



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



**REPORT OF THE INFORMAL CONSULTATIVE GROUP ON THE
TAXATION OF COLLECTIVE INVESTMENT VEHICLES AND
PROCEDURES FOR TAX RELIEF FOR CROSS-BORDER INVESTORS**

ON

**THE GRANTING OF TREATY BENEFITS WITH RESPECT TO THE
INCOME OF COLLECTIVE INVESTMENT VEHICLES**

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At a Roundtable on Selected Tax Issues Related to Collective Investment Vehicles sponsored by the OECD's Centre for Tax Policy and Administration on 1-2 February 2006, government and business participants considered legal questions and administrative barriers that affect the ability of collective investment vehicles ("CIVs") and other portfolio investors to effectively claim the benefits of tax treaties (see http://www.oecd.org/document/1/0,3343,en_2649_33747_36202817_1_1_1_1,00.html). The legal issues relate primarily to the treaty entitlement of the CIVs themselves and of their investors. Even where there is no question regarding treaty entitlement, however, there may be very important compliance and administrative difficulties in ensuring that the benefits of tax treaties are effectively granted (including the possibility of claiming benefits with respect to a very large number of investors in a CIV). These difficulties may result in the benefits of tax treaties not being granted or being inappropriately granted, with risks of double taxation or double non-taxation that are of concern for both the country of source of the income and the country of residence of the investor.

At the conclusion of the Roundtable, participants agreed that work should continue on both the granting of tax treaty benefits to income of CIVs and the procedural impediments to the effective delivery of tax treaty relief to eligible cross-border investors. The OECD's Committee on Fiscal Affairs ("CFA") subsequently established the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors (the "ICG") to take forward the work (see http://www.oecd.org/document/14/0,3343,en_2649_33747_37840206_1_1_1_1,00.html). The ICG includes representatives from the financial industry as well as representatives of the tax administrations of some OECD member countries (see Annex 2 of this Report for a list of the ICG members).

This Report, which has been prepared by the ICG for consideration by the CFA, relates to the legal issues relevant to the treaty entitlement of CIVs and their investors. (A separate ICG report, which discusses the procedural problems in claiming treaty benefits faced by portfolio investors more generally and makes a number of recommendations on "best practices" regarding procedures for making and granting claims for treaty benefits for intermediated structures, is being issued contemporaneously with this Report.) The Report includes a comprehensive set of recommendations with respect to the legal and policy issues relating specifically to CIVs (*i.e.* the extent to which either the vehicles or their investors are entitled to treaty benefits). The Report 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 ("Model 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 Convention to reflect the conclusions of the ICG with respect to these issues.

With respect to existing treaties, the ICG members agreed 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. Because administrative difficulties in many cases prevent individual claims by investors, the ICG also recommends

that countries adopt procedures to allow a CIV to make the claim on behalf of investors including, where necessary, through the conclusion of mutual agreements.

With respect to future treaties, the ICG recommends that Contracting States address directly the treatment of CIVs to provide certainty to CIVs, investors and intermediaries. It recommends additions to the Commentary on Article 1 of the Model Convention regarding proposed provisions as options for countries to consider in their future treaty negotiations. The favoured approach 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.

The conclusions of the report are solely those of the ICG and should not, at this stage, be attributed to the OECD or any of its member states. The CFA will be deciding whether to refer the Report to one of its subsidiary bodies for further consideration. Given the recommendations included in the Report, however, the CFA has decided to invite comments from all interested parties before further consideration of the Report by the CFA or its subsidiary bodies.

Interested parties are therefore invited to send their comments on this Report before **6 March 2009**. Comments should be sent electronically (in Word format only) to Jeffrey.owens@oecd.org. Unless otherwise requested at the time of submission, comments submitted to the OECD in response to this invitation will be posted on the OECD website.

