Treaty Benefits for Investment Vehicles in a Post-BEPS World

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I. Introduction

In 2013, the Organisation for Economic Co-operation and Development (the “OECD”) and G20 published an Action Plan on Base Erosion and Profit Shifting (the “BEPS Action Plan”) to strengthen international tax standards. The BEPS Action Plan was driven by the perception that weaknesses in the current international tax rules and standards create opportunities for base erosion and profit shifting by multinational businesses and investors. Action 6 of the BEPS Action Plan identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns.

The work on BEPS Action 6 arguably will make it more difficult for investment vehicles to claim treaty benefits. Indeed, many investment vehicles are finding it more difficult in practice to obtain treaty benefits. The BEPS Action 6 Final Report, in response to concerns about the ability of investment vehicles to claim treaty benefits, incorporated the recommendations of an earlier OECD report, The Granting of Treaty Benefits with respect to the

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4 BEPS Action 6 2015 Final Report, Executive Summary.

5 There are a number of different definitions of investment vehicle, depending on the context. We use the term “investment vehicle” broadly in this article to refer to an entity or arrangement through which more than one investor pools capital to invest in financial assets or real property. After an initial examination of the policy concerns involving investment vehicles, this article also provides a more formal definition of investment vehicle that may be helpful in the treaty context.


7 See, e.g., Association of Global Custodians, Comments on Draft Provisions for the U.S. Model Income Tax Treaty, reprinted in Tax Notes Today, 2015 TNT 203-15 (Oct. 21, 2015) (noting that Japan requires that U.S. regulated investment companies provide the name, address, status, and number of shares of each shareholder, and that Switzerland has recently begun imposing similar requirements).
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Income of Collective Investment Vehicles (the “OECD CIV Report”).

This article argues that the incorporation of the recommendations of the OECD CIV Report in the BEPS Action 6 2015 Final Report is not sufficient to ensure that investment vehicles obtain treaty benefits in appropriate case, and examines the current status of the work on the treaty entitlement of investment vehicles. The article then suggests possible improvements to provide for treaty benefits in appropriate circumstances while also protecting against potential abuses.

A. Objective of Investment Vehicles

The basic objective of investment vehicles is to allow investors to pool their capital to achieve certain investment goals that each investor could not easily achieve on its own. From an investor perspective, the main benefits of pooling capital in this way are to achieve: (i) a diversified portfolio of investments that aligns with the investor’s risk tolerance; (ii) access to professional investment advice or management; and (iii) access to investments the investor may not be able to access individually. In theory, larger investment vehicles (i.e., investment vehicles with more capital) are more economically efficient than smaller investment vehicles, because the startup, management, and regulatory costs can be spread over a larger investment and more investors, thereby reducing each investor’s cost.

From the perspective of users of investment capital (e.g., operating businesses, real estate developers, and infrastructure projects), investment vehicles also allow efficient funding for assets that otherwise might have a very limited universe of investors willing and able to invest. In other words, pooling of capital and diversification of risk allow investment vehicles to invest in assets that would be too large or too illiquid for the investors in the investment vehicle to invest in on their own. Pooling of investment capital through investment vehicles thus promotes liquid markets and a more efficient allocation of capital.

Investment vehicles are a tremendously important source of investment capital. Worldwide invested capital in regulated open-end funds was $37.2 trillion in 2015, and U.S.

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10 See OECD CIV Report, ¶ 16.
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mutual funds and exchange-traded funds ("ETFs") had $17.8 trillion in net assets in 2015.\(^\text{11}\) In OECD countries in 2014, pension funds and public pension reserve funds – another form of investment vehicle – held $30.2 trillion.\(^\text{12}\) Private equity funds held $2.6 trillion in assets in 2014,\(^\text{13}\) and hedge funds managed $3.1 trillion in assets in 2014.\(^\text{14}\)

B. General Tax Policy Concerns with Respect to Investment Vehicles

Tax policy makers generally have recognized the benefits of investment vehicles, and therefore have sought to reduce the tax impediments to investment in and by investment vehicles. A key objective in this regard is to tax investors in an investment vehicle similarly to how they would have been taxed if they had invested in the underlying assets directly, and to avoid creating an additional layer of tax at the investment vehicle level. In other words, the investment vehicle generally does not pay tax at the entity level, and tax policy seeks to ensure that the investors are taxed on their share of the income earned through, or distributed by, the investment vehicle. Indeed, the OECD has noted that “[m]ost countries now have a tax system that provides for neutrality between direct investments and investments through a [collective investment vehicle], at least when the investors, the CIV, and the investment are all located in the same country.”\(^\text{15}\)

