

The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles

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EXECUTIVE SUMMARY

This Report is a modified version of the Report “Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles” of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors (ICG) which was released on 12 January 2009. In that original Report, the ICG addressed the legal and policy issues specific to collective investment vehicles (“CIVs”) and formulated a comprehensive set of recommendations addressing the issues presented by CIVs in the cross-border context.

The ICG invited the OECD Committee on Fiscal Affairs (CFA) to refer these recommendations to its Working Party 1 (WP1) on Tax Conventions and Related Questions (the CFA subsidiary body responsible for changes to the OECD Model Tax Convention) for further consideration. This Report is the result of the subsequent work on these recommendations. The main conclusions and recommendations of the Report are similar to those in the ICG Report, with some modifications that reflect the varied experiences of the delegates. Like the ICG Report, this Report therefore analyses the technical questions of whether a CIV should be considered a “person”, a “resident of a Contracting State” and the “beneficial owner” of the income it receives under treaties that, like the OECD Model Tax Convention, do not include a specific provision dealing with CIVs (*i.e.* the vast majority of existing treaties). Further, the Report includes proposed changes to the Commentary on the Model Tax Convention to reflect the conclusions of the Working Party with respect to these issues. Although the Report includes an analysis of the application of the “beneficial owner” requirement to the specific case of CIVs, the conclusions with respect to CIVs should not be seen as pre-judging WP1’s continuing work on the “beneficial owner” requirement more generally.

Although these proposed changes to the Commentary will clarify the treatment of CIVs, it is clear that at least some forms of CIVs in some countries will not meet the requirements to claim treaty benefits on their own behalf. Accordingly, the Report also considers the appropriate treatment of such CIVs under both existing treaties and future treaties.

With respect to existing treaties, the Report concludes that, if a CIV is not entitled to claim benefits in its own right, its investors should in principle be able to claim treaty benefits. The Report reflects different views regarding whether such a right should be limited to investors who are residents of the Contracting State in which the CIV is organised, or whether that right should be extended to treaty-eligible residents of third States. In any event, administrative difficulties in many cases effectively prevent individual claims

by investors. Accordingly, the Report concludes that countries should adopt procedures to allow a CIV to make the claim on behalf of investors.

With respect to future treaties, the Report endorses the ICG recommendation that the Commentary on Article 1 of the Model Tax Convention should be expanded to include a number of optional provisions for countries to consider in their future treaty negotiations. Inclusion of one or more of these provisions in bilateral treaties would provide certainty to CIVs, investors and intermediaries. The favoured approach for such a provision would treat a CIV as a resident of a Contracting State and the beneficial owner of its income, rather than adopting a full look-through approach. Because different views were expressed on the issue of whether treaty-eligible residents of third countries should be taken into account in determining the extent to which the income of a CIV should be entitled to treaty benefits, the proposed Commentary includes alternative provisions that adopt different approaches with respect to the treatment of treaty-eligible residents of third countries. The proposed Commentary also includes an alternative provision that would adopt a full look-through approach. The look-through approach would be appropriate in cases where the investors, such as pension funds, would have been eligible for a lower, or zero, rate of withholding had they invested directly in the underlying securities.

The Report also addresses several ancillary issues, including the procedures that could be adopted to determine the proportion of treaty-eligible investors under either existing treaties or a future treaty provision. In addition, the Report discusses a possible provision that would allow an investor in a CIV to claim foreign tax credits for withholding taxes suffered at the level of the CIV, although it does not include any changes to the Commentary on the Model Tax Convention relating to this issue.

I. INTRODUCTION

1. Portfolio investors in securities frequently make and hold those investments by pooling their funds with other investors in a collective investment vehicle (“CIV”), rather than investing directly. This occurs because of the economic efficiency and other advantages CIVs provide. There are several different forms CIVs take, depending on the country in which they are established (*e.g.* companies, trusts, contractual arrangements). The growth in investments held through CIVs has been very substantial in recent years and is expected to continue. Most countries have dealt with the domestic tax issues arising from groups of small investors who pool their funds in 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. Treaties do this by allocating taxing jurisdiction over a person's income between that person's country of residence and the country of source of the income, in order to avoid double taxation. For example, treaties typically limit a source State's taxing rights over dividends, interest and capital gains derived by a resident of another State from holding investment securities in the source State. 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. In 2006, the Committee on Fiscal Affairs (the "Committee") established the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors (the "ICG"). In January 2009, the Committee approved the release for public comment of the ICG's report with respect to the legal and policy issues relating specifically to CIVs (*i.e.* the extent to which either the CIVs or their investors are entitled to treaty benefits) as well as a second report by the ICG on "best practices" regarding procedures for making and granting claims for treaty benefits for intermediated structures more generally. This Report, which adopts the ICG's report with some modifications, focuses exclusively on the legal and policy issues relating to CIVs.

4. For purposes of this Report, the term "CIV" is limited to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established. The term would include "master" and "feeder" funds that are part of "funds of funds" structures where the master fund holds a diversified portfolio of investments on behalf of the feeder funds that are themselves widely held. "Intermediated structures" relates to the holding of securities, including interests in CIVs, through layers of financial intermediaries. However, issues of treaty entitlement with respect to investments through private equity funds, hedge funds or trusts or other entities that do not fall within the definition of CIV set out in this paragraph were not considered during the preparation of this Report.

5. Section II of this Report provides background regarding the benefits of CIVs and the structure of the industry. Section III discusses the application of current treaty rules to CIVs under treaties that, like the Model Tax Convention, do not include a specific provision dealing with CIVs. Section IV describes certain considerations that countries that are negotiating new treaties may want to take into account when determining whether the results that otherwise would apply to CIVs established in their jurisdictions under the analysis of Section III are appropriate or whether they should be modified by adopting new provisions addressing CIVs. Section V consists of additions to the Commentary on Article 1 incorporating such possible new provisions.

II. BACKGROUND

2.1 Benefits of investing through CIVs

6. Nearly US\$20 trillion currently is invested through CIVs worldwide.¹ This number can only be expected to grow because of the numerous advantages provided to small investors who invest through CIVs.

7. A small investor who tried to by-pass CIVs and other 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. 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 out of all proportion to the actual amount invested.

8. CIVs allow small investors to gain the benefits of economies of scale even if they have relatively little invested. They provide access to a number of markets that might be closed to the small investor. These benefits are provided in a form that is highly liquid, as securities issued by a CIV may be redeemed on a frequent (daily, weekly or monthly) basis at net asset value ("NAV") or can be transferred with minimal restrictions. CIVs also allow for highly efficient reinvestment of income. Distributions on portfolio securities held by the CIV can be reinvested by the CIV. It would be difficult for individual investors to reinvest small distributions on an efficient basis.

9. In addition, investors in CIVs benefit from the market experience and insights of professional money managers. The cost of these money managers is spread over all of the CIV's investors. Moreover, a small investor who buys interests in a CIV can instantly achieve the benefits of diversification that otherwise would require much greater investment. For example, an employee

who puts \$100 each month into a CIV that is invested in a broad market index (either directly, or through his employer's retirement plan or a personal savings plan) has diversified his risk of loss as much as if he had bought a share of stock in each company in the index, but at a substantially lower cost than if he had bought the individual stocks.

10. Governments have long recognised the importance of CIVs as a complement to other savings vehicles in terms of facilitating retirement security. In many countries, participants in defined contribution retirement plans invest primarily in CIVs. Because CIVs allow small investments, they are ideally suited for such periodic savings plans. They are highly liquid, allowing withdrawals as needed by retirees. With ageing populations in many countries, CIVs will become increasingly important.