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REPORT ON THE GRANTING OF TREATY BENEFITS WITH RESPECT TO THE INCOME OF COLLECTIVE INVESTMENT VEHICLES

Executive Summary

This Report addresses the legal and policy issues specific to collective investment vehicles (“CIVs”). It includes a comprehensive set of recommendations addressing the issues presented by CIVs in the cross-border context.

The Report first 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 ICG with respect to these issues.

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 the different views that were expressed by the members of the ICG, however, 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 also recommends that countries adopt procedures to allow a CIV to make the claim on behalf of investors.

With respect to future treaties, the Report recommends the inclusion in the Commentary on Article 1 of the Model Tax Convention of a number of optional provisions for countries to consider in their future treaty negotiations. Inclusion of one or more of these provisions 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. Under the proposed provision, countries could choose whether to give benefits only in the proportion that the CIV’s investors are themselves entitled to treaty benefits, or to give benefits with respect to all of the CIV’s income as long as a certain threshold of treaty-eligible investors is met. Because different views were expressed on the issue of whether treaty-eligible residents of third countries should be counted in making these determinations, the proposed Commentary includes provisions that adopt both approaches. 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 recommend 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, limited partnerships, 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 (“CFA”) established the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors (the “ICG”). This Report discusses the recommendations of the ICG with respect to the legal and policy issues relating specifically to CIVs (*i.e.* the extent to which either the vehicles or their investors are entitled to treaty benefits). The ICG also agreed to consider developing recommendations on “best practices” regarding procedures for making and granting claims for treaty benefits for intermediated structures more generally. These more general issues are discussed in the Report of the ICG on Possible Improvements to Procedures for Tax Relief for Cross-Border Investors. The Report on procedures also elaborates on the application of the procedures that apply to intermediated structures more generally to the specific case of 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 “funds of funds” that achieve diversification by investing in other CIVs that themselves hold diversified portfolios of investments. “Intermediated structures” relates to the holding of securities, including interests in CIVs, through layers of financial intermediaries. However, the ICG did not consider 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.

II. Background

5. Over 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.

6. 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.

7. 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 per security 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.

8. 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 his employer's retirement plan or a personal savings plan that is invested in a broad market index has diversified his risk of loss as much as if he had bought a share of stock in each company in the index, but at a substantially lower cost than if he had bought the individual stocks.

9. 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.

III. Structure of the CIV Industry

10. CIVs typically are organised by financial services firms (including securities firms, banks, and insurance companies). The organising firm often is referred to as the CIV's "manager". The CIV manager typically will have hundreds or thousands of employees. The manager provides services such as portfolio management (advisory) and transfer agency (shareholder recordkeeping). In some cases, the manager may

¹ These figures do not take account of amounts held through private equity funds or hedge funds. ICI 2008 Fact Book. http://www.icifactbook.org/pdf/08_fb_table48.pdf.

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.

11. 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.

12. 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.

13. 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.* U.S. 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.

14. 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 13. However, regulators see the benefits of a smaller number of larger CIVs, and regulatory changes, such as the UCITS Directive within the European Union,³ are designed to encourage global business.

15. 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 part of the investment 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).

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 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.

16. 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). Because of nominee accounts, the CIV’s manager may not be aware of changes in its underlying investors.

17. In the case of either the domestic or the global CIV market, the investments could be domestic or international. International diversification of investment portfolios is becoming more significant. For example, over 25% of all equity assets held by U.S. CIVs are issued by non-U.S. companies.⁴ About 30% of the assets of U.K. CIVs are invested outside the United Kingdom.⁵ More than one-third of the assets of Japanese CIVs are foreign securities.⁶ Assets of Luxembourg, Swiss and Irish funds are predominantly invested outside of their home market.⁷

18. 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.

