Recent OECD Work relating to Cross-Border Portfolio Investment

Patricia A. Brown

Centre for Tax Policy and Administration, OECD

Christopher M. Gilbert

JPMorganChase

Recent OECD Work

- Committee on Fiscal Affairs created Informal Consultative Group on Taxation of Collective Investment Vehicles in 2007 to consider
  - Technical issues relating to the granting of benefits with respect to the income of collective investment vehicles
  - Possible improvements to current procedures for claiming treaty benefits by all cross-border portfolio investors

January 2009 ICG Reports

- Two Reports:
  - The Granting of Benefits with respect to the Income of Collective Investment Vehicles
  - Possible Improvements to Procedures for Tax Relief for Cross-Border Investors
- ICG was a joint business-government group, so Reports did not reflect an official position of the Committee on Fiscal Affairs or OECD Member States

Follow-up on CIVs

- ICG Report referred to Working Party 1, which deals with treaty issues
- Working Party 1 released its own discussion draft of the report on December 9, 2009
- Final version of the report should be available imminently, to be reflected in 2010 Update to the OECD Model Tax Convention

Follow-Up on Procedures

- In January 2009, CFA approved creation of a "Pilot Group" to develop standardised documentation to implement the "best practices" in the ICG Report
- On February 8, 2010, the CFA released a discussion draft of the "Implementation Package"
  - Complete set of the documents to be used
  - Includes model mutual agreements relating to CIVs

Scope of CIV Work

- widely-held CIVs
- owned by large group of retail and institutional investors
- highly regulated for investor protection
- invest in portfolio securities
- derive income and capital gains
- not intended to affect treatment of hedge funds or private equity or venture capital funds, which have different business models

CIV Structures and Attributes

- CIV structures are intended to allow portfolio investors
  - to gain economies of scale and
  - diversification benefits

  by banding together with other portfolio investors
- Legal form and tax structure can vary considerably

Types of CIV Markets

- Two distinct types of markets for CIVs:
  - “Domestic” CIV markets
  - “Global” CIV markets
- Investments could be domestic or international

Tax Considerations

- Investors entitled to preferential rate will want to preserve that benefit
- Most retail CIVs calculate net asset value (NAV) every day
- Basis for subscriptions and redemptions
- Ability to claim tax benefits affects NAV
- Accordingly, CIVs require certainty
- Certainty is in short supply

Requirements for Treaty Benefits

- Must be a “person”
- Must be a “resident”
- Must be the “beneficial owner”
- In U.S. and some other treaties, must meet Limitation on Benefits requirements

Definition of “Person”

Article 3, paragraph 1, subparagraph (a) of the OECD Model Convention on Income and Capital:

“the term “person” includes an individual, a company and any other body of persons;”

Definition of “Resident”

Article 4, paragraph 1 of the OECD Model:

“For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature…”

Definition of “Beneficial Owner”

- Not defined in OECD Model or in most bilateral tax treaties.
- Article 3, paragraph 2, arguably would allow the source state to define the term:

  “As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the laws of the State for the purposes of the taxes to which the Convention applies…”

Beneficial Owner (cont’d)

- Not enough that income be paid to a resident
- Original explanation focused on receipt of income by “an agent or nominee”
- Later Commentary also suggests that conduit companies may not be the beneficial owner of income

Case 1
Fonds Communs de Placement

- Contractual arrangement for the joint ownership of assets
- No income tax imposed at level of fund
- In some countries, a taxable “person”; in others, not
- Tax imposed on investors when they receive distributions

Case 2
Transparent Investment Funds

- Tax base determined at fund level, and attributed to investors

- Investors subject to tax on income of fund, whether distributed or not

- Foreign source income can be paid to non-resident investors free of withholding tax

Case 3
Italian SICAVs

- Legal form is corporation with variable capital

- Subject to tax at rate of 12.5% on its income from securities activities, in lieu of income tax

- Income not taxable in hands of Italian investors, either through exemption or credit

Policy Considerations

- Application of these rules to different legal structures and tax structures can result in CIVs in one State getting benefits and those in other not receiving benefits.
  - If economics are the same, are disparate results appropriate?
- If fund cannot claim benefits, can investors?
- If neither the CIV nor the investors can claim benefits, then is the tax treaty achieving its goals?

New Commentary on CIVs

- Comprehensive set of recommendations relating to existing treaties and future agreements
- Analysis of issues of qualification as a “person”, “resident” and “beneficial owner” under existing treaties
- Also, recommendation that countries allow CIVs to make claims for investors if CIV not entitled to benefits in its own right
- Optional provisions for new treaties to provide certainty to CIVs, investors and intermediaries

Case 1: FCP may be a Person

- Term "person" should be given wide meaning
- Distinguishes mere joint ownership from an arrangement treated as a person
- In case of a trust, depends on whether a "person" under tax law of country in which established
- Treaty entitlement of FCP therefore depends on where the FCP is established

Case 2: Transparent Fund not a Resident

- Investment fund not a resident if it is viewed as transparent
- However, many countries (applying Paragraph 8.5 of Commentary on Article 4) will treat a non-transparent CIV as a resident even if it does not pay any tax in fact (*e.g.*, because of a dividends-paid deduction or exemption of certain income)
- Some countries will apply Paragraph 8.6 of Commentary and deny benefits in absence of specific treaty provision

Case 3: CIV often will Qualify as the Beneficial Owner

- Ownership of interests in the CIV is not the equivalent of ownership in underlying assets
- Functions performed by CIV's managers generally go beyond functions of a nominee or agent
- A CIV (as defined) therefore should be treated as the beneficial owner of its income so long as the manager has discretionary authority to manage investments