2.2 Structure of the CIV industry

11. CIVs typically are organised by financial services firms (including securities, banking and insurance groups). The organising firm often is referred to as the CIV's "manager". It is not uncommon for the CIV manager to have hundreds or thousands of employees managing a number of CIVs and providing investment advice for other types of investors. The manager provides services such as portfolio management (advisory) and transfer agency (shareholder recordkeeping). In some cases, the manager may select other firms to sub-advise part, or all, of the portfolio.² The manager also may decide to hire unaffiliated parties to perform other services, such as legal and audit services, tax consulting, custodial services and others.

12. With respect to the portfolio, the adviser decides which securities the CIV will hold, and when they will be bought or sold. The adviser thus will research securities and anticipate market movements. Even in the case of "index funds" (i.e. funds the aim of which is to match the movements of an index of a specific financial market), the adviser must decide whether the CIV will hold all of the securities in the index, or whether some smaller sample of the relevant securities will provide essentially the same return as the index, but at a lower cost. The adviser must also ensure that the CIV's portfolio is consistent with applicable regulations. Typically, there will be regulatory requirements relating to concentration of investments, restricting a CIV's ability to acquire a controlling interest in a company, prohibiting or restricting certain types of investments, and limiting the use of leverage by the CIV.

13. Investments by the CIV could be domestic or international. International diversification of investment portfolios is becoming more significant. For example, over 25% of all equity assets held by US CIVs are issued by non-US companies.³ About 30% of the assets of U.K. CIVs are invested outside the United Kingdom.⁴ More than one-third of the assets of Japanese CIVs are

foreign securities.⁵ Assets of Luxembourg, Swiss and Irish funds are predominantly invested outside of their home market.⁶ As more investments are made cross-border, the issue of CIVs' qualification for treaty benefits is becoming increasingly important.

14. Interests in the CIV are distributed through affiliated and/or unaffiliated firms. Typically, the CIV will have a distributor related to the manager. This distributor will enter into distribution arrangements with other firms that will distribute CIV shares or units. There are two distinct types of markets for CIVs – “domestic” and “global”. In this context, the term refers to the location of the investors, not the investments.

15. In the case of the domestic CIV market, the CIV and essentially all of its investors are located in the same country. This situation may arise because of securities law restrictions on the public offering of non-domestic CIVs. In other cases, tax considerations applicable to non-domestic CIVs or to non-resident investors in a domestic CIV may make them uneconomic (e.g. US passive foreign investment company rules or local tax advantages). There also may be no identifiable reason, other than investors' preferences for the form of investment vehicle with which they are most familiar.

16. The global CIV market is one in which the CIV and a significant portion of its investors are located in different countries. The global CIV can be much more efficient – it can benefit from the economies of scale described above to a greater extent than smaller CIVs. Taken to its extreme, a manager would create a single CIV for each asset class or portfolio type. This may not be possible, for the reasons described in paragraph 15. However, regulators see the benefits of a smaller number of larger CIVs, and regulatory changes, such as the UCITS Directive within the European Union,⁷ are designed to encourage global business.

17. Distribution of interests in the CIV is also highly regulated. Many jurisdictions require the delivery of a disclosure statement (i.e. prospectus), which may be reviewed by the regulator. Sales of interests in the CIV are effected through regulated entities that are subject to “know your customer” rules. However, there are a number of different distribution channels. Direct share purchases are effected between the ultimate investor and the CIV or its transfer agent/paying agent. However, in almost all markets, direct purchases (and holdings) are a small proportion of the investments in the CIV. Much more common are indirect share purchases through one or more intermediaries (e.g. securities firms, banks, insurance companies and independent financial advisers).

18. Interests in CIVs acquired through intermediaries often are registered at the CIV level through nominee/street name accounts. One reason for this is competitive – intermediaries view customers' identities as highly valuable

proprietary information. Another reason is efficiency – intermediaries aggregate their customers' purchases and sales each day and effect only a net purchase or a net sale each day in the nominee account. Whilst investments in a CIV are typically long-term, a CIV's shareholder base may change every day, as new shares are issued and existing shares are redeemed (or as shares trade on an exchange). When interests in the CIV are held through such nominee accounts, the CIV's manager may not be aware of changes in its underlying investors.

19. CIVs thus act as both issuers of securities and investors in securities. As a result, there may be layers of intermediaries both above the CIV (i.e. between the issuer of the security in which the CIV is invested and the CIV), and below the CIV (i.e. between the CIV and the beneficial owner of the interests in the CIV). 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. Accordingly, CIVs present issues as regards what they 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 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.

20. Difficulties in claiming treaty benefits at the time payment is made, and delays in payment of refunds, reduce the return to any investor unless, in the case of a refund, it is accompanied by interest to compensate for the delay. However, there are added dimensions to such difficulties and delays when the investor is a CIV. Investors in CIVs may change daily, making it extremely difficult, if not impossible, to track particular income streams to particular investors. For example, an investor could hold shares in a CIV on 15 June, when the CIV receives a dividend. If the investor redeems or sells those shares on 1 July, the investor generally will recognise a gain or loss. To the extent that the CIV is required to allocate income to particular investors, the remaining or future investors in the CIV generally would be credited with the dividend, even if they did not own shares in the CIV at the time the dividend was received. The difficulty in tracing of course also is compounded by the fact that interests in CIVs frequently are held through layers of intermediaries. In those cases, the CIV's records will show the names of the intermediaries through which the investors hold their interests in the CIV, rather than the names of the investors themselves.

21. CIVs typically calculate NAV every day because it is the basis for subscriptions and redemptions. In calculating the NAV, the CIV must take into account amounts expected to be received, including any withholding tax

benefits provided by treaty. If the withholding tax benefits ultimately obtained by the CIV do not correspond to its original assumptions about the amount and timing of such withholding tax benefits, there will be a discrepancy between the real asset value and the NAV used by investors who have purchased, sold or redeemed their interests in the CIV in the interim. Accordingly, CIVs require certainty regarding their qualification for treaty benefits. Unfortunately, for the reasons described in the following section, certainty is in short supply.

III. APPLICATION OF CURRENT TREATY RULES TO CIVS

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

22. The OECD Model Tax Convention on Income and on Capital (the “Model Convention”), which is the basis on which about 3,000 bilateral tax treaties worldwide have been negotiated, contains general provisions addressing each Contracting State’s taxing rights over income derived by a person resident in the other Contracting State, but it does not have any specific provisions relating to CIVs. 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. It may also have to be 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.

a) Is a CIV a “person”?

23. The determination of whether a CIV is a person begins with the legal structure of the CIV. CIVs take different legal forms in OECD member countries. In Canada and the United States, both companies and trusts are commonly used. In Australia, New Zealand and Japan, the trust is the predominant form; this also used to be the case in the United Kingdom, but that country has recently introduced corporate vehicles. In many European countries, both joint ownership vehicles (such as *fonds communs de placement*) and companies (such as *sociétés d’investissement à capital variable*) are commonly used. In all of these countries, of course, there are also forms of custodianship arrangements that are purely contractual in nature.

24. Paragraph 2 of the Commentary on Article 3 states that the definition of the term “person” that is found in the Model Convention is not exhaustive and should be given a very wide sense. That paragraph also provides the example of a foundation (*fondation, Stiftung*) as an arrangement that may fall within the meaning of the term “person” because it is treated as a body corporate for tax purposes.

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25. Applying this guidance to the case of CIVs, a CIV structured as a company clearly would constitute a person. However, in the absence of specific provisions, a CIV that is treated merely as a form of joint ownership, and not as a person, under the tax law of the State in which it is established clearly would not constitute a person for purposes of tax treaties.