19. 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 is an added dimension to such difficulties and delays when the investor is a CIV. Investors in CIVs may change daily. CIVs typically calculate net asset value (“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 CIV’s assumptions about the amount and timing of such withholding tax benefits are incorrect, then investors that have purchased, sold or redeemed their interests in the CIV in the interim will have done so at the wrong NAV. Accordingly, CIVs require certainty regarding their qualification for treaty benefits. Unfortunately, in many cases, certainty is in short supply.

⁴ http://www.icifactbook.org/pdf/08_fb_table04.pdf.

⁵ “Asset Management in the UK 2007”, published by the Investment Management Association, UK (www.investmentuk.org).

⁶ Data regarding the holdings of Japanese CIVs is published by The Investment Trusts Association at <http://www.toushin.or.jp/result/index.html>.

⁷ 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 (<http://www.snb.ch/en/iabout/stat/statpub/statmon/stats/statmon>)).

IV. Application of Current Treaty Rules to CIVs

A. Can a CIV Claim the Benefits of Tax Treaties on Its own Behalf?

20. The OECD's 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.

Is a CIV a "person"?

21. 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.

22. The ICG considered these different legal forms in determining which CIVs should be treated as persons for purposes of tax treaties. The general view was that, in the absence of specific provisions, a CIV that is treated merely as a form of joint ownership, and not as a legal person, under the tax law of the State in which it is established clearly would not constitute a person for purposes of tax treaties. On the other hand, a CIV structured as a company clearly would constitute a person. 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.

23. The ICG also considered the position 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, may constitute a taxpayer. Accordingly, the view was expressed that 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. A large majority of the members of the ICG agreed with this interpretation. This is borne out by the fact that, 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. The fact that there is not unanimity on this point suggests that negotiators may want to continue that practice in future bilateral agreements.

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

24. 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.

25. In some States, a CIV established therein is treated as fiscally transparent (“flow-through”). Other States regard the CIV to a greater or lesser degree as an entity interposed between investor and investments (“opaque”). In some States, a CIV is in principle subject to tax but is exempt if it fulfils certain criteria with regard to its activities, which may involve looking at its distribution practice, its sources of income, and sometimes its sectors of operation. More frequently, CIVs are subject to tax but the base for taxation is reduced, in a variety of different ways, by reference to distributions paid to investors. Deductions for distributions will usually mean that no tax is in fact paid. Other States tax 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.

26. The ICG concluded that 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. However, the mechanism by which neutrality is accomplished will affect the treaty analysis. A CIV that is transparent for tax purposes should not be treated as a resident, nor should a CIV that is totally and unconditionally exempt from income taxation (*i.e.* 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 should 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 treat all CIVs in the same manner, regardless of legal form, the determination of residence should be the same with respect to all CIVs established in that country.

27. 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.

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

28. 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. The question then arises whether a Contracting State can effectively decide the question by invoking its right to define the term “beneficial owner” when it is the source country, even if the country of residence would take the opposite view. There is disagreement within the international tax community regarding this question. Because of this disagreement, the issue has been put on the agenda for Working Party No. 1 of the Committee on Fiscal Affairs.

29. The ICG decided not to consider this more general question regarding the beneficial ownership requirement, but to limit its recommendations to the application of the requirement in the context of CIVs. A large majority of the ICG concluded that a widely held CIV that meets the “person” and “resident” requirements for claiming benefits should also 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. For these members, the question turns on the functions that the CIV performs. A CIV and its managers perform significant functions that go beyond those performed by a nominee, agent or conduit.

30. A small minority of the ICG took the position that a CIV is not the beneficial owner of the income it receives. These representatives made several technical arguments, largely based on local law regarding the relationship between investors and the CIV or its managers. In addition, they argued that, because CIVs usually are subject to little, if any, taxation in the country in which they are established, granting treaty benefits to a CIV would encourage treaty-shopping. Other delegates argued in response that the Model Convention leaves it to individual countries to adopt appropriate anti-treaty-shopping measures and that existing proposed measures are adequate.

