| asset management group

22 April 2016

Sent via email: taxtreaties@oecd.org

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA
2, rue André Pascal
Paris, France

Re: Public Discussion Draft – Treaty Entitlement of Non-CIV Funds, dated 24 March 2016

Dear sir / madam:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to respond to the Organisation for Economic Co-operation and Development (the "**OECD**") on questions included in its recent consultation document on the treaty entitlement of non-CIV funds (the "**Discussion Draft**"). Specifically, this letter addresses those questions relating to: (i) non-CIV funds set up as transparent entities; (ii) the suggestion that the limitation on benefits include a derivative benefit rule applicable to certain non-CIV funds; (iii) the suggestion that a "Substantial Connection" approach be adopted; and (iv) the suggestion of a "Global Streamed Fund" regime.

I. INTRODUCTION

SIFMA AMG is concerned that investors in non-CIV funds[2] may often be denied treaty benefits under the currently proposed principal purposes test (the "**PPT**") and limitation on benefits ("**LOB**") provisions. These investors would be denied such benefits that they otherwise would have been entitled to had they invested directly rather than through such funds. In recognition of this concern, the Discussion Draft provides that pension funds will be entitled to treaty benefits, which will be reflected in upcoming changes to the OECD Model Tax Convention. SIFMA AMG supports this change, and further supports permitting the entitlement of treaty benefits to the other types of non-CIV funds as well.

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[1] The AMG is the voice for the buy side within the securities industry and broader financial markets, which serves millions of individuals and institutional investors as they save for retirement, education, emergencies, and other investment needs and goals. The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. SIFMA AMG is comprised of over fifty members – the list of members is available at: http://www.sifma.org/amg-member-directory/. The clients of AMG member firms include, among others, registered investment companies, separate accounts, ERISA plans, and state and local government pension funds.

[2] A "non-CIV", or "non-collective investment vehicle", is defined as an investment vehicle that does not qualify as a "collective investment vehicle" within the meaning of the 2010 OECD Report, The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles. "Collective investment vehicles" is defined therein as being 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."

For investors, access to treaty benefits is important for purposes of avoiding an additional layer of tax, but it is not the principal purpose of non-CIV funds. Rather, non-CIV funds provide vital sources of capital to fund various economic activities around the world. Non-CIV funds provide investors with access to additional capital markets that provide opportunities to diversify risk and seek increased returns. Non-CIV funds also provide access to capital for diverse asset types including small- and medium-sized enterprise funding, private equity, and non-publicly issued debt, among others.

When considering the various types of assets mentioned above and the inclusion of all funds that are not CIVs (as defined in footnote 2), non-CIV funds are quite diverse in terms of the structure, number and types of investors, investment mandate (regarding asset classes and jurisdiction), and commercial structure (i.e., whether the fund is open-ended or closed-ended). The diversity and complexity of non-CIV funds increase as the number of cross-border investments increase as well. Moreover, the investments are pooled from investors in different countries. This convergence of events raises the question of which bilateral income tax treaty applies and whether treaty benefits should be granted.

II. <u>OBJECTIVE</u>

Investors in non-CIV funds who are entitled to treaty benefits on a direct basis should receive those treaty benefits notwithstanding their investment in a pooled vehicle. Many investors in non-CIVs, however, are concerned that they are losing treaty benefits that they would have received if they invested directly. Investors are seeking reassurances that non-CIV funds will cope in the future world and are raising questions about the tax assumptions within pricing models used to evaluate investments. A reduction in investor activity in non-CIV funds will negatively impact the economies of source countries by reducing the number of investment opportunities. It is important that there is a workable solution that recognizes entitlement of treaty benefits for non-CIV funds.

At the same time, SIFMA AMG recognizes there are two general concerns about granting treaty benefits with respect to non-CIVs: (i) non-CIVs may be used to provide treaty benefits to investors that are not themselves entitled to treaty benefits; and (ii) investors may defer recognition of income on which treaty benefits have been granted. Accordingly, we support a solution that results in a “principled” outcome that acknowledges these concerns while maintaining the important role that non-CIVs play in the global economy.

