association of the luxembourg fund industry

Luxembourg, 8 January 2015.

The Association of the Luxembourg Fund Industry (ALFI) has taken note of the OECD Public Discussion Draft "Follow-up Work on BEPS Action 6: Preventing Treaty Abuse" dated 21 November 2014 (the "**Follow-up Discussion Draft**"). This Follow-up Discussion Draft was issued further to the release of the report "BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" in September 2014 (hereafter referred to as the "**September Report**").

ALFI is pleased to provide its comments on the Follow-up Discussion Draft. These comments only address (i) the situation of collective investment vehicles ("**CIV**") being widely-held, diversified, and subject to investor-protection regulation in the country of establishment of the CIV, as previously defined by the 2010 OECD report on treaty eligibility for investors in CIVs[1] (the "**2010 Report**") and (ii) section A of the Follow-up Discussion Draft relating to the LOB provision and treaty entitlement.

1 Importance and functioning of the European investment fund industry

Before entering into a technical discussion on the issues relating to treaty eligibility of CIVs as addressed by the Follow-up Discussion Draft (see section 2 below), ALFI would like to recall the importance of the European fund industry and its functioning. It is indeed important to clearly set out the economic and legal framework of the investment fund industry within the EU as its characteristics explain and justify, to a large extent, the proposed tax treatment with respect to treaty benefit of CIVs, as outlined in section 2 below.

The investment fund industry is a vital part of the EU financial sector

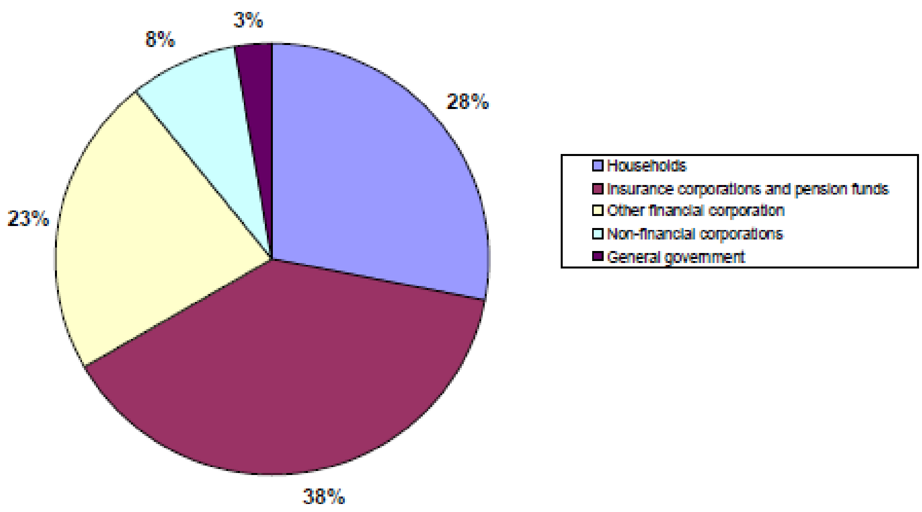
As recently recalled by the EU Commission[2], the investment fund industry is a vital part of the EU financial sector. UCITS (i.e., Undertakings for Collective Investment in Transferable Securities) are investment funds regulated at European Union level by Directive 2009/65/EC as modified by Directive 2014/91/EU (the "**UCITS Directive**"). They account for around 75% of all collective investments by retail investors in Europe.

The success of UCITS as a cross-border vehicle for investments can be best evidenced by the rapid growth of assets managed in UCITS funds. Total assets under management (AuM) grew from €3,403bn at the end of 2001 to €5,889bn by 2010. In September 2011 AuM stood at €5,515bn. This development is in part due to the UCITS Directive's harmonized rules on collective investment schemes that establish a European passport for the distribution of investment fund products that comply with the UCITS standard. The evolution of the UCITS rules is therefore important for the development of an integrated market that allows the cross-border sale of UCITS[3].

By the end of 2014, about 80% of UCITS assets are invested by funds domiciled in four jurisdictions: Luxembourg (32.8%), Ireland (15.8%), France (14.8%), and the United Kingdom (12.5%)[4].

