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Final Paper on:

“Application of Tax Treaties To Investment Funds”

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Executive Summary

The paper addresses the issue of the application of Tax Treaties to investment funds.

The starting points are the definition, the forms and the activities of an investment fund at the Community level. In this respect, it must be pointed out that the forms under which an investment fund may be organized are crucially linked to its entitlement to the benefits of Tax Treaties. In order to having granted such benefits, an investment fund must be considered both a “person” and a “resident” in accordance with the definitions of such terms as laid down in the relevant provision of the Model Convention. In this respect, an investment fund organized under corporate law is considered to fall within the meaning of “company” as defined in art. 3(1)(a), or whether the entity lacks of the requirements of a company it may still be encompassed in the definition of “body corporate” provided that is treated as a company for tax purposes. By contrast, when an investment fund is organized under contractual agreement, it is author opinion that such fund should fall within the meaning of the term “body of persons”, irrespective of the rationale developed by common-law jurisdictions. The second step toward the entitlement to treaty benefits of investment funds concern their inclusion in the term “resident”. As a matter of fact, when a fund is assessed as a separate taxable entity the author agrees that it has to be considered as a resident for treaty purposes (even if such entity benefits from a tax-exemption regime) due to the wide interpretation of the term “liable to tax” that crystallizes a “potential taxation and not actual taxation”; On the other hand, if the fund is evaluated as a transparent entity, the issues to be solved, in order to consider it as a resident for treaty purposes, are more complicated; in fact, in this case even the adoption of the wide definition of the term “liable to tax” does not assure the inclusion in such definition of entities that are disregarded for tax purposes. However, after an in-depth analysis of the OECD Commentary, combined with the characteristics of the transparent fund, we believe that a transparent entity may be entitled to treaty benefits (i.e., a resident for treaty purposes) even though it may appear that such an inclusion goes beyond the mere technical meaning of the wording of art. 4 of the OECD Model Convention. Moreover, we believe that such an inclusion would constitute an important starting point to achieve the more general goal of eliminating the practices that discourages cross-border activities of investment funds.

Chapter 2 poses particular attention to the regulation of the investment fund at the level of the European Union, namely the UCITS Directive which covers only publicly-offered open-end investment funds which invest in transferable securities and its implementation made by the issuance of the UCITS III Directive that has brought closer the definitions of investment funds and hedge funds. Nevertheless, also the “Management Company” Directive and the “Product” Directive are investigated, with the attempt of drawing the guidelines of the new investment fund industry in line with such Directives.

Chapter 3 is devoted to describe the outlines of the taxation of investment funds in specific EU Member Countries (i.e. Italy, Luxembourg and Switzerland) and in off-shore jurisdictions, combined with an overview of the main forms under which such funds may be organized in the relevant countries. In this respect, is also analyzed the taxation arising from: i) the distribution of income made by an investment fund; and, ii) the disposal or redemption of the shares of a fund made by its participants-investors. In each country the analysis is made with regard, both, on domestic and foreign investment funds, and on respect of domestic and foreign participants-investors. Nevertheless, the aim of the paper, as underlined in chapter 4, is to reach a clear answer to the treaty entitlement of investment funds. In this respect, the tax events in the chain of an investment fund investment are evaluated. Accordingly, the issues of: i) whether or not an investment fund falls within the personal scope of tax treaties; ii) whether such funds are “liable to tax”; iii) whether investment vehicles may be considered as the beneficial owners of the income received; and, iv) whether the

income have to be considered as “paid to” such vehicles, are investigate from the perspective of the source state of the income in order to reduce its taxation on the income.

According to the foregoing, the analysis of the “beneficial owner” requirement (as laid down in art 10, 11 and 12) has been developed. However, the fact that such term is defined neither in the Model Convention nor in the Commentary, has lead our investigation to be pursued in accordance with the purpose of its insertion in the distributive rules. We have seen that the conclusion that investment funds should be considered the “beneficial owners” of the income they generate, is achieved from both from the fact that setting an investment vehicle in a relevant country has not the scope of circumventing the law, and also that the rights and obligations which an investment fund is subject to are not of the same contents as the ones proper of a conduit company (that according to the Commentary is excluded from being considered as the beneficial owner). As a result, the author believes that an investment fund is undoubtedly the beneficial owner of the income it derives.

In respect of the definition of the term “paid to”, since such definition is not provided in the Model Convention our attention was moved to art. 3 MC according to which when a term is not defined therein, reference has to be made to the domestic law of the state applying the Convention. On this grounds, a comparison between the result achieved by the application of the “lex fori” of the state applying the Convention and the one (based on the assumption that the context otherwise require) achieved by means of the application of the principle stated in the Partnership Report (i.e. an item of income is paid to a resident of a Contracting State if the latter exercises its taxing power over the income) has shown that the latter result is able to avoid conflicts of qualification that otherwise would lead to double taxation of the income. As a result, we believe that the Partnership Report codifies the appropriate meaning of the term “paid to” and we do not see any reason why such solution should not be applicable to investment funds. In addition to the investigation of the appropriate meaning of the term “paid to”, the application of the Partnership Report to investment fund has been analyzed. Accordingly, the scenarios of bilateral cases and triangular cases have been addressed respectively, depending on the different tax treatment of the fund (fiscally transparent or not). Each scenario was examined in light of the tax regime reserved to the fund and to the participants-investors from the countries involved. The result outlined is that where on one hand the principle (stated in the Partnership Report) that indicates that the state of source must follow the residence state in case of conflicts of qualifications concerning the tax status of a partnership, should be applied to investment funds, on the other hand, such application may give rise to administrative difficulties (considered marginal by the author as opposed to the benefits derived) that need to be solved. Ultimately, both the issues arising from the re-characterization of items of income at the fund level (i.e. when the income is first received by the fund and then distributed to the investors), and the issues concerning the relief for the taxes paid in the state of source (to be credited to the fund against its liabilities in its residence state) and for the taxes paid at the fund level (to be credited to the investors) are analyzed.

Finally, the last chapter is devoted to the author’s conclusions with respect to the recommended application of tax treaties to investment funds in the light of the findings achieved in this paper.

Overview of Main Findings

The paper aims at finding a solution to the application of tax treaties to investment funds.

To this end, the forms under which an investment vehicle may be organized have been examined in the light of their possible inclusion in the treaty definition of “persons” and “resident”.

Regarding the concept of persons, as defined in art. 3(1)(a) of the Model Convention, the result outlined by the analysis is that where an investment fund is organized under corporate law, it has to be evaluated as encompassed in the definition of company or body corporate (for the entity treated as a company for tax purposes); by contrast, when such fund is organized under a contractual arrangement, it may not be included in such definition. However, the author agreed with the view that encompassed such type of fund as included in the definition of body of persons. Moreover, the author believes that also common-law jurisdictions should agree on this point, since the arguments put forward for the exclusion from such definition are not well grounded.

The same problem has to be addressed with regard to the definition of resident in art. 4(1). In this regard, it goes without saying that when an investment fund is considered as a taxable entity it is a resident for treaty purposes. Nevertheless, issues arise when the figures of tax-exempted entities and transparent entities are addressed. Concerning the latter ones, the analysis of the term “liable to tax” becomes crucial. As we have seen to such definition has to be given a wide interpretation in the sense that it should have the meaning of “potential taxation”. As a consequence, we do not see any reason why entities that are potentially liable to tax (but actually are not) such as tax exempt entities, should not be assessed as resident for treaty purposes. By contrast, the same may not be said when an entity is disregarded for tax purposes (i.e. transparent entities) since such entity will never become potentially taxable. As a result, the only way through which transparent vehicles may be entitled to treaty benefits is by the insertion of a specific provision dealing with the matter in the Model Convention or in its Commentary.

On the same grounds, an analysis has been conducted through the concept of “beneficial owner”, and on the reasons concerning its insertion in the Model Convention, as defined in art. 10, 11 and 12. The outcome of such analysis is that an investment fund may very well be considered as the beneficial owner of the income it derives.

Regarding the application of the Partnership Report to investment funds, the analysis has been performed both in respect of the definition of the term “paid to” in such Report as compared to the definition arising from the application of the “lex fori” of the state applying the Convention, and also on the applicability of some of the principles of such Report to investment vehicles. The results outlined is: i) that the appropriate meaning of the term “paid to” is the one developed by the Partnership Report, and ii) where on one hand the principle (stated in the Partnership Report) that indicates that the state of source must follow the residence state in case of conflicts of qualifications concerning the tax status of a partnership, may also be applied to investment funds, on the other hand, such application may give rise to administrative difficulties that need to be solved.

The ultimate issue that has been investigated concerns the case of “transformation” of income distributed from an investment fund to its investors. In this respect, the author suggest that, while the same tax treatment of item of income is a solution hard to achieve, a special rule that obliges every fund to retain the original character of the income received when distributing it to participants-investors, would constitute a necessary step forward to the elimination of double taxation in the case of investment funds investment.

Application of Tax Treaties to Investment Funds

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Chapter 1

Introduction

1.1. SCOPE AND AIM OF THE PRESENT PAPER

The present paper concentrates on the possible application of tax treaties to investment funds.

Among financial investors, investment funds are the ones that mostly have increased their importance in capital markets where the regulation on investment funds is still incipient. By using investment funds, individual investors can have the possibility to participate in various companies as well as in market places worldwide without the need of specific and elaborate knowledge of the same companies and markets. Investments through investment funds are generally considered as indirect investments as compared to direct investments.

The present work starts by analyzing the definition, forms and activity of an investment fund at the Community level. In this respect, it goes without saying that the forms that an investment fund may adopt are crucially linked to its entitlement to the benefits of a Treaty.

Particular attention is also paid to the UCITS Directive² which covers only publicly-offered open-end investment funds which invest in transferable securities and its implementation made by the issuance of the UCITS III Directive³ that brought closer the definitions of investment funds and of hedge funds.

The taxation of investment funds in specific EU Member Countries (i.e. Italy, Luxembourg and Switzerland) and in off-shore jurisdictions, combined with an overview of the main forms that such funds may adopt in the relevant countries, are also addressed.

The aim of the paper, however, is to contribute in finding a clear answer in order for an investment fund of being granted the benefits arising from the application of a Tax Treaty. In this respect, the tax events in the chain of an investment made by an investment fund are evaluated.

Accordingly, the issues of: i) whether or not an investment fund falls within the personal scope of tax treaties; ii) whether such funds are "liable to tax"; iii) whether investment vehicles may be considered as the beneficial owners of the income received; and, iv) whether the income have to be considered

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² Council Directive 85/611/EEC of 20 December 1985.

³ Which is composed of two different Directives: i) Council Directive 2001/108/EC of 21 January 2002; and, ii) Council Directive 2001/107/EC of 21 January 2002

as “paid to” such vehicles, are investigated from the perspective of the source state of the income in order to reduce its taxation thereon.

In respect of the question if an investment fund is a person for treaty purpose, the analysis will stem from the definition of the term provided in art. 3(1)(a) of the OECD Model Convention and its Commentary. However this is not enough. In fact, according to the wording of the provision of the treaty, an investment fund has also to be considered as a resident for treaty purposes.

As a consequence, our attention is paid to the meaning of “liable to tax”. The supported line of reasoning is that such meaning implies a “potential taxation”. On this ground, a distinction has to be made depending on how such fund is treated for tax purposes. In fact, when the fund is assessed as a separate taxable entity, it is the author’s opinion that it has to be considered as a resident for treaty purposes (notwithstanding the fact that it may also be a tax-exempt entity), whereas, if the fund is evaluated as a transparent entity, the issues to be solved, in order to consider it as a resident for treaty purposes, are of a different nature (i.e. an entity that is disregarded for tax purposes can never become potentially liable to tax); however, after an analysis of the OECD Commentary combined with the characteristics of the fund as a transparent entity, we believe that entitlement to treaty benefits of such figure (i.e. as resident for treaty purposes) would constitute a great step forward in the elimination of double taxation cases stemming from such issue, even though it may appear that such an inclusion goes beyond the mere technical meaning of the wording of art. 4 of the OECD Model Convention.

