funds but at a special low or zero tax rate. Finally, some States tax CIVs fully but with integration at the investor level to avoid double taxation of the income of the CIV. The integration may take the form of exemption in the hands of the investor or imputation of the tax imposed at the level of the CIV.

31. These various approaches to the treatment of the CIV may affect whether the CIV will be treated as a resident of a Contracting State within the meaning of Article 4 of the Model. In order for a CIV to so qualify, it must be “liable to tax” under the laws of that State by reason of its domicile, residence, place of management or other criteria of a similar nature. Paragraph 8 of the Commentary to Article 4 clarifies that the scope of the term “resident” is intended to be limited to those persons who are subject to “comprehensive taxation”. This term is further elucidated in paragraphs 8.2 to 8.4 of the Commentary to Article 4:

“8.2 Paragraph 1 refers to persons who are “liable to tax” in a Contracting State under its laws by reason of various criteria. In many countries, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organizations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. Most countries would view such entities as residents for purposes of the Convention (see, for example, paragraph 1 of Article 10 and paragraph 5 of Article 11).

8.3 In some countries, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws. These countries may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention. Contracting States taking this view are free to address the issue in their bilateral negotiations.

8.4 Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership “flows through” to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the Conventions concluded by the States of which they are residents. This latter result will obtain even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.”

32. Although these paragraphs suggest some differences of opinion between States, they also lay out some general principles that could also apply to CIVs.

33. First of all, applying the rule of paragraph 8.4, a CIV that is a “flow-through” under the laws of the State in which it is organized should not be treated as a resident of that Contracting State. However, the investors in the CIV should be entitled to claim treaty benefits under the Conventions concluded by the States of which they are residents in such a way that both double taxation and unintended double non-taxation can be avoided. Of course, if the investor in the CIV is another CIV that is treated as a “flow through” by the State in which it is organized, then the same analysis would be applied to the investor CIV, and so on.

34. The difficulty arises in determining which CIVs should be treated as “flow-through”. This issue is more complicated in the case of trusts than in the case of partnerships. In some cases, different classes of income are treated differently.

35. On the other hand, paragraph 8.2 makes it clear that most countries believe that it is not necessary to actually pay tax in order to be “liable to tax”. It is generally accepted that a company that is in a loss position, or using net operating loss carry-forwards to eliminate current tax, is a resident of a Contracting State. Entities, such as charities and pension funds, that are subject to the taxing jurisdiction in the country in which they are organized are residents because they are potentially liable to tax (for, instance, for failing to comply with specific requirements to secure an exemption). Beyond those examples, however, views begin to diverge.

36. Those countries in which CIVs are structured as companies (or treated as companies for tax purposes) have generally succeeded in having those CIVs treated as residents for treaty purposes. Such treatment has been built on a number of arguments. First, those CIVs generally are treated as taxable corporations in the country in which they are organized. Most countries accept that a company that is subject to the corporate income tax (ie, not a flow-through) satisfies the requirements for being a resident, without regard to the effect that various deductions might have on their taxable income. The second argument is a direct analogy to the analysis of paragraph 8.2 of the Commentary. That is, such CIVs generally are exempt only to the extent that they meet certain criteria set out by the States in which they are organized. Third, while the CIV itself may not be taxed on its income, distributions by a CIV that is structured as a company (or, in some countries, even as a trust) usually change character when they are distributed by the CIV, and frequently will be subject to a withholding tax if paid to a non-resident. Finally, whether because of the withholding tax on payments to non-residents or other factors, interests in such CIVs tend to be held overwhelmingly by residents of the same country in which the CIV is organized.

37. Other countries may put greater or lesser weight on each of these arguments, and some are entirely unpersuaded by the first three. In that case, they may insist on giving benefits only if the CIV can demonstrate an extremely high level of ownership by residents of the same State. As a practical matter,

concerns about treaty-shopping recede as more tax is imposed at the level of the CIV. Accordingly, there are a range of approaches from outright recognition of the CIV as a resident, to recognition of the CIV as a resident only if a certain percentage of interest holders are “good” residents, to giving benefits to the CIV only in proportion to the percentage of “good” residents.

Is the CIV the “beneficial owner” of income?