31. The view of the majority expressed in paragraph 29 is reflected in the proposed Commentary to Article 1, found in paragraph 50 below. The ICG also agreed that the full arguments in favour of both the majority and minority conclusions in the context of CIVs would be provided in the final report. They are provided in the background material in Annex 1 to this Report.

B. If a CIV cannot Claim Benefits, is there any Relief for the Investors?

32. The ICG then considered the position of an investor in a CIV that is not able to claim benefits on its own behalf. The ICG agreed that, 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. There was general agreement that there should be some way for those investors who are resident in the State in which the CIV is established to claim benefits. Otherwise, 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. However, some government representatives on the ICG had strong reservations about the idea of allowing claims in respect of treaty-eligible investors located in third countries, given the bilateral nature of the treaty process. This matter is further discussed in paragraph 47.

33. Whichever approach to “good investors” is adopted, administrative difficulties effectively prevent individual claims by 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 unlikely that individual investors would bother with such claims, particularly as avoiding such administrative burdens is one of the benefits of investing collectively. Moreover, CIVs are either publicly traded or have an obligation to redeem the shares of investors at the option of the investor and, as a result, have frequent ownership changes. Accordingly, it would be extremely difficult, if not impossible, to track particular income streams to particular investors, even if the CIV had a reliable roster of the names of actual beneficial owners. This difficulty is compounded by the fact that interests in CIVs frequently are held through layers of intermediaries. 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. 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.

34. There was general agreement that countries should adopt procedures that would 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 indicated that such claims, including claims in respect of treaty-eligible residents of third countries, could be made currently under their domestic law. Other countries indicated that a mutual agreement would be useful or necessary.

35. The ICG concluded that 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 business acknowledged that regular determinations are possible, it noted that 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. 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.

36. The ICG agreed that the proposed Commentary to Article 1 will discuss both methods for determining the actual proportion of "good" investors, however defined. It will describe some circumstances in which a government might be willing to rely on presumptions. The proposed Commentary will also describe in general terms a method based on regular testing. Under that method, 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. More detailed procedures ultimately might be included in model mutual agreements to be developed in the future.

C. *Relief from Double Taxation for Income Received by CIVs*

37. 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).

38. 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.

39. 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.

40. 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.

41. 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.

42. 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.

43. 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 by the ICG could, if implemented, increase investors' interest in making such claims. Accordingly, the ICG agreed that it would be premature either to drop the issue entirely or to make a recommendation with respect to the issue.

V. Possible Provisions Dealing with the Specific Problems Presented by CIVs

44. The ICG considered whether the Model Convention or its Commentaries should be modified to include a provision dealing specifically with CIVs. In doing so, it considered the following issues, and how they had been resolved in a number of provisions included in recent bilateral tax treaties:

1. in what circumstances is it appropriate to provide benefits to a CIV on its own behalf, without regard to the residence of its investors;
2. in what circumstances would it be appropriate to provide benefits with respect to all of the income of a fund on the basis of a certain high threshold of ownership by “good” investors;
3. should benefits be proportional to the percentage of “good” investors;
4. should third country residents entitled to equivalent benefits qualify as “good” investors;
5. how to prevent claims by the fund and investors in respect of the same tax;
6. if benefits are based on ownership, as under (2) and (3), what means can be used to verify such ownership, and what is the relevant point of time for ascertaining this, or should it be averaged across a period?

45. After considering these issues, the ICG agreed on a proposed provision, for inclusion as an option in the Commentary on Article 1 of the Model Convention, that would allow a CIV to claim benefits to the extent that its investors would have been entitled to equivalent benefits if they had owned the underlying assets directly. The ICG also agreed that the draft should provide an option under which a CIV would be entitled to benefits with respect to all of its income if “good” investors exceed a specific ownership threshold, although the threshold would not be specified in the proposed provision.