Another question arising when analyzing the treaty entitlement to investment funds is whether we can consider the fund as the “beneficial owner” of the income received. The term, nevertheless is defined neither in the Model Convention nor in its Commentary. As a result, such investigation stems from the scope and purpose that led to the introduction of such term in the Model Convention of 1977.

For the scope of the present paper, it is essential to investigate whether an item of income may be assessed as “paid to” an investment fund. In such case, a comparison between the solution stemming from the application of the “lex fori” of the state applying the Convention and the solution provided for in the Partnership Report is made.

In light of the application of the Report is important to mention that, while apparently they may overlap, the concepts of “paid to” and “beneficial owner” are separate and distinct. In fact, while the concept of “paid to” shows that a connection between the income and the taxpayer is needed in order for such income to be considered as paid to, the concept of beneficial owner as included in articles 10, 11 and 12 of the OECD Model Convention pursue another goal; accordingly, to prevent the misuse of tax treaties (i.e. treaty shopping⁴).

Thus, under a chronological aspect, it first has to be investigated whether an item of income is correctly paid to a taxpayer, and, only after having that for granted, the question of whether such recipient is also the beneficial owner of the income may be posed.

Thereafter the perspective of the state of source, the issues regarding both the state of residence of the investment fund and the state of residence of the unit holders of such fund are fully addressed. In particular, the problems of the relief for the taxes paid in the state of source (to be credited to the fund

⁴ The attempt of being granted treaty benefits otherwise not available.

against its liabilities in its residence state) and the credit to be granted at the investors level for the taxes paid at the fund level are analyzed.

Furthermore, in case of distribution of income from a fund, organized as a corporation, to its participants-investors, the concerns stemming from the re-characterization and thus the taxation imposed on such income at the fund level, are investigated.

Finally, the last chapter is devoted to the author's conclusions with respect to the recommended application of tax treaties to investment funds in the light of the findings achieved in this paper.

Chapter 2

The Definition Of Investment Fund

2.1. DEFINITION AND FEATURES OF AN INVESTMENT FUND

“Investment fund” is a generic term used to refer to a wide range of vehicles used for investment purposes. This unspecific definition arises from two main reasons:

- *The several meanings given to the term;*
- *The doctrine's and legislation's constant development of criteria that must be met in order for an investment fund to be eligible to benefit from the relevant domestic and treaty provisions.*

Nowadays, however, investment funds are considered as financial intermediaries⁵ that collect money from participants-investors and reinvest the money in diversified portfolio investments.

Acting as an intermediary between the individual (or corporate) investors and the ultimate users of the capital, investment funds can take the form of several types and include many features that are inevitably to be analyzed in order to show the purpose of this paper.

Investment funds are generally classified by their investment objective and by administrative policy. Within the first group fall the so called “Equity funds, Bond funds and Hedge funds” whose specific characteristics will be discussed in the next paragraphs. Within the second group fall the so called “Open-end funds, Close-end funds and Umbrella funds”.

One of the most important features of investment funds is that they facilitate the pooling of money from small investors that the fund reinvest in financial assets. In return, of this investment, the shareholders are paid income and capital gains produced by the fund and managed by a professional fund manager.

From the investor's point of view it can be more advantageous to invest through an investment fund as compared to a direct investment.

The most important advantage is considered to be the “risk-spreading” reached by the diversification of investments made by the fund. Investment funds also incur in lower trading commissions that can result in a better investment performance, these are called “economies of scale”.

In addition investment funds are generally administered by managers whose professional skills are used in choosing the investment portfolio and whose compensation is linked to the performance of the fund.

Additional features worthy to be mentioned are: i) the fact that the funds are subject to the strict control of the public authorities (rules and regulations are issued to protect investors from specific risks; and these rules and regulations may also include minimum standards to be observed by the fund's activity

⁵ This definition leads to the basic distinction between direct and indirect investments, the former are the ones made without an intermediary whereas the latter are the ones made by financial intermediaries such as investment funds.

and structure) and ii) the benefits for the economy of the country that gives the possibility to the funds to invest in public sectors.

Finally, another important characteristic of investment funds is “liquidity”, meaning that they can be purchased and sold with no price impact. The same may not be said about individual stocks or bonds.

2.2. FORMS OF INVESTMENT FUNDS

As previously mentioned there are several forms of investment funds; in particular they may be divided into two main groups and within each group there are different types.

The analysis will start with the main distinction between the objective of an investment fund and the administrative policy to which an investment fund is subject.

Within the first group, the author starts analyzing the second most popular fund type, that is, the Equity fund.

This type of fund invests the majority of its assets in shares of companies. Among equity funds there are different categories, each of them having differences regarding risks and return (distinctions can be made geographically among global, country and regional funds).

The income earned by an equity fund encompasses flowing dividend periodically to the fund (for the classification of investment fund distributions refer to para. 4.3.2.2.) and realized and unrealized capital gains⁶.

The so called bond funds are included in the same group.

Bond funds are the most popular fund type; they usually invest their money in long-term fixed-income securities⁷. Generally, fixed-interest securities are issued by the governments, international organizations or large companies⁸.

The income earned by these funds is mainly composed by both the periodic interest payment received by the fund for the security's investment (coupon yield), and by any hypothetic capital gain that can be realized upon sale of the securities.

The last type of fund analyzed for the purpose of this paper is the hedge fund.

Hedge funds are generally considered to be highly risky funds⁹ which aim to give a positive return using particular financial instruments irrespective of any specific market situations. It is worth to underline that Italy is the only country that has a specific legislation on hedge funds in the European Union.

⁶ Vitala Tomi, *Taxation of Investment Funds in the European Union* (Amsterdam: International Bureau of Fiscal Documentation, 2005), pp. 20.

⁷They are called fixed-income securities because the rate of interest does not change at regular intervals.

⁸ The author points out that within this group are included the “junk bond funds”, funds specialized in bonds that bear high credit risk.

⁹ The opposite opinion and the reasons behind it, which the author supports, will be analyzed in para. 2.3.2.

Recently, due to the “UCITS III” Directive , hedge funds have enormously increased their popularity. The second group classification includes the open-end fund, the closed-end fund and the umbrella fund.

Open-end fund are the most common type of investment fund; the term refers to the possibility given by the fund to its investors to continually buy or sell its units. However, the issuance of the units may be restricted to a certain period of time, as well as the possibility to redeem units on request may be an obligation¹⁰.

Opposite to the open-end fund are the closed-end funds, which have a fixed share capital and are not obliged to redeem units at the investor’s request.

These type of funds have several similarities with a publicly listed company as both have their shares traded on a stock exchange. As a result they tend to be more volatile then the open-end funds.

The last types of investment funds analyzed for the purpose of this paper are the so called “umbrella funds”. This category of funds adopts a multi-level structure in the sense that the fund may be composed of two or dozens of sub-funds so that, under the same vehicle, several different objects and policies may be offered to the participant-investors¹¹.

This structure gives the investors the possibility of switching from one sub-fund to another at lower costs than those that would be imposed in switching to the units of a completely different fund vehicle.

Each sub-fund is treated independently for the purposes of calculating income, losses and expenses. Therefore, each investor participates only in the financial result of the fund in which he holds the units.

2.3. THE ACTIVITY OF AN INVESTMENT FUND

Generally speaking, an investment fund reveals its nature by holding assets for the purpose of receiving income. The income so derived is called “passive income¹²”, that is, the income generated from the purchase, sale and holding of stock and securities¹³.

In order to reach a better understanding of the subject of this paper, the author believes that a simplified structure of an investment fund should be analyzed. The framework of an investment fund is generally composed of different parties with different functions.

There is a management company that collects the money from investors, puts it into the investment fund and invests further. The management company may administer several different investment funds, it acts in its name on behalf of the investors and the activity of the management company is strictly regulated.

¹⁰ See *supra* note 2

¹¹ See *supra* note 3

¹² Stefano Grilli, “Treaty entitlement of investment fund” , *Diritto e pratica tributaria internazionale*. - Padova. - Vol. IV (2004), no. 3 ; p. 863-948.

¹³ On this ground an investment fund should not be confused with the so called “private equity fund” that are only companies located in jurisdictions with a compliant corporate law that allows them to collect money and invest it in targets without being subject to the control of the competent financial authorities.

Each investment fund is generally administered by a fund manager, hired by the management company, to whom the responsibility of selecting the investments is given. The fund manager is chosen for his professional skills and is subject to specific rules and regulations in order to avoid any possible conflict of interest¹⁴. His duty is to invest the assets in the most profitable way without exceeding the given risk level.

A depository will be entrusted with the assets of the investment fund. The role of the depository is to exercise control over the assets and protect the participants-investors of the fund.

The investment fund encompasses all the assets purchased with the investors' money (collected by the management company); generally, the participants-investors receive units of the fund, each unit representing the participation of the investor in the total asset.

The fund may have different legal structures:

- *It may have the legal structure of a trust and so being regulated by common law principles.*
- *It may either have the corporate form, under which the investors act as shareholders, or it may have a contractual scheme, under which the fund is co-owned by the unit-holders.*

2.4. REGULATION OF INVESTMENT FUND IN THE EUROPEAN UNION

2.4.1. The UCITS Directive

One of the goals of the European Union is to design an internal market with the characteristics of free movement of persons, goods and capital. As a consequence, a single financial market is assessed to be the best part of an internal market.

The first step taken towards the establishment of a single financial market were the provisions included in the EC Treaty, specifically: i) article 43 that provides the freedom of the right of establishment; ii) article 49 that provides the freedom to supply cross-border services within the European Union; and iii) article 56¹⁵ that provides the free movement of capital.

So far, however, regardless of the direct applicability of the fundamental freedoms, the single financial market is still a dream to be sought, and many authors agreed that an important support to this goal may be given by the harmonization of the national tax law of the European Member countries.

The reasons behind this lack of harmonization are of different nature, but most of them can be identified in the different approaches that countries adopt in regulating investment funds. An example may be clarifying. Broadly speaking, the "genus" of the problems are two: at one extreme there are countries that adopt a specific legislation for investment funds that regulates the legal form of the fund, the rights of the investors and the obligations of the fund managers. At the other extreme, some countries leave to the funds the opportunity of choosing their legal form and the terms under which the

¹⁴ For the purpose of this paper an investment fund does not aim to interfere on the management of the investee company.

¹⁵ The old articles (67-73°) were renumbered by the Amsterdam Treaty that entered into effect on May 1999.

relation with their investors is established. Other issues may arise from the residence of the investment funds, their capital structure, and the information made available to the participants-investors. Finally, in 1985 the Council Directive number 611 on the coordination of law, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (commonly known as “UCITS Directive”) was enacted.

As previously mentioned, the UCITS Directive represents the first step toward the creation of a single financial market. It is worth to mention that the UCITS directive has been amended by other two amending directives adopted in 2001¹⁶.

Article 1 of the Directive contains the definition of UCITS as:

- *“an undertaking the sole object of which is the collective investment in transferable securities and/or in other liquid financial assets¹⁷, of capital raised from the public which operates on the principle of risk-spreading and the units of which are at the request of the holders repurchased or redeemed directly or indirectly out of the undertaking’s assets¹⁸”.*

The Directive also lays down common basic rules for structuring an investment fund, regarding the obligations of the management company and depositaries, in order to render more efficient the protection of the fund investors, but also to facilitate cross-border distributions of units of investment funds across different Member States, thereby contributing to the creation of a single financial market. For this purpose each Member State must apply the Directive to investment funds. It is also important to say that the protection given by the Directive is the minimum level of protection required, but each Member State is free to enact its stricter rules.