38. The final requirement for the CIV to be entitled to treaty benefits is that it is the beneficial owner of its income. It is understood that some countries have taken the position that a CIV, even if it is formed as a corporation, is not the beneficial owner of income because it has offsetting obligations (i.e. to make current distributions). Other countries have taken the position that the beneficiaries of a trust, and not the trust itself, are the beneficial owners of income derived by the trust. These arguments are discussed below.

39. The term “beneficial owner” is not defined in the Model. Pursuant to paragraph 2 of Article 3, it should be given the meaning that it has at that time under the law of the State applying the Convention, unless the context otherwise requires. There is no general agreement as to whether the context requires an autonomous meaning of the term; in the cases relevant to CIVs, however, the State of source is, for practical purposes, the State that determines the beneficial owner of income.

40. Nevertheless, the Commentaries to Articles 10, 11 and 12 do provide some insight into the purpose of the beneficial ownership requirement in those Articles. Paragraphs 12 and 12.1 of the Commentary to Article 10 are representative:

“12. The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words “paid...to a resident” as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term “beneficial owner” is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

12.1 Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies”...concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.”

41. Thus, the Commentary on beneficial ownership provides some guidance to the source State regarding the context in which it is to interpret the term “beneficial owner”. The source State clearly is entitled to interpret beneficial owner as not including agents or nominees. In addition, the source State

need not treat a “conduit company” as the beneficial owner of income, even if the State of residence would treat the company as the beneficial owner of the income and tax it on the income it receives.

42. Paragraph 12.1 of the Commentary paraphrases a longer discussion of the question that is found in the Report on Conduit Companies and that may be helpful in distinguishing between conduit companies and CIVs. Paragraph 14 of that Report sets out anti-abuse provisions in the 1977 Model that might be used to address the problem of conduit companies. Subparagraph b) of Paragraph 14 reads:

“b) Articles 10 to 12 of the OECD Model deny the limitation of tax in the State of source on dividends, interest and royalties if the conduit company is not its “beneficial owner”. Thus the limitation is not available when, economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income (paragraphs 12, 8 and 4 of the Commentary to Articles 10, 11 and 12 respectively). The Commentaries mention the case of a nominee or agent. The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or agent. Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company)...In practice, however, it will usually be difficult for the country of source to show that the conduit company is not the beneficial owner. The fact that its main function is to hold assets or rights is not itself sufficient to categorise it as a mere intermediary, although this may indicate that further examination is necessary...”

43. Thus, the determination of whether a company (or other entity) is a conduit depends on the functions that the company performs. If it has “very narrow powers” with respect to the property, then it may be viewed as a conduit. For example, a special purpose vehicle frequently has fixed obligations that exactly offset the expected income flows on its initial investments. Those obligations effectively prevent the special purpose vehicle from modifying its investment mix, since changes in income flows could jeopardize its ability to make the fixed payments.

44. Most CIVs, however, would not be conduit companies within the meaning of this paragraph. The managers of these CIVs do not have “narrow powers”, but discretionary powers to manage the assets on behalf of the holders of interests in the CIV. In general, they exercise this authority within the parameters that they have set for themselves in the offering documents they use to gain subscribers to the CIV. Although they may have practical or legal obligations to distribute their income in order to qualify for preferential treatment, this obligation does not constrain their ability to vary investments, since they are obligated only to distribute what they receive, not some fixed or pre-determined amount.

45. In the case of trusts, the situation is more complicated. If the trust is a flow-through, countries tend to look through to the residence of the beneficiaries, as they are the ones who are taxable on the income. However, in some cases the trust itself (or its trustees on behalf of the trust) may be subject to tax. In those cases, the residence country likely would treat the trust as the beneficial owner. If trusts are also common in the source country, it is likely that the source country would provide benefits to the trust itself in that case. However, if the source country is unfamiliar with trusts, then it is more likely that it would take the position that the trust is not the beneficial owner.

Are the investors in the CIV the “beneficial owners” of the CIV’s income?