[1] See OECD report on "The granting of treaty benefits with respect to the income of collective investment vehicles", 23 April 2010.
[2] See Commission staff working document regarding the proposal of amendment of the Directive 2009/65/EC, SWD (2012) 186 final, July 2012.
[3] See footnote 2, section 3.1.
[4] Source: EFAMA Quarterly Statistical Release N°59 (Third Quarter of 2014).

EU investors to mutual funds (2010)



Source: EU Commission

Most EU investors are – directly or indirectly – retail investors

According to 2010 data gathered by the EU Commission[5], EU investors held €6,900bn in mutual funds[6], of which about 75% was invested in EU-domiciled funds and 25% in funds that are not domiciled in the EU. Non-EU investors invested further €3,300bn into EU-domiciled mutual funds. The investor profile of an EU mutual fund is shown in the graph above.

As more than 85% of EU mutual fund investments are directed towards UCITS vehicles to (€5,889bn out of €6,900bn in 2010), the graph is representative for the UCITS investor profile as well. The graph shows that retail investors are the principal investors in mutual funds. 28% of fund holdings are made up of direct retail investments while another 61% are intermediated either through insurance policies, pension funds and other financial corporations. Intermediaries, for example pension funds that provide retirement benefits to individual investors, invest monies they collect from retail investors into mutual funds.

Essentially this means that around 90% of mutual fund investments are directly or indirectly attributable to retail investors.

Importance of the EU Single Market

The EU has been promoting for many years the Single Market as a key factor in the global competitiveness of the EU. Its role is to provide an environment that is conducive to developing, buying, selling and investing

[5] See footnote 2, section 3.2.
[6] Both UCITS and non-UCITS.

freely throughout Europe and beyond. In this respect, European policies also aim at ensuring the greater convergence of rules and standards at international level[7].

As far as investment funds are concerned, the goal of the European Commission is to facilitate the development of an internal market for asset management within the EU. Asset management comprises collective investment funds but also a wide variety of individually managed investment products. Asset management therefore plays a crucial role in facilitating the accumulation of personal savings, be it for major investments or for retirement. Asset management is also an important vehicle in channeling institutional and personal savings to companies and projects that will be crucial in bringing about Europe's economic recovery[8].

An increasing number of CIVs are distributed on a cross-border basis

CIVs may have hundreds of thousands of investors, which change very rapidly and which are resident in numerous different jurisdictions. This is typically the case of jurisdictions like Luxembourg. The number of cross-border funds has grown steadily over the last 10 years.

Luxembourg, as one of the most popular markets for cross-border fund distribution, with a 67% global market share, is a location where the top 100 management groups distributing cross-border funds represent 92% of the market and the most popular markets from cross-border funds from Luxembourg are Germany, Switzerland, Austria, France and the Netherlands, the UK and Italy.

CIVs are mainly set up for commercial reasons

In practice, CIVs are usually put in place in order to achieve various investment objectives of portfolio investors in an efficient and cost-effective manner. Indeed the pooling of assets through regulated vehicles usually implies greater economies of scales, and better risk-spreading, compared to a direct investment.

In the EU more specifically, and as mentioned above, the introduction and further enhancement of the UCITS legal framework in the EU legislation aimed at two objectives:

- To facilitate the cross-border offer of investment funds for the retail investor, and
- To protect retail investors by limiting fund risks through strict diversification rules on the investment policy of funds[9].

The European Commission recognized that the diversity of EU Member State's tax regimes was considered as one important barrier to the cross-border sale of funds. Barriers are sometimes the result of historical developments (and cultural preferences) or the desire to privilege the use of a particular investment vehicle (e.g. pension funds). Tax constraints generate often additional administrative requirements and are powerful financial disincentives. Concrete examples of such requirements are the need to appoint a tax representative or to make a complex tax computation. A clear illustration of a financial disincentive could be the fact that dividends distributed by foreign funds are subject to a withholding tax[10]. It is also worth

[7] Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions, "Towards a Single Market Act", Brussels, 11.11.2010, COM(2010) 608 final/2.
[8] http://ec.europa.eu/finance/investment/index_en.htm.
[9] Commission staff working paper, annex to the "Green paper on the enhancement of the EU framework for investment funds", COM(2005)314 final.
[10] See footnote 9.

noting at this juncture that the European Court of Justice has consistently ruled[11] that tax rules of EU jurisdictions applying withholding tax on dividends paid to foreign funds where an exemption exists for dividends paid to comparable domestic funds are discriminatory and therefore contrary to the fundamental freedoms enshrined in the EU treaty.