26. The issue may be less clear in the case of a CIV that is structured as a trust. Under the domestic tax law of most common law countries, the trust, or the trustees acting collectively in their capacity as such, constitutes a taxpayer. Accordingly, failing to treat such a trust as a person would also prevent it from being treated as a resident despite the fact that, as a policy matter, it seems logical to treat it as a resident when the country in which it is established treats it as a taxpayer and a resident. The fact that the tax law of the country where the trust is established would treat it as a taxpayer would be indicative that the trust is a person for treaty purposes. 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. Because some countries, particularly civil law countries, may not recognise the concept of a trust in their domestic law, negotiators may want to continue the practice of including such modified definitions in future treaties.

b) Is a CIV a “resident of a Contracting State”?

27. The determination of whether a CIV that qualifies as a person is a resident of a Contracting State depends on the tax treatment of the CIV in the Contracting State in which it is established. The tax treatment of CIVs varies considerably from country to country, even though a consistent goal is to ensure that there is only one level of tax, at either the CIV or the investor level. Thus, the intent is to ensure 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.

28. In some States, a CIV established therein is treated as fiscally transparent (“flow-through”); that is, the holders of interests in the CIV are liable to tax on the income received by the CIV, rather than the CIV itself being liable to tax on such income. 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 CIVs 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.

29. Under the principles of paragraph 8.5 of the Commentary on Article 4, a CIV may be “liable to tax”, and therefore a resident of a Contracting State, even if that State does not in fact impose any tax on the CIV. However, the mechanism by which neutrality is accomplished will affect the treaty analysis. A CIV that is transparent for tax purposes in the State in which it is established will not be treated as a resident because it is not liable to tax in that State, nor will a CIV that is totally and unconditionally exempt from income taxation (*e.g.* without regard to the type of income it receives or its distribution policy). However, a CIV that is treated as opaque in the Contracting State in which it is established will be treated as a resident of that Contracting State even if the specific items of income it receives are exempt from taxation, or if it receives a deduction for dividends paid to investors, or it is subject to a lower rate of tax on its income. This analysis would apply to any entity that has satisfied the “person” requirement. Accordingly, for purposes of the residence test, the legal form of the CIV is relevant only to the extent that it affects the taxation of the CIV in the Contracting State in which it is established. So, for example, with respect to those countries that, for tax purposes, treat all CIVs in the same manner, regardless of legal form, all CIVs established in that country should be treated as residents, or none of them should, for treaty purposes.

30. The preceding analysis is consistent with the interpretation of the term “liable to tax” that is found in paragraph 8.5 of the existing Commentary on Article 4 of the Model Convention. However, paragraph 8.6 of that Commentary notes that some countries would take the view that an entity that is exempt from tax would not be “liable to tax” within the meaning of Article 4. Accordingly, it would be prudent to address the issue of CIVs directly in bilateral negotiations if one of the countries adheres to the position described in paragraph 8.6.

c) Is a CIV the “beneficial owner” of the income it receives?

31. In a few cases, CIVs have been denied treaty benefits because the relevant source country has taken the position that a CIV can never be the beneficial owner of the income that it receives. Because the term “beneficial owner” is not defined in the Model, it ordinarily would be given the meaning that it has under the law of the State applying the Convention, unless the

context otherwise requires. Accordingly, a Contracting State might consider itself entitled to decide effectively the question with respect to CIVs investing in that State, even if the country of residence would take the opposite view. Because such a position would affect an entire, significant class of investors, it is particularly important to develop a broad consensus on this issue.

32. Those taking the position that a CIV can never be the beneficial owner of the income it receives generally take the view that, because of the relationship under local law of the investor and the CIV or its managers, ownership of an interest in a CIV is the equivalent of ownership of the underlying assets. However, the position of an investor in a CIV is significantly different from the position of an investor who owns the underlying assets directly. The function of a CIV is to allow a small investor to achieve investment goals that it cannot achieve on its own. An investor better his position by joining with other investors, and in doing so, has invested in something substantially greater than his allocable share of the underlying assets. The investor has no right to the underlying assets. While the investor in the CIV has the right to receive an amount equal to the value of his allocable share of the underlying assets, this right is not the equivalent of receiving the assets as either a commercial or tax matter. Any shareholder in a publicly-traded company can receive the then-value of his allocable share of the corporation by selling his shares on the market. Selling on the market is also the way that an investor in an exchange-traded CIV realizes the value of his investment.

33. An investor who owned the underlying assets directly generally could direct the sale or purchase of particular securities. This is not possible with respect to the vehicles that fall within the definition of “CIV” in paragraph 4, which are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established. In the case of such CIVs, it is the manager of the CIV that has discretionary powers to manage the assets on behalf of the holders of interests in the CIV. In general, managers 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 the CIV’s income in order to qualify for preferential treatment, this obligation does not constrain their ability to vary investments.

34. In most countries, the investor’s tax situation is substantially different than it would be if it owned the assets directly. For example, in most countries, an investor who redeems its shares in a CIV is taxed on a capital gain, not on its share of the income earned by the CIV. Accordingly, for the reasons described in paragraph 20, income from a particular asset generally cannot be traced to a particular investor, even in those countries that purport to treat the CIV as a transparent entity.

35. For these reasons, a widely-held CIV, as defined in paragraph 4, should be treated as the beneficial owner of the income it receives, so long as the managers of the CIV have discretionary powers to manage the assets on behalf of the holders of interests in the CIV and, of course, so long as it also meets the requirements that it be a “person” and a “resident” of the State in which it is established. This conclusion, however, relates only to those economic characteristics that are specific to a CIV. It does not suggest that a CIV is in a different or better position than other investors with respect to aspects of the beneficial ownership requirement that are unrelated to the CIV’s status as such. For example, where an individual receiving an item of income in certain circumstances would not be considered as the beneficial owner of that income, a CIV receiving that income in the same circumstances could not be deemed to be the beneficial owner of the income.

3.2 If a CIV cannot claim benefits, is there any relief for the investors?

36. While application of the principles set out above will clarify that many CIVs are entitled to treaty benefits, other CIVs clearly will not so qualify. It therefore is necessary to consider the position of an investor in a CIV that is not able to claim benefits on its own behalf. If there were no way for an investor that is a resident of a State with which the source State has a tax treaty to claim treaty benefits, then the treaty would have failed in its purpose of eliminating double taxation. Investors who invest through a CIV would be put in a worse position than if they had invested directly. The risk of double taxation would also argue for allowing treaty benefits whether the investors were resident in the same State in which the CIV is established, or in a third State where they would be entitled to benefits under that State’s tax treaty with the source State. An argument could be made, however, that allowing claims in respect of treaty-eligible investors located in third countries is inconsistent with the bilateral nature of the treaty process. In particular, there may not be a significant risk of double taxation if neither the CIV nor residents of third States currently are taxable on the income received by the CIV. This matter is further discussed in paragraphs 55 and 58 to 59.

37. In any event, administrative difficulties effectively prevent individual claims by CIVs’ investors. Given the number of investments by a typical CIV, and the thousands of individual investors in the CIV, each individual claim for exemption (or refund of withheld taxes) would be for relatively small amounts. It is likely that very few, if any, individual investors would bother with such claims, particularly as avoiding such administrative burdens is one of the benefits of investing collectively. Moreover, for the reasons described in paragraph 20, investors may not be able to prove that they have paid the withholding taxes. These administrative difficulties likely would result in benefits going unclaimed in many cases. If such claims were made, however,

tax administrations would be overwhelmed by the sheer number of such small individual claims.

38. Accordingly, developing a system that would allow CIVs to make claims in respect of investors appears to be in the interests of both business and governments. Such a system could allow claims by CIVs with respect to existing treaties, in line with countries' views regarding the extent to which claims should be allowed with respect to treaty-eligible investors located in third countries. Some countries currently could allow such claims, including claims in respect of treaty-eligible residents of third countries, under their domestic law. For other countries, a mutual agreement would be useful or necessary.