46. The ICG believed that, in most cases, it would be simpler to treat the CIV as a resident and the beneficial owner of the income it receives. This approach would provide for only one withholding rate on dividends. However, the ICG also recognised that there may be cases where countries would want to adopt a look-through approach. 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. It was agreed that this possibility should be addressed in the Commentary to the draft provision.

47. The ICG also discussed the treatment of third country residents. It was argued that all residents of OECD countries should be treated as “good” owners for purposes of claiming treaty benefits on source country income at rates most commonly used by the source country in its treaties with other OECD countries. This approach would allow investors, particularly those from small countries, a greater choice of investment vehicles. Adopting such an approach would substantially simplify compliance procedures, and could be viewed as justified, 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 side, the view was expressed that expanding the definition of “good” investors beyond residents of the two Contracting States would change the bilateral nature of tax treaties. Some doubt was expressed about the proposal to give benefits to all investors resident in an OECD country. However, several government delegates expressed the view that investors who are residents of third countries with which the source country has a relevant treaty (which includes an exchange of information provision) should also be counted. Because there is no agreement in the ICG on which investors should be counted for these purposes, the ICG agreed that the proposed Commentary should provide both an option including treaty-eligible third country investors and one limited to residents of the same country in which the CIV is established.

48. The ICG agreed to provide an option under which a CIV would be allowed to make claims in proportion to its “good” ownership and, once the CIV has passed some threshold of “good” ownership, should be entitled to benefits with respect to 100% of the income it receives. This dual approach was justified on the basis that a pure “cliff” effectively would deny benefits to investors who otherwise would be entitled to treaty benefits. 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 larger class of investors, such as treaty-eligible third country investors, were treated as “good” owners. The ICG did not reach a consensus on a threshold, leaving the issue to bilateral negotiations.

49. The ICG also agreed to leave the definition of the CIVs covered by the provision to bilateral negotiations, although the Commentary will discuss some of the relevant considerations, including the risk of treaty shopping.

VI. Draft Commentary Changes to Reflect Recommendations of the ICG

50. The ICG recommends the following proposed addition to the Commentary on Article 1 to address the issues discussed in this Report:

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 “Report on the Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles,” 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 Model 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 OECD Model, 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. In most cases, however, the CIV would be treated as a “person” for purposes of the tax law of the State in which it is established. Where that is the case, the CIV should be treated as a person for purposes of applying the Convention.

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, CIVs are treated as fiscally transparent (or as “flow-throughs”). Such a CIV should not be treated as a resident of the Contracting State in which it is established. By contrast, in other States, a CIV is in principle subject 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. In all these other cases, the CIV should be treated as a resident of the State in which it is established 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.

6.12 In general, a widely-held CIV that meets both the “person” and “resident” requirements should 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 on behalf of the holders of interests in the CIV. Such treatment is appropriate because the functions performed by the CIV and its managers are substantially different from those of a nominee, agent or custodian.

Policy Issues raised by Current Treatment of Collective Investment Vehicles

6.13 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 CIV’s assumptions about the amount and timing of such withholding tax benefits are incorrect, then investors that have purchased, sold or redeemed their interests in the CIV in the interim will have done so at the wrong NAV.

6.14 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 32 to 34 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.

6.15 The same considerations would suggest that treaty negotiators address directly the treatment of CIVs when negotiating new treaties. Thus, even if it appears that CIVs in each of the Contracting States would be entitled to benefits, it may be appropriate to include a provision confirming that reciprocal treatment or otherwise to confirm that position publicly (for example, through an exchange of notes) in order to provide certainty. For example, such a provision could read:

[] 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 resident of the Contracting State in which it is established and as the beneficial owner of the income it receives. 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.

6.16 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 replicate in the international context the effect of domestic provisions addressing the treatment of CIVs – equivalent treatment between a direct investment and an investment through a CIV.

6.17 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. 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. 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 accumulates a substantial portion of its income for long periods rather than distributing it immediately. However, even if the investor is not immediately taxed on the income received by the CIV, he will be taxed eventually, either on the distribution, or on any capital gains if he sells his interest in the CIV before the CIV distributes the income.

