Towards the end of treaty benefits for funds?

In the last couple of years, there has been a tightening of the rules and practice around treaty benefits. This is not news for fund managers and investors, but this seems to be more common than before and for distribution to a wider range of beneficiaries. This is partly due to the OECD BEPS project that aims at tackling tax evasion. However, this goes beyond the sole purpose of fighting tax evasion, as it allows states to restrict treaty access to certain categories of tax payers. Let us dive into the details of the OECD BEPS proposals and see the position of France and Luxembourg, regarding treaty access for funds.

Hélène Alston
Partner
Tax
Taj

Viviane Carpentier
Senior Manager
Tax
Taj

Eric Centi
Partner
Tax
Deloitte

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The position of the OECD
The OECD BEPS proposals address a wide range of themes throughout 15 action plans, with a view to adapt the existing international tax rules to enable countries to combat tax fraud and tax avoidance more efficiently. One of these "actions," namely Action 6, looks at developing model treaty provisions and recommendations regarding the design of domestic rules to prevent granting treaty benefits in appropriate circumstances. Treaty access for investment funds and pension funds is specifically covered in this action.

Pension funds
The response of the OECD for pension funds is relatively clear: pension funds should be considered as "resident" for treaty purposes in the country where they are constituted, as long as they fall within the definition of a "recognized pension fund."[1] Under the proposed rules, a *"recognized pension fund"* should mean *"an entity or arrangement established in that state that is treated as a separate person under the taxation laws of that state and: (i) that is constituted and operated exclusively to administer or provide retirement or similar benefits to individuals and that is regulated as such by that state or one of its political subdivisions or local authorities; or (ii) that is constituted and operated exclusively to invest funds for the benefit of entities or arrangements referred to in subdivision i)."*

The definition is rather generic and clear; we expect that, if implemented, it should not raise particular difficulties.

Investment funds
The position of the OECD in respect to investment funds is less easy to apprehend and is still, to a certain extent, a work in progress.[2] The OECD proposes to make a distinction between "CIV" and "non-CIV" funds.

The term CIV would be used to designate "funds that are widely-held, hold a diversified portfolio of securities, and are subject to investor-protection regulation in the country where they are established." In Europe, this should encompass funds that qualify as UCITS. These funds, which are open to the public and tightly regulated, should benefit from treaty benefits. The understanding is that these vehicles are not aimed at tax avoidance or profit shifting.

Funds that are not CIVs (e.g., private equity funds, hedge funds, trusts, etc.) would be qualified as "non-CIVs" and their entitlement to treaties remains uncertain: OECD members have not yet been able to reach a common position in this respect and are currently reviewing the public comments received on their draft proposal of 24 March 2016. Non-CIVs would typically have to meet criteria in order to benefit

1 OECD public discussion draft "Treaty residence of pension funds" dated 29 February 2016

2 Cf. OECD Report "The granting of treaty benefits with respect to the income of collective investment vehicles" adopted by the OECD Committee on Fiscal Affairs on 3 April 2010

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from tax treaties. These conditions could either be the conditions set out under a specific "limitation-on–benefits" (LOB) clause or, alternatively, a "principal purpose" test. The application of these tests to investment funds may be difficult in practice and therefore the OECD is still working on the detailed rules.

While not finalized, we can already see that the approach of the OECD is quite sophisticated, as it differentiates between pension funds, CIV funds, and non-CIV funds, on the basis of their purpose and legal or regulatory features. In our view, by adopting this approach, the OECD acknowledges the diversity of funds and tries to design the most appropriate rules for each category of fund.

The OECD has chosen to dismiss the "look-through approach" when addressing the treaty entitlement of funds for pension funds and CIVs. That is, the funds themselves would be entitled to treaty benefits (subject to certain conditions being met), as opposed to having to "look through" the fund and apply treaty benefits at the level of each investor. This is probably good news for many funds, as this circumvents the practical difficulty of determining the identity and tax residency of each of the investors at a given time (which is almost impossible for funds that are not dedicated to a limited number of investors).

Concerns are expressed about the complexity of the rules proposed by the OECD, especially the application of the LOB clause and the principal purpose test to funds. We share these concerns, but the rules are not yet finalized; we welcome the fact that the situation of funds would be covered in tax treaties.

In terms of implementation, these provisions could be included in tax treaties upon negotiation of bilateral tax treaties (which may take several years and lead to discrepancies) or they could be implemented through the execution of a multilateral treaty under the aegis of the OECD (it is however unlikely that the negotiation of a multilateral instrument would be achieved in the short term).