46. Under the principles enunciated in the 1999 report by the Committee on Fiscal Affairs on “The Application of the OECD Model Tax Convention to Partnerships” (the Partnership Report), it could be

argued that the source country should respect the treatment in the residence state if it actually taxes a CIV formed as a trust (or if it treats the CIV in the same manner as a CIV formed as a corporation). However, if a CIV is treated as a flow-through by the State that would otherwise be its State of residence, whether the CIV is formed as a company or as a trust, then the Partnership Report would suggest that benefits should be available only to the extent that the country or countries of residence of the investors also treat the CIV as a flow-through and have a treaty relationship with the source State (it is worth remembering, however, that the Partnership Report only dealt expressly with partnerships).

47. Application of the principles of the Partnership Report to widely-held CIVs would present certain practical problems. Such CIVs are either publicly traded or have an obligation to redeem the shares of investors at the option of the investor. Accordingly, it would be extremely difficult, if not impossible, to track particular income streams to particular investors, even if the CIV had a reliable roster of the names of actual beneficial owners. This difficulty is compounded by the fact that interests in CIVs frequently are held through layers of intermediaries. A strict application of the principles of the Partnership Report, without modification, to widely-held CIVs thus could result in the denial of benefits to many investors who are residents of countries that have treaties with the source state. This would be particularly troublesome if the investor is subject to current taxation on the income derived through the CIV pursuant to his home country's foreign investment fund rules. Accordingly, it will be necessary to consider whether a strict application of the Partnership Report produces the correct result as a policy matter.

How does the residence country provide double taxation relief?

48. Finally, there is only so much the source country can do to achieve neutrality with respect to income earned through CIVs. Investment in foreign securities through a CIV will only be neutral as compared to a direct investment in such foreign securities if the residence country of the person who is tax as a resident on the CIV's income provides a foreign tax credit for withholding taxes imposed on payments to the CIV. Such credits may flow naturally to the investor if the investor's residence country treats the CIV as a flow-through entity. If, however, the country of residence of the investor treats the CIV as opaque but taxes the investor on the CIV's current distribution of its income to the investor, it may be necessary to change that country's domestic law to allow for such credits to the investor or to provide for such credits by treaty.

ANNEX

RECENT APPROACHES TO CIVS IN BILATERAL AGREEMENTS

1. In response to some of the issues described in this note, some countries have recently adopted provisions in their bilateral agreements that provide more comparable treatment.
2. In 1995, France and Japan agreed to allow investment funds to make claims on behalf of investors in the funds. The provision reads as follows:

“Where the participants in an approved investment fund of a Contracting State are entitled to the benefits provided for in Article 10 or 11, as being the beneficial owners of the dividends or interest derived by the fund, these benefits may be claimed by the persons charged with the management of French funds, or by the trustees of Japanese funds, for the part of the income corresponding to the rights held by the persons participating in the funds and entitled to these benefits. The admission of any such claim in whole or in part by the other Contracting State may be made subject to such conditions as that other Contracting State deems proper to impose, after having consulted the first-mentioned State, in order to avoid that the benefits provided for in this Convention be granted to participants who are not entitled to these benefits. The admission of any such claim by the other Contracting State shall not affect the right of that State to recover from the persons participating in the fund the amounts of tax or payments or refunds corresponding to the benefits provided for in Article 10 or 11 to which they were not entitled.”

3. This provision basically builds into the treaty the principle of proportional claims. It does not, however, set out a procedure by which those claims could be made. Accordingly, it would be interesting to find out on what basis investment funds are in fact making claims under the agreement.
4. A slightly more elaborate provision is found in the 2001 treaty between Belgium and the Netherlands. Article 25 (Collective Securities Investment Enterprises) is as follows:

“1. A collective securities investment enterprise (CSIE) which is not a body corporate and which is established in a Contracting State in which it is not subject to a tax referred to in Article 2, Paragraph 3, a), (2), or Paragraph 3, b), (3), which received dividends or interest arising in the other State, may itself, in lieu and in stead of the individual shareholders of the CSIE who are residents of the first-mentioned Contracting State, file a request for purposes of obtaining, on behalf of the individual shareholders, the tax reductions and exemptions or other advantages provided for by the Convention.

Notwithstanding the preceding provision, the CSIE referred to in this provision may invoke the provisions of Article 10, Paragraph 2, b) and Article 11, Paragraph 2, provided that at least 75 percent of the shares of this CSIE are held by persons who are residents of the Contracting State in which the CSIE is established.