Foreign Tax Credits

- CIV may be entitled to foreign tax credit for source-country withholding tax but, if it has no tax liability, theoretical credit is not of much use
- If investors located in same country as CIV, some countries allow credit to investors
- Third countries may allow credit to investors if CIV is viewed as transparent
- Report makes no recommendation although it includes a draft of a possible provision that would allow a credit to investors in third country

Policy Considerations

- In drafting new treaties, should try to reach equitable results
  - Provide clear guidance so that CIVs, investors and custodians have certainty
  - Treat economically similar entities similarly
  - However, economic differences between CIVs in different countries, or even within the same country, would justify different treatments
  - In particular, consider treaty shopping possibilities and possible deferral of income

Optional Provisions

- CIV entitled to claim benefits on own behalf, without regard to ownership (other than any general limitation on benefits provisions)
- CIV entitled to claim benefits to the extent of “good” investors
  - Option to provide benefits for 100% of income if threshold of “good” investors met
- CIV treated as a look-through in order for pension funds, etc. to claim preferential rates

“Good” Investors

- No agreement
- Business and some governments believe definition should include third country residents entitled to equivalent benefits; ie, “equivalent beneficiaries”
- Other countries want to limit definition to residents of State in which CIV is established

Role of MAPs

- Until treaty is revised, can achieve some benefits by allowing CIV to claim benefits to extent that it is owned by “good” investors
- Avoids multiple small claims by small investors
- Need practical procedures for determining proportion of “good” investors

Determining Ownership of CIVs

- Reporting information regarding ownership (on a “pooled” basis) no more often than quarterly
- Sales restrictions
  – Investor Restriction
  – Geographic Restriction
  – Preferential Rate Restriction
- Direct Tracing

Treaty Benefits: From Theory to Practice

- OECD has recently refocused our efforts on the implementation of treaties.
- The treaty provisions must work not only in theory but also in practice.
- Rules for applying tax treaty benefits to cross-border portfolio income streams have not kept up with current business models.

Intermediated Structures

- Vast majority of publicly traded securities now held through a complex network of domestic and foreign intermediaries.
- Cross border investors rarely have a direct relationship with the issuer of the securities in which they invest
- There will usually be several intermediaries between these two parties and separate contractual agreements will normally be in place between each party in the chain
- Income payments typically flow from the issuer to the investor via each interposed intermediary

Intermediaries Commonly Involved

- **Paying Agent**
  - *The paying agent acts for issuer of security and is responsible, inter alia, for facilitating distributions from the issuer to its shareholders*
- **Central Securities Depository (CSD)**
  - *In most markets, the vast majority of publicly traded securities are held through a CSD. A CSD is designed, inter alia, to facilitate electronic settlement of security transactions on behalf of its members (which are typically local financial institutions such as brokers and custodian banks)*
- **Custodian Bank**
  - *The custodian bank will normally be a local bank and a member of the CSD. The custodian bank offers a full range of settlement, banking and custodian services*

Intermediaries Commonly Involved

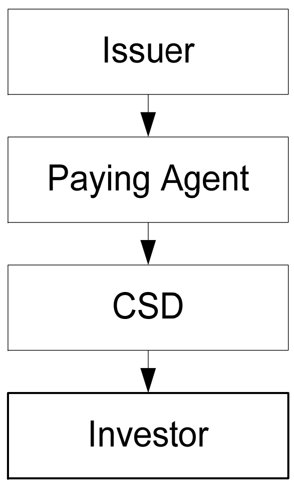
- **Global Custodian**
  - *A global custodian provides a single access point to national CSDs in various countries through its network of local custodian banks. It offers lower overall costs of settlement and a wide range of other services by exploiting economies of scale and spreading fixed costs such as technology investments.*
- **International Central Securities Depository (ICSD)**
  - *The two ICSDs (Euroclear Bank and Clearstream Banking) were originally established for the electronic settlement of eurobonds*
  - *ICSDs now also have similar functions as global custodians for other securities (although overall security coverage may be more limited with an ICSD compared to a global custodian).*

Intermediaries Commonly Involved

- **Investment Manager**
  - *Provides professional investment execution services. May also have contractual custodial responsibilities in respect of those investments, although such responsibilities are normally outsourced by the investment manager to a global custodian*
- **Other**
  - *May include broker, private bank, bank in residence country, professional trustee etc.*

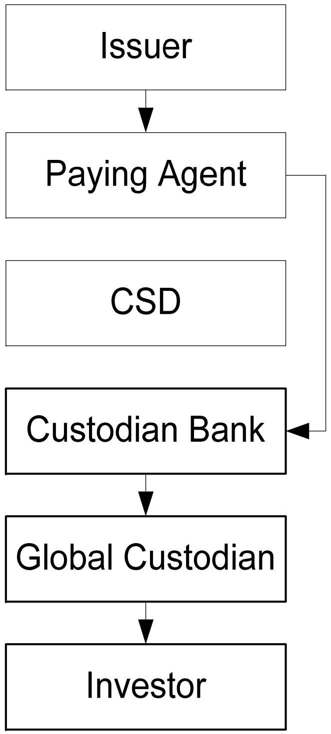
Potential Investment Structure & Income Flow

(Rarely exists in practice except in purely domestic scenario)