39. Any approach that allows claims by a CIV on behalf of its investors would rely on the development of practical and reliable procedures for determining ownership of interests in CIVs and of securities held through other intermediated structures. Whilst it would be possible to require regular determinations, the costs of such determinations would be significantly higher, and compliance likely much lower, if the testing dates were determined after the fact. By contrast, if the date or dates were known in advance, the testing requirement could be built into automatic data collection systems. Under that system, information identifying the beneficial owner would be held by the intermediary with the direct relationship with the investor, rather than passed up the chain of intermediaries. However, information identifying the beneficial owners should be available to the source State upon demand.

40. However, there also may be situations where even such automatic data collection might not be necessary. This might be true, for example, where the CIV industry is largely domestic in nature. For example, governments may be willing to rely on the fact that the fund manager or sponsor restricted sales of interests in the CIV to specific countries for purposes of concluding that the investors are resident in such countries, although they may want to confirm that such sales restrictions are co-extensive with relevant tax criteria. Alternatively, a CIV could establish separate classes of interests for those investors entitled to treaty benefits and for those investors who are not. The CIV could then require distributors to restrict sales accordingly.

3.3 Relief from double taxation for income received by CIVs

41. Discussion of the problems faced by CIVs has tended to focus on the problem of qualifying for the reduced withholding rates provided by Articles 10 (Dividends) and, to a lesser extent, 11 (Interest), and therefore on claims for benefits that are directed to the source country. In fact, an equal or even greater tax loss may result from the fact that, in most cases, neither the CIV

nor the investor can claim foreign tax credits for the withholding taxes imposed by the source country after application of the treaty (i.e. 15% for portfolio dividends according to the Model Convention).

42. Because most of the income received by CIVs consists of portfolio dividends and interest, the income will be subject to withholding taxes in the country of source under treaties that follow the Model Convention. Accordingly, Article 23 (Relief from Double Taxation) of the Model Convention provides for the use of the credit method for such income, even for countries that use the exemption method as the primary means of relieving double taxation. However, a theoretical right to a foreign tax credit is irrelevant to an entity that has no residence State tax liability, which is the case with respect to most CIVs. Accordingly, if the CIV is treated as a resident, then the foreign tax credit is likely to go unused, unless there is a special treaty or domestic law provision that would allow the credit to flow through to the CIV's investors. Some countries do allow investors in a domestic CIV to claim the foreign tax credit, at least in some circumstances.

43. Alternatively, if the CIV is treated as transparent in the Contracting State in which it is established, then an investor in the CIV should be entitled to claim a foreign tax credit with respect to its proportionate share of the foreign withholding taxes paid on the income of the CIV. That should be relatively straightforward (e.g. under the domestic law of the CIV's State if not under Article 23 itself) if the investor is a resident of the same Contracting State in which the CIV is established. However, it could become more difficult, and may require specific legislation, if that Contracting State does not view the CIV as transparent but achieves integration in some other way, such as exempting income or providing a deduction for dividends paid. Some countries have taken a different approach, "refunding" the foreign withholding tax to the CIV (i.e. making a cash payment to the CIV); under that approach, relief is achieved from the double taxation that would otherwise arise if the investors are subject to tax in the Contracting State in which the CIV is established, whether because they are residents of that State or, if they are non-residents, because that State levies a withholding tax at the time the earnings of the CIV are distributed.

44. Of course, the situation may become even more difficult if the investor is located in a different State, and that third State does not view the CIV as transparent. In that case, that third State is unlikely to provide a foreign tax credit for withholding taxes imposed on income received by the CIV. Moreover, this problematic situation involves three different countries. In theory, the Contracting State in which the investor is resident should not apply its treaty (if any) with the Contracting State in which the income arises, because the first-mentioned Contracting State sees the CIV in a third State as the beneficial owner of the income. The treaty between the State in which the CIV

is established and the State in which the investor is a resident could solve the problem by requiring the State in which the investor is a resident to provide a foreign tax credit for any taxes withheld on payments to the CIV.

45. Such a provision could read as follows:

[]. Where a resident of a Contracting State owns an interest or interests in a collective investment vehicle established in the other Contracting State, and that collective investment vehicle derives items of income that are subject to tax in a third State, the first-mentioned Contracting State shall allow as a deduction from the tax on the income of the resident of that Contracting State an amount equal to the tax paid in the third State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to the income derived by that resident from its ownership interest in the collective investment vehicle, as determined under the laws of the first-mentioned Contracting State.

46. Some countries may be reluctant to include such a provision in a bilateral treaty because it would constitute a two-party, and therefore incomplete, solution to a multilateral problem. As a result, a Contracting State potentially would be providing relief for taxes paid to a third State without regard to whether that third State would provide reciprocal benefits. Moreover, it potentially could require the Contracting State in which the investor is a resident to provide a greater foreign tax credit than would have been granted if the investor had invested directly. (This situation could arise if the State in which the investor is resident had negotiated with the source State a lower withholding rate on the type of income than did the State in which the CIV is established.) Finally, it was noted that the proposed provision raises fundamental questions regarding when economic double taxation arises.

47. To date, investors have not expressed an interest in making such claims with respect to CIVs located in third countries and have not demanded the information that would be necessary to make such claims. However, it may be that other changes proposed in this Report could, if widely implemented, increase investors' interest in making such claims.

IV. POLICY ISSUES RAISED BY CURRENT TREATMENT OF CIVS

48. As noted above, the discussion and conclusions in Section III assume that the relevant tax treaties do not include any provisions specifically addressing the treatment of CIVs. Because the principles set out above are necessarily general, their application to a particular type of CIV might not be clear to the CIV, investors and intermediaries. Section III therefore does not

address the issue of whether the treaty entitlement of any particular type of CIV is appropriate or not. However, as noted above, clarity is critical for a CIV because it affects the calculation of its NAV, the basis for all purchases, sales and redemptions. For these reasons, some countries have begun to include in their tax treaties provisions that specifically address the treatment of CIVs. In some cases, the provisions merely confirm the treatment that otherwise would apply while in other cases that treatment is modified to achieve specific policy goals.

49. This section addresses the policy considerations that countries entering into new treaties or modifying existing treaties may want to consider in determining how to treat the specific CIVs that are common in the two Contracting States. In some cases, the Contracting States might provide a single treatment that would apply to all of the forms of CIV in common use in the two countries. However, given the continuing proliferation of new forms of CIVs, it seems just as likely that the policy considerations discussed in this section will suggest that CIVs in the two Contracting States, or even within the same Contracting State, should be treated differently. At the same time, negotiators will want to keep in mind that some countries may have difficulties with a treaty providing more than one treatment for a single type of legal entity.

4.1 Potential for differential treatment of economically similar CIVs

50. The discussion in Section III demonstrates that there could be significant differences in the treatment of CIVs that take different legal forms and are subject to different tax regimes. This is true even though the goal of all of the systems is, to the extent possible, to ensure neutrality between direct investment and investment through CIVs. Such differential treatment could be seen as violating the general policy goal of treating economically similar structures similarly. Moreover, it could in many cases result in CIVs in one Contracting State qualifying for treaty benefits while those in the other Contracting State fail to so qualify, thus possibly violating the implicit assumption of reciprocity in bilateral tax treaties. Such unbalanced situations frequently have proven to be, not surprisingly, unstable. It is politically difficult for a country to provide benefits to CIVs established in another country when that other country does not provide benefits to CIVs located in the first country. That may increase the pressure on governments to deny claims for treaty benefits made by CIVs, undermining one of the primary goals of the tax treaty – to eliminate barriers to cross-border investment.