This is the reason why most EU and OECD countries (including Luxembourg) have implemented a tax system that provides for a quasi-tax neutrality between direct investments and investments through a CIV, so that taxation should arise only at the level of the investors.

For cross-border CIVs, double tax treaties play an important role, as they help achieving neutrality between a direct investment and an investment through a CIV in the international context, just as the goal of most domestic provisions addressing the treatment of CIVs is to achieve such neutrality in the wholly domestic context.

2 Issues surrounding the treaty entitlement for CIVs

The September Report stated that policy considerations had to be addressed to make sure that the BEPS proposals do not unduly impact CIVs in cases where countries do not intend to deprive them of treaty benefits.

The BEPS recommendations must not unduly impact CIVs

The September Report expressly stated why the situation of CIVs is specific and why their situation becomes problematic when it comes to applying the proposed LOB tests to them. The main reasons are as follows:

- the interests in the CIV are not publicly-traded (even though these interests are widely distributed);
- these interests are held by residents of third States;
- the distributions made by the CIV are deductible payments, and
- the CIV is used for investment purposes rather than for the "active conduct of a business"[12].

ALFI shares this observation and would like to recall that, although it is perfectly legitimate to find a compromise solution that may allow contracting states to avoid treaty shopping, in many cases, denying the right for CIVs to claim for treaty benefits, will undermine one of the primary goals of the tax treaty, i.e. to eliminate barriers to cross-border investment[13].

On the contrary, and as mentioned in the 2010 Report, granting treaty benefits to CIVs will allow to:

- Serve the goals of neutrality as between direct investments and investments through a CIV.
- Decrease the risk of double taxation between the source State and the State of residence of the investor, to the extent that there is a tax treaty between them.
- Benefit investors, particularly those from small countries, who will consequently enjoy a greater choice of investment vehicles.

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[11] Case C-190/12, Emerging Markets Series of DFA Investment Trust Company, is the most recent in a consistent line of cases on this point.
[12] See § 31
[13] See 2010 Report, § 50.

- Increase economies of scale, which are a primary economic benefit of investing through CIVs.

It is therefore of the utmost importance to ensure that CIVs will effectively be granted treaty benefits. Furthermore, as CIVs are principally set up for genuine commercial reasons and given their economic characteristics it is reasonable to conclude that CIVs cannot, in principle, be effectively used for treaty shopping. This is the reason why the main focus of the BEPS action plan is – and should remain – multinationals and not CIVs.

The September Report suggested several alternatives provisions based on the 2010 Report

The September Report suggested several alternative provisions that may be used to deal adequately with the CIVs that are found in each Contracting State. In this respect, the Report suggested that Contracting States wishing to address the issue of CIVs' entitlement to treaty benefits may want to consider the economic characteristics, including the potential for treaty shopping, of the different types of CIVs that are used in each Contracting State and may conclude that the tax treatment of CIVs established in the two States does not give rise to treaty-shopping concerns and decide to include in their bilateral treaty a provision which would expressly provide for the treaty entitlement of CIVs established in each State[14].

The September Report specifically referred to Paragraphs 6.8 to 6.34 of the Commentary on Article 1 (deriving from the 2010 Report) that discuss various factors that should be considered for the purpose of determining the treaty entitlement of CIVs and acknowledge that these paragraphs are therefore relevant when determining whether a provision on CIVs should be included in the LOB clause and how it should be drafted.

The September Report thus does not exclude that the solutions agreed in the 2010 Report are still valid and could be sufficient in order to address the issues surrounding treaty eligibility of CIVs.

The conclusions of the 2010 Report remain valid

As mentioned in the Follow-up Discussion Draft, it is now intended to review the above mentioned alternative approaches and to examine whether it would be possible to suggest a single preferred approach not only with respect to the application of the LOB to CIVs but also with respect to the more general question of the treaty entitlement of CIVs, taking into account developments since 2010 and, in particular, the results of the work on the Treaty Relief and Compliance Enhancement (TRACE) project.

In this respect, the OECD is seeking input as to whether the recommendations of the 2010 Report continue to be adequate for widely-held CIVs.