2. A shareholder of such CSIE may claim the benefit of the advantages provided for by the Convention in the Contracting State in which the income arises only and insofar as, in the cases referred to in Paragraph 1, this CSIE does not itself claim the advantages provided for by the Convention.”
5. This provision has several interesting features. The CIV is expected to make the claim on behalf of its investors, and only if it does not do so are the investors entitled to make a claim. It also appears to have a two-tiered rule with respect to entitlement to benefits. The CIV may claim benefits with respect to the portion of its income that is payable to residents of the country in which the CIV is established. However, once ownership by such residents exceeds 75% of the shares of the CIV, then the CIV can claim benefits with respect to 100% of the dividends and interest it receives. The provision depends on a determination of whether the CIV is “subject to tax” but does not provide guidance on what that might mean.
6. An even more elaborate provision is found in a signed treaty between France and the United Kingdom that is not yet in force. This provision distinguishes between CIVs that are treated as corporations in their country of organization and those that are not. The provision is worth quoting in its entirety:

“Article 31

Investment Schemes

1. An investment scheme constituted under the law of, and established in, a Contracting State which:
- a) is not a body corporate;
 - b) receives income arising in the other Contracting State;
 - c) is treated as a body corporate for the purpose of taxing that income in the Contracting State under the law of which it is constituted; and
 - d) is subject to tax on that income in that State,
 - e) shall be treated for the purposes of Articles 11, 12 and 24 of this Convention as:
 - 1) a resident of that State;
 - 2) the beneficial owner of that income; and
 - 3) an individual, except that such a scheme shall be treated as a company for the purposes of paragraphs (2) and (5) of Article 11 of this Convention.
2. Subject to paragraph (4) of this Article, an investment scheme constituted under the law of, and established in, a Contracting State which, irrespective of whether it is a body corporate under that law:
- a) receives income arising in the other Contracting State;
 - b) is not treated as a body corporate for the purpose of taxing that income in the Contracting State under the law of which it is constituted; and

c) is not subject to tax on that income in that State,

shall, subject to any conditions imposed by the law of the Contracting State in which the income arises, be treated for the purposes of Articles 11, 12 and 24 of this Convention as:

- 1) a resident of the State in which it is established;
- 2) the beneficial owner of the aggregate amount of that income on which residents of that State are subject to tax therein; and
- 3) an individual, except that such a scheme shall be treated as a company for the purposes of paragraphs (2) and (5) of Article 11 of this Convention.

3. Where an investment scheme constituted under the law of, and established in, a Contracting State is treated by virtue of paragraph (2) of this Article as the beneficial owner of any income for the purposes of Article 11, 12 or 24 of this Convention then, notwithstanding anything in the Article concerned, that income shall not be regarded for the purposes of any of those Articles as the income of persons participating in the scheme who are residents of that Contracting State and subject to tax there on that income.

4. The competent authorities of the Contracting States may agree on the conditions for the application of paragraph (2) of this Article in the case of an investment scheme and, in calculating the aggregate amount of income falling within Articles 11, 12 and 24 respectively of this Convention, shall have regard to the extent to which persons participating in the scheme would have been entitled to the benefit of those Articles but for the provisions of paragraph (3) of this Article.

5. Where paragraph (2) of this Article applies to an investment scheme, nothing in this Article shall prevent the Contracting State in which income of an investment scheme arises from recovering from a person participating in the scheme any repayment of tax or any payment of a fiscal credit which that person should not have received by reason of the provisions of paragraph (3) of this Article.

6. For the purposes of this Article:

(a) "investment scheme" means, in the case of the United Kingdom, a collective investment scheme within the meaning of the Financial Services Act 1986 or the Financial Services and Markets Act 2000 of the United Kingdom (other than a charitable unit trust scheme or a limited partnership scheme) and, in the case of France, a "fonds commun de placement" or a "société d'investissement à capital variable"; and includes any other investment fund or company of either Contracting State which the competent authorities of the Contracting States agree to regard as an investment scheme;

(b) a person participating in an investment scheme means a person who is entitled to participate in or receive profits or income from the acquisition, holding, management or disposal of any part of the property (including money) which is subject to the arrangements constituting the investment scheme or sums paid out of such profits or income."

7. The provision is tied to particular regulated entities in the two Contracting States, but provides flexibility with respect to new entities. It does not answer the question of what it means to be "subject to tax" in the Contracting State in which the CIV is located. It would be interesting to find out how the Contracting States intend to apply the rule.