The Directive also includes two important principles, respectively, the “one-license principle” and the “mutual recognition principle”, whereby, an undertaking¹⁹ for collective investment in transferable securities²⁰ (hereinafter the UCITS) that is authorized and is under the supervision of one Member State, may market its units in another Member State without the duty of applying for the authorization in the hosting country either by establishing a subsidiary or by engaging in cross-border provisions of services (“mutual recognition principle”). It is important to mention that the establishment of an investment fund in the host state is forbidden by article 3 of the Directive, according to which:

¹⁶ Directive 2001/108/EC, known as the “Product Directive”, and Directive 2001/107/EC, known as “Management Company and Prospectus Directive” will be analyzed by the author in the next paragraph stressing in particular the new relation between investment funds and hedge funds according to the amending directives.

¹⁷ Liquid financial assets are generally considered as: deposits with credit institutions, units of investment funds, financial derivative instruments and money market instruments. See art 19 (e-h) of the Directive 85/611/EEC.

¹⁸ See article 1(2) of the Directive 1985/611/EEC.

¹⁹ For the purpose of the paper an undertaking for collective investment may be constituted by contractual law, statute or trust law.

²⁰ The term was not defined in the original Directive, however, the definition was subsequently included in the amended UCITS Directive.

- *“an investment fund is deemed to be situated in the Member State in which the management company has its registered and head office²¹”.*

Nonetheless, as pointed out in article 49 of the EC Treaty, concerning the rules not governed by the Directive, the UCITS have to comply with the rules of the hosting country applied taking into account the non-discrimination²² principle.

Arts. 2(1) and 1(4) of the Directive identify different types of collective investment undertakings, which are outside the scope of this Directive:

- *UCITS of the closed-end type;*
- *UCITS which raise capital without promoting the sale of their units to the public within the Community or any part of it. The scope of the term "promoting" is not confined to advertising, but includes all types of promotional activities aimed at raising capital, such as direct selling;*
- *UCITS whose units, under the fund rules or the investment company's instruments of incorporation, may be sold only to the public in non-member countries;*
- *investment companies whose assets are invested through subsidiary companies essentially other than in transferable securities (Art. 1(4) of the Directive); and*
- *UCITS categories, prescribed by the regulations of the Member States, for which the rules laid down in Sec. V and Art. 36 of the Directive are inappropriate in view of their investment and borrowing policies.*

Finally, according to art 1(3) of the Directive, the investment fund may have different legal structures, (trust, company or contractual scheme). However, it seems that the form is not considered determinative. In spite of the mentioned provision, it is the author's opinion that the legal framework of the investment fund will become critical when the discussion regarding the possible inclusion of the investment fund in the term "person" provided for in art 3(1)(a) of the OECD Model Convention takes place²³.

2.4.2. The UCITS III Directive and Hedge Funds

2.4.2.1. The Product Directive

Currently the UCITS regulations do not cover specifically hedge funds. However, the two amending directives²⁴ effectively reduced the discrepancies between investment funds and hedge funds. Before analyzing in depth the two amending directives, it is worth to mention the general highlighted differences between UCITS I and UCITS III.

²¹ See art. 3 of the Directive 1985/611/EEC.

²² The prohibition of discrimination is included in the right to the fundamental freedoms regulated by the EC Treaty. Vitala Tomi, *Taxation of Investment Funds in the European Union* (Amsterdam: International Bureau of Fiscal Documentation, 2005) chapter 7.

²³ See paragraph 4.2.1.1.

²⁴ See note 12.

The UCITS III directive extended the list of products an investment fund is permitted to invest in, by including money market instruments, cash deposits and financial deposit in addition to transferable securities. It also introduced the requirements of a simplified prospectus, finally extended the scope of the permitted activities of the management companies, imposed capital and qualification requirements and introduced the “EU Passport” for management companies.

We shall now analyze the two main directives that composed the UCITS III Directive, named the “Product Directive” and the “Management Company Directive”.

The most important change that the Product Directive introduced is that it extends the range of instruments in which a UCITS can invest; accordingly, a UCITS is now allowed to have mixed investments and to invest in any combination of permitted investments²⁵.

It also, for the first time, gives a definition of transferable securities in article 1(8), stating that the term includes:

- *Shares in companies and other securities equivalent to shares in companies (shares);*
- *Bonds and other forms of securitized debts (debt securities);*
- *Any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange;*

Two other significant developments are worth mentioning. The first one is the fact that a UCITS may now be established as a fund of funds²⁶ and, the second one is the obstacle for a UCITS to set up a subsidiary in a non-EU Member State.

2.4.2.2. The Management Company Directive

The second main directive composing the UCITS III Directive brought important changes in the management company of an investment fund. The Directive introduced the new criterion of “service provider based authorization²⁷”, extended the scope of permissible activities, introduced the “EU Passport” and, more important, presented the new concept of “simplified prospectus”.

In addition there is a prohibition of investing all or part of the investor’s portfolio in funds that the management company manages without the approval of the clients. Moreover, specific conditions are provided for taking up business such as: i) minimum capital requirements, ii) a guarantee by a credit institution or an insurance undertaking in case of additional capital is requested when the amount of the portfolios under management exceed a precise threshold and iii) the honorability requirements, such as experience and good reputation for the business managers.

²⁵ This includes: other collective investment schemes, money market instrument, index tracker funds and financial derivatives; in particular, the latter one are not anymore investment done solely for the purpose of efficient portfolio management or for hedging against exchange rate risks.

²⁶ Previously a UCITS was allowed to invest only up to 5% of its assets in other categories of fund.

²⁷ Before the implementation of the relevant legislation the authorization was “product based”.

Finally, delegation of certain management functions to third parties will be allowed only in the case that such an arrangement will not prevent the effectiveness of supervision, where the investor's interests are not jeopardized and where the third party is actually subject to a prudent supervision²⁸.

²⁸ In cases where the delegated third party is in another country, an efficient co-operation must be foreseen.

Chapter 3

Presentation of Models for Taxing Investment Funds

3.1. INTRODUCTION

For the purpose of this paper, a presentation of three different models in taxing investment funds and an introduction to the system of “offshore jurisdictions”, will be made. Accordingly, the analysis will start by describing the major forms of investment funds in each one of the models, followed by the taxation of the vehicles as regulated by the law of each particular jurisdiction.

3.2. ITALY

The Italian legislation of investment funds was enacted in 1983. However, it was not until 1993²⁹ that this topic was reviewed³⁰ in depth.

Investment funds are divided into “domestic investment vehicles” and “foreign investment vehicles”.

Within the first group are the “*open-end investment funds*”³¹ and the “*closed –end vehicles*”

The common funds management company is the most commonly used open-end investment vehicle; is defined as:

- *a pool of assets without legal personality and jointly owned by the investors*³²;

Two particular features of the common fund management company are: i) the fact that the units of the fund are redeemable at the request of the investors and, ii) the assets of the management company are separated from the assets of the fund.

Alike the above mentioned investment vehicle is the so called “SICAV”, introduced in Italy after the implementation of the UCITS Directive.

SICAVs generally take the form of a joint-stock company, with the difference of having its capital linked to the subscriptions and redemptions of the investors and, as a consequence, not fixed.

This exception, together with the extreme restrictive nature of its regulations, has played an important role in developing a sense of distrust in such a vehicle.

The second important category of investment vehicles are the “*closed-end investment funds*”;

²⁹ In the same year closed-end common funds were regulated.

³⁰ International Bureau of Fiscal Documentation. A Report on direct and indirect taxation in Italy (Amsterdam: IBFD, 2005).

³¹ Open-end investment vehicles include both the so called “Common funds management company” and the “SICAV”.

³² For the given definition refer to art. 3 of Law 77/1983.

They were introduced in the Italian legislation by the Law 344/1993 and the only regulated type of domestic vehicle is the common funds management company. The only difference between an open-end fund and a closed-end fund is that the units of the latter one may be redeemed only at fixed dates. The second group is composed of foreign investment vehicles allowed to market in Italy as long as they comply with the regulation enacted for the control of the activities of a foreign investment fund. The purpose of the control is to distinguish between the vehicles that qualify as UCITS and the foreign investment funds that lack this qualification.

Concerning the taxation system an investment vehicle is subject to in Italy, it should be noted that all open-end investment funds are subject to the same regime, irrespective of whether they qualify as UCIs or not. The goal to be achieved through this policy was a substantial tax neutrality between indirect and direct investment by assessing domestic vehicles as transparent entities, and, as a consequence, taxing directly the income in the hands of the investors. However, being Italy the country of uncertainty, it has been decided to set up a special tax regime, that clearly does not achieve tax neutrality, where:

- *the vehicles are not subject to income taxes, but are not considered transparent entities for tax purposes;*
- *withholding taxes deducted from income paid to the funds are not recoverable and considered to be a final tax liability;*
- *domestic vehicles are subject to a substitute tax to be applied on the result accrued at year-end³³;*
- *taxpayers not acting in the course of a business are exempted from tax on the profits derived from the fund;*
- *taxpayers acting in the course of a business must include in their taxable income the profits derived from the fund, however they are entitled to a tax credit if the investment vehicle is related to the business activity. A tax credit is also granted to corporate taxpayers.*

A 12,5% substitute tax rate applies to the result from the management activity accrued at the year-end; the result is obtained by subtracting the net asset value at the beginning of the year from the net asset value at the year-end. In case of negative result, the loss may either be carried forward or used, only for open-end funds, to offset a positive result of other funds managed by the same company.

Regarding foreign investment vehicles, they are regulated by art 10-ter of the Law 77/1983.

It is important to say that the only foreign vehicles governed by the law are the “open-end investment vehicles authorized to market their shares in Italy before February 1992”.

The tax regime applicable to these funds is essentially the same as the one that applies to domestic open-end vehicles³⁴.

For other foreign investment funds, in the silence of the law, reference should be made to the general provisions of Italian Tax Law. As consequence, these funds are subject to the Italian income tax only if they derive “Italian-source” income that is not subject to substitute or withholding taxes.

³³ It is worth to mention that nowadays is under discussion the possibility of applying the general rate (27% instead of 12,5%) also to income generated by investment vehicles.

³⁴ They are not liable to income taxes and the withholding taxes paid cannot be recovered.

For the sake of completeness it is now important to analyze the different taxation regimes of resident investors investing through domestic and foreign vehicles, as well as the taxation of non-resident investors investing through domestic vehicles.

Resident individual investors, investing through domestic vehicles are exempted from taxes and no withholding tax applies as long as the profits are not realized in the course of a business; in the case of distribution of income from the fund to the resident investors, the income is fully exempted from taxes in the hands of the latter³⁵; in case of income generated by redemption or disposal of the units of the fund, it may be classified as capital or as miscellaneous. If the income is considered capital it is not taxable in the hand of the investors since it has already been taxed at the fund level; whereas, if the income is assessed as miscellaneous, it is subject to tax at the substitute rate of 12,5%.

Resident companies' investors deriving income from the participation in a domestic vehicle, are exempted from withholding taxes. However, they are required to include the full amount of income in their taxable income of the year for corporate tax purposes. The investors are entitled to a flat tax credit for taxes paid by the fund on the income distributed to the investors.

In case of distribution of income, irrespective of the form of the distributing fund, the full amount distributed must be included in the taxable income of the year for corporate income tax purposes³⁶.

Finally, income from the sale or redemption of units of a domestic vehicle is fully subject to corporate income tax; however, investors are entitled to a 15% credit on the capital gain that is subject to tax at the fund level.

Let's now turn to the hypothesis of resident individual investors investing through foreign vehicles.

As mentioned in the previous chapter a distinction has to be made between a distribution of income to a resident individual: i) from an open-end fund authorized to market its shares in Italy prior to February 1992, ii) from a vehicle qualified as such under the UCITS Directive and, iii) from a vehicle that does not qualify under the UCITS Directive³⁷.

