Managed Funds Association
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via email: taxtreaties@OECD.org

Marlies de Ruiter
Head, Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA
2, rue André Pascal
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France

Re: Managed Funds Association Comments on OECD BEPS Project

Dear Ms. de Ruiter:

Managed Funds Association ("MFA")[1] appreciates the opportunity to submit for your consideration comments regarding the tax treaty proposals on collective investment vehicles ("CIVs") that have been published by the Organisation for Economic Co-Operation and Development ("OECD") as part of its Base Erosion and Profit Shifting ("BEPS") project. MFA supports the goals underlying the OECD's project of preventing tax abuse in connection with granting tax treaty benefits. We also believe that it is important for the BEPS project to establish a treaty benefit framework that avoids imposing double taxation on investors who would be entitled to treaty benefits when making a direct investment, but who choose to invest through a pooled investment vehicle, such as a private investment fund, in order to have some of their capital managed by third-party managers. To the extent investors, including pension plans, endowments, and charitable foundations, would be subjected to an additional layer of tax simply because they choose to invest through a pooled vehicle, they likely would no longer choose to invest through that type of asset management structure, thereby losing the benefits of such investments and to the detriment of capital markets in which investment funds participate.

Private investment funds are funds are sold through non-public offerings to sophisticated investors and are able to invest in a broad range of assets pursuant to different investment

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[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

strategies. Private investment fund, like other pooled investment vehicles such as UCITS or mutual funds, are formed for commercial purposes to facilitate investment by underlying investors such as pension plans and charitable foundations. The commercial rationale of CIVs, as identified by the OECD,[2] applies equally to private investment funds (*e.g.*, risk diversification and economies of scale).

Our overarching goal is to achieve a neutral result for investors that pool their capital in private investment funds and not increase their incidence of taxation – or at least try to minimize tax disadvantages to them from investing in such funds (as compared to their tax treatment if they had made the investment directly themselves). As there is no single pooling vehicle in any jurisdiction that would preserve such neutrality for all of our international investors, what private investment funds seek to achieve with tax treaties is to mitigate double taxation – the raison d'etre for tax treaties.

Private investment funds utilize a variety of investment strategies and invest in diverse assets, such as listed securities, distressed debt, emerging markets securities, transport and infrastructure assets, real estate, commodities, and derivatives. Private investment funds can take the form of private equity funds, hedge funds, distressed credit funds, real estate funds and special situations funds. As noted above, investors in private investment funds are sophisticated, not retail investors, and are predominantly institutional investors from around the world, such as public and private pension funds, sovereign wealth funds, corporations with investable capital (such as insurance companies), foundations, endowments, as well as high net worth investors.

Private investment funds and their managers are subject to a variety of regulations. For example, private fund managers operating in the EU are subject to regulation under the Alternative Investment Fund Managers Directive ("AIFMD") and in the U.S., fund managers are subject to registration and regulation at the state level (for smaller managers) and at the Securities and Exchange Commission for larger managers as well as at the Commodity Futures Trading Commission. Private investment funds and their managers also are subject to a wide range of securities and commodity futures laws and regulations, which govern their market conduct.

In addition to the benefits private investment funds provide to investors, these funds also serve a valuable role in capital markets, including by acting as an alternative source of capital to business, especially where there is limited risk appetite from traditional sources of capital. There are currently more than 11,000 hedge funds globally with more than $3 trillion in assets under management. These funds invest globally and are increasingly providing capital and liquidity in areas where traditional sources of capital have declined. The European Commission has recognized the valuable role that alternative investment funds play in its recent green paper, *Building a Capital Markets Union*. In that paper, the Commission notes that the asset management industry plays a "pivotal role" in channelling investors' money into the economy. The Commission goes on to note that the UCITS and the AIFMD[3] frameworks have played a key role in providing the asset management industry

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[2] See section 2.1 of the OECD's Report on "The Granting Of Treaty Benefits With Respect To The Income Of Collective Investment Vehicles" dated 23 April 2010.
[3] Directive 2011/61/EU.

with a regulatory environment that allows them to effectively provide this intermediating role.