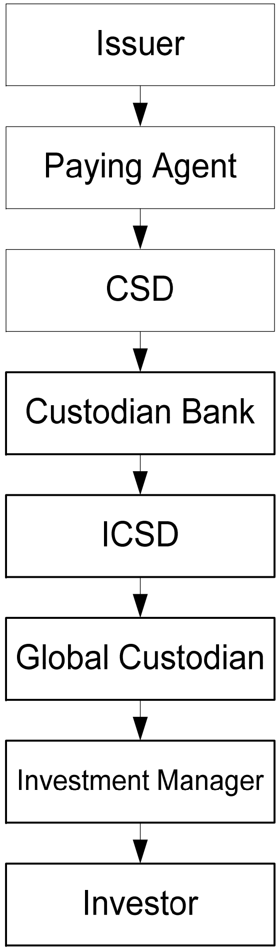
Potential Investment Structure & Income Flow

(More representative of cross border investment)



Potential Investment Structure & Income Flow

(Also representative of cross border investment, but more complex)



Current issues effecting cross border investors

- Few countries recognize this multi-tiered holding environment in their withholding tax collection and relief procedures.
- Many systems based on implicit assumption of direct relationship between issuer and investor.
- Tax relief arrangements vary considerably; urgent need to harmonise and streamline global tax relief procedures

Problems Securing Tax Relief

- Responsibility for withholding tax usually rests with one of the parties at the top of the chain (typically issuer, paying agent, CSD or custodian bank in source country)
- Investor information usually rests at the bottom of the chain, with the intermediary acting directly for the investor
- There are commercial, economic and practical difficulties attached to passing investor information up the chain

Some Specific Problems

- Investors required to complete multiple tax declarations
- Other documentation requirements (e.g. notarisation of documents, provision of multiple residence certificates)
- Imposition of local advisors in certain countries
- No “at source” relief facilities in certain countries
- No centralised tax office for retrospective claims in certain countries
- Extended refund timeframes in certain countries
- Some countries view the legal owner as being the beneficial owner, but a nominee cannot claim to be the beneficial owner for treaty purposes

New Focus on Portfolio Investors

- Result: it may be difficult or impossible for a portfolio investor to make an effective claim for treaty relief because of the reality of intermediated financial structures.
- Corporations that hold direct stakes in foreign subsidiaries will make sure they get benefits.
- Same administrative costs may be prohibitive for smaller investors.

High-Level Concerns about Market Effects

- G30 [a private international body composed of very senior representatives of the private and public sectors and academia] produced January 2003 Report on "Global Clearing and Settlement – A Plan of Action"
- Recommendation 8 highlighted the need, *inter alia*, to automate and standardize tax relief arrangements:

  "Market participants and public authorities should work together to minimize the administrative costs to each party involved in tax relief arrangements through standardization and automation of procedures and communication of information and through the use and acceptance of electronic data and documentation"

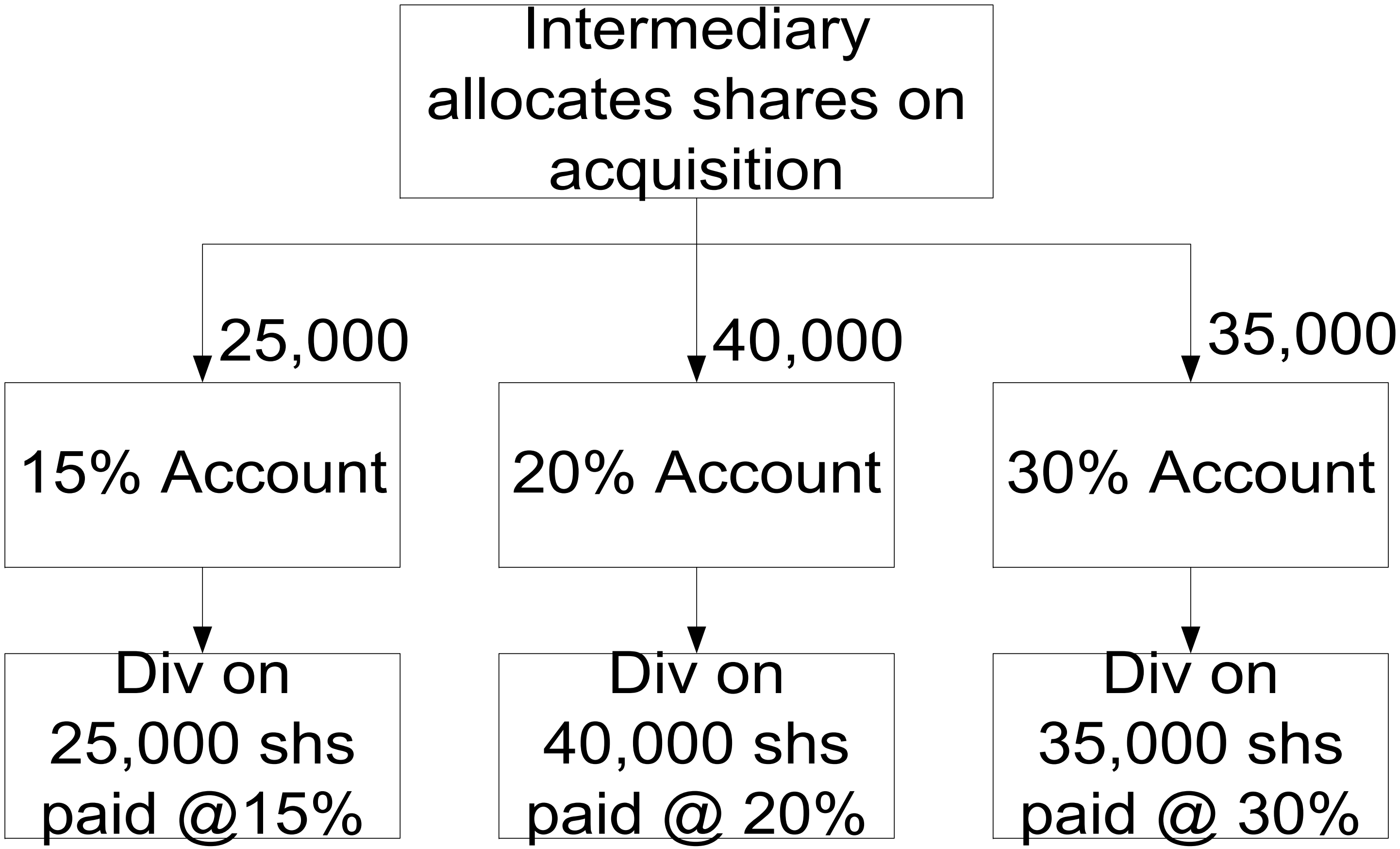
International Securities Services Association Model