In the first case, the income distributed are fully tax exempt, as well as gains on the redemption or disposal of the units; in the case of funds qualifying under the Directive, the income distributed is subject to the substitute tax rate of 12,5%, as the gains from the disposal or redemption of the units of the fund; in the last case, the entire amount of the income distributed from the fund, including gains on the redemptions or disposal of the units, must be included in the aggregate income subject to tax at progressive rates³⁸.

In the case of resident companies' investors, the amount derived from the distribution from open-end funds authorized to market their shares in Italy prior to February 1992³⁹ or of the distribution made by other foreign investment vehicles⁴⁰ must be included in the taxable base for corporate tax purposes.

³⁵ However, the income is taxed at the substitute rate when generated at the fund level.

³⁶ However, investors are entitled to a tax credit of 15% of the gross amount of the profits received. If the credit exceeds the amount of tax due, the excess may be carried forward or refunded.

³⁷ However, this type of vehicles may also be authorized to market their shares in Italy, case in which, at the moment of distribution, the bank entrusted will withhold a 12,5% tax at source.

³⁸ Income taxes eventually paid on the same income, but in foreign jurisdictions, are creditable.

³⁹ In this case nevertheless the investor is also entitled to a credit of 15%.

The same should be said in case of profits from the redemption or disposition of the quotas in an open-end fund authorized to market its shares in Italy prior to February 1992⁴¹; in case of profits realized with the redemption of units of a foreign vehicle, not authorized to market its shares in Italy prior to February 1992, the corporate tax rate will apply⁴².

The last hypothesis to be analyzed is that of a non-resident investor investing through domestic vehicles. In this case non-resident investors may be taxed only on Italian-source income if a permanent establishment is present in Italy. Otherwise such income is exempted from any Italian tax.

In the case of distribution of income from an Italian vehicle to non-resident investors the income is fully exempted from taxes, as well as income from the disposal or redemption of quotas in domestic vehicles.

3.3. LUXEMBOURG

The legislation regulating investment vehicles in Luxembourg was enacted in 1988, implementing the EU Directive 611/1985 (the so called UCITS I)⁴³.

Part I of the 1988 law regulates funds which qualify under the UCITS I Directive and therefore are freely marketable in other Member States; Part II regulates UCITs and UCITS which do not qualify under the Directives and, as a consequence, are not freely marketable within the European Union; Part III regulates foreign funds marketed in or from Luxembourg.

Two new European Directives (together commonly known as "UCITS III"⁴⁴) came into force in 2002; Luxembourg law implementing UCITS III was approved at the end of the same year, making Luxembourg the first EU Member State to implement the EU Directive into domestic law.

Nowadays Luxembourg is in a transitional period that started with the approval of the domestic law implementing UCITS III Directive and shall end in 2007, when the 1988 Law will cease to be effect.

It is now important to briefly examine the major forms of investment vehicles in Luxembourg.

According to both 1988 and 2002 laws, investment funds may be formed either under statute or under contractual law:

- *Investment funds formed under statute can be SICAVs, which are variable capital investment companies that issues capitalization or distribution shares and adopt the form of a public limited company, or SICAFs, which, in contrast to SICAVs, are investment companies that have the capital fixed in advance;*

⁴⁰ Eventual income taxes paid in foreign jurisdictions on the same income are fully creditable to offset the Italian corporate income tax.

⁴¹ The investor is also entitled to a credit of 15% for the part of the income subject to tax at the fund level.

⁴² However, taxes paid in foreign jurisdictions on the gains are fully creditable against the Italian corporate income tax.

⁴³ International Bureau of Fiscal Documentation. A Report on the direct and indirect Taxation in Luxembourg (Amsterdam: IBFD, 2005).

⁴⁴ The features of the UCITS III Directive have been widely discussed in Chapter 2 paragraph 2.4.2.

- *Investment funds formed under contractual law can be Collective investment funds or FCPs⁴⁵, defined as an undivided collection of transferable securities and other financial assets, managed on behalf on joint owners who are liable just for the contributions made to the fund and whose rights are represented by units issued by the fund.*

It is now time to begin the analysis of the taxation of investment vehicles.

Domestic vehicles, such as SICAVs and FCPs, are not subject to any income or profit taxes.

Therefore they are not entitled to any domestic or foreign tax credit, since the condition for a credit to be granted is that such credit is to be offset only against income tax⁴⁶.

For this type of funds the above mentioned tax regime is the same either if the fund distributes or if it accumulates its income.

Foreign investment vehicles are not subject to corporate income tax in Luxembourg, provided that they do not have a permanent establishment in Luxembourg⁴⁷. By contrast, where the fund has a permanent establishment in Luxembourg or such fund is deemed to be resident in Luxembourg for tax purposes, the ordinary corporate income tax will apply.

It is also important to note, in this context, that a withholding tax of 20%⁴⁸ is to be applied in case of dividends and interests paid by a Luxembourg entity to non-resident beneficiaries.

As previously discussed in the Italian model presentation, it is now essential to investigate the taxation of Luxembourg resident investors and, by contrast, the taxation of non-resident investors.

Individual resident investors investing through SICAVs are not subject to any withholding tax on the dividends paid by the fund; however, the dividends are directly taxed in the hands of the investors, who are not entitled to any underlying tax credit.

Whereas, in case of individual resident investors investing through FCPs, the legislation is ambiguous due to the position of fiscally transparent entities adopted by this type of funds.

What is clear is that also in this case no withholding tax is applied on the income distributed by the FCPs. However, the main consequence of the transparency regime (i.e. the tax burden of the investors should not suffer any consequences) is not a result that can be taken for granted.

In fact two problems may arise:

- *The FCP is subject to a marginal taxation (annual subscription tax fee);*
- *May the unit holders claim the benefits of a Tax Treaty from foreign investment of the FCP?!*

In case of capital gains realized upon the disposal or redemption of the shares of a SICAV, no tax is due if the shares were held for at least 6 months⁴⁹. By contrast, if the minimum holding period is not satisfied the gain is subject to the individual's marginal rate.

⁴⁵ Fonds Communs de placement may either be capitalization or distribution FCPs.

⁴⁶ But this does not mean that such funds may not qualify for treaty benefits.

⁴⁷ The existence of a permanent establishment will be assessed on a case by case approach.

⁴⁸ The amount of the withholding tax may be reduced under a treaty.

⁴⁹ Substantial participations are subject to tax even if held for more than 6 months.

In case of gains from the redemption or disposal of shares of a FCP, due to the transparency regime that makes the income being taxed directly in the hands of the investors as it arises, no further taxation is imposed.

In the case of corporate resident investors, the income distributed by a SICAV is not subject to any withholding tax. However, corporate investors are subject to the ordinary corporate tax rate upon distribution⁵⁰. The same regime applies to distributions made by FCP funds.

Gains on disposal or redemption from SICAV's shares are subject to the ordinary corporate tax rate and the "PEX" does not apply. On gains on FCP's units no further taxation is imposed⁵¹.

Both Individual and corporate⁵² resident investors investing through foreign SICAVs or FCPs are treated in the same way as the ones investing in domestic vehicles.

Non-resident investors receiving income from a SICAV or a FCP are not subject to any withholding tax, unless they have a permanent establishment in Luxembourg to which the assets producing the income are related.

Gains from the disposal or redemption of the units of either a SICAV or a FCP are not subject to any Luxembourg tax where the condition of the minimum holding period (i.e. 6 months) is satisfied.

After having analyzed the major forms of investment funds, attention should be paid to a new type of fund now introduced by a law of 2004 and commonly known as SICAR, which represents an alternative to the classic vehicles investing in private equity and venture capital funds⁵³.

SICARs are designed for sophisticated investors, not only institutional and professional investors, but also private individuals having specific requirements; in addition their shares may, in principle, be fixed or variable. These funds do not benefit from a general income tax exemption on revenues; however, a SICAR has the option to structure itself either as a tax transparent entity or as a taxable entity; its shares may, in principle, be fixed or variable.

When a SICAR is incorporated as a company it is subject to corporate income tax in Luxembourg and, in this respect, it should be noted that it may be able to claim treaty protection⁵⁴. Revenues and gains received from securities investments are tax exempt and no withholding tax on distributions to resident and non-resident investors is to be applied.

When a SICAR is incorporated as a transparent entity no corporate income tax is imposed at the entity level; in addition, regarding the possibility of claiming treaty benefits, it should be borne in mind that this possibility is subject to the acceptance of the transparent status by the source country⁵⁵. At the

⁵⁰ The participation exemption regime does not apply in any case.

⁵¹ Taxes have already been imposed when they arose in the hands of the participants.

⁵² It is important to mention that the PEX regime may apply to dividends paid to certain types of foreign funds.

⁵³ For a deep analysis of the subject see: Claude Kremer and Thierry Lesage, "Investment company in risk capital (SICAR): response to venture capital and private equity", IBFD Bulletin (2005).

⁵⁴ On the opposite, due to their subjective exemption regime, UCIs are not automatically considered as Luxembourg resident for purposes of income tax treaties.

⁵⁵ For Luxembourg source income or gains, Luxembourg will grant treaty benefits to investors in a transparent SICAR who are resident in a treaty country.

investor level, taxation may be levied if a permanent establishment is assessed to be present in Luxembourg. However, according to a Parliamentary document⁵⁶, SICARs that elect to be fiscally transparent shall not be regarded as business undertakings, assuring in this way that non resident-investors will not become taxable in Luxembourg only because of their investment in a SICAR.

3.4. SWITZERLAND

In 1995 the Swiss Federal Law governing investment funds (Investment Fund Act) came into force, replacing the former law of 1966 in order to put Switzerland in line with the requirements of the European Union. However, the 1995 Law has been implemented, due to the enactment of the UCITS III Directive, by a Law dated June 2006.

It must be said that in Switzerland, before the new legislation, investment funds were restricted from being incorporated under company law⁵⁷. However, due to the new legislation adopted, the types of Investment vehicles nowadays available have increased.

The new legislation introduced the basic distinction between open-end and closed-end investment funds. The first group includes SICAVs and the domestic vehicles already regulated by the 1995 Law; the second group includes SICAFs and a special vehicle available only to qualified investors such as governmental institutions, banks and private investors who can certify their experience in the field.

These new types were included in a more general reform developed in order to make the Swiss investment funds market more competitive versus the other European markets and in line with the new requirements issued by the UCITS III Directive.

What follows is a brief description of the taxation of investment vehicles (both domestic and foreign) from a Swiss perspective; in addition an analysis of the new vehicles introduced is provided at the end of this chapter.

Concerning domestic investment funds, it should be noted that these vehicles, incorporated under Swiss law, are fiscally transparent (with the only exception of real estate investment funds) and therefore are not liable to income taxes. The transparency regime is not jeopardized by the possibility of the fund accumulating or distributing the income, however the option of accumulating or distributing the income has an impact on the investor's level.

In fact, distributions made by a Swiss fund to its investors are generally subject to a withholding tax⁵⁸, where, on the other hand, the redemption of shares of a Swiss fund will not suffer any withholding tax.

In case of distributions to non-resident investors the rate of the withholding tax may be reduced according to a double tax treaty; in addition, non-resident investors that have an income the 80% of which is foreign-source income, may claim an exemption from the applicable withholding tax.

⁵⁶ Doc. Par. Num. 5201, Opinion of the Chamber of Commerce.

⁵⁷ International Bureau of Fiscal Documentation. A Report on direct and indirect taxation in Switzerland (Amsterdam: IBFD 2005).

⁵⁸ However, to the fund is given the possibility of splitting the distribution by using two different coupons; the distribution made out of the dividend account will be subject to the withholding tax, whereas the distribution made out of the capital gains account will be tax exempt.

Regarding foreign investment vehicles, a withholding tax is levied on dividends, bank interest and interest on bonds issued by Swiss debtors. Despite this the fund may claim relief for such taxes if a double tax treaty is available between Switzerland⁵⁹ and the country of residence of the foreign investors.