Given the global nature of the private investment fund industry, we believe all OECD member jurisdictions have an interest in ensuring that the limitation-on-benefits action item includes as CIVs private investment funds that do not present the risks of tax abuse underlying the OECD project. To the extent private investment funds are not able to rely on tax treaty benefits for certain treaty countries, institutional investors in those jurisdictions would be adversely affected in their ability to obtain the risk management, portfolio diversification, and investment expertise provided by private funds. Private investment funds also would be less likely to invest in such jurisdictions, adversely affecting capital markets and the businesses that seek financing from such markets and the economies in those countries. To avoid these unintended, adverse consequences, while developing a framework that addresses policy makers' concerns about tax abuse, we encourage the OECD to adopt the suggestions discussed below.

We emphasize at the outset that our proposals build on the considerable work done by the OECD to pave the path for recognizing CIVs as tax treaty residents. Our proposals regarding treaty residence for CIVs are mostly based on proposals already made by the OECD in the following publications.

- BEPS Action 6 discussion draft published on 22 May 2015 ("**2015 Discussion Draft**")
- BEPS Action 6 discussion draft published on 21 November 2014 ("**2014 Discussion Draft**")
- BEPS Action 6: 2014 Deliverable report ("**2014 Report on Action 6**")
- Commentary to Article 1 of the OECD Model Tax Treaty ("**Article 1 Commentary**"),
- 2010 OECD Report "*The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles*" (the "**2010 Report**");
- Treaty Relief and Compliance Enhancement ("**TRACE**") project.

Within the context of the OECD's global objective of preventing the abuse of tax treaties, the OECD has recognized for several years the special case of CIVs with international investors, when they seek to obtain tax treaty benefits. We wholeheartedly agree with the OECD, when it stated about CIVs:

> The goal is to achieve neutrality between a direct investment and an investment through a CIV in the international context, just as the goal of most domestic provisions addressing the treatment of CIVs is to achieve such neutrality in the wholly domestic context.[4]

The words of the OECD capture the crux of the issue for private investment funds, which have many investors that would in their own right qualify for tax treaty benefits, if the

[4] Paragraph 6.18 of the Article 1 Commentary.

cross-border investments made by the investment fund were made directly by its investors. The OECD has already proposed tax treaty language to implement additional residence requirements for CIVs.[5] As private investment fund managers, we appreciate the OECD's work to date but have several concerns. First and foremost, the OECD generally refers to CIVs as being "widely-held", but many private investment funds may not meet that requirement. So our references to "CIVs" in this letter are to those that are not widely-held. We accept that the test of being widely-held is indeed a relevant consideration for the tax treaty treatment of an investment fund, and its relevance can be preserved by imposing additional requirements on CIVs that do not meet that requirement. We see no compelling international tax policy rationale for excluding non-widely-held CIVs categorically from qualifying for tax treaty benefits.

In short, we believe that any regulated investment fund should be regarded as a CIV but that tax treaty access is based on certain qualifications of the CIV. First, any "widely-held" CIV, such as a US mutual fund or a European UCITS fund, should qualify as a treaty resident and as a per se "qualified person" under any limitation-on-benefits article. Secondly, if a fund is not regarded as "widely-held", then it would still be a CIV but would need to meet the ownership and equivalent beneficiaries tests of a limitation-on-benefits provision, outlined below, to be entitled to full or proportionate treaty access.

In summary, the core elements of the approach that we hope the OECD will adopt include the following.

a) Amend the OECD's current description of a CIV in its model tax treaty commentary to include those fund entities that are intended for use as private investment funds, such as the "qualifying investor alternative investment funds" ("QIAIFs") in Ireland, the "specialized investment funds" in Luxembourg, Resident Fund Scheme in Singapore, and their equivalents in other countries. This would mean that a CIV would not be required to be "widely-held" (however defined) to be considered a treaty resident.

b) We believe that the appropriate requirement for an investment fund to be regarded as a CIV should be that the fund or the fund's investment manager is subject to regulation in the country in which it was established[6] – for example, all EU funds within the scope of the AIFMD. We believe that limiting the definition of CIV to these regulated funds significantly reduces the risk of providing tax treaty benefits to entities structured to avoid taxes. Regulated funds and their managers are subject to significant compliance and regulatory costs and provide significant transparency to their government regulators with respect to their investment activities and, as such, are highly unlikely to be established or operated as tax avoidance vehicles.