- ISSA developed proposed tax relief model with aim of converting the high level G30 aspiration into practical working reality
- ISSA consists of 82 member institutions [banks, clearing organisations, central depositories, stock exchanges, brokers, asset managers and other finance professionals] in 43 countries.
- ISSA is dedicated to promoting best practice and improving efficiency and risk management in the global asset servicing industry.
- Proposal released in 2005

Key features of ISSA Model

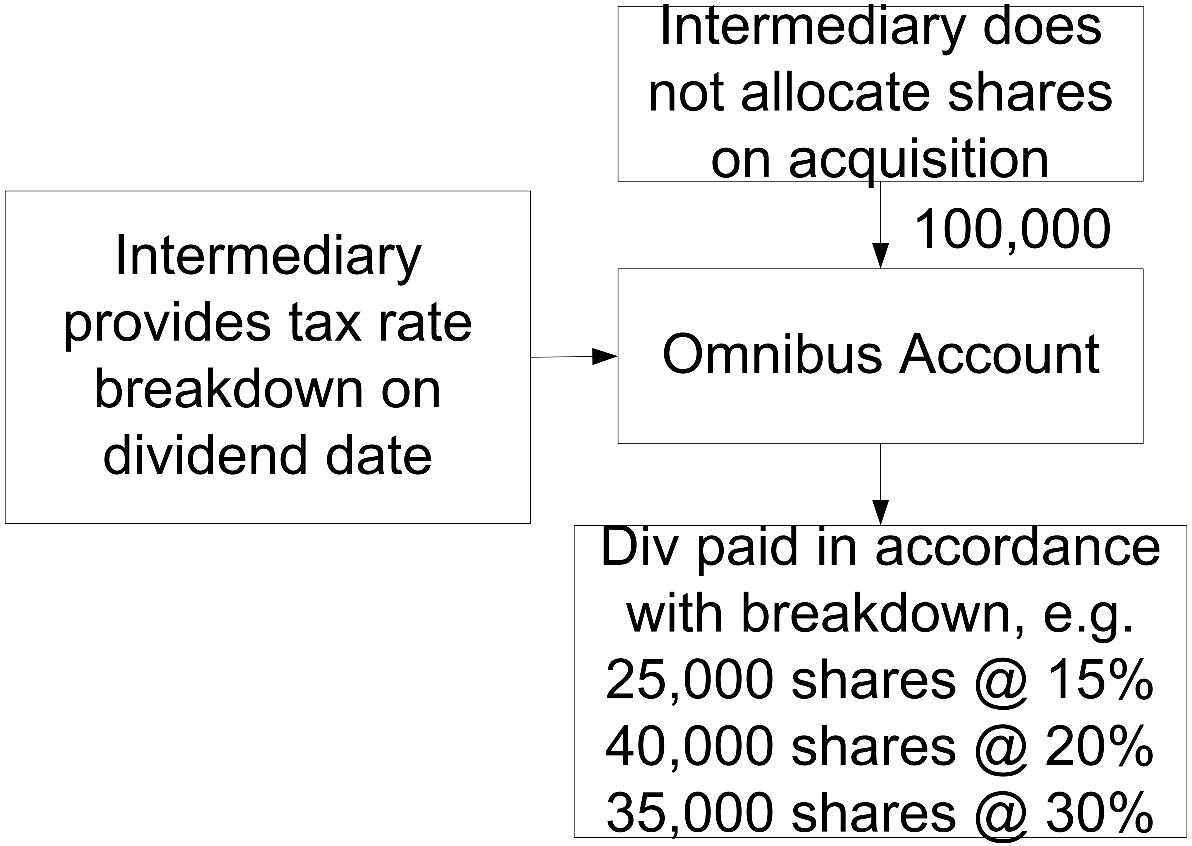
- Single self certification by investor
- Available tax relief provided at source
- Passing of tax rate information (“pooled information”) to upper tier intermediaries in lieu of underlying investor information/documentation
- Arrangements restricted to “authorised” intermediaries subject to review

Passing of Tax Rate Information ("pooled information")
Illustration 1 - Allocating Securities to Separate Withholding Rate Pools



Passing of Tax Rate Information ("pooled information")

Illustration 2 – Apportioning Tax Rates to Income Arising on Securities Held in a Single Pool