51. On the other hand, the differences in legal form and tax treatment in the two Contracting States may mean that it is appropriate to treat CIVs in the two States differently. In comparing the taxation of CIVs in the two States, taxation in the source State and at the investor level (taking into account the treatment

of both resident and non-resident investors) should be considered, not just the taxation of the CIV itself. The goal is to achieve neutrality between a direct investment and an investment through a CIV in the international context, just as the goal of most domestic provisions addressing the treatment of CIVs is to achieve such neutrality in the wholly domestic context. Developing practical solutions that ensure that the CIVs that are common in each jurisdiction have access to treaty benefits, even if on different terms, is likely to be more beneficial for both countries in the long run.

4.2 Potential for treaty shopping through CIVs

52. Some countries are also concerned about the prospect that a CIV could be treated as meeting the technical requirements for treaty benefits, and thus claim benefits in its own right, or at least without regard to the nature of the CIV's investors. They argue that a CIV, which generally is not subject to substantial taxation in the country in which it is organised, could easily serve as a vehicle for treaty shopping. Accordingly, it may be appropriate to restrict benefits that might otherwise be available to such a CIV, either through generally applicable anti-abuse or anti-treaty shopping rules or through a specific provision dealing with CIVs.

53. Again, in deciding on the appropriate approach, negotiators will want to consider the economic characteristics of the various types of CIVs that are prevalent in each of the Contracting States. For example, a CIV that is not subject to any taxation in the State in which it is established may present more of a danger of treaty shopping than a scenario in which the CIV itself is subject to an entity-level tax or where distributions to non-resident investors are subject to withholding tax.

54. A number of countries have dealt with the possibility of treaty shopping by adopting general provisions such as those mentioned in paragraphs 13 to 21.4 of the Commentary on Article 1 of the Model Convention. Some of these provisions are quite flexible and, in some treaties, such provisions apply to all claims for treaty benefits by any person. In others, there are no general anti-treaty shopping rules, but there may be specific ones that apply to CIVs. Still others may include a general anti-treaty shopping provision but apply stricter standards to CIVs. Negotiators developing a specific provision addressing the treatment of CIVs will also want to consider the effect of, and co-ordinate the provision with, any general anti-treaty shopping provision included in the treaty.

55. In the case of CIVs, an anti-treaty shopping provision generally would seek to determine whether a CIV is being used for treaty shopping by determining whether the owners, or a specific proportion of the owners, of interests in the CIV are residents of the Contracting State in which the CIV is

organised or, in some cases, whether the owners of interests in the CIV would have been entitled to equivalent benefits had they invested directly. The latter approach would help to ensure that investors who would have been entitled to benefits with respect to income derived from the source State had they received the income directly are not put in a worse position by investing through a CIV located in a third country. The approach thus serves the goals of neutrality as between direct investments and investments through a CIV. It also decreases the risk of double taxation as between the source State and the State of residence of the investor, to the extent that there is a tax treaty between them. It is beneficial for investors, particularly those from small countries, who will consequently enjoy a greater choice of investment vehicles. It also increases economies of scale, which are a primary economic benefit of investing through CIVs. Finally, adopting this approach substantially simplifies compliance procedures. Compliance procedures could be greatly simplified, because in many cases, nearly all of a CIV's investors will be "equivalent beneficiaries", given the extent of bilateral treaty coverage and the fact that rates in those treaties are nearly always 10-15% on portfolio dividends. On the other hand, some countries have expressed concern that taking into account residents of countries other than the source country and the country in which the CIV is established changes the bilateral nature of tax treaties.

56. Such a provision could be structured in various ways. The simplest would provide a binary application; an entity should either receive 1) full treaty benefits if the requirements for benefits are satisfied, or 2) no treaty benefits if the requirements are not satisfied. This is the standard approach under many anti-treaty shopping provisions. However, that approach would create a pure "cliff", which effectively would deny benefits to investors who otherwise would be entitled to treaty benefits. For that reason, those countries that have developed provisions to specifically address the treatment of CIVs generally have allowed a CIV to make claims in proportion to its "good" ownership, whether defined to include only residents of the same State or other treaty-entitled investors as well. Procedures could be further simplified, without significantly increasing the risk of treaty shopping, by providing that, once the CIV has passed some threshold of "good" ownership, the CIV would be entitled to benefits with respect to 100% of the income it receives. This dual approach would avoid the "cliff" effect described above. On the other hand, the "cliff" effect applies equally above the threshold, in that some investors who might not have been entitled to benefits nevertheless would benefit. This might argue for the adoption of a high threshold. A higher threshold might also be justified if a broader class of investors, such as all treaty-entitled investors, were treated as "good" owners. Because of these variables, the choice of threshold is best left to bilateral negotiations.

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57. An alternative approach, which has been adopted in a number of treaties that include general anti-treaty shopping provisions, would be to provide that a CIV that is publicly traded in the Contracting State in which it is established will be entitled to treaty benefits without regard to the residence of its investors. This provision has been justified on the basis that a publicly-traded CIV cannot be used effectively for treaty shopping because the shareholders or unitholders of such a CIV cannot individually exercise control over it.

4.3 Potential deferral of income

58. Some source States may be concerned about the potential deferral of taxation that could arise with respect to a CIV that is subject to no or low taxation and that accumulates its income rather than distributing it on a current basis. Their view is that benefits to the CIV should be limited to the proportion of the CIV's investors who are currently taxable on their share of the income of the CIV, similar to the approach taken with respect to partnerships. Because such an approach would be difficult to apply to widely-held CIVs in practice, for the reasons described in paragraph 20 above, countries that are concerned about the possibility of deferral may wish to negotiate provisions that extend benefits only to those CIVs that are required to distribute earnings currently.

59. Other States have less concern about the potential for deferral. They take the view that, even if the investor is not taxed currently on the income received by the CIV, it will be taxed eventually, either on the distribution, or on any capital gains if it sells its interest in the CIV before the CIV distributes the income. Those countries may wish to negotiate provisions that grant benefits to CIVs even if they are not obliged to distribute their income on a current basis. Moreover, in many countries, the tax rate with respect to investment income is not significantly higher than the 10-15% withholding rate on dividends, so there would be little if any residence-country tax deferral to be achieved by earning such income through an investment fund rather than directly. Others view the risk of deferral in these circumstances as an issue primarily of concern to the State of which the investors are resident. In fact, many countries have taken steps to ensure the current taxation of investment income earned by their residents through investment funds, regardless of whether the funds accumulate that income, further reducing the potential for such deferral. When considering the treatment of CIVs that are not required to distribute income currently, countries may want to consider whether these or other factors address the concerns described in the preceding paragraph so that the type of limits described therein might not in fact be necessary.

4.4 Loss of preferential benefits

60. In most cases, it will be simpler to treat the CIV as a resident and the beneficial owner of the income it receives. Under this approach, the CIV would be entitled to the rates on income generally applicable to portfolio investors. This approach would provide for only one reduced withholding rate on dividends. However, there may be cases where countries would want to adopt a look-through approach with respect to the entire CIV or a class of interests in the CIV. This might be the case, for example, where pension funds are substantial investors in the CIV, since they might be entitled by treaty to a full exemption from source country tax on certain types of investment income.

61. In considering whether to adopt such a look-through approach, however, negotiators should pay particular attention to the types of vehicles to which the rules will apply. It is intended that the provisions included in the proposed Commentary that follows would apply only to CIVs as defined in paragraph 4, and therefore be limited to funds (including “funds of funds”) that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established. It is appropriate to provide simplified methods for determining the ownership of these types of vehicles because of the difficulty in tracing investment income received by the CIV to specific investors. Where ownership in the vehicle is sufficiently stable to allow the custodian, manager or other fiduciary to credit specific income received by the vehicle to specific investors, it should also be possible to determine the extent to which those individual investors or classes of investors are entitled to treaty benefits. Where such tracing of specific income items to specific investors is clearly possible, it would be inappropriate to apply one of the less-targeted approaches provided in the proposed Commentary.