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The position of france and Luxembourg

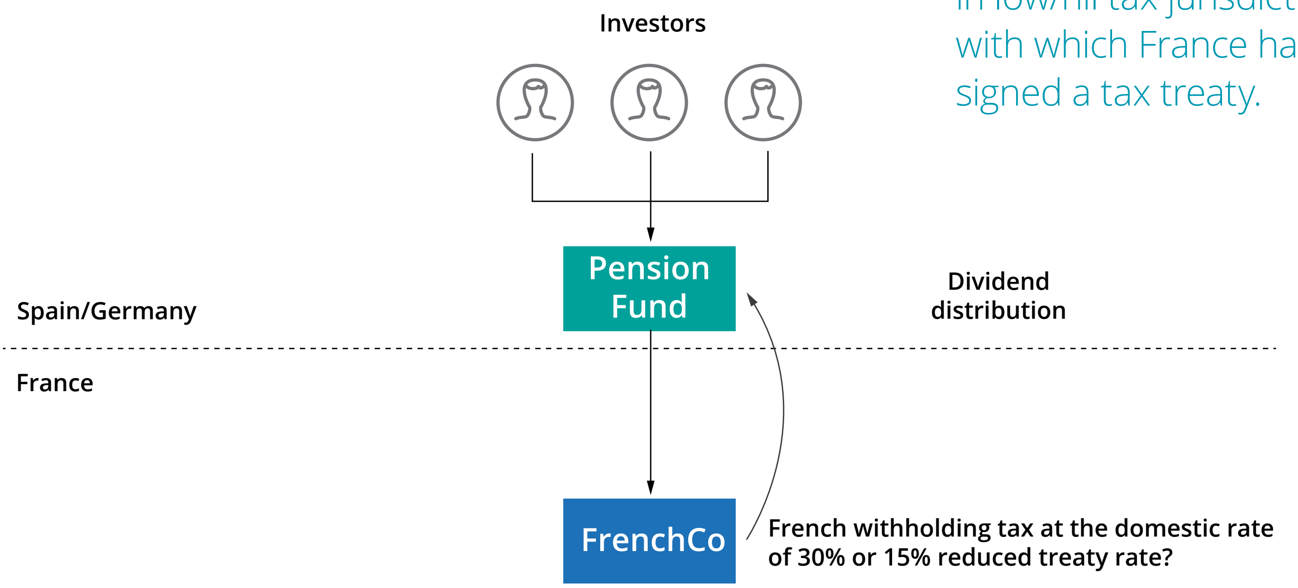
France – A strict application of the "subject to tax" clause

Some tax treaties signed by France already contemplate and allow the application of some of their provisions to qualifying pension funds or UCITS, but it represents only a minority of tax treaties currently in force.

Further, treaty entitlement of non-French funds and pension fund investors has become a topical question in France, pursuant to two recent decisions of the French Administrative Supreme Court (*"Conseil d'Etat"*).[3] In these cases, the French Administrative Supreme Court denied access to the France-Germany and France-Spain tax treaties to a German pension fund and a Spanish pension fund, respectively. Consequently, dividends paid under the French shares held by Germans/Spanish pension funds suffered French withholding tax at the standard rate of 30 percent (as opposed to the 15 percent reduced rate provided in these treaties).

The facts are summarized in the diagram below:

This raises a lot of uncertainties on the treatment of holding companies benefiting from favorable tax regime on dividends or capital gains, and the application of the parent-subsidiary directive. More generally, this could affect any entities located in low/nil tax jurisdictions with which France has signed a tax treaty.



3 Conseil d'Etat, 9 November 2015, N. 370054, min. c/ Landesärztekammer Hessen Versorgungswerk and Conseil d'Etat, 9 November 2015, N. 371132, min. c/ Sté Santander Pensiones SA EGFP

The reasoning of the *Conseil d'Etat* in the case relating to the German pension fund was that since a pension fund is exempt from corporate income tax in Germany due to its status and activity, it should not be regarded as "subject to tax" and therefore should not qualify as a "resident" under the Germany-France tax treaty.

Regarding the other case, the *Conseil d'Etat* reached the same conclusions (and denied the application of the France-Spain tax treaty) on the basis that the Spanish pension fund was subject to corporate income tax at the rate of zero percent in Spain, and therefore could not be regarded as "subject to tax" in its country of residence.