III. <u>DISCUSSION</u>

SIFMA AMG believes that the Discussion Draft correctly identifies two basic approaches to granting treaty benefits to non-CIV funds. The first approach is granting treaty benefits directly to the fund based on its own characteristics, and the second approach is granting treaty benefits based on the treaty benefits that the investors would have received if they invested directly. Notwithstanding the viability of the first approach, SIFMA AMG believes that there is a growing acceptance within the industry that any solution to granting treaty benefits will be through a proportional approach that involves investor identification (i.e., the second approach).

The solution should balance the policy concerns of the governments and need for operability. Under the first approach, the source country’s policy concerns about treaty shopping may not be satisfied by a mere reference to whether the fund is regulated or widely held, whereas under the second approach, the need for operability may be hindered by an unwieldy investor identification process. The framework for CIVs that are not widely held should permit such investment funds to receive treaty benefits, under either approach, to the extent that ultimate investors in a fund would be entitled to treaty benefits if they had invested directly in capital markets, rather than through a pooled investment fund. SIFMA AMG believes that if governments provide clear and reasonable rules defining the documentation required to allow for treaty

benefits, non-CIV funds would implement the systems and procedures to collect such documentation. After documentation, a wide range of principled solutions become possible based on either of the approaches.

Below are our responses to the questions raised in the Discussion Draft relating to the granting of treaty benefits for non-CIV funds.

a. **Transparent Non-CIV Fund Entities** *(Discussion Draft Question 7)*

The Discussion Draft describes the new treaty provisions on transparent entities that was included in Part 2 of the Report on Action 2, Neutralising the Effects of Hybrid Mismatch Arrangements. Applicable in this context, the provisions would ensure, for example, that treaty benefits are available to an investor in a non-CIV fund so long as the non-CIV fund is treated as transparent. To this effect, the Discussion Draft asks questions about practical difficulties of the application where an entity with a wide investor base is treated as fiscally transparent under the domestic laws of a State that entered into tax treaties.

SIFMA AMG notes that many funds in the U.S., some with a large investor base, are currently designed to be fiscally transparent. But as capital markets expand, funds are becoming increasingly complex due to the growing number of investors from multiple jurisdictions and due to the funds themselves investing in multiple jurisdictions. Despite being treated as fiscally transparent in the U. S., there is no worldwide recognition of this classification. As such, any solution addressing cross-border transactions would require all jurisdictions to allow funds to be treated as transparent. The consequence of non-conformity would lead to treaty-shopping.

The coordination of jurisdictions would be required on multiple fronts. This includes standardization and coordination of documentation, withholding rules, tax transparency treatment, standard accounting and reporting systems. Additionally, an end-to-end data flow from investments to the ultimate investors would be needed because fund of fund structures would no longer be effective. SIFMA AMG believes that this is possible in theory, but if the governments of various jurisdictions are ready to consider such coordination, we encourage the OECD to further examine the Global Streamed Fund regime to support such an initiative (discussed in Part III.d.).

b. Derivative Benefit Rule *(Discussion Draft Questions 8 to 21)*

The Discussion Draft contains questions on the suggestion that the LOB include a derivative benefit rule applicable to certain non-CIVs. Among the questions are those relating to: (i) aspects of the proposal; (ii) the identification of the investors in a non-CIV, (iii) the prevention of treaty-shopping, and (iv) the prevention of deferral. Select questions are addressed below.

i. Proposal Aspect *(Discussion Draft Questions 8, 9)*

With respect to question 8 regarding "institutional investors", that term generally refers to pension funds, sovereign wealth funds, banks, and insurance companies. However, the use of a definition of "institutional investors" that identifies a class of investors eligible for treaty benefits may not be helpful because of the wide range of entities and structures that exist amongst the general understanding of the term "institutional investors." Thus, in order to accurately define "institutional investors" source countries would have to create a broad definition of this term. An expanded definition of "institutional investors" may, however, lead to treaty shopping by those entities that should not be entitled to treaty benefits.