V. PROPOSED CHANGES TO THE COMMENTARY TO ADDRESS CIVS

62. The following proposed addition to the Commentary on Article 1 addresses the issues discussed in this Report. It begins with the conclusions from Section III regarding the application of current treaty rules to the specific case of CIVs. That is followed by a discussion of a number of optional provisions that could be adopted in new treaties to address the concerns discussed in Section IV. Because of the various factors and policy considerations discussed in Section IV, it is not possible to propose a single approach for the treatment of CIVs that could apply in all cases.

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Add the following paragraphs 6.8 to 6.34 to the Commentary on Article 1 of the Model Tax Convention:

Cross-border issues relating to collective investment vehicles

6.8 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 general, the goal of such systems is to provide for neutrality between direct investments and investments through a CIV. Whilst those systems generally succeed when the investors, the CIV and the investment are all located in the same country, complications frequently arise when one or more of those parties or the investments are located in different countries. These complications are discussed in the report by the Committee on Fiscal Affairs entitled *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*,⁸ the main conclusions of which have been incorporated below. For purposes of the Report and for this discussion, the term “CIV” is limited to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established.

Application of the Convention to CIVs

6.9 The primary question that arises in the cross-border context is whether a CIV should qualify for the benefits of the Convention in its own right. In order to do so under treaties that, like the Convention, do not include a specific provision dealing with CIVs, a CIV would have to qualify as a “person” that is a “resident” of a Contracting State and, as regards the application of Articles 10 and 11, that is the “beneficial owner” of the income that it receives.

6.10 The determination of whether a CIV should be treated as a “person” begins with the legal form of the CIV, which differs substantially from country to country and between the various types of vehicles. In many countries, most CIVs take the form of a company. In others, the CIV typically would be a trust. In still others, many CIVs are simple contractual arrangements or a form of joint ownership. In most cases, the CIV would be treated as a taxpayer or a “person” for purposes of the tax law of the State in which it is established; for example, in some countries where the CIV is commonly established in the form of a trust, either the trust itself, or the trustees acting collectively in their capacity as such, is treated as a taxpayer or a person for domestic tax law purposes. In view of the wide meaning to be given to the term “person”, the fact that the tax law of the country where such a CIV is established would treat it as a taxpayer would be indicative that the CIV is a “person” for treaty purposes. Contracting States wishing to expressly clarify that,

in these circumstances, such CIVs are persons for the purposes of their conventions may agree bilaterally to modify the definition of “person” to include them.

6.11 Whether a CIV is a “resident of a Contracting State” depends not on its legal form (as long as it qualifies as a person) but on its tax treatment in the State in which it is established. Although a consistent goal of domestic CIV regimes is to ensure that there is only one level of tax, at either the CIV or the investor level, there are a number of different ways in which States achieve that goal. In some States, the holders of interests in the CIV are liable to tax on the income received by the CIV, rather than the CIV itself being liable to tax on such income. Such a fiscally transparent CIV would not be treated as a resident of the Contracting State in which it is established because it is not liable to tax therein.

6.12 By contrast, in other States, a CIV is in principle liable to tax but its income may be fully exempt, for instance, if the CIV fulfils certain criteria with regard to its purpose, activities or operation, which may include requirements as to minimum distributions, 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 CIVs but at a special low 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. For those countries that adopt the view, reflected in paragraph 8.5 of the Commentary on Article 4, that a person may be liable to tax even if the State in which it is established does not impose tax, the CIV would be treated as a resident of the State in which it is established in all of these cases because the CIV is subject to comprehensive taxation in that State. Even in the case where the income of the CIV is taxed at a zero rate, or is exempt from tax, the requirements to be treated as a resident may be met if the requirements to qualify for such lower rate or exemption are sufficiently stringent.

6.13 Those countries that adopt the alternative view, reflected in paragraph 8.6 of the Commentary on Article 4, that an entity that is exempt from tax therefore is not liable to tax may not view some or all of the CIVs described in the preceding paragraph as residents of the States in which they are established. States taking the latter view, and those States negotiating with such States, are encouraged to address the issue in their bilateral negotiations.

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6.14 Some countries have questioned whether a CIV, even if it is a “person” and a “resident”, can qualify as the beneficial owner of the income it receives. Because a “CIV” as defined in paragraph 6.8 above must be widely-held, hold a diversified portfolio of securities and be subject to investor-protection regulation in the country in which it is established, such a CIV, or its managers, often perform significant functions with respect to the investment and management of the assets of the CIV. Moreover, the position of an investor in a CIV differs substantially, as a legal and economic matter, from the position of an investor who owns the underlying assets, so that it would not be appropriate to treat the investor in such a CIV as the beneficial owner of the income received by the CIV. Accordingly, a vehicle that meets the definition of a widely-held CIV will also be treated as the beneficial owner of the dividends and interest that it receives, so long as the managers of the CIV have discretionary powers to manage the assets generating such income (unless an individual who is a resident of that State who would have received the income in the same circumstances would not have been considered to be the beneficial owner thereof).

6.15 Because these principles are necessarily general, their application to a particular type of CIV might not be clear to the CIV, investors and intermediaries. Any uncertainty regarding treaty eligibility is especially problematic for a CIV, which must take into account amounts expected to be received, including any withholding tax benefits provided by treaty, when it calculates its net asset value (“NAV”). The NAV, which typically is calculated daily, is the basis for the prices used for subscriptions and redemptions. If the withholding tax benefits ultimately obtained by the CIV do not correspond to its original assumptions about the amount and timing of such withholding tax benefits, there will be a discrepancy between the real asset value and the NAV used by investors who have purchased, sold or redeemed their interests in the CIV in the interim.

6.16 In order to provide more certainty under existing treaties, tax authorities may want to reach a mutual agreement clarifying the treatment of some types of CIVs in their respective States. With respect to some types of CIVs, such a mutual agreement might simply confirm that the CIV satisfies the technical requirements discussed above and therefore is entitled to benefits in its own right. In other cases, the mutual agreement could provide a CIV an administratively feasible way to make claims with respect to treaty-eligible investors. See paragraphs 36 to 40 of the report on *The Granting of Treaty Benefits to Income Earned by Collective Investment Vehicles* for a discussion of this issue. Of course, a mutual agreement could not cut back on benefits that otherwise would be available to the CIV under the terms of a treaty.

Policy issues raised by the current treatment of collective investment vehicles

6.17 The same considerations would suggest that treaty negotiators address expressly the treatment of CIVs. Thus, even if it appears that CIVs in each of the Contracting States would be entitled to benefits, it may be appropriate to confirm that position publicly (for example, through an exchange of notes) in order to provide certainty. It may also be appropriate to expressly provide for the treaty entitlement of CIVs by including, for example, a provision along the following lines:

Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the Convention to such income as an individual that is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof). For purposes of this paragraph, the term “collective investment vehicle” means, in the case of [the first Contracting State], a [] and, in the case of [the other Contracting State], a [], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph.

6.18 However, in negotiating new treaties or amendments to existing treaties, the Contracting States would not be restricted to clarifying the results of the application of other treaty provisions to CIVs, but could vary those results to the extent necessary to achieve policy objectives. For example, in the context of a particular bilateral treaty, the technical analysis may result in CIVs located in one of the Contracting States qualifying for benefits, whilst CIVs in the other Contracting State may not. This may make the treaty appear unbalanced, although whether it is so in fact will depend on the specific circumstances. If it is, then the Contracting States should attempt to reach an equitable solution. If the practical result in each of the Contracting States is that most CIVs do not in fact pay tax, then the Contracting States should attempt to overcome differences in legal form that might otherwise cause those in one State to qualify for benefits and those in the other to be denied benefits. On the other hand, the differences in legal form and tax treatment in the two Contracting States may mean that it is appropriate to treat CIVs in the two States differently. In comparing the taxation of CIVs in the two States, taxation in the source State and at the investor level should be

considered, not just the taxation of the CIV itself. The goal is to achieve neutrality between a direct investment and an investment through a CIV in the international context, just as the goal of most domestic provisions addressing the treatment of CIVs is to achieve such neutrality in the wholly domestic context.