It is now time to examine the taxation of the investors as such and in this respect three different scenarios are presented.

The first scenario concerns a Swiss individual resident investor investing through domestic vehicles; at the time of distribution the income is taxable both at the federal and cantonal levels; withholding tax is levied on the total distribution or, if separate coupons are issued by the fund, the withholding tax applies only to the distribution made out of dividends/interests account. Due to its transparent status, income accumulated in the fund is treated as a deemed distribution of income and therefore taxable both at federal and cantonal levels.

Disposal of the fund's units is treated as a tax-free transaction both at federal and cantonal levels, provided that the shares are not held for business purposes; the same may be said in case of redemption of the shares by the fund at the federal level (where taxes are imposed only in case of liquidation of the fund) and cantonal level (that considers redemption, in any case, as tax free). In the same scenario we should analyze the taxation of a company resident investor investing through Swiss funds. When this happens the distribution is generally subject to tax both at federal and cantonal levels; nevertheless it should be borne in mind that if the company is entitled to the holding company privilege, it will not be subject to the cantonal taxes⁶⁰.

Disposal and redemption of the units of the fund by the company are subject to tax on the difference between the book value and the sale/redemption prices.

The second scenario regards with the taxation of resident investors (individual and corporate) investing through foreign vehicles; distributions to resident individuals are taxable both at the federal and cantonal levels⁶¹; disposal of the shares of a foreign fund, not characterized as a Swiss fund, is considered as tax-free capital gain at both levels if the shares are not held for business purposes; redemption of the fund units is taxed at both levels as a partial liquidation. Distributions to resident corporate investors are generally subject to income tax; however, if the company qualifies for the holding company regime it will be exempted from taxes at the cantonal level. The participation relief, however, is not applicable to distributions received from transparent investment funds that are not considered as foreign companies for Swiss tax purposes. Both disposal and redemption of the shares of the fund give rise to gains taxable at federal and cantonal level.

In the third and final scenario the author will examine the taxation of non-resident investors investing through a Swiss investment vehicle. In this case a withholding tax applies in case of distribution to

⁵⁹ On this respect it is important to bear in mind that issues may arise whether the foreign fund is considered as a taxable entity (in which case the fund itself will claim the refund) or as a transparent entity (in which case the investors themselves will have to claim the refund) in its country of residence.

⁶⁰ However, the participation relief is not applicable to investments in Swiss investment vehicles because of their transparent status.

⁶¹ It should not be forgotten that when a distribution is made out of two different coupons only the one made out of the dividends account will be taxable.

foreign investors⁶², however, as previously described, if at least 80% of the income is generated from foreign sources the withholding tax does not apply; the disposal of the shares of a domestic fund will give rise to no taxation, whereas in case of redemption of the shares a withholding tax will apply only in the case of accumulation fund's units.

It is important to say that the new legislation does not deal only with taxation aspects, but it is a complete reform of all the terms, requirements and conditions of such investment vehicles and investors; however, for the purposes of this paper, only the tax aspects of the regulations will be analyzed.

The major feature of the new legislation is the introduction of SICAVs and SICAFs as investing vehicles.

SICAVs are defined as variable capital investment companies that issue capitalization or distribution shares and adopt the form of a public limited company.

SICAFs, in contrast to SICAVs, are defined as investment companies with the capital fixed in advance.

However, the two vehicles are subject to a different taxation regime.

SICAVs are in fact subject to the same tax treatment as collective investment funds organized under contractual law; in the author's opinion it could not have been otherwise because, if not, the SICAV would be subject to company law and therefore taxed at the company level.

SICAFs, on the other hand, are subject both to corporate income tax⁶³, as companies, and to taxation at the moment of disposal or redemption of the fund's shares.

3.5. INTRODUCTION TO OFFSHORE JURISDICTIONS

Offshore jurisdictions have always played an essential role in the world of investment funds. This is mainly because either the fund itself or the participants-investors in the fund, are not subject to any taxation⁶⁴ in such jurisdictions⁶⁵.

The features of simple regulations, anonymity and no taxation have made these countries very attractive for purposes of tax planning and money laundering. However, during the past years, particular attention has been paid to such problems, leading to the publication of three important reports, namely the OECD Harmful Tax Competition, the EU Savings Directive and the Code of Conduct, all the three of them aiming at regulating offshore centres.

For the sake of completeness, the author will briefly describe the main features set in these reports.

The 1998 and 2000 OECD Reports begin by giving a definition of tax havens as jurisdictions with the following characteristics: i) no nominal taxation is provided in the domestic tax regime; ii) lack of transparency and, iii) no substantial exchange of information between tax authorities. In addition a list

⁶² The foreign investors may recover the withholding tax paid according to the applicable tax treaty.

⁶³ Also its investors are subject to taxation at the moment of distribution.

⁶⁴ No income taxes and no withholding taxes apply.

⁶⁵ International Bureau of Fiscal Documentation. A Report on Taxation of direct and indirect investment in offshore jurisdictions (Amsterdam: IBFD 2005).

of countries that carry on such practices was drafted. The first step taken was to give such jurisdictions the opportunity to end such practices. However, the majority of the tax havens made the implementation of their commitments⁶⁶ conditional upon a level playing field, including both OECD Member countries and non-OECD Member countries.

The second tax package which was developed in order to try regulating offshore jurisdictions includes the implementation of the EU Savings Directive and the Code of Conduct.

The EU Savings Directive is intended to:

- *enable savings income in the form of interest payments made in one member State to beneficial owners who are individuals resident in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State*⁶⁷.
- *The ultimate aim of bringing about effective taxation of interest payment in the beneficial owner's Member State of residence for tax purposes can be achieved through the exchange of information concerning interest payment between Member State*⁶⁸.

However, the Directive does not cover interest payments to corporate bodies and to non-EU resident individuals.

Finally the adoption of the Code of Conduct:

- *is needed in order to reduce the distortions in the single market, to prevent significant losses of tax revenue and to curb harmful tax measures*⁶⁹.

It is worth mentioning that once certain tax havens countries agree to adopt such Code (like Cayman Island and Jersey did) they are required to eliminate the practices perceived as discriminatory in line with the terms stated in the Code.

Nonetheless, the author believes that, despite all efforts made by the OECD, there are still several reasons, like the taxation at low rates, the principle of secrecy and the austerity of the legislation, which will keep offshore jurisdictions playing an essential role in the future of financial services markets.

⁶⁶ However, only some countries actually adopted the recommendations issued by the OECD. For further information about the specific countries see: 1998 OECD Harmful Tax Competition Report.

⁶⁷ Paragraph 9 of the Preamble of the Council Directive 2003/48/EC on Taxation of savings income in the form of interest payment.

⁶⁸ Paragraph 14 of the Preamble of the Council Directive 2003/48/EC on Taxation of savings income in the form of interest payment.

⁶⁹ As stated in the Preamble of the Resolution of the Council on the Code of Conduct for business taxation.

CHAPTER 4

Application of Tax Treaties to Investment Funds

4.1. GENERAL INTRODUCTION

Tax treaties entitlement of investment funds is an open-issue since a clear and undoubted solution has not yet been provided; in fact neither the OECD Model Convention, nor its Commentary addresses the issue. However, some countries, and in particular common-law countries, have updated their Treaties by including provisions that deal with these problems.

Before analyzing the specific treaty issues regarding the possible election of investment funds to treaty benefits, is worth to point out that this goal may be achieved either by granting access to the treaty benefits to the fund itself or by giving such access to the investors themselves.

Generally speaking, the issues relating to the grant of treaty benefits to collective investment vehicles, are: i) whether the vehicle is a person under the definition of art 3(1)(a) of the OECD Model Convention; ii) in the affirmative, we should consider if such person may be treated as a resident of the treaty country (and therefore “liable to tax”) iii) if, being a resident, it may be considered as the “beneficial owner” of the income; iv) and, if the income may be evaluated as “paid to” to such fund.

The author in the next pages will analyze these issues, and will also offer some suggestions bearing in mind that the aim of this paper is not to give an ultimate solution to the problem, but rather to contribute to the discussion.

4.2. DOES INVESTMENT FUNDS FALL WITHIN THE PERSONAL SCOPE OF A DTC?

Art. 1 of the OECD Model Convention reads as follow:

- *This Convention shall apply to persons who are residents of one or both of the Contracting States.*

In this respect, the term “person” is then defined by art. 3(1)(a) “ as including an individual, a company and any other body of persons⁷⁰. Partnerships and foundations are, according to the Commentary, also included in such definition.

While the term “individual” is clearly to be considered outside the scope of this paper, the term “company” is then defined in the same article but under sub-para (b) as “any body corporate or any entity that is treated as a body corporate for tax purposes⁷¹”.

⁷⁰ The OECD Model Commentary makes clear that in the term person shall be included also foundations and partnerships.

⁷¹ The Commentary defined “body corporate” as: “ any other taxable unit, although not incorporated, that is treated as a body corporate according to the tax law of the Contracting State in which it is organized.”

Having defined, for the purposes of the treaties, the terms persons, body of persons, companies and body corporate, our analysis should now move to investigate whether investment funds may fit in such definitions or not.

Accordingly, investment vehicles may not be considered as individuals, but may better be assimilated to companies or body of persons; however, in which definition investment funds fall in depends on the legal structure they have adopted under their domestic law.

As a consequence, it may be easily inferred that if an investment fund has, under its domestic law, the form of a corporation it definitely fits in the definition of “company⁷²” as laid down by the Model Convention⁷³. In addition, due to the wide definition of “body corporate” given in the Commentary, also an entity, “*although not incorporated*”, may fit in the above definition, and thus be treated as a company, provided that is treated as such for tax purposes.

We have seen, in the aforementioned cases, that the condition for qualifying as a person, under the sub-definition of company, is a matter of how the entity is treated in its country of establishment; if the entity is a company in its residence country, then it will be considered as a person within the meaning of the Convention; if the entity is not a company but is treated as such for tax purpose it may be included of the definition of body corporate according to the wording of para. 2 of the Commentary on art. 3.

So far, however, we have not reached a conclusion for investment funds not treated as corporations⁷⁴. The last solution that may be considered is whether such type of funds, in order to fall within the meaning of persons, may be included in the definition of “other bodies of person”.

This term is defined neither in the Model Convention nor in the Commentary, so in order to understand its proper meaning we should investigate the origin of such term.

In this respect a distinction between common-law jurisdictions and civil-law jurisdictions⁷⁵ is consistent to the scope pursued by this paper⁷⁶.

The author shares the opinion that was put forward by Stefano Grilli⁷⁷, according to which the problem stems from the different definition given to the term “body of persons”. *Common-law* countries defines a body of person as: “*any body politic, corporate or collegiate, and any company, fraternity, fellowship and society of persons whether corporate or non-corporate*”⁷⁸ and they hardly consider non-corporate entities as “body of persons”. But, it is commonly accepted that investment funds may constitute an “association of person”; not a “body of person” because they lack of independent identity (i.e. legal personality) from the participants-members. Accordingly, investment funds formed under a contractual

⁷² An example of corporate form of investment fund is the Luxembourg SICAV.

⁷³ Stefano Grilli, “Treaty entitlement of investment fund”, *Diritto e pratica tributaria internazionale*. - Padova. - Vol. IV (2004), no. 3 ; p. 863-948.

⁷⁴ This is the case of investment funds organized under contractual agreement.

⁷⁵ As will be demonstrate by the following thoughts, civil-law countries give a definition of the term that encompasses investment vehicle, whereas common-law jurisdictions are reluctant to stress their definition in order to include such vehicles in the term person.

⁷⁶ See *supra* note 74.

⁷⁷ See *supra* note 74.