Including regulated funds within the scope of the definition of a CIV also would allow the OECD to use relevant definitions from the securities and financial services regulations of a treaty country, rather than having to create a stand-alone definition for purposes of tax treaties, which could cause confusion and uncertainty for market participants and policy-makers.

[5] Paragraphs 6.17, 6.21, 6.26 and 6.32 of the Article 1 Commentary, and TRACE.
[6] In this letter, we refer to investment funds subject to regulation or whose investment manager or investment adviser is subject to regulation with respect to the management of the investment fund as "regulated funds."

To the extent the OECD does not agree with the above recommendation, at a minimum, we believe the OECD should include funds that are regulated its country of establishment within the definition of a CIV. As a precedent, the tax treaty between Ireland and the United States does not include references to "widely-held" or "diversified"; it simply refers to "Collective Investment Undertakings", which includes QIAIFs that are not widely-held.

c) In the definition of a CIV within a treaty, adopt the approach proposed by the OECD in paragraph 6.21 of the Article 1 Commentary, paragraph 36 of the "Commentary on the LOB Rule" in the 2014 Discussion Draft and 2014 Report on Action 6, and in TRACE.

i. This definition would simply enumerate a list of specific entities that would be treated as CIVs in accordance with the relevant regulations of the country of residence. Certification of "CIV" status could be confirmed by reviewing regulatory filings with a country's fund regulatory body or tax authority as well as through discussions with such authorities;[7]

ii. The list could be amended from time-to-time by agreement of the competent authorities, as needed;

iii. The definition would confirm that a CIV is treated as the beneficial owner of any income it receives.

d) To address any particular concerns about CIVs that are not "widely-held" (however defined), we further propose that CIVs that are not "widely-held" meet the additional limitation-on-benefits ("LOB") requirements set out below.

i. We support the "simplified LOB" included in the recent 2015 Discussion Draft that grants treaty benefits to treaty residents that are more than 75% owned, directly or indirectly, by "equivalent beneficiaries."

ii. For CIVs in particular, we would propose modifying the "simplified LOB" to grant proportional benefits of up to 75% based on the percentage ownership of the resident by equivalent beneficiaries.[8] If equivalent beneficiaries own more than 75% of a CIV, then the CIV would be entitled to 100% of the treaty benefits (in accordance with the general equivalent beneficiaries proposal, above).

iii. Documenting the tax residence and equivalent beneficiary status of a CIV's investors, would be done on an annual basis and through investor self-certifications.[9]

[7] This equivalent beneficiaries ownership test is also found in paragraph 36 of the "Commentary on the LOB Rule" in the 2014 Discussion Draft and 2014 Report on Action 6, which is based on 6.21ff of the Article 1 Commentary.
[8] See paragraph 6.27 of the Article 1 Commentary and the TRACE Implementation Package for the Adoption of the Authorised Intermediary System (the **"TRACE Report"**).
[9] See paragraph 6.29ff of Article 1 Commentary, paragraph 36 of the "Commentary on the LOB Rule" in the 2014 Discussion Draft and 2014 Report on Action 6 and TRACE's draft "self-declaration" language.

iv. Investor-specific information would be shared only with either the tax authority of the source country or the CIV's country of residence (which in turn could provide such information to the source country and investors' residence countries under exchange of information agreements).

e) Implement the comprehensive "Authorized Intermediary System" ("AIS"), as found in the TRACE Report, for streamlining the collection of withholding taxes and claiming of treaty benefits by financial institutions (including CIVs) in respect of its customers or investors. As an organization that represents many U.S. managers of private investment funds, we note and welcome in TRACE's AIS proposals a convergence with the US "Qualified Intermediary" system and the FATCA/IGA regimes. We believe such convergence will result in very tangible efficiencies for industry participants and enhance the administration and collection of tax for tax authorities.

f) If a CIV qualifies as a treaty resident by virtue of the foregoing tests, then any "principal purpose test" ("PPT Rule") should not apply – or at least there should be a rebuttable presumption that the CIV has complied with the PPT Rule.