6.19 A Contracting State may also want to consider whether existing treaty provisions are sufficient to prevent CIVs from being used in a potentially abusive manner. It is possible that a CIV could satisfy all of the requirements to claim treaty benefits in its own right, even though its income is not subject to much, if any, tax in practice. In that case, the CIV could present the opportunity for residents of third countries to receive treaty benefits that would not have been available had they invested directly. Accordingly, it may be appropriate to restrict benefits that might otherwise be available to such a CIV, either through generally applicable anti-abuse or anti-treaty shopping rules (as discussed under “Improper use of the Convention” below) or through a specific provision dealing with CIVs.

6.20 In deciding whether such a provision is necessary, Contracting States will want to consider the economic characteristics, including the potential for treaty shopping, presented by the various types of CIVs that are prevalent in each of the Contracting States. For example, a CIV that is not subject to any taxation in the State in which it is established may present more of a danger of treaty shopping than one in which the CIV itself is subject to an entity-level tax or where distributions to non-resident investors are subject to withholding tax.

Possible provisions modifying the treatment of CIVs

6.21 Where the Contracting States have agreed that a specific provision dealing with CIVs is necessary to address the concerns described in paragraphs 6.18 through 6.20, they could include in the bilateral treaty the following provision:

- a) Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the Convention to such income as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof),

but only to the extent that the beneficial interests in the collective investment vehicle are owned by equivalent beneficiaries.

- b) For purposes of this paragraph:
- (i) the term “collective investment vehicle” means, in the case of [the first Contracting State], a [] and, in the case of [the other Contracting State], a [], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph; and
 - (ii) the term “equivalent beneficiary” means a resident of the Contracting State in which the CIV is established, and a resident of any other State with which the Contracting State in which the income arises has an income tax convention that provides for effective and comprehensive information exchange who would, if he received the particular item of income for which benefits are being claimed under this Convention, be entitled under that convention, or under the domestic law of the Contracting State in which the income arises, to a rate of tax with respect to that item of income that is at least as low as the rate claimed under this Convention by the CIV with respect to that item of income.

6.22 It is intended that the Contracting States would provide in clause (b)(i) specific cross-references to relevant tax or securities law provisions relating to CIVs. In deciding which treatment should apply with respect to particular CIVs, Contracting States should take into account the policy considerations discussed above. Negotiators may agree that economic differences in the treatment of CIVs in the two Contracting States, or even within the same Contracting State, justify differential treatment in the tax treaty. In that case, some combination of the provisions in this section might be included in the treaty.

6.23 The effect of allowing benefits to the CIV to the extent that it is owned by “equivalent beneficiaries” as defined in clause (b)(ii) is to ensure that investors who would have been entitled to benefits with respect to income derived from the source State had they received the income directly are not put in a worse position by investing through a CIV located in a third country. The approach thus serves the goals of neutrality as between direct investments and investments through a CIV. It also decreases the risk of double taxation as between the source State and the State of residence of the investor, to the extent that there is a tax treaty between them. It is beneficial for investors, particularly those

from small countries, who will consequently enjoy a greater choice of investment vehicles. It also increases economies of scale, which are a primary economic benefit of investing through CIVs. Finally, adopting this approach substantially simplifies compliance procedures. In many cases, nearly all of a CIV's investors will be "equivalent beneficiaries", given the extent of bilateral treaty coverage and the fact that rates in those treaties are nearly always 10-15% on portfolio dividends.

6.24 At the same time, the provision prevents a CIV from being used by investors to achieve a better tax treaty position than they would have achieved by investing directly. This is achieved through the rate comparison in the definition of "equivalent beneficiary". Accordingly, the appropriate comparison is between the rate claimed by the CIV and the rate that the investor could have claimed had it received the income directly. For example, assume that a CIV established in Country B receives dividends from a company resident in Country A. Sixty-five per cent of the investors in the CIV are individual residents of Country B; ten per cent are pension funds established in Country C and 25 percent are individual residents of Country C. Under the A-B tax treaty, portfolio dividends are subject to a maximum tax rate at source of 10%. Under the A-C tax treaty, pension funds are exempt from taxation in the source country and other portfolio dividends are subject to tax at a maximum tax rate of 15%. Both the A-B and A-C treaties include effective and comprehensive information exchange provisions. On these facts, 75% of the investors in the CIV – the individual residents of Country B and the pension funds established in Country C – are equivalent beneficiaries.

6.25 A source State may also be concerned about the potential deferral of taxation that could arise with respect to a CIV that is subject to no or low taxation and that may accumulate its income rather than distributing it on a current basis. Such States may be tempted to limit benefits to the CIV to the proportion of the CIV's investors who are currently taxable on their share of the income of the CIV. However, such an approach has proven difficult to apply to widely-held CIVs in practice. Those countries that are concerned about the possibility of such deferral may wish to negotiate provisions that extend benefits only to those CIVs that are required to distribute earnings currently. Other States may be less concerned about the potential for deferral, however. They may take the view that, even if the investor is not taxed currently on the income received by the CIV, it will be taxed eventually, either on the distribution, or on any capital gains if it sells its interest in the CIV before the CIV distributes the income. Those countries may wish to negotiate provisions that grant benefits to CIVs even if they are not obliged to

distribute their income on a current basis. Moreover, in many countries, the tax rate with respect to investment income is not significantly higher than the treaty withholding rate on dividends, so there would be little if any residence-country tax deferral to be achieved by earning such income through an investment fund rather than directly. In addition, many countries have taken steps to ensure the current taxation of investment income earned by their residents through investment funds, regardless of whether the funds accumulate that income, further reducing the potential for such deferral. When considering the treatment of CIVs that are not required to distribute income currently, countries may want to consider whether these or other factors address the concerns described above so that the type of limits described herein might not in fact be necessary.

6.26 Some States believe that taking all treaty-eligible investors, including those in third States, into account would change the bilateral nature of tax treaties. These States may prefer to allow treaty benefits to a CIV only to the extent that the investors in the CIV are residents of the Contracting State in which the CIV is established. In that case, the provision would be drafted as follows:

- a) Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the Convention to such income as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof), but only to the extent that the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established.
- b) For purposes of this paragraph, the term “collective investment vehicle” means, in the case of [the first Contracting State], a [] and, in the case of [the other Contracting State], a [], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph.

6.27 Although the purely proportionate approach set out in paragraphs 6.21 and 6.26 protects against treaty shopping, it may also

impose substantial administrative burdens as a CIV attempts to determine the treaty entitlement of every single investor. A Contracting State may decide that the fact that a substantial proportion of the CIV's investors are treaty-eligible is adequate protection against treaty shopping, and thus that it is appropriate to provide an ownership threshold above which benefits would be provided with respect to all income received by the CIV. Including such a threshold would also mitigate some of the procedural burdens that otherwise might arise. If desired, therefore, the following sentence could be added at the end of subparagraph a):

However, if at least [] per cent of the beneficial interests in the collective investment vehicle are owned by [equivalent beneficiaries][residents of the Contracting State in which the collective investment vehicle is established], the collective investment vehicle shall be treated as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of all of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof).