The principle has become that treaty benefits cannot be granted to an entity that is not effectively liable to tax due to its status or its activity, unless specifically provided for in the wording of the tax treaty.

Although this principle was outlined in the case of pension funds and investment funds, it actually has much broader consequences, especially when taken in the context of BEPS discussions.

The denial of the treaty benefits to EU pension funds has given rise to criticisms by French tax experts, but the French Administrative Supreme Court has confirmed its approach in a case relating to an offshore Lebanese company (not a fund), which was subject to tax at a low fixed amount: treaty access has been denied to the company on the basis that it could not be regarded as "subject to tax."[4] This case clearly shows the current trend of the French tax authorities who take a very restrictive approach to treaty benefits and deny treaty access even when there is no tax evasion, solely on the basis that the recipient of the income is subject to a minimal tax in its country of residence. They consider that if the recipient is exempt from tax in its country of residence, there is no double taxation on this particular income and therefore there is no need for France to apply the treaty provisions. This raises a lot of uncertainties on the treatment of holding companies benefiting from favorable tax regime on dividends or capital gains, and the application of the parent-subsidiary directive. More generally, this could affect any entities located in low/nil tax jurisdictions with which France has signed a tax treaty.

Is France going too far?

When claiming that the sole purpose of a tax treaty is to prevent situations of double taxation, and that there is none when the fund is exempt from tax, the French tax authorities and French Court overlook one important point: investors are generally subject to tax, and in most countries, funds are exempt, so that investors are subject to tax as if they had invested directly in the underlying assets held by the fund.

Whether it is widely held investment funds or pension funds, they are hardly set up as tax avoidance or fraud vehicles. They are rather instruments put in place to encourage long-term savings or payment of retirement pensions whether sponsored by employers or by governments. Other AIFs widely held or meeting strict qualifying criteria should be in the same situation. On this basis, it seems wrong to deny treaty benefits.

Regarding the effects of Action 6 more generally and the use of holding companies, although Action 6 clearly aims to deter groups of investors from using empty shells as holding companies, a lot of international structures do use intermediate holdings. These can be located in a different jurisdiction from the assets or from the investors. From now on, this will have to be supported by strong commercial reasons. In reality, commercial financial and tax reasons are often intricately linked and therefore this may reduce the availability of treaty benefits to these vehicles.

4 Conseil d'Etat, 20 May 2016, N. 389994

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Having said that, denying treaty benefits to holding companies in general again seems to go beyond the initial purpose of the OECD initiative.
Further, the position of France is not in line with the proposals made by the OECD in the context of BEPS which, although complex and not finalized, try to find a solution adapted to each form of funds, where France basically rejects the application of the treaty to any fund which is not specifically referred to in the relevant tax treaty.

Luxembourg - A pragmatic approach
On 12 February 2015, the Luxembourg Tax Authorities (LTA) issued Circular L.G.-A. n°61 that provides an update on the Double Tax Treaty (DTT or "treaty") access for Luxembourg investment funds and new guidance rules on the issuance of Certificates of Tax Residence (CoTR).
The scope of the circular concerns both UCITS Funds (established under the Law of 17 December 2010) and Specialized Investment Funds (established under the Law of 13 February 2007).

This circular will be regularly updated to take into account new DTTs (or amendments to existing tax treaties) entering into force in Luxembourg.

With the publication of this circular, the LTA correlates the access of investment funds to treaty benefits to the issuance of certificates of tax residence. On what concerns Luxembourg investment funds, the LTA will issue—depending on the investment fund type and the contracting party's jurisdiction—one out of three types of CoTR: 1) Type 1 Certificate; 2) Type 2 Certificate; and 3) Type 3 Certificate.

1) Certificate of Tax Residence for SICAV-SICAF Funds - Type 1
In section 4.A of the circular, the LTA has confirmed that, on what concerns the treaty jurisdictions[5] that have accepted to grant the benefits of the treaties to the Luxembourg SICAV-SICAF Funds, a CoTR (Type 1 Certificate) will be issued. For information purposes, the template of such CoTR is attached in appendix to the Circular.

Where the FCPs are considered tax residents due to the wording of the DTT, the FCPs are entitled to obtain a CoTR issued by the LT.