⁷⁸ See T.A. 1988 Sec. 832(1).

agreement are considered as a pool of assets separate and independent from the ones of the management company and from the assets of the investors. Moreover such funds are totally independent having their own liabilities, duties and rights. In addition, it should be underlined that the Commentary to art 3, in its para. 2 specifies, for partnerships, that “*where it is not the case*⁷⁹ *(they have to be considered as persons) because they constitute other body of persons*”.

For the reasons expressed, the author believes that either common-law countries should update their treaty definitions in line with the development of this economic figure in a way that includes such funds, whereas, under the civil-law countries perspective, investment funds organized under contractual law are considered as totally separate bodies from their investors and, as a result, included in the definition of “body of persons.”

In order to reach this conclusion both para. 2 of the Commentary on art.3, which expressly mentions that the terms “*persons is to be used in a wide sense*”, and the General Report on the IFA Congress in 1997 according to which, if specific requirements are met, such funds are regarded as persons for treaty purposes⁸⁰ were essential. The author shares the view of the civil-law jurisdictions, though, even admitting that there are still many problems that need to be solved, he believes that the suggestions above examined may be useful to find a common solution to include unincorporated funds in the definition of persons as laid down in art. 3.

4.3. THE STATE OF SOURCE

4.3.1. Investment Fund in State R

The analysis of the taxation in the source State of the income represents, chronologically, the first event in the taxation of an investment fund investment.

In this respect, first the taxation of domestic vehicles and then the taxation of foreign vehicles will be assessed. In addition, the issues concerning: i) whether an investment fund is a “resident” for treaty purposes; ii) whether it may be considered as the “beneficial owner” of the income and, iii) whether the income is “paid to” the investment fund, are also investigated.

Where an investment fund is resident in the source state of the income, it will be subjected to the special tax rules provided for it by the domestic law and therefore no particular issues arise in this respect.

In the context of cross-border investments i.e. when the fund is resident in the source state and the investors in another state, issues may arise either from the fact that the residence state of the investors wants to exercise its right to tax the income received by the participants, and also because the source state where the income arose and was paid to non-residents⁸¹ wants to tax such income.

⁷⁹ In the sense that such entities are not assessed as separate taxable entities.

⁸⁰ Requirements are: i) the fund must be independent; ii) the assets should not be mixed; iii) the public must have real access to the shares of the fund; iv) the units and shares of the fund must be traded on a regular and wide base.

⁸¹ Generally the taxation of the source state is in the form of a withholding tax on the distribution of dividends/interest, whereas capital gains are taxed only in the residence state. In addition, the

Despite the fact that the conditions “liable to tax”, “paid to” and “beneficial ownership” concern the situation of an investment fund in the State of residence, however, it is logical to explore these conditions in the context of the State of source, so as their cumulative analysis will then allow to determine whether the State of source has to reduce its taxing rights.

4.3.1.1. Is an Investment Fund “liable to tax”?

As mentioned in the previous paragraphs, having agreed that an investment fund may be considered as a “person” for treaty purposes⁸², the second step toward the entitlement of investment funds to tax treaties is to check whether they may be assessed as a “resident” in the meaning of art. 4(1) of the Model Convention⁸³.

The problems concerning the interpretation of this article stems from the different definition that may be given to the term “liable to tax”⁸⁴.

Firstly being a “resident” of a Contracting State in the sense expressed by the Model Convention means that the person may have to be subject to world wide taxation in at least one of the two Contracting States;

However, issues arise in defining the term “liable to tax”. According to a wide interpretation, the term “liable to tax” would imply that a “*potential taxation*” would be sufficient in order to be eligible for treaty benefits.

By contrast, according to a narrower interpretation, the term “liable to tax” would imply that an “actual taxation” is the “condition sine qua non” for treaty entitlement.

The issue is not solved and the OECD remains in a neutral position, just stating that countries are free in their bilateral negotiations to address the issue as they prefer.

Besides analyzing the lead that brought different scholars to the two different opinions, the author believes, and shares in this the view of most scholars, that the term should be interpreted in a wide sense⁸⁵ bearing in mind the “objective and purpose of the Convention”.

withholding tax may be reduced in accordance with a treaty between the source state and the residence state of the investors.

⁸² Bearing in mind the particular case of Common-law jurisdictions that disagree on including in the term “body of persons” investment funds organized under contractual arrangements.

⁸³ Art. 4(1) OECD Model reads as follow: “ For the purpose of this Convention, the term “resident of a Contracting State” means any person who, under the law of that state, is liable to tax therein by reason of his domicile, residence, place of effective management or any other criterion of similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect of income from sources in that State or capital situated therein.”

⁸⁴ Stefano Grilli, “Treaty entitlement of investment fund” , *Diritto e pratica tributaria internazionale*. - Padova. - Vol. IV (2004), no. 3 ; p. 863-948 and Vitala Tomi, *Taxation of Investment Funds in the European Union* (Amsterdam: International Bureau of Fiscal Documentation, 2005), pp. 220.

⁸⁵ So as to imply that a potential liability to tax would be sufficient.

To support the wide interpretation, we wish to mention that also according to the 1996 US Model Technical Explanation to art. 4(1), the term “liable to tax” *does not require actual taxation*. In spite of this, neither the Model Convention, nor the Commentary, deal with the specific issue of residence related to investment funds.

In this respect we would say that whether an investment fund is to be considered as a resident of a Contracting State for treaty purpose, depends on the tax treatment to which such fund is subjected to in its country of residence.

Investment funds treated and taxed as separate taxable entities without doubt satisfy the requirements of residence and thus are eligible for treaty benefits.

On the other hand, issues arise both in the case of tax-exempt entities and transparent entities. In the former case, the issues arise from the fact that there may be entities that are tax-exempt due to the fulfillment of requirements set up by the law of the residence State, and entities that are in any case assessed as tax-exempt entities⁸⁶. The general opinion, in this respect, is that entities that satisfy the requirements of the domestic law in order to be considered as tax-exempt are thus evaluated as resident of the same State for treaty purpose; whereas entities that are by law assessed as always tax-exempt are not resident for treaty purpose⁸⁷.

Despite of the general opinion we wish to point out that: Whether a tax-exempt entity is to be considered as resident for treaty purposes must be assessed according to the object of the Model Convention i.e. to avoid double taxation. As we have studied, tax-exempt entities that fulfill certain requirements are treaty resident whereas a tax exemption granted by law in any case constitute an obstacle for treaty residence. The question arises of how a double taxation may arise if the recipient of the income is a tax-exempt entity⁸⁸.

As a result, it is auspicial that the OECD will dedicate further consideration to this matter.

The same problem arises in the case of transparent entities⁸⁹ i.e. entities that are totally disregarded for tax purposes.

In this respect we should analyze how partnerships are treated according to the OECD Partnership Report⁹⁰. Para. 40 of the Report states that whether a partnership is to be considered “liable to tax” depends on how the income is determined; in this respect, if the income is determined “*in relation to*

⁸⁶ See *supra* note 85

⁸⁷ However, in this respect, it should be mentioned that the OECD Commentary in its para. 8.2 on art. 4 allow “pension fund, charities entities and other organizations” to be considered as resident for treaty purpose.

⁸⁸ In this respect the author does not see any difference between entities that satisfying certain requirements are considered as tax-exempted and entities that are in any case tax-exempted (because they satisfy the requirements be considered as such).

⁸⁹ However, according to the line of reasoning showed for the entities that are in any case tax exempt, also entities that are considered as transparent should be encompassed in the treaty definition of resident.

⁹⁰ The OECD Partnership Report recognizes that the principles discussed therein may apply also to other non-corporate entities i.e. investment funds.

the characteristics of the partners” then the partnership itself is not to be considered as “liable to tax” for treaty purpose, but instead the partners should qualify as residents as long as “*they are liable to tax on their share of the partnership income.*”

The Report yet, takes also into consideration the possibility that the income is computed at the partnerships level of before being allocated to the partners⁹¹, or that the income is technically paid by the partnership, however specifying that none of this alternatives would change the result (i.e. the partnership is not liable to tax).

In spite of such conclusion, to the author, the simple consideration of such situations means that the partnership may be considered as “liable to tax” by itself, in the sense that a potential taxation may arise, and therefore a “resident” for treaty purpose. The author is, however, aware that issues need to be deeply analyzed.

Nevertheless, the OECD considers that stretching the meaning of the term “liable to tax” as to include pass-through entities is too far reaching, including pass-through entities as resident for treaty purpose. Conversely, it is in line with the objectives and purposes of the Model Convention, thus, is a common hope, that this will be achieved either by forcing the borders of the term “liable to tax”, or by adding new paragraphs dealing with issue, in the Model Convention or in the Commentary⁹².

4.3.1.2. Is the income derived from the state of source “paid to” to the investment fund?

As generally known, when the Model Convention lack of a definition, reference should be made to the “lex fori” of the State applying the Convention with preference to the definition given in “tax law.”

However it may happen that reference to the “lex fori” may lead to an undesirable result i.e. double taxation⁹³.

An example may clarify this point:

- Let’s suppose that an accumulation investment fund is organized under the law of state R and that it receives dividend from a source in state S that sees the investment fund as fiscally transparent. According to their domestic laws, State R will impute and tax the income to the investment vehicle as accumulated income, whereas state S, not seeing the fund, will argue that the income is not “paid to” a resident of state R. As a consequence, state S will consider the R-S treaty not applicable and thus will not reduce its withholding tax. State R, on the other hand, will tax the full amount of the dividend and will grant relief only for the amount of withholding tax that should have been paid according to R-S treaty.

⁹¹ Accordingly, the Report goes on and excludes the partnership from being liable to tax also in this respect by stating that the liability to tax is to be caused by one of the connecting factor listed in art. 4(1) OECD Model.

⁹² It is worth to mention that the same conclusion has been reached by Stefano Grilli, “Treaty entitlement of investment fund” , *Diritto e pratica tributaria internazionale*. - Padova. - Vol. IV (2004), no. 3 ; p. 863-948.

⁹³ Danon Robert, *Switzerland's direct and international taxation of private express trusts* (Schulthess/ Linde Verlag/ Bruylant/ Westlaw, 2004).

The result will be that the withholding tax will not be entirely creditable against the investment fund liability in state R.

This is the scenario according to the interpretation of the term “paid to” to the *lex fori*.

However, another solution may be possible. Such alternative solution stems from the wording of art. 3(2) of the OECD Model Convention. Para. 2 of the relevant article, in fact, encompasses the possibility of developing another definition, i.e. not referring to the domestic law of the state applying the Convention when a lack of definition is involved, based on the assumption that the context requires such alternative solution.

Hence, we can try to apply the approach taken by the OECD Partnership Report which states that: *“an item of income is to be considered as paid to a resident of the other Contracting State, if the latter exercises taxing power over the income”⁹⁴.*

If we apply the principle of the OECD Partnership Report to this situation, we will end up that state S will be bounded by the attribution of the income made by the state of residence⁹⁵, so that: i) the R-S treaty will be applicable; ii) the withholding tax will be reduced by state S according to the treaty; and iii) the entire amount of the withholding will be credited against the liability of the fund in state R.

The general rule of the Partnership Report, as will be explained next, has also the essential characteristics of solving conflicts of attribution, and thus avoiding double taxation, both in a bilateral cases i.e. where the state of source sees the investment fund as taxable whereas the state of residence imputes the income to the investors, (resident in the same state of the investment fund), due to the transparency status of the fund, as well as in triangular cases i.e. where the fund is established in one jurisdiction and the investors in another country which derives income from a third state; in such a case, if the resident state of the participants imputes the income to them, then they will claim the benefits of the treaty with the third country, whereas the fund’s state allocates the income to the investment vehicle so as the applicable treaty will be the one between the third country and the country under which the fund is organized. Where both the countries of the investors and of the fund want to exercise their taxing rights, the third country will be bounded by two treaties. A double benefit arises in this situation.