6.28 In some cases, the Contracting States might wish to take a different approach from that put forward in paragraphs 6.17, 6.21 and 6.26 with respect to certain types of CIVs and to treat the CIV as making claims on behalf of the investors rather than in its own name. This might be true, for example, if a large percentage of the owners of interests in the CIV as a whole, or of a class of interests in the CIV, are pension funds that are exempt from tax in the source country under terms of the relevant treaty similar to those described in paragraph 69 of the Commentary on Article 18 (Pensions). To ensure that the investors would not lose the benefit of the preferential rates to which they would have been entitled had they invested directly, the Contracting States might agree to a provision along the following lines with respect to such CIVs (although likely adopting one of the approaches of paragraph 6.17, 6.21 or 6.26 with respect to other types of CIVs):

- a) A collective investment vehicle described in subparagraph c) which is established in a Contracting State and which receives income arising in the other Contracting State shall not be treated as a resident of the Contracting State in which it is established, but may claim, on behalf of the owners of the beneficial interests in the collective investment vehicle, the tax reductions, exemptions or other benefits that would have been available

under this Convention to such owners had they received such income directly.

- b) A collective investment vehicle may not make a claim under subparagraph a) for benefits on behalf of any owner of the beneficial interests in such collective investment vehicle if the owner has itself made an individual claim for benefits with respect to income received by the collective investment vehicle.
- c) This paragraph shall apply with respect to, in the case of [the first Contracting State], a [] and, in the case of [the other Contracting State], a [], as well as any other investment fund, arrangement or entity established in either Contracting State to which the competent authorities of the Contracting States agree to apply this paragraph.

This provision would, however, limit the CIV to making claims on behalf of residents of the same Contracting State in which the CIV is established. If, for the reasons described in paragraph 6.23, the Contracting States deemed it desirable to allow the CIV to make claims on behalf of treaty-eligible residents of third States, that could be accomplished by replacing the words “this Convention” with “any Convention to which the other Contracting State is a party” in subparagraph a). If, as anticipated, the Contracting States would agree that the treatment provided in this paragraph would apply only to specific types of CIVs, it would be necessary to ensure that the types of CIVs listed in subparagraph c) did not include any of the types of CIVs listed in a more general provision such as that in paragraph 6.17, 6.21 or 6.26 so that the treatment of a specific type of CIV would be fixed, rather than elective. Countries wishing to allow individual CIVs to elect their treatment, either with respect to the CIV as a whole or with respect to one or more classes of interests in the CIV, are free to modify the paragraph to do so.

6.29 Under either the approach in paragraphs 6.21 and 6.26 or in paragraph 6.28, it will be necessary for the CIV to make a determination regarding the proportion of holders of interests who would have been entitled to benefits had they invested directly. Because ownership of interests in CIVs changes regularly, and such interests frequently are held through intermediaries, the CIV and its managers often do not themselves know the names and treaty status of the beneficial owners of interests. It would be impractical for the CIV to collect such information from the relevant intermediaries on a daily basis. Accordingly, Contracting States should be willing to accept practical and reliable approaches that do not require such daily tracing.

6.30 For example, in many countries the CIV industry is largely domestic, with an overwhelming percentage of investors resident in the country in which the CIV is established. In some cases, tax rules discourage foreign investment by imposing a withholding tax on distributions, or securities laws may severely restrict offerings to non-residents. Governments should consider whether these or other circumstances provide adequate protection against investment by non-treaty-eligible residents of third countries. It may be appropriate, for example, to assume that a CIV is owned by residents of the State in which it is established if the CIV has limited distribution of its shares or units to the State in which the CIV is established or to other States that provide for similar benefits in their treaties with the source State.

6.31 In other cases, interests in the CIV are offered to investors in many countries. Although the identity of individual investors will change daily, the proportion of investors in the CIV that are treaty-entitled is likely to change relatively slowly. Accordingly, it would be a reasonable approach to require the CIV to collect from other intermediaries, on specified dates, information enabling the CIV to determine the proportion of investors that are treaty-entitled. This information could be required at the end of a calendar or fiscal year or, if market conditions suggest that turnover in ownership is high, it could be required more frequently, although no more often than the end of each calendar quarter. The CIV could then make a claim on the basis of an average of those amounts over an agreed-upon time period. In adopting such procedures, care would have to be taken in choosing the measurement dates to ensure that the CIV would have enough time to update the information that it provides to other payors so that the correct amount is withheld at the beginning of each relevant period.

6.32 An alternative approach would provide that a CIV that is publicly traded in the Contracting State in which it is established will be entitled to treaty benefits without regard to the residence of its investors. This provision has been justified on the basis that a publicly-traded CIV cannot be used effectively for treaty shopping because the shareholders or unitholders of such a CIV cannot individually exercise control over it. Such a provision could read:

- a) Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the Convention to such income as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an

individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof), if the principal class of shares or units in the collective investment vehicle is listed and regularly traded on a regulated stock exchange in that State.

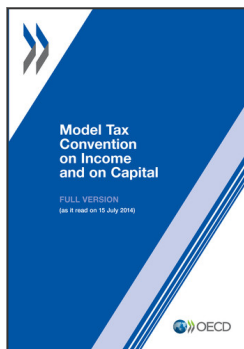
- b) For purposes of this paragraph, the term “collective investment vehicle” means, in the case of [the first Contracting State], a [] and, in the case of [the other Contracting State], a [], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph.

6.33 Each of the provisions in paragraphs 6.17, 6.21, 6.26 and 6.32 treats the CIV as the resident and the beneficial owner of the income it receives for the purposes of the application of the Convention to such income, which has the simplicity of providing for one reduced rate of withholding with respect to each type of income. These provisions should not be construed, however, as restricting in any way the right of the State of source from taxing its own residents who are investors in the CIV. Clearly, these provisions are intended to deal with the source taxation of the CIV’s income and not the residence taxation of its investors (this conclusion is analogous to the one put forward in paragraph 6.1 above as regards partnerships). States that wish to confirm this point in the text of the provisions are free to amend the provisions accordingly, which could be done by adding the following sentence: “This provision shall not be construed as restricting in any way a Contracting State’s right to tax the residents of that State”.

6.34 Also, each of these provisions is intended only to provide that the specific characteristics of the CIV will not cause it to be treated as other than the beneficial owner of the income it receives. Therefore, a CIV will be treated as the beneficial owner of all of the income it receives. The provision is not intended, however, to put a CIV in a different or better position than other investors with respect to aspects of the beneficial ownership requirement that are unrelated to the CIV’s status as such. Accordingly, where an individual receiving an item of income in certain circumstances would not be considered as the beneficial owner of that income, a CIV receiving that income in the same circumstances could not be deemed to be the beneficial owner of the income. This result is confirmed by the parenthetical limiting the application of the provision to situations in which an individual in the same circumstances would have been treated as the beneficial owner of the income.

Notes

1. These figures do not take account of amounts held through private equity funds or hedge funds. ICI 2009 Fact Book, www.icifactbook.org/pdf/09_fb_table58.pdf.
2. Hereafter, the term “adviser” will be used to describe the person with portfolio-manager responsibilities, whether that person is the manager or a sub-adviser.
3. www.icifactbook.org/pdf/08_fb_table04.pdf.
4. “Asset Management in the UK 2007”, published by the Investment Management Association, UK (www.investmentuk.org).
5. Data regarding the holdings of Japanese CIVs is published by The Investment Trusts Association at www.toushin.or.jp/result/index.html.
6. For example, as of June 2008 approximately 70% of the assets under management of Swiss-domiciled CIVs were invested outside Switzerland (see Swiss National Bank, SNB, Monthly Statistical Bulletin, October 2008 (www.snb.ch/en/i/about/stat/statpub/statmon/stats/statmon)).
7. The Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (No. 85/611/EEC), as amended.
8. Reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention at page R(24)-1.



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