ALFI considers that <u>the recommendations of the 2010 Report continue to be adequate for CIVs</u> (for the reasons outlined above), although this conclusion should not prevent from also considering these recommendations as being only <u>the minimum level of protective provisions</u> for CIVs.

But improvements to the conclusions of the 2010 Report are required

ALFI believes that improvements could be made to the conclusions included in that Report.

Indeed, in our view, these alternative provisions leave too much flexibility to Contracting States, as the situation and potential for treaty shopping of each CIV has to be analyzed on a case by case basis and then to be clarified bilaterally. This means that CIVs of a country may qualify as treaty resident for the

[14] See § 34

purpose of certain treaties concluded by that country, but not for others, which does not appear to be appropriate in practice and will bring inevitably some legal uncertainty for CIVs. And, in the worst case scenario, sometimes, treaty negotiators (deliberately or not) may not even address the situation of CIVs, in which case determining treaty eligibility will prove difficult, if not impossible, in practice.

ALFI therefore suggests identifying and defining the CIVs which will always qualify as resident within the meaning of the LOB clause and with respect to the more general question of treaty entitlement.

Both the 2010 Report and the September Report state that "*Contracting States wishing to address the issue of CIVs' entitlement to treaty benefits may want to consider the economic characteristics, including the potential for treaty shopping, of the different types of CIVs that are used in each Contracting State*"[15]. This means that CIVs having the same economic characteristics should be able to benefit from the same tax treatment with respect to treaty entitlement. Based on this, ALFI believes that there are good grounds to consider that all CIVs set up as UCITS should always be considered as residents for treaty purposes.

Similarly, ALFI is of the opinion that this principle must be extended to all other widely-distributed non-CIVs which have characteristics that are comparable to UCITS.

The UCITS Directive indeed provides for common basic rules for the authorization, supervision, structure and activities of UCITS established in EU Member States.

ALFI also considers that the proposed rule should apply without regard to the residence of the UCITS' investors. Indeed, UCITS being by definition widely-held, we do not see any reason why the alternative approach proposed in the 2010 Report for publicly-traded CIVs[16], could not be expanded to all UCITS. Based on this alternative approach, it was indeed proposed that all publicly-traded CIVs be granted treaty benefit on the basis that they cannot be used effectively for treaty shopping because the shareholders or unit holders of such a CIV cannot individually exercise control over it.

Granting treaty benefit to all UCITS would thus bring two benefits:

- First, to reduce the obstacles to the establishment of cross-border CIVs, which the UCITS Directive has been promoting for many years;
- Second, to avoid or solve a number of practical issues deriving from most of the other alternative solutions suggested by the 2010 Report, these alternative provisions implying that the CIVs are able to determine who their investors are. Indeed, because ownership of interests in CIVs changes regularly, and such interests frequently are held through intermediaries, the CIVs and their managers often do not themselves know the names and treaty status of the beneficial owners of interests. Obtaining treaty entitlement may thus impose substantial administrative burdens for CIVs or become practically impossible. Developing practical solutions for establishing the treaty entitlement of CIVs (or their investors) is therefore a key aspect.

3 ALFI's recommendations

Consequently, ALFI believes that the final report on Action 6 should foresee that all CIVs set up as UCITS as well as all other widely-distributed non-CIVs whose characteristics are similar to those of UCITS will

[15] See § 35 of the September Report (referring to § 6.19 and 6.20 of the Commentary on Article 1 of the OECD Model Convention).
[16] See 2010 Report, § 57.

automatically qualify as resident for the purpose of article 1 of the OECD Model Convention and that they will also be considered as qualified residents for the purpose of the LOB clause.

As a result, the wording of Article 1 of the OECD Model should be amended in order to include the provision currently proposed in paragraph 6.17 of the Commentary on Article 1, which would only have to be slightly amended in order to expressly provide for the treaty entitlement of CIVs established as UCITS and comparable non-CIVs (because such CIVs would then be treated as an individual that is a resident of the Contracting State in which they are established).

Accordingly, subparagraph f) of paragraph 2 of the LOB clause would have to be drafted to ensure that CIVs set up as UCITS and comparable non-CIVs always constitute qualified persons.

Finally, ALFI also suggests to include a statement that Contracting States are encouraged to consider that UCITS and comparable non-CIVs will not be considered as creating opportunities for treaty shopping.