In light of the foregoing, it must be said that linking the definition of the term “paid to” in the source country to the one adopted by the residence country of the recipient of the income has the aim of achieving a common interpretation of the term which results in a clear allocation of taxing rights. In addition, as shown by the example above, it seems that the solution achieved by the Partnership Report is the most appropriate in solving the conflicts of attribution (so far only in the field of partnership, but it is a common hope that such solution will be spread so as to include also investment funds) by considering an item of income as “paid to” a resident of a Contracting State when such state exercise its taxing rights on such income.

Furthermore, It has been said that the application of the OECD Partnership Report to investment funds is nowadays questionable; in this respect I do not see any reason why such Report should not apply to investment funds, taking into consideration both that the Report itself, in its paragraph 1,

⁹⁴ The same attempt was made, for trusts, by Prof. Robert Danon in his Doctoral Thesis, see *supra* note 94.

⁹⁵ Thus recognizing that the income is “paid to” to the investment fund.

states that “many of the principles of the Report may also apply with respect to trusts and other non-corporate entities”, and also that investment funds may be considered as transparent entities as partnerships.

4.3.1.3. Is the investment fund the “beneficial owner” of the income?

As previously noted, three are the types of income that may be generated from an investment fund’s distribution: dividends, interests and capital gains. Both dividends and interests when distributed are subject, by the state of source, to a withholding tax that may vary according as to whether the recipient of the income may be considered as the “beneficial owner” of the income⁹⁶ or not. By contrast, capital gains are generally taxed only by the state of residence of the recipient.

The term “beneficial owner” was introduced in the 1977 version of the OECD Model Convention with the scope of fighting the phenomenon commonly known as “treaty shopping”.

The term “beneficial owner”, however, is not defined either in the Model Convention itself, or in its Commentary. In the latter, it is instead expressly mentioned that the term “*has not to be used in a narrow technical sense*⁹⁷”; in addition, the Commentary also specified that “*agent or nominee may not be considered as the beneficial owner*⁹⁸” of the income as well as “*conduit companies the powers of which are so narrow that, as a practical matter, they amount to be as mere fiduciary or administrator acting on account of the interested parties*⁹⁹”.

As a result, it may be inferred that, in order to apply the concept of “beneficial owner” to an investment fund that is resident in a Contracting State, a strict analysis of the rights and obligations of the fund receiving the income should be made. However, it should be borne in mind that the rights and obligations of the fund, have to be taken into account as well as its form.

Before starting to examine whether an investment fund may qualify as the “beneficial owner” of the income, it is worth mentioning that under the 1996 US Technical Explanation of art. 10(2), the beneficial owner is defined as: “*any person resident in Contracting State to whom that State attributes the dividend for purpose of its tax.*”

Having in mind: i) the fact that the purpose of the “beneficial owner” requirements is to avoid the improper use of the Convention; ii) the fact that an investigation of the rights and obligations of the person receiving the income; and iii) the fact that the form of the investment vehicle is also to be assessed, we should analyze these requirements in light of the purposes of an investment vehicle.

Firstly, of course an investment fund may be misused in order to get treaty benefits otherwise not attainable, but this possibility cannot become a “default statement” according to which an investment fund is “always used to circumvent a higher tax burden otherwise applicable.” In fact, the mere interposition of a fund does not imply an attempt to elude the law. In addition, the investment vehicles under consideration may have a high number of participants-investors, residents of different states. The consequences of not considering such fund as the beneficial owner of the income received, just

⁹⁶ Capital gains are subject to tax only by the state of residence.

⁹⁷ Para.12 OECD Commentary on art. 10.

⁹⁸ Para. 12(1) OECD Commentary on art.10.

⁹⁹ See *supra* note n. 80.

because the vehicle may crystallize an attempt to circumvent the law, lacks of substance since the reasons behind the setting up of an investment fund are far beyond tax motivations.

Secondly, the rights and obligations of an investment fund are definitely not narrow, (as requested by the Commentary in order to exclude the beneficial ownership from conduit companies), in fact: i) an investment fund is actually engaged in the trade of securities; ii) Its shares are listed on a stock exchange in order to be available to the public; iii) it is subject to the regulations issued by the competent financial authorities. As a result, such funds may not be assimilated to mere fiduciaries acting on account of the real owner of the income.

Thirdly, an investigation concerning the consequences of the different forms that an investment vehicle may adopt are essential. The result, is that, irrespective of whether the fund is incorporated under company law or under contractual arrangements, investment funds should be considered as the beneficial owner of the income. I acknowledge, on the other hand, that such conclusion may struggle with an investment fund being considered as a transparent entity. In this case, the conclusion reached by the Partnership Report (i.e. the income flows-through to the participants-investors, hence they have to be considered as the beneficial owners) is the most appropriate for such situation.

In spite of the conclusion reached, a consideration is due. When an investment fund is not considered as the beneficial owner of the income (for example because it is a transparent entity), the underlying investors have to be considered as the beneficial owners of the income (according to the Partnership Report); however, if we suppose that the investors are residents in the same state where the vehicle is organized which would be the difference of considering the investors as the beneficial owners? None, treaty benefits will still be applicable irrespective of who is the beneficial owner. The same however is not true when the residence countries are different.

Finally, it is author's opinion, that is impossible not to consider investment funds as the "beneficial owners" of the income they generate (except for the case of investment funds assessed as transparent entities), and, as a consequence, where a distribution of dividends or interests is made by the fund, the relevant withholding tax would be the one in accordance with the applicable treaty¹⁰⁰.

4.3.2 Units holders in state R

As anticipated above there are still two cases to be analyzed in order to properly understand the benefits that can derive from the application of the Partnership Report to the investment fund.

The case under analysis concerns a situation where:

- *An investment fund is organized under the law of state R; residents of state R are also the units holders of the fund; the investment fund derives income from state S that under its domestic law sees the fund as a taxable entity; on the other hand, state R imputes the income directly to the investors because under its domestic law the fund is considered as a transparent entity.*

¹⁰⁰ The same opinion was reached by Stefano Grilli, "Treaty entitlement of investment fund", *Diritto e pratica tributaria internazionale*. - Padova. - Vol. IV (2004), no. 3 ; p. 863-948.

If we apply the “lex fori” of state S, the result will be that: i) since state S consider under its domestic law the fund as not entitled to treaty benefits, it will not reduce the applicable withholding tax according to the treaty with state R; ii) the investors will not be credited the entire amount of the withholding paid since state R will refund only up to the amount established in its treaty with state S.

However, by applying the principle stated in the Partnership Report, the situation will change positively for the participants-investors in state R. In fact: i) state S will be bounded from the allocation of the income made by state R i.e. the income is considered as “paid to” the investors; ii) state S will be obliged to reduce its withholding tax under the R-S treaty; iii) the withholding tax paid in state S will be fully credited to the participants resident in state R¹⁰¹.

As in the previous example, the principle according to which “ the state of source follow the state of residence on how to treat an item of income in order to prevent a double taxation otherwise arising” fits in also when applied to investment funds.

4.3.3. Triangular situation: investment fund in state P and units holders in state R

Triangular cases may give rise to several problems with respect to the determination of the entitlement to treaty benefits.

The case under analysis will investigate the situation where the state of source is bound by two treaties.

The relevant facts are:

- *An investment fund is organized under the law of state P which sees the fund as a taxable entity; the investors are resident of state R which sees the fund as a transparent entity; the fund derives income (dividends or interests) from state S which sees the fund as a taxable entity.*

In this circumstance a double entitlement to treaty benefits with respect to the same item of income takes place.

Accordingly, the fund being considered as a resident in its state of organization in considered by the state of source as the recipient and the beneficial owner of the income received and thus entitled to the benefits deriving from the states S-P treaty¹⁰².

Even so, the state where the investors are resident (namely state R), due to the fact that sees the fund as a transparent entity¹⁰³, attributes the income to its resident-investors and taxes them in respect of

¹⁰¹ It is important to mention that the same result has been reached, in the case of trusts, by Danon Robert, *Switzerland's direct and international taxation of private express trusts* (Schulthess/ Linde Verlag/ Bruylant/ Westlaw, 2004).

¹⁰² For the sake of clarity, it should be borne in mind, that, from the point of view of states, the granting the benefits of a treaty is subject to the former verification of the truthful entitlement of such benefits from the recipient. In the case under discussion, where the source state cannot obtain the information requested (for example because the investment fund is resident in a tax haven), it may happen that the source state will tax the income at the rate of the withholding provided in its domestic law, then applying the refund mechanism once it gets the information.

the income received; as a consequence, the fund's investors are to be considered as entitled to the benefits of the convention between states S-R due to the fact that they are liable to tax in their residence state.

As a result, both the convention S-R and S-P are applicable and will restrict the right to tax of state S¹⁰⁴.

Having analyzed the case where the source state is bound by two treaties, we will now investigate the case where the source state is not bound by any treaty.

The facts are:

- *An investment fund is organized under the law of state P which sees the fund as fiscally transparent; investors of the fund are resident in state R which sees the fund as a taxable entity; the fund derives income (dividends or interests) from state S which sees the vehicle as a taxable entity;*

In this situation, the fund is not a resident of state P since, being viewed as a transparent entity, it is not liable to tax therein. On the same ground, the fund is tax-liable for the income both under the domestic law of the state of source of the income and also under the domestic law of the state where the investors are resident, however the fund is not liable to tax in state R because it is not a resident.

In addition, the investors are potentially liable to tax in state R. However, under its domestic law, it allocates the income to the fund and not to them. Hence, the investors are not entitled to the benefits of the S-R treaty.

As a result, state S will not be bound by any treaty in the application of its withholding tax.

Both the results achieved demonstrate that the proper meaning of the term "paid to" is the one given in the OECD Partnership Report, since only by applying such Report the object of avoiding double taxation is consistently pursued¹⁰⁵.

¹⁰³ In a case where the residence state of the investors sees the fund as a taxable entity, then the investors will not be considered as liable for tax in respect of the income derived by the investment fund. As a consequence, the only applicable treaty will be the one between the source state and the state under which the investment vehicle is organized. Finally it is worth mentioning that, according to the Partnership Report's principle, the convention between the source state and the state of residence of the fund will reduce the withholding tax applicable on the income even if the state of source, under its domestic law, would tax the income in the hand of the investors.

¹⁰⁴ On this respect, it should be said that the lower tax rate under the two conventions will apply.

¹⁰⁵ The result is in accordance with the one achieved (in the case of trusts) by Prof. Robert Danon in his Doctoral Thesis, *Switzerland's direct and international taxation of private express trusts* (Schulthess/ Linde Verlag/ Bruylant/ Westlaw, 2004).

4.4. THE STATE OF RESIDENCE

4.4.1. State of residence of the investment fund

So far, the approach taken by the state of source in the taxation of investment funds has been investigated. It is now time to address the taxation of both the state of residence of an investment fund and the taxation of the state where the participants-investors reside. In addition, the issues concerning: i) the credit granted for the taxes paid in the state of source by the residence state of the fund; ii) the credit granted for the taxes levied at the fund level by the state of residence of the investors; iii) and the characterization of the income distributed by an investment fund.

In the previous chapter we have seen that whether or not an investment fund is to be considered as resident in the state under which law it is organized, depends on the legal form.

Accordingly we have analyzed both the cases when an investment vehicle has or a corporate form or a contractual form.

In the former case, the fund would generally be taxable, as a corporation, on its income¹⁰⁶; conversely, under a contractual form the fund would be assessed as a transparent entity, the received income of which will be imputed “pro-rata” basis directly to its participants-investors.

In the case of a fund assessed as a corporate entity, it has to be considered resident of the state under which it is organized, no matter what. Thus, if we have a situation where the investment fund derives income from a foreign source and distributes that income to participants-investors who are resident of the same state of the fund, we have to deal with two issues: i) the triple taxation of the same income first in the cross-border income flow (the withholding tax imposed by the source state) and, ii) the possible domestic double taxation arising from the adoption of a “classical system” by the resident state of the investment fund/participants-investors.