6.18 Where the Contracting States have agreed that a specific provision dealing with CIVs is necessary to address the concerns described in paragraphs 6.16 and 6.17, 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 resident of the Contracting State in which it is established and as the beneficial owner of the income it receives, but only to the extent that equivalent beneficiaries are the owners of the beneficial interests in the collective investment vehicle.
- 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.

6.19 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.

6.20 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.

6.21 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 percent of the investors in the CIV are individual residents of Country B; ten percent 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.

6.22 Some States believe that taking treaty-eligible third country investors 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 resident of the Contracting State in which it is established and as the beneficial owner of the income it receives, but only to the extent that residents of the Contracting State in which the collective investment vehicle is established are the owners of the beneficial interests in the collective investment vehicle.
- 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.

6.23 Although the purely proportionate approach set out in paragraphs 6.18 and 6.22 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 [] percent of the owners of the beneficial interests in the collective investment vehicle are [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 resident of the Contracting State in which it is established and as the beneficial owner of all of the income it receives.

6.24 Each of the provisions in paragraphs 6.15, 6.18 and 6.22 treats the CIV as the resident and the beneficial owner of the income it receives, which has the simplicity of providing for one rate of withholding with respect to each type of income. There may be circumstances in which it is appropriate to treat the CIV as making claims on behalf of the investors. This might be true, for example, if a large percentage of the owners of interests in the CIV are pension funds that are exempt from tax in the source country under the terms of the relevant treaty. In those cases, the Contracting States might agree to a provision along the following lines, rather than one of the provisions in paragraphs 6.15, 6.18 and 6.22, in order to ensure that the lower rates applicable to the investors would apply instead of the general portfolio withholding rate:

- [] a) A collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State may itself, in lieu of and instead of, the owners of the beneficial interests in the collective investment vehicle, claim 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) 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.

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 6.20, 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).

6.25 Under either the approach in paragraphs 6.18 and 6.22 or in paragraph 6.24, 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.

6.26 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.

6.27 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 information regarding the proportion of investors that are treaty-entitled on a regular basis, perhaps at 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 self-declaration and ensure the correct withholding at the beginning of each relevant period.

Annex 1:

Background Regarding the Meaning of “Beneficial Owner” in Tax Treaties

1. As noted in paragraphs 28 to 31, the ICG did not consider some of the more general questions regarding the meaning of the term “beneficial owner”, but limited itself to the question of whether a CIV that meets the requirements that it be a “person” and a “resident” should be treated as the beneficial owner of the income it receives. Almost all of the members of the ICG believe that a widely-held CIV 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. A few government representatives disagreed. The arguments made and considered by both groups are set out in this Annex.

2. For those members of the ICG who agree that a CIV that satisfies the first two requirements for treaty benefits should be treated as the beneficial owner of the income that it receives, the question turns on the functions that the CIV performs. A CIV and its managers perform significant functions that go beyond those performed by a nominee, agent or conduit. The managers of these CIVs do not have the “narrow powers” of a nominee, agent or conduit, but discretionary powers to manage the assets on behalf of the holders of interests in the CIV. In general, they exercise this authority within the parameters that they have set for themselves in the offering documents they use to gain subscribers to the CIV. Although they may have practical or legal obligations to distribute their income in order to qualify for preferential treatment, this obligation does not constrain their ability to vary investments.