8. A step beyond proportional claims is found in the 2006 protocol between the Federal Republic of Germany and the United States. Provisions relevant to CIVs are found in several articles of the protocol.

Paragraph 2 b) of Article XVI (which modifies the protocol that was signed at the same time as the 1989 Convention) states:

“It is understood that a German Investment Fund and a German Investmentaktiengesellschaft (collectively referred to as Investmentvermögen) to which the provisions of the Investment Act (Investmentgesetz) apply are residents of the Federal Republic of Germany and that a U.S. Regulated Investment Company (RIC) and a U.S. Real Estate Investment Trust (REIT) are residents of the United States.”

9. Despite the egalitarian treatment with respect to residence, Article 28 (Limitation on Benefits) provides different treatment for German CIVs. Paragraph 6 thereof provides:

“Notwithstanding the preceding provisions of this Article, a German Investment Fund and a German Investmentaktiengesellschaft (collectively referred to as Investmentvermögen) may only be granted the benefits of this Convention if at least 90 percent of the shares or other beneficial interests in the German Investmentvermögen are owned, directly or indirectly, by residents of the Federal Republic of Germany that are entitled to the benefits of this Convention [under specific provisions of the Limitation on Benefits article] or by person that are equivalent beneficiaries with respect to the income derived by the German Investmentvermögen for which benefits are being claimed. For the purposes of this paragraph, beneficiaries of entities that are subject to numbers 3 and 5 of paragraph 1 of section 1 of the German Corporate Tax Act shall be treated as indirectly owning shares of a German Investmentvermögen. Foundations referred to in number 5 of paragraph 1 of section 1 of the German Corporate Tax Act, other than those referred to in subparagraph d) of paragraph 2 of this Article, shall not be taken into account in determining whether a German Investmentvermögen meets the 90 percent minimum ownership threshold.”

10. Because U.S. RICs are not referred to in this paragraph, they are subject to the normal Limitation on Benefits rules. Accordingly, a publicly-traded RIC could qualify under the publicly-traded company test, while an open-ended RIC would have to meet the 50% ownership/base erosion rule. The difference in treatment between CIVs in the two countries was based on the relatively greater transparency of German CIVs. U.S.-source income paid to a German CIV could pass through to a third-country investor without any tax in Germany, while German-source income paid to a U.S. RIC would be subject to a substantial withholding tax if paid to a third-country investor.

11. Finally, paragraph 24 of Article XVI provides:

“(With reference to Paragraph 6 of Article 28 (Limitation on Benefits))

The competent authorities of the Contracting States shall establish procedures for determining indirect ownership for purposes of determining whether the 90 percent ownership threshold contained in paragraph 6 of Article 28 is satisfied. It is anticipated that these procedures may include the use of statistically valid sampling techniques.”

12. No such procedures have yet been announced.

13. Unlike the other provisions above, the German-U.S. provision allows ownership by third-country investors to count towards the 90% minimum threshold. Also, if the 90% threshold is met, the CIV will qualify for benefits with respect to all of its income. If it does not meet the threshold, then none of its income qualifies. However, unlike the provision in the Belgium-Netherlands treaty, this provision does not purport to prevent a claim by individual investors, so it is conceivable that the investors in a German CIV that fails to qualify on its own behalf could still make a claim on their own behalf.

14. These provisions raise some questions regarding the structure of a specific provision dealing with CIVs, such as:

(a) in what circumstances is it appropriate to provide benefits to a CIV on its own behalf, without regard to the residence of its investors;

(b) in what circumstances would it be appropriate to provide benefits with respect to all of the income of a fund on the basis of a certain high threshold of ownership by “good” investors;

(c) should benefits be proportional to the percentage of “good” investors;

(d) should third country residents entitled to equivalent benefits qualify as “good” investors;

(e) how to prevent claims by the fund and investors in respect of the same tax;

(f) if benefits are based on ownership, as under (b) and (c), what means can be used to verify such ownership, and what is the relevant point of time for ascertaining this, or should it be averaged across a period?

15. It may also be appropriate to require the country of residence of the investor to provide a foreign tax credit for withholding taxes imposed on payments made to the CIV.