By contrast, in the case of transparent entities, the domestic double taxation may not, in principle, arise due to the status of the fund, since the income is directly attributed to the investors¹⁰⁷.

Nevertheless, international double taxation still remains possible because of the withholding tax imposed by the source state combined with the income tax imposed by the resident state on the investors.

4.4.1.1. Credit for taxes levied in the source state at the fund level

Regarding the credit that the state of residence of the investment fund has to give in order to avoid a double taxation, we need to distinguish two different situations. The situation of the participants-investors will be investigated in the next paragraph.

¹⁰⁶ In the sense that the fund is considered as a separate legal entity distinct from its investors.

¹⁰⁷ However, it should be borne in mind that transparent entities may be subject to the same tax treatment as the corporate funds; if this is the case, the problem of double taxation may arise also in respect of transparent vehicles.

Accordingly: i) we first need to analyze the situation where an investment fund is a corporate entity; and ii) the situation of an investment fund treated a transparent entity.

If the investment fund is treated as a corporate entity, and thus entitled to the credit for the withholding tax levied in the source state, the situation will not create particular issues¹⁰⁸, in fact the full amount of the withholding tax paid will be credited against the liabilities of the fund in its state of residence.

If the investment fund is considered as a transparent entity, it will not be considered entitled to the treaty benefits (i.e. the relief from the withholding tax); in this case, the participants-investors are entitled to the credit for the withholding tax paid in the source state in respect of the income received that will be fully credited according to the relevant Convention¹⁰⁹.

4.4.2. State of residence of unit holders

4.4.2.1. Credit for taxes levied at the fund level

Generally, the state of residence of the participants-investors constitutes the last taxing event in the chain of investment fund investments.

Attention should be paid to the cases where the investor's state is the same of the investment fund or it is a third state. In the following pages we shall analyze both the possibilities in respect of the entitlement to treaty benefits of the investors and the credit that the residence state of the participants-investors is obliged to grant according to the relevant Convention.

The consequences of an international "triple taxation" and the "double benefits" that derives from a triangular situation are also considered for the purpose of this sub-paragraph.

In line of the foregoing, we will analyze the taxation of the state of unit holders; in this respect, we have to evaluate both the possibilities of the unit holders being residents of the same state of the investment fund, and the possibility that the investors are residents in a different state.

When the investors are residents of the same state of the fund, and the latter is treated as a corporation, the relief that the resident state has to grant will be credited to the fund, and it concerns only the withholding tax paid to the source state. However, as previously mentioned, in case of classical system adopted by the residence state, a relief from the "Corporate Income Tax" paid by the fund is to be given to the investors.

In case where the fund is treated as a transparent entity, the investors will be entitled to the underlying credit for the taxes paid in the source state of the income.

In addition, we have now to deal with the cases where the participants-investors are residents of a third state.

¹⁰⁸ Whether the investors are residents of the same state of the fund and this state adopts a classical system, thus taxing the same income at the fund and investors level, the issue will be solved by domestic law.

¹⁰⁹ Nevertheless, this situation may involve many issues, in giving the relief, when there are several investors in the fund.

In case of a distribution of income from a fund, treated as a corporation under its domestic law, to its participants-investors, the resident state of the unit holders will have to grant credit for the amount of taxes paid by the fund in its country of residence. It is worth mentioning that this is only a side of the more general “triple taxation” arising from the withholding tax applied by the source state of the income, the tax paid in the resident state of the fund and the taxation to which the investors are subject in their country of residence.

By contrast, in the same triangular situation mentioned above (i.e. source state of the income, resident state of the fund and investors resident in a third country), where the fund is considered from its state as a transparent entity, the unit holders are considered entitled to the credit for the withholding tax imposed in the source state.

However, in this situation, how the investment fund is assessed in the resident state of the investors becomes crucial. In fact, if the latter sees the fund also as a transparent entity then the credit will be directly imputed to the participants-investors; on the opposite, if the state of residence of the unit holders sees the fund as a taxable entity, then, as a result, the source state will not be bound by any treaty since none of the relevant rules will be applicable.

4.4.2.2. Characterization of income made by investment funds

Another important issue concerning the interposition of an intermediary, (like an investment fund), in an investment between the investment target and the investors, concerns the tax classification of the distribution made by the intermediary to its participants¹¹⁰.

This issue, commonly known as “*income’s transformation*”¹¹¹ is perceived as the situation occurring when the type of the income received by the investment fund is re-characterized when distributed to the fund’s investors.

In this respect, we have to start by saying that, generally, the classification of income’s distribution depends crucially from the classification of the entity making such distribution¹¹². According to the foregoing, investment funds may be either considered as a separate taxable entity or as a transparent entity.

It flows therefrom that problems of classification mostly arise when the fund is considered as a company, the distribution of which are generally classified as dividends¹¹³; conversely, when the funds

¹¹⁰ Helminen Marjaana, “Classification of investment fund distributions”, *Derivatives and financial instruments*. - Amsterdam. - Vol. 2 (2000), no. 2 ; p. 135-139.

¹¹¹ Vitala Tomi, *The taxation of investment funds in the European Union* (Amsterdam: International Bureau of Fiscal Documentation, 2005) pp: 52-54.

¹¹² Helminen Marjaana, “Do distributions from Investment funds constitute dividends for international tax law purposes?”, *Tax Notes International*. - Arlington. - Vol. 18 (1999), no. 21 ; p. 2155-2170.

¹¹³ It is author opinion that the same case is likely to happen where an investment fund, even though considered as a taxable entity, is actually tax exempted; In fact the condition of being tax exempt refers, basically, to the treaty concept of “liable to tax” intended as potentially (and not actually) subject to tax. As a consequence, even though an investment fund in the form of a corporation is tax exempted, the income in return of its investment must be imputed to the fund.

are assessed as transparent entities the income “flows through” the fund directly to the investors without any transformation at the fund level.

The problem of re-qualification of the income distributed by an investment vehicle, may be felt as a disadvantage in respect of direct investments. In fact, such problem is not likely to happen in a direct investment, since the income is directly received by the investors.

An example may be helpful:

- Lets suppose that in return of an investment the fund (for the purpose of this example the fund is considered as a company) receives a capital gain which the fund has to distribute to its participants-investors; when distributed the income is re-classified as dividends and as a consequence, the resident state of the fund will apply a withholding tax in accordance with the treaty with the investors residence state; as a result, the income that should have only being taxed in the investor’s state is previously taxed in the state of the fund. By contrast, where the investment would have been made directly by the investors, such income is received free of tax.

The situation described constitutes a clear distortion from the principle of “tax neutrality¹¹⁴” which requires no difference between direct and indirect investment.

One possible solution to the issue may be applying the same tax regime to all incomes generated by an investment fund, irrespective of their natural characterization. Another solution may be to foresee a special rule in the case of investment fund that prevents re-classification from applying and oblige the fund to keep the character of the item of income received when distributing such income to the participants-investors.

¹¹⁴ Vitala Tomi, *The taxation of investment funds in the European Union* (Amsterdam: International Bureau of Fiscal Documentation, 2005) pp: 67-71.

Chapter 5

Conclusion

5.1. FINAL CONSIDERATIONS AND PROPOSAL ON THE APPLICATION OF TAX TREATIES TO INVESTMENT FUNDS

Tax treaty access to investment funds has always been a debatable issue but it is an issue that has to be solved, in fact, a substantial part of the income generated by an investment fund, derives from cross-border transactions, thus, such income need to have granted the treaty benefits to which it is entitled.

We have seen, in this respect, that there are both practical and administrative issues that may prevent these benefits from being granted or from being appropriately granted, with the result that double taxation may arise. Such issues arise principally from the various interpretations that may be given to the terms “person”, “liable to tax” and “beneficial owner”.

The applicability of the Model Convention to investment funds has its starting point in art. 1 where is stated the “The Convention applies only to persons who are residents of one or both of the Contracting States”. Such definition bring us to examine whether an investment fund may be considered as a person, according to art 3(1)(a) and whether it may also be considered as a resident, under the definition of art 4.

We have analyzed the questions in the light of the possible forms that an investment fund may adopt. As a result, it goes without saying that, while a fund with a corporate form falls within the meaning of the term “company” and thus has to be considered as a person; to achieve the same result when the fund has not a corporate form (for example when the fund is constituted by contractual agreement) is more problematic.

Having this in mind, we should not forget that in art 3(1)(a), in addition to the terms individual and company, also the concept of body of persons is mentioned as part of the more general term of person. In this respect, it is author opinion that an unincorporated investment fund may be encompassed in this definition, considering the structure, duties, and obligation a fund is subject. Furthermore, in order to be eligible to treaty benefits, an investment fund has also to be considered as a resident of one or both of the Contracting State. But, for being a resident the fund has to be “liable to tax” in its state of organization. The term “liable to tax” has been deeply analyzed by many scholars. In this respect, it is important to mention that two are the lines of reasoning for defining the term. The narrow interpretation considers the term as meaning an “actual taxation” in the sense that materially an entity has to pay to tax in order to be considered as liable to tax. By contrast, a wider interpretation considers the term as meaning a “potential liability to tax” in the sense that the an entity that fulfils the requirement in order to be subject to tax must be assessed as liable irrespective of whether it actually pay the tax or is exempted for whatever reason. I believe that the latter is the correct interpretation in line with the scope and object of a treaty.

Hence, for the purpose of this paper, an investment fund that is treated as a taxable entity (irrespective if subject to tax or tax exempt) is to be considered as a resident for treaty purpose. On the other hand, a fund deemed to be a transparent entity may not be considered as resident and thus entitled to the benefits; the underlying investors, in this case, are entitled to such benefits. However,

as described in para 4.3.1.3. This solution may lead to administrative difficulties in particular where the participants-investors are resident in a different state from the one under which the fund is organized. A possible solution, together with the one that stresses the literal wording of art 4(1) to encompass transparent entities, is to insert the investment fund figure in the wording of the articles that deal with it and specifically regulate the problems that may arise from such inclusion.

According to the foregoing, the analysis of the “beneficial owner” requirement (as laid down in art 10, 11 and 12) has been developed. However, the fact that such term is defined neither in the Model Convention nor in the Commentary, has lead our investigation to be pursued in accordance with its purpose. Indeed, it is author opinion that the investment fund should be considered the “beneficial owner” of the income it derives.

The last term that has been examined is the definition of “paid to” as defined in the Partnership Report. In this respect, since the definition is not provided in the Report, a comparison between the “lex fori” of the state applying the Convention and the one given according to the principle stated in the Partnership Report has shown that the latter, at least, is able to avoid conflicts of qualification that otherwise would lead to double taxation. Accordingly, the application of the Partnership Report to investment funds was also encompassed. The scenarios of bilateral cases and triangular cases have been addressed respectively, depending on the different tax treatment of the fund (fiscally transparent or not).

Each scenario was examined in light of the tax regime reserved to the fund, to the participants-investors and to the countries involved.

The result outlined is that some of the principles stated in Partnership Report may be applied to investment funds despite of the inconveniences that may arise. Moreover it is author opinion that such application would constitute an important goal that need to be achieved in the light of the more general ones to be pursued to finally remove the obstacles that discourage the cross-border activities of investment funds.

Finally, from the perspective of the residence States of both the investment fund and the participants-investors, the credit for the taxes paid in the source state (from the perspective of the fund) and the credit for the taxes levied at the fund level (from the perspective of the investors) have been analyzed in the light of the tax regime accorded to the fund in its country of organization.

The last issue that has been investigated concerns the transformation of the income when distributed from the fund to its investors. In this respect, the author suggest that, while the same tax treatment of any item of income is a solution hard to achieve, a special rule that obliges every fund to retain the original character of the income received when distributing to participants-investors, would constitute a necessary step forward to the elimination of double taxation in the case of investment fund investment.

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