With respect to question 9 regarding the term "non-CIV", similar to question 8, SIFMA AMG does not believe that a narrower definition than the one provided in the 2010 OECD report on CIVs is needed. Because non-CIV funds cover the breadth of asset classes, and vary with respect to their structure, number and types of investors, different solutions are likely needed to address the various issues presented. The solution should generally include treaty benefits for all types of managed funds, such as those investing in real estate (infrastructure, real estate including social housing for example), unlisted companies (private equity funds, venture capital funds, loan origination funds), and hedge funds. Governments could take preferred actions with respect to personal holding companies and trusts.

ii. Investor Identification *(Discussion Draft Questions 13,14, 15, 16)*

With respect to question 13 regarding ownership of interests in non-CIV funds, the stability of ownership varies. There are certain non-CIV funds that invest in infrastructure and real estate where the ownership is fairly stable – these are typically closed-end funds and provide a longer stable investment. Alternatively, there are certain non-CIV funds where ownership is constantly changing.

With respect to question 14 regarding ultimate beneficial ownership, a non-CIV fund should be aware of the investor's identification when there is direct investment in a non-intermediated manner. While the investor itself may be a complex organization, so long as the entity making the investment is eligible for treaty benefits, that should suffice for purposes of treaty benefits. Where the investment is made through an intermediary or other similar manner, there will be someone in the chain of intermediation who is aware of the ultimate beneficial ownership's identity. Investors in many alternative investment funds hold their interests directly rather than holding "in street name". Further, regulatory requirements, including know your customer rules, U.S. FATCA and UK CDOT, require fund managers to gather and information about their investors. To the extent investment funds have intermediary investors, such as funds of funds or bank-sponsored funds, those intermediary investors can conduct similar diligence on their investors to provide representations or certifications to the investment fund seeking proportional treaty benefits. We note that other tax frameworks, including U.S. FATCA and UK CDOT recognize that investor certifications are an important mechanism for investment funds and other entities to be able to use as part of their diligence process.

With respect to questions 15 and 16 regarding the type of information, while there is certain information available under anti-money laundering, U.S. FATCA, and the common reporting standard rules, additional information or documentation may be needed for purposes of determining treaty benefits eligibility. The information generally provided in the above-mentioned documentation includes name, jurisdiction(s), residence and taxpayer identification numbers. The jurisdiction information is essential to establishing treat benefits eligibility, but there may be additional information required. SIFMA AMG encourages adopting the self-certification system developed in TRACE as a mechanism to demonstrate the appropriate information to tax authorities. However, we encourage the OECD to provide individual jurisdictions to adopt alternative approaches that would accomplish the same goal, to ensure that the ability to obtain treaty benefits is not entirely dependent on implementation of TRACE.

iii. Treaty-Shopping Prevention *(Discussion Draft Questions 17)*

With respect to question 17 regarding intermediary chains, SIFMA AMG believes documentation and reporting could be implemented to identify the ultimate investor, similar to U.S. FATCA, the common reporting standard, and the qualified intermediary system in the U. S. The qualified intermediary system provides for certifications, or lack thereof, to identify the residence of investors.

With respect to question 18 regarding certain thresholds for granting full benefits to a non-CIV fund, SIFMA AMG believes that the percentage rate is a balance between the administrability concerns and the perceived risk to government policy concerns. For example, requiring a 100 percent threshold would render funds to be cost-prohibitive to investors and ultimately reduce cross-border investments. At the other end of the spectrum, having no threshold requirement would lead to treaty shopping. The percentage threshold determination would be adjusted up and down to address the level of concern to a particular jurisdiction. Proportionate benefits could also be considered to address such concerns. Such benefits would be in line with what the investors would have received had they invested directly. This would be particularly difficult for fund of fund structures.

iv. Deferral Prevention *(Discussion Draft Questions 20, 21)*

With respect to question 20 regarding income deferral, it may be difficult for source countries to determine whether investors have included their proportionate share of fund income. Many non-CIVs distribute cash to investors and generate a greater return on investment when dispositions are made. Furthermore, investors often want cash because they are either tax exempt–so deferral is not an incentive–or they do not want to recognize phantom income and the resulting tax liability. While the distribution is within a degree of control of the non-CIV funds, investors may establish intermediate holding entities (that are eligible for treaty benefits) to secure the deferral of taxable income. In this respect, governments should seek to define anti-deferral regimes that address funds.

SIFMA AMG believes that concerns about deferral of income are best addressed by the investors' country of residence through anti-deferral rules such as the U.S. passive foreign investment company ("**PFIC**") framework or the UK reporting fund framework.