Parallel Work within EU

- Giovannini Report identified a number of barriers to single European market for trading in securities
- Two tax barriers – transaction taxes and withholding tax procedures
- Created FISCO (EU Clearing and Settlement Fiscal Compliance Experts' Group) to address the tax barriers
- FISCO made up of business representatives and academics

FISCO Reports

- FISCO Second Report on Solutions proposed a system similar to ISSA Model
- Less focus on compliance concerns because
  - “European context” (*i.e.*, Savings Directive, Mutual Assistance Directive)
  - Lack of government representation meant less focus on compliance concerns
  - Work originated with MARKT, not TAXUD

Joint EU/OECD Work on Procedures

- Joint Working Group established to coordinate work
- Met three times in 2008
- Intention was to ensure that EU and OECD approaches were compatible
- Focus much more on government compliance concerns than proposals from ISSA or FISCO

Government Concerns

- Governments want to ensure that an intermediated holding does not facilitate treaty shopping or tax avoidance by residents
- G30/ISSA proposal assigns oversight responsibilities to local tax authorities -- <u>very</u> difficult for source countries to give up oversight.
- Also want to receive investor-specific information <u>at some point</u> in order to determine whether further inquiry is necessary.

Government Benefits

- Investors will receive benefits negotiated in tax treaties, rather than claiming relief for excess withholding from residence countries
- System will link treaty claim process with information reporting and exchange, increasing the amount of usable information available to tax authorities in both source and residence countries

ICG “Best Practices”

- System would be based largely on business proposal
- Claims would be allowed “at source” on basis of tax rate pools or – optionally – by the AI assuming withholding responsibility
- However, reporting of beneficial owner information to source country could be required, not at time of payment, but annually

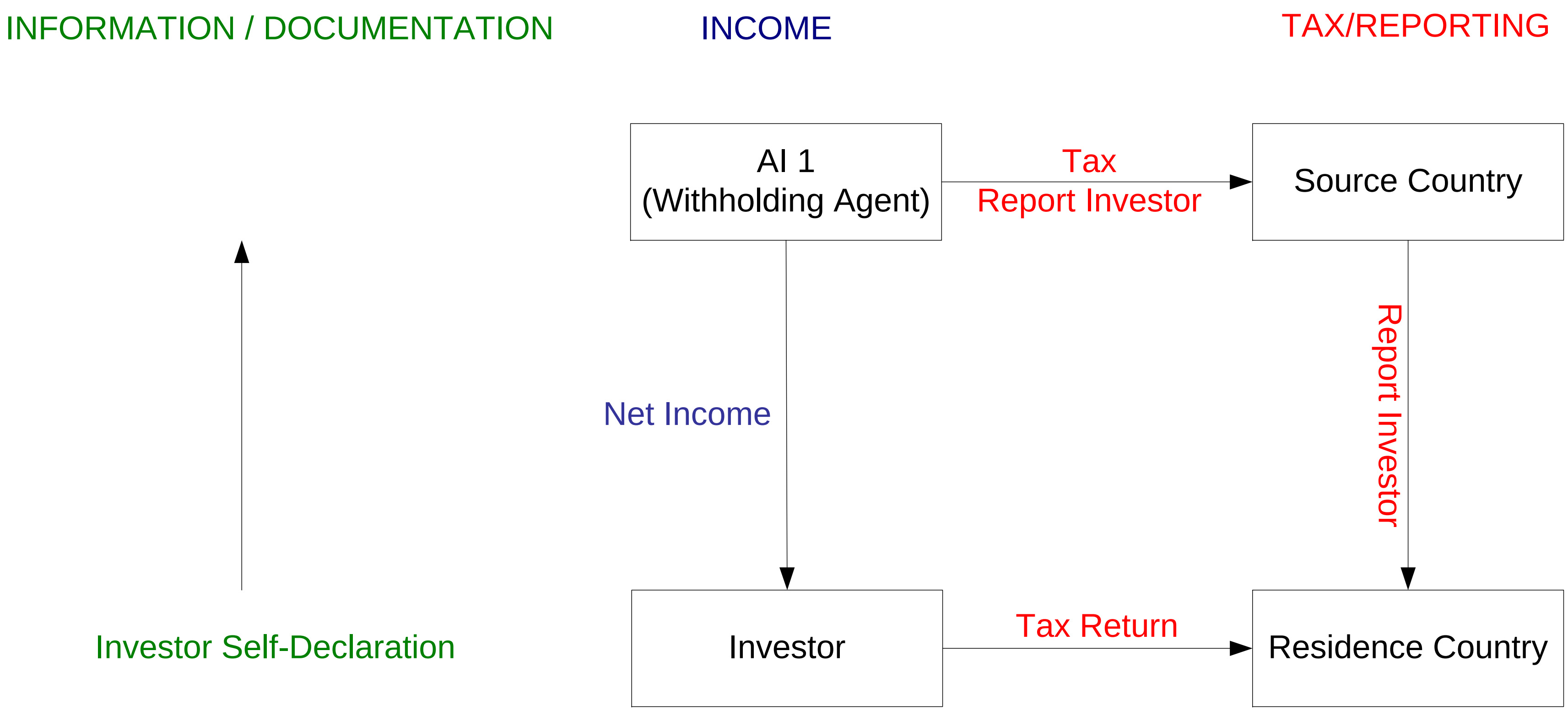
ICG “Best Practices” (cont’d)

- Intermediaries would enter into contracts with source countries
- Source countries would retain right to review compliance
- Countries would work on standardizing reporting and documentation to minimise the burden for intermediaries

Best Practice Illustration 1

Income flows from:

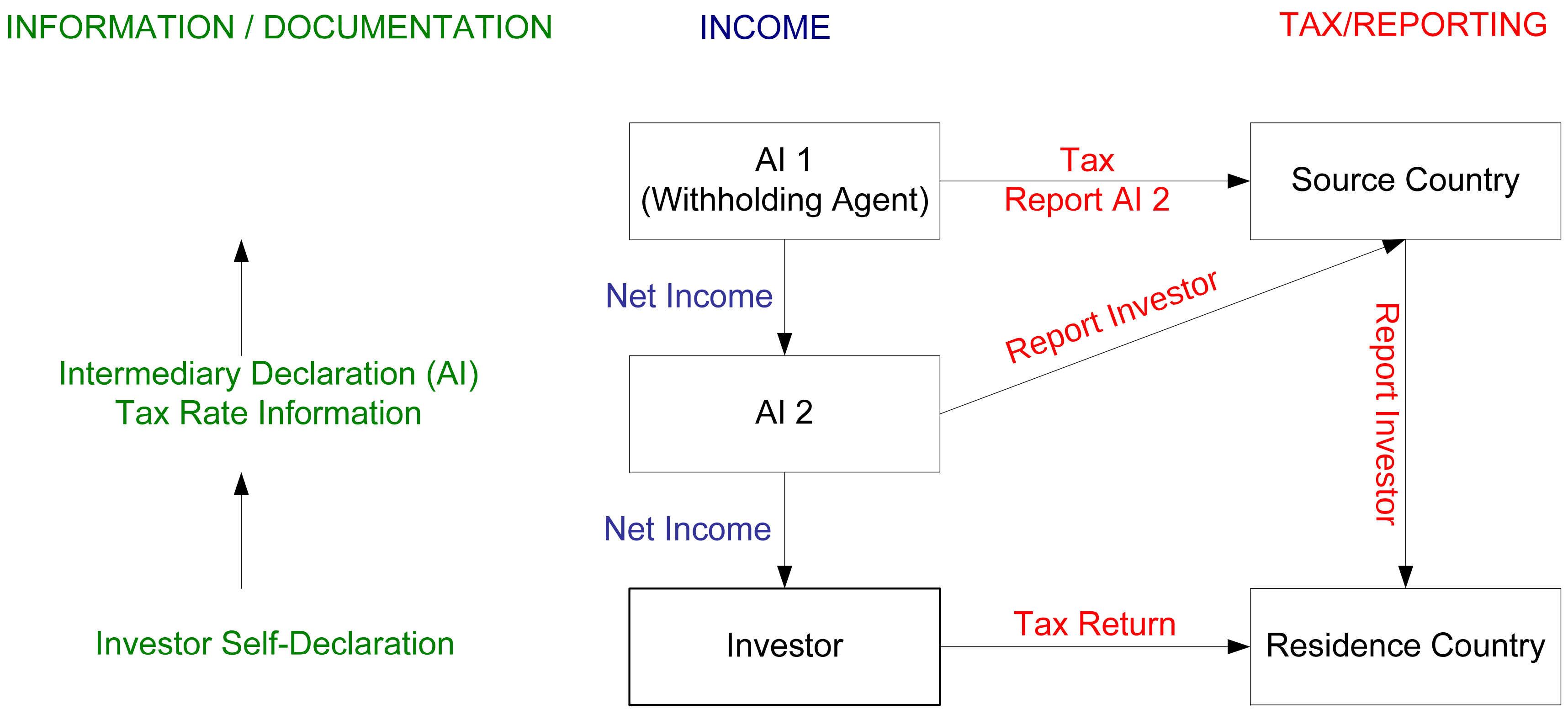
- Authorised Intermediary (AI 1) acting as withholding agent; to
- Investor



Best Practice Illustration 2

Income flows from:

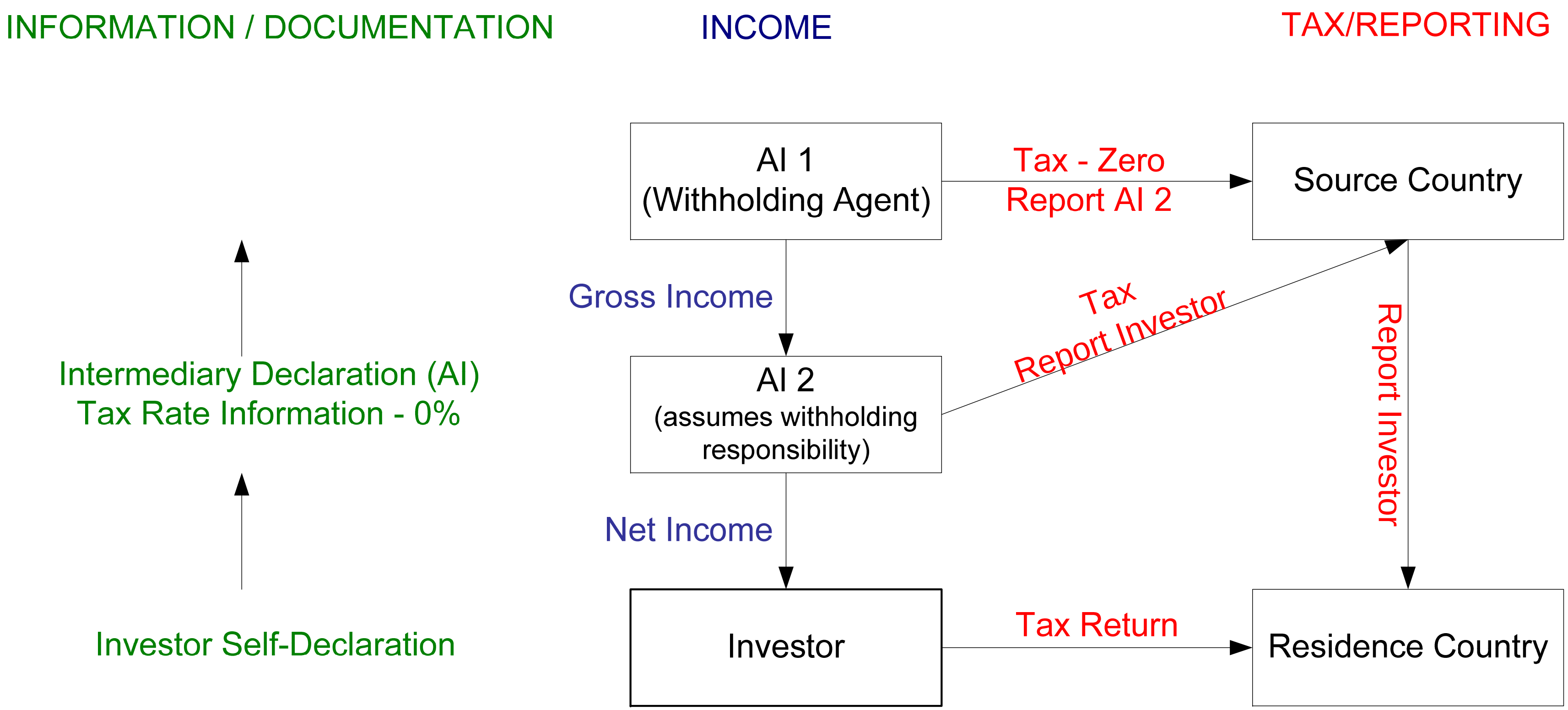
- Authorised Intermediary (AI 1) acting as withholding agent; to
- Authorised Intermediary (AI 2); to
- Investor



Best Practice Illustration 3

Income flows from:

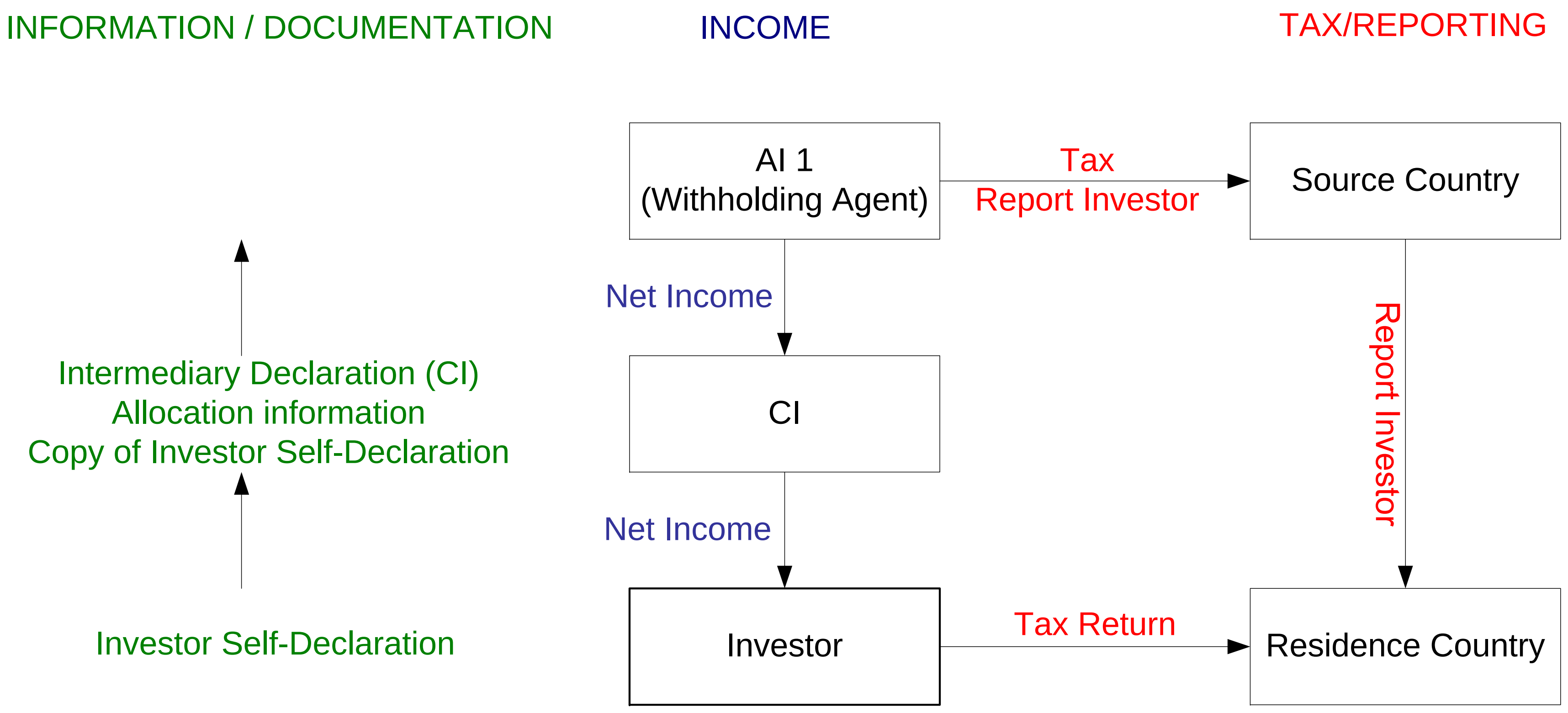
- Authorised Intermediary (AI 1) acting as withholding agent; to
- Authorised Intermediary (AI 2) <u>that assumes withholding responsibility</u>; to
- Investor