2) Specificities applicable to FCP Funds – Type 2
While FCPs do not, in general, have access to the treaty benefits due to their lack of legal personality, the LTA has nevertheless confirmed that FCPs can benefit from them due to the treaty special wording (e.g., Germany, Saudi Arabia[6]). Depending on the DTT, the access may be subject to specific requirements such as the existence of Luxembourg resident investors into the FCP—this is the case in respect of the DTT between Germany and Luxembourg.

Where the FCPs are considered tax residents due to the wording of the DTT, the FCPs are entitled to obtain a CoTR issued by the LTA—an example of which is attached in appendix to the Circular (Type 2 Certificate).

3) Certificate of Tax Residence based on Luxembourg tax legislation – Type 3
Finally, the LTA has confirmed that both UCITS and SIF SICAV-SICAF funds can obtain a CoTR based on the Luxembourg domestic tax legislation (Type 3 Certificate). Such a certificate may be of assistance when the funds need to confirm their Luxembourg tax residence for reasons other than the access to the DTT provisions (e.g., EU tax reclaims under the "Santander" and "Aberdeen" European Court of Justice jurisprudence). The template of such CoTR is also attached in appendix to the Circular.

The reason justifying the request for a CoTR must be described in the request to the LTA.

The Circular also provides clarity on the Luxembourg DTT whereby the contracting party's jurisdiction does not accept to extend the benefits of the DTT to the Luxembourg funds[7] and also the ones where its application is uncertain.[8]

Practical modalities to obtain a CoTR
Irrespective of the type of CoTR requested to the LTA, a regulatory attestation from the *Commission de Surveillance du Secteur Financier* (CSSF) must be attached to the request. This attestation will confirm the legal form of the fund and its current supervision by the CSSF.

In respect of Type 3 Certificates, the details on the income received by the SICAV-SICAF funds must also be attached to the request to the LTA. In case a request is introduced in relation to a future income, a description of the investment policy of the fund must be provided with the request to the LTA, and the details of the income for which the certificate is requested must be provided to the LTA no later than 30 June Y+1.

In practice, and although the circular provides clarity on the countries that accept to grant treaty benefits to the Luxembourg investment funds, we see that theory can sometimes be disconnected from reality.

It can become quite challenging to apply the DTT reduced rates when this application is 1) dependant on the confirmation that the majority of the investors reside in the same country of the investment fund—clearly an issue for Luxembourg-domiciled funds that are distributed on a worldwide basis; 2) dependant on the completion of tax reclaims forms designed by tax administrations that assimilate investment funds to commercial companies, and expect that the same substance requirements are to be extended to the first entities; 3) limited to UCITS investment funds and disregarded when it comes to UCITS-like funds; 4) dependant on time consuming, burdensome, and costly administrative procedures.

To the point:

- The world of investment is varied and cover many different types of structures and investors. The OECD acknowledges that situation and tries to define different rules – which are still a work in progress - to apprehend this reality.
- The countries should however not overlook that, despite this complexity, it is critical to balance the objective to tackle abuse and tax avoidance with the necessity to protect long term investments.

5 Denmark, Spain, Indonesia, Ireland, Morocco – due to a clear agreement between both competent authorities; Germany, Saudi Arabia, Armenia, Austria, Azerbaijan, Bahrain, Barbados, China, United Arab Emirates, Georgia, Guernsey, Hong Kong, Isle of Man, Israel, Jersey, Laos, Liechtenstein, Macedonia, Malaysia, Malta, Moldavia, Monaco, Uzbekistan, Panama, Poland, Portugal, Qatar, Czech Republic, Romania, San Marino, Seychelles, Slovenia, Sri Lanka, Tajikistan, Taiwan, Trinidad and Tobago, Tunisia, Turkey, Vietnam – by virtue of a clear text; Finland, Kazakhstan, Republic of Slovakia, Singapore, Thailand – by virtue of the interpretation of the Luxembourg tax authorities (possibly subject to challenge by the other competent authority).

6 Germany, Saudi Arabia, Guernsey, Isle of Man, Jersey, Seychelles, Tajikistan.

7 South Africa, Belgium, Brazil, Japan, Norway, Netherlands, United Kingdom – by virtue of an agreement; Canada, Estonia, Hungary, India, Iceland, Latvia, Lithuania, Switzerland – by virtue of the interpretation of a clear text; United States, (Memorandum of understanding), France (art 10bis), Mauritius (Protocol), Mexico, Sweden (Protocol) – by virtue of the Double Tax Treaty; Russia – by virtue of the interpretation of the tax authorities.

8 Bulgaria, Greece, Italy, South Korea.