i. Tax considerations are inherently a principal reason (but not the sole reason) for choosing to form a CIV in a particular treaty country. As the OECD has acknowledged, neutrality is a goal of investing internationally through a CIV – as distinct from the more complex considerations of a multinational enterprise in deciding where to locate its people and assets around the world. Without an exception or special presumption for CIVs, it may be difficult for a CIV to comply with a PPT Rule.

ii. Similarly, there should be no additional "substance" requirements imposed on the CIV, such as a need for control, management, employees or other activity to be located in the relevant treaty state. "Substance" for a CIV is the fact that the regulated fund or its manager (1) is subject to regulation in that treaty state (which regulations impose certain local requirements, such as mandatory use of a locally regulated administrator) and (2) meets the LOB requirements.

The rationale for the "Equivalent Beneficiary" LOB approach is explained very well in paragraph 23 of the OECD's own Article 1 Commentary:

> The effect of allowing benefits to the CIV to the extent that it is owned by equivalent beneficiaries as defined in subdivision (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 percent on portfolio dividends.

Furthermore, a proportional benefits approach is especially needed by CIVs, because, unlike multinational enterprises that structure entities within their group and choose the jurisdiction(s) of those entities, the manager of a global fund does not choose the jurisdiction of its investors. It would thus be arbitrary, in the case of CIVs, and inconsistent with the goal of neutrality to impose a minimum equivalent beneficiary ownership threshold.

g) In considering the treatment of intermediate entities, we believe it is important to understand the basic structure for private investment funds. A common structure for private investment funds is the "master-feeder" structure (see attached diagram), in which investors invest in feeder funds, which in turn invest in one or more master funds. In a master-feeder structure, many private investment funds use Cayman Islands companies as intermediate entities -- one reason for which is to facilitate investment by U.S. tax-exempt institutional investors, which may be limited in their ability to invest in the U.S.-domiciled feeder fund because of the application of U.S. debt-financed income rules for U.S. tax-exempt entities. The use of Cayman Islands-based funds allows managers to set up a corporate entity that is itself not subject to tax in its country of residence.

i. We generally advocate looking through such intermediate entities to beneficial owners in applying the equivalent beneficiaries ownership test.

ii. We believe that the explanation given in paragraph 44 of the 2015 Discussion Draft for the requirement that each intermediate owner be a resident of either Contracting State (*i.e.*, that it is necessary to prevent the interposition of a company in a tax haven to which income derived from the State of source could be paid through a base eroding payment) is not relevant in the context of a CIV. A CIV is typically tax-exempt and would not therefore make base eroding payments. Accordingly, we consider that the intermediate owner requirement should not apply to CIVs.

iii. A special purpose vehicle owned by one or more CIVs formed in the same country as the vehicle should aggregate all of the investors in the intermediate CIVs to determine the proportional benefits of the special purpose vehicle.

h) With respect to the issue of income deferral, we recognize that, in paragraph 24 of the 2015 Discussion Draft, a concern was raised about "non-CIV" funds being used by investors to defer recognition of income on which treaty benefits have been granted. While we understand policy maker concerns about deferral, we believe deferral is a separate issue from the ability of a CIV to obtain treaty benefits. It also is important to note that many countries already have CFC rules and similar legislation dealing with income deferral. To the extent such domestic legislation is absent or deficient, we believe that amending domestic legislation is the best approach to dealing with issues of income deferral. In any event, we would note that work is already being undertaken under BEPS Action 3 with a view to strengthening CFC rules and accordingly addressing regimes that permit income deferral.

Lastly, we note that if a treaty includes CIVs as residents, then the tax regime applicable to CIVs should not be treated as a "special tax regime" (paragraph 53 of 2015 Discussion Draft). This is already envisaged in sub-paragraph (vii) of Proposal 1 but in our view the exemption should apply to any CIV and should not specify any additional criterion such as 'widely held', 'diversified portfolio' etc.

If you have any questions regarding any of the information provided above, or if we can provide further information with respect to the application of the limitation on treaty benefits to private investment funds, please do not hesitate to contact Benjamin Allensworth or me at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice-President and Managing
Director, General Counsel

Schedule

Basic "Master-feeder" Structure