This neutrality principle can be achieved in different ways. One is to treat the investment vehicle as fiscally transparent. In theory, fiscal transparency provides the most complete parity between direct investment and investment through an investment vehicle. There is no entity level tax, and the investor generally recognizes its share of the investment vehicle’s income on a current basis and with the same character.\(^\text{16}\) In a wholly domestic context, fiscal transparency of


\(^{15}\) OECD CIV Report, ¶ 1.

\(^{16}\) Of course, there can be differences between investing directly and investing through a fiscally transparent entity such as a partnership. For example, sale of a partnership interest may give rise to different treatment than if the investor had sold a proportionate share of each of the partnership’s assets. See, e.g., sections 741 and 751 of the U.S. Internal Revenue Code of 1986, as amended (the “Code”). Unless otherwise noted, all section references are to the Code and the regulations thereunder.
the investment vehicle often can be achieved simply by the choice of legal entity, rather than due
to any special tax regime applicable to investment vehicles.

Another model is to exempt the investment income of the investment vehicle from tax,
and to tax the distributions from the investment vehicle in the hands of the investors. This
exemption can be a complete exemption, or can be achieved through a dividends paid deduction,
as in the case of U.S. regulated investment companies (“RICs”).17 Treating the investment
vehicle as fiscally opaque but eliminating the entity-level tax can differ significantly from the tax
treatment that investors would have received if they had invested directly in the underlying
assets. For example, exempting the investment vehicle and taxing the investment vehicle’s
distributions in the hands of its investors can change both the timing of the tax on the income and
the character of the income. The U.S. federal income tax rules governing the U.S. federal
income tax treatment of RICs and their investors attempt to address this issue by providing
special treatment of certain distributions to provide investors with treatment that is more closely
aligned with the treatment the investors would have received if they had received their share of
the RIC’s income directly. We discuss these rules in more detail in Section V.C, below.

C. Cross-Border Investment In and By Investment Vehicles

A significant benefit of investment vehicles is that they can allow investors to pool costs
of portfolio management, custodial services, and transaction fees. Investment vehicles and their
investors thus benefit from economies of scale by spreading those costs over a greater number of
investors. A single domestic market, however, may not have sufficient demand by investors for
particular assets, and in order to achieve the relevant economies of scale, investment vehicles
may pool capital from investors from different jurisdictions. Investors from smaller jurisdictions
also may have to invest in an investment vehicle in another jurisdiction in order to gain access to
certain types of assets that may not be available in the investor’s domestic market. Similarly,
investment vehicles may invest in assets in different jurisdictions to achieve the desired
diversification and risk profile. Tax treaty policy must deal with both of these types of cross-
border investment – investors owning interests in investment vehicles in another jurisdiction, and
investment vehicles investing cross-border. Ideally, the tax policy objectives will be to avoid
double taxation and to achieve neutrality between direct investment and investment through an
investment vehicle.

Double taxation can result with respect to income earned by investment vehicles to the
extent that the vehicle itself is not entitled to treaty benefits, either the investment vehicle or its
investors (or both) are subject to tax in their residence jurisdictions on the income, and neither
the investment vehicle nor the investors can credit the source country tax.18 Even if the
investment vehicle or investors can credit the tax, failure by the source country to provide treaty

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17 See Section 852.
18 See OECD CIV Report, ¶¶ 44 – 46.
benefits seems to be inconsistent with the deal struck in the treaty, at least when the investment vehicle or investors are subject to residence country tax on the income.

While jurisdictions are concerned to avoid double taxation with respect to investment vehicles, source countries also are concerned about the potential for treaty shopping and deferral by investors in investment vehicles. In particular, some jurisdictions are worried that, if they provide treaty benefits to an investment vehicle, an investor that is not entitled to treaty benefits from the source country could inappropriately receive treaty benefits by investing through the investment vehicle. Moreover, if the investment vehicle (or even a holding company that owns interests in the investment vehicle) is not fiscally transparent with respect to the investor, the investor may not recognize its share of the income of the investment vehicle until the investment vehicle (or holding company) makes a distribution. In that case, the source country may not want to grant treaty benefits because the relevant income is not being taxed currently (assuming that the investment vehicle itself does not bear current tax on the relevant income).