3. This position is consistent with the view expressed by Klaus Vogel in the preface to Articles 10-12 of his book on double taxation conventions.¹ There he sets out the following test for determining beneficial ownership:

The ‘substance’ of the right to receive certain yields has a **dual aspect**. The first is the right to decide whether or not a yield should be realized – i.e., whether the capital or other assets should be used or made available for use – the second is the right to dispose of the yield. Ownership is merely formal, if the owner is fettered in regard to **both** aspects in law or in fact. On the other hand, recourse to the treaty is justified – i.e., is not improper – if he who is entitled under private law is free to wield at least **one** of the powers referred to. **Hence, the ‘beneficial owner’ is he who is free to decide (1) whether or not the capital or other assets should be used or made available for use by others or (2) on how the yields therefrom should be used or (3) both.** (*Emphasis in original.*)

Under this test, a conduit company therefore fails because it normally does not have the ability to vary either its investments or its obligations. However, a CIV arguably should be treated as the beneficial owner of its assets because it has the ability to vary those investments and thus satisfies the first of Vogel’s criteria. Some have questioned, however, how much discretion the investment manager actually has, because he is constrained by the representations made to investors in the offering documents for the CIV.

4. Vogel’s analysis also responds to one of the arguments made by those holding the view that a CIV cannot be the beneficial owner, which is that an entity should not be treated as a beneficial owner if it has an obligation to pay out all of its income. According to Vogel, that fact is a necessary, but not sufficient, condition to finding that a legal owner is not the beneficial owner. Accordingly, even if a CIV is required, as a legal or practical matter, to distribute all of its profits annually, it would still be treated as

¹ Vogel, Klaus Vogel on Double Taxation Conventions, 3rd edition (1997), Kluwer Law, p. 562.

the beneficial owner of the income it receives under Vogel's test because it would satisfy the first requirement.

5. Those taking the view that a CIV should be treated as a beneficial owner also point out that 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 the sum of all of the underlying assets. The investor has no right to the underlying assets and, in most countries, the investor's tax situation is substantially different than it would be if he owned the assets directly. So, for example, an investor who sells his investment in the CIV in most cases will recognize gain on the transaction, rather than being taxed on his proportionate share of the income received by the CIV to that time. Accordingly, 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.

6. Those taking the opposite view rely on several additional technical arguments. One is that the CIV always is acting on behalf of its investors. Others counter that, whilst this may be true, that is also true of other entities that are acknowledged as the beneficial owners of the income they receive, generally without question. The managers and directors of companies, for example, have a fiduciary duty to the shareholders of the company.

7. A second argument is that the investor in a CIV is the owner of the underlying assets because he can, at any time, require the CIV to redeem his interests. However, the right to receive an amount equal to the value of underlying assets is not the same as receiving the assets as either a commercial or tax matter. Any shareholder in a publicly-traded company can receive the then-value of his shares 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. Therefore, this argument would suggest different tax treaty treatment of exchange-traded and open-ended funds. Such differential treatment would appear problematic and unjustified. Moreover, in most countries, an investor who redeems his shares in a CIV is taxed on a capital gain, not on his share of the income earned by the CIV. Finally, as a commercial matter, in many cases redemptions do not result in any change to the underlying assets held by the CIV. If a CIV is in a growth position, purchases exceed redemptions, and thus the CIV will fund redemptions out of cash inflows rather than selling assets.

8. There are, in addition, several policy arguments that have been cited against treating any CIV as a beneficial owner. One is the general point that mere differences in legal form, without differences in economic treatment, should not be treated differently. An across-the-board determination that a CIV is never the beneficial owner of the income it receives thus serves to level the playing field between CIVs taking different legal forms. This argument assumes that there are no economic differences that result from differences in legal form, which is a question of fact.

9. Finally, some governments have expressed the view that a CIV should not be treated as the beneficial owner of the income it receives because doing so would create opportunities for treaty shopping. Because the CIV generally is not subject to substantial taxation in the country in which it is established, treaty shopping would be relatively costless. There are, however, cases where a CIV is subject to taxation on at least some of its income or where it is required to withhold tax on distributions to non-resident investors. In those cases, treaty shopping may not be a concern. This suggests that it may be more appropriate to address treaty shopping concerns in other, more flexible, ways.

Annex 2:

Members of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors

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