Best Practice Illustration 4

Income flows from:

- Authorised Intermediary (AI 1) acting as withholding agent; to
- Contractual Intermediary (CI); to
- Investor



Enhanced Information Reporting

- Ultimate goal is to have self-confirming system
  - Information on income, with TINs, reported to source country
  - Sent to purported residence country through automatic exchange of information
  - Residence country will inform source country if purported resident not entitled to benefits
- Should no longer need certificates of residence

Draft Implementation Package

- Consists of the following documents:
  - Application to become an authorised intermediary ("AI")
  - Agreement between AI and tax authority of the source State
  - General procedures to be followed by an AI
  - Investor Self-Declaration and Intermediary Declarations
  - Forms for information reporting
  - Procedures for Independent Review

Drafting Philosophy

- Start with simplest case
- Longest document – the general procedures – should be the same for all source countries.
- Variations and options are included in annexes and appendices.
- Modifications found only in the agreement between the AI and the tax authorities.

General Procedures Document

- Three assumptions greatly simplify document:
  - Single investor self-declaration;
  - AI does not take on withholding responsibilities; and
  - Source State does not allow intermediary to rely on documentary evidence/KYC rules.
- Withholding and documentary evidence/KYC options could be provided for in appendices.
- Goal is to allow document to be used by any source State, simply by inserting the name of the relevant country.

Tax Rate Information

- Requirement to provide tax rate information to payor from which the AI receives payment.
- Tax rate information can be in the form of a message to upper-tier payor or establishing accounts segregated by withholding rates.
- The AI may rely on tax rate information received from other authorised intermediaries, unless it knows or has reason to know it is incorrect.

Documentation and Account Opening

- The AI may not claim reduced rate of withholding on a payment made to a direct account holder that is not an intermediary unless it has an investor self-declaration.
- The AI is liable for claims made by investors through non-AIs (change from ICG "best practices")
- Procedures for ensuring appropriate claims therefore largely left to AI, although AI agrees to comply with applicable KYC rules.

Adjustments, including “Quick Refund”

- The AI may ask payor to make an adjustment for over-withholding.
- Adjustment may take the form of reimbursement or set-off.
- Also requires intermediary to notify payor if tax has been under-withheld and to take steps to remedy shortfall.

Information Reporting

- Provides for reporting to the source State of income paid to investors that are the AI's direct account holders or that hold through non-AIs.
- Reporting limited to:
  - Payments for which withholding is reduced
  - Payments to residents of the source State
  - Payments to AIs to allow tax authorities to assess compliance

Independent Review

- Annexes prescribe specific tasks to be performed by independent reviewers.
- Compliance procedures take into account the fact of information reporting to source country.
- Independent Reviewer will review a sample of accounts and payments.
- Coordinated schedule for reviews for multiple source countries.

Application to become an AI

- List of the AI’s affiliates subject to the Agreement
- Appropriate representations regarding capacity to comply with general procedures.
- List of types of income to be covered by the Agreement.
- Whether the intermediary wishes to take on withholding responsibilities.
- Request for authorised intermediary identification numbers for intermediary and affiliates.

Elements of the Agreement

- Agreement to allow the AI to undertake responsibilities described in general procedures document.
- List of types of income to which Agreement relates.
- List of Eligible Countries.
- Whether intermediary takes on withholding responsibilities.

Investor Self-Declaration

- Name, address, country of residence for tax purposes, and residence-State TIN (or other specified identifying information).
- Certification that the investor is entitled to treaty benefits.
- Authorisation to disclose information relevant to qualification for benefits to any relevant tax authorities.
- Authorisation for set-off in the case of under-withholding.

Investor Self-Declaration -- Entities

- Line items to deal with specific cases relating to entities:
  - If the investor is entitled to preferential withholding rates under any treaties.
  - A CIV that is not a look-through would list the treaties for which it is entitled to benefits with respect to all of its income, and those for which it is entitled to benefits with respect to a portion, along with the relevant proportions

Miscellaneous Provisions

- Scope: Offices of the intermediary located in “Eligible Countries” that have received income covered by the Agreement.
- “Eligible Countries” to be determined by source State, intended to encompass those countries that have adequate KYC rules.
- “Taxpayer Identification Number” defined to also include any other form of identification or combination of identifiers used by a residence State to facilitate the collection of taxes.

Specific Areas for Further Work

- Co-ordination of Independent Review for multiple source States
- Consideration of compliance requirements, including reconciliation between tax rate information and annual reports
- Development of information reporting and exchange systems
- Development of electronic ISDs

Future Work

- In January 2010, CFA approved continuing work
  - Treaty Relief and Compliance Enhancement ("TRACE") Group will continue work on Implementation Package
  - TRACE IT Expert Group will develop information reporting and exchange system
- Comments on Draft Implementation Package due August 31, 2010

Commission Recommendation

- European Commission issued its own Recommendation on October 19, 2009
- Substantially less detailed than ICG Report and Implementation Package
- Implementation Package is consistent with proposals in the Recommendation
- Recommendation not legally binding on EU Member States but countries will pay attention