Investment vehicles thus raise complicated treaty policy issues, because of the multiple jurisdictions involved. Even a simple structure with a single investment vehicle can raise tax policy concerns in three jurisdictions: the residence jurisdiction of the investor, the residence jurisdiction of the investment vehicle, and the source country of the underlying investment. Each of those jurisdictions presumably wants to avoid double taxation. In addition, the jurisdiction of residence of the investor may be concerned about granting foreign tax credits with respect to income that should have been entitled to a reduced rate of withholding tax, and may also have concerns about the possibility of investors evading tax on foreign investments that are not reported. The source jurisdiction may be concerned about the potential for treaty shopping and deferral of income by investors, but may also be concerned about creating a favorable environment for inbound foreign investment. Finally, the jurisdiction of the investment entity may be concerned about attracting foreign investment and collecting the appropriate tax as a source country.

While cross-border investment involving a single investment entity raises complex issues, cross-border investment through investment vehicles can involve multiple tiers of entities. Interests in investment vehicles generally are held through one or more financial intermediaries, and investment vehicles may, in turn, invest in interests of other investment vehicles or through other structures.

The lack of a coordinated approach among jurisdictions with respect to the treaty entitlement of investment vehicles creates tremendous complexity and uncertainty regarding whether or how benefits may be claimed. This uncertainty is a significant issue for investment vehicles for at least two reasons. One is that investment vehicles generally must be able to value

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their assets on a regular basis. Investors generally buy or sell units on the basis of the net asset value ("NAV") established by the investment vehicle. If there is uncertainty regarding a major cost, such as withholding taxes, the NAV, and therefore the prices paid by investors, may be materially incorrect. In addition, investment vehicles often have a limited life, and must be wound down at the end of that life. If there is uncertainty regarding a significant potential liability such as withholding tax, that may either prevent investors from receiving the funds to which they are entitled (because assets are held in escrow to cover the liability) or prevent governments from collecting the tax that is due (because the funds have been paid out to investors).

Recognizing the importance of cross-border investment by and through investment vehicles and the need to coordinate the tax policy concerns among jurisdictions, the OECD undertook a significant project related to the treaty entitlement of collective investment vehicles ("CIVs"), which the OECD defines as vehicles that are widely held, are subject to investor protection regulation, and invest in a diverse portfolio of securities. Ultimately, the OECD project was split into two separate pieces, one dealing with the treaty entitlement of CIVs, and the other dealing with procedures for addressing treaty claims through intermediated structures, which became known as the TRACE Project.

The work at the OECD regarding CIVs is important, and this article will examine that work in detail. Unfortunately, the work also has three important limitations. First, the OECD’s work is limited exclusively to investment vehicles that meet the OECD’s definition of a CIV. Investment vehicles that fall outside the definition of a CIV – including real estate investment trusts, private equity funds, infrastructure funds, and pension funds – raise similar tax policy and treaty entitlement issues, but neither the OECD CIV Report nor the BEPS Action 6 2015 Final Report addresses those similarities. This article attempts to develop a more inclusive framework for addressing the treaty benefits of investment vehicles.

Second, although the conclusions from the OECD’s work on CIVs have been incorporated into the OECD Commentaries on the Articles of the Model Tax Convention (the “Commentary on the OECD Model”), they have not been widely adopted by jurisdictions in


24 As discussed below, some pension funds may qualify as CIVs.

25 See Commentary on Article 1 of the OECD Model, ¶¶ 6.6 – 6.34.
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their bilateral treaties. The BEPS Action 6 2015 Report also noted that, in order for the recommendations in the OECD CIV Report to be implemented in a practical way, the principles of the OECD Treaty Relief and Compliance Enhancement (“TRACE”) Project26 would also need to be implemented consistently by source countries.27 To date, no jurisdiction has implemented the principles of the TRACE Project.28 The disappointing pace of implementation of the recommendation in the OECD CIV Report and the TRACE Project may be due, in part, to the fact that the CIV Report does not provide a single recommendation, but provides a menu of options that jurisdictions may adopt. The menu approach lessens the “peer pressure” that would brought to bear if there were a single OECD recommendation in this area. Given the OECD’s definition of a CIV, however, there cannot be a single approach to granting CIVs treaty benefits, because CIVs are organized and taxed in so many different ways. If the approach instead based treaty eligibility on factors that align more closely with the policy concerns in the area (such as fiscal transparency/opacity and investor identification), perhaps the OECD recommendations could be more prescriptive. This article explores that possibility.