Under U.S. tax rules, foreign investment funds are generally deemed a PFIC. A PFIC is a foreign corporation where at least 75 percent of its gross income is passive income, or where the average percentage of its assets which produce passive income (or which are held for the purpose of producing passive income) is at least 50 percent. Direct and indirect U.S. shareholders of a PFIC are all subject to PFIC rules and are subject to U.S. tax as set out in the rules. However, these shareholders may elect to be treated as shareholders of a qualified electing fund ("**QEF**"), which subjects the shareholder to an anti-deferral regime that is a modification of the "pure" PFIC regime. We believe the U.S. PFIC regime, and in particular, the U.S. QEF PFIC regime, provides an example of an anti-deferral framework that addresses policy concerns regarding investor deferral of income. SIFMA AMG would urge the coordination of a regime that allows for compliance and administrability that do not pose prohibitive burdens on the non-CIV funds.

With respect to question 21 regarding indirect ownership, whoever is claiming the treaty benefit will be tested. Thus, beneficiary would be the one entitled to the equivalent treaty benefits under the derivative benefits proposal. This would typically be determined at the first entity not treated as transparent.

c. Substantial Connection Approach (Discussion Draft Question 23)

The Discussion Draft highlights a suggested amendment to the LOB rule allowing certain non-CIV funds that are considered to constitute the active conduct of a business to be eligible for treaty benefits with respect to the income derived in connection with such conduct. If the fund has a "sufficiently substantial connection" with its State of residence, then the income would be eligible. The potential criteria for determining "substantial connection" included, among other things, the residence of board members or managers and administrators, whether the board members residing in the jurisdiction

have the relevant expertise to direct the fund's business, and whether the managers and administrators have qualified personnel in the jurisdiction to carry out the fund's transactions.

However, the Discussion Draft notes that Working Party 1 dismissed the "substantial connection" approach in the context of the LOB rule due to treaty shopping and tax deferral concerns, and the Discussion Draft further asks whether there is a practicable way to designing such an approach without raising these concerns.

In light of Working Party 1's hesitance to further consider the "substantial connection" approach in the context of the LOB rule,[3] SIFMA AMG supports the consideration of the "substantial connection" approach in the context of the PPT: Where there are considerable non-tax commercial reasons for establishing the fund and its activities have a substantial connection to the State of residence, these non-CIV funds should be entitled to treaty benefits.

As stated in Part I, the principal purpose of non-CIV funds is not to obtain treaty benefits. In deciding on where to establish a fund's jurisdiction, the fund manager looks at many commercial considerations: (i) political stability, and the regulatory and legal system; (ii) legal flexibility and simplicity, particularly to facilitate co-investments; (iii) flexibility to extract exit proceeds from sales of the portfolio; (iv) access to personnel like directors with regional investment expertise and knowledge, and (v) certainty of taxation of the holding company at the end of investment. When these considerations are factored into determining "substantial connection," the PPT would deny fewer legitimate entitlements of treaty benefits.

d. Global Streamed Fund Regime (Discussion Draft Question 24)

The Discussion Draft highlights a recent suggestion and questions the suggestion of a "Global Streamed Fund" ("**GSF**") regime, an international regime that would permit treaty benefits for certain qualifying funds. The regime would be implemented through the adoption of uniform domestic laws allowing a fund to elect, regardless of its legal form, to be treated as a GSF. Similar to Working Party 1, SIFMA AMG has not yet fully examined the GSF regime. Nonetheless, we support the further discussion of the GSF regime, which looks like an innovative and pragmatic approach to address country concerns around investor identity and treaty entitlement while providing a means for non-CIVs to continue to be a viable means of cross-border investment. We encourage Working Party 1 (or the formation of a sub-working group) to further address the relevant issues and to successfully design such a regime.

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[3] Additionally, certain OECD member countries have signaled that they are not in favor of a "substantial connection" approach in determining treaty benefits entitlement under the LOB rule.

SIFMA AMG sincerely appreciates the opportunity to send our responses and your consideration of these views. We stand ready to provide additional information or assistance that the OECD might find useful. Please do not hesitate to contact either Timothy Cameron at (202) 962.7447 or tcameron@sifma.org, or Lindsey Keljo at (202) 962.7312 or lkeljo@sifma.org with any questions.

Sincerely,

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