Third, the OECD/G20 Base Erosion and Profit Shifting (“BEPS”) Project has shifted tax treaty policy to focus more on protecting against granting inappropriate treaty benefits to investors in investment vehicles and on preventing deferral by investors. These are certainly legitimate policy concerns for governments. However, the recommended methods to protect these interests, in particular the principal purposes test (“PPT”), increase the uncertainty regarding when an investment entity will be entitled to treaty benefits. This article argues that additional certainty should be provided regarding when investment vehicles will be entitled to treaty benefits.

Section II discusses the work of the OECD regarding the treaty eligibility of investment vehicles, specifically the OECD CIV Report and the BEPS Action 6 2015 Final Report. Section II also develops a framework of treaty policy concerns to evaluate the OECD work on CIVs.

Section III discusses the impact of financial intermediation in claiming treaty benefits, and evaluates the proposed solutions in the OECD TRACE Project, as well as the way the U.S. withholding tax regime attempts to address these issues.

Section IV argues that the same treaty concerns relevant to CIVs are also relevant to many other types of investment vehicles, and that similar approaches should be adopted with respect to those investment vehicles. Section IV proposes a definition of an investment vehicle that could be used in the treaty context. The proposed definition draws on recent developments

26 TRACE IP.


28 Arguably, the United States has implemented many of the key elements of the TRACE Project through its qualified intermediary (“QI”) system. The QI system, however, pre-dates the TRACE Project and does not include all of the key elements of the TRACE Project.
in FATCA and the CRS. Section IV then develops a potential framework for evaluating the treaty entitlement of different types of investment vehicle.

Section V examines how fiscally transparent entities and RICs are treated under U.S. treaties.

Section VI describes and evaluates potential changes to the U.S. treatment of investment vehicles for treaty purposes. Section VI also describes and evaluates proposals to improve treaty access for investment vehicles on a multilateral basis.

II. OECD CIV Report and BEPS Action 6 2015 Final Report

In 2006, the OECD’s Committee on Fiscal Affairs (the “CFA”) established the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors (the “ICG”). The work of the ICG culminated in the OECD CIV Report, and also in a separate project regarding procedures for making claims for treaty benefits through intermediated structures more generally, referred to as the TRACE Project. The OECD CIV Report was adopted by the CFA on April 23, 2010, and the changes recommended by the OECD CIV Report were adopted as part of the 2010 Update of the Commentary on the OECD Model Convention.

The OECD CIV Report deals with the treaty entitlement of CIVs, which the OECD defines as funds that are widely held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established. According to the OECD, the term CIV would also include ‘master’ and ‘feeder’ funds that are part of ‘fund of funds’ structures where the master fund holds a diversified portfolio of investments on behalf of the feeder funds that are themselves widely held. The definition of CIV does not include private equity funds, hedge funds, or other alternative funds. While not entirely clear, it seems possible that some pension funds may qualify as CIVs under the OECD’s definition. Many pension funds’ beneficial interests are widely held, the funds themselves often are subject to

29 See OECD CIV Report, ¶ 3.

30 See TRACE IP, Introduction to the Implementation Package.

31 See OECD CIV Report, ¶ 4.


33 OECD CIV Report, ¶ 4.
regulation to protect the investors/beneficiaries, and pension funds often are invested in a diverse portfolio of securities.\textsuperscript{34}

The OECD CIV Report discusses many of the practical difficulties in determining whether and when a CIV should be entitled to treaty benefits, and suggests several proposed approaches that have been incorporated into the Commentary on the OECD Model. The OECD CIV Report generally tries to resolve these issues in a way that favors granting treaty benefits to CIVS.

A. CIV Eligibility for Treaty Benefits

One of the main objectives of tax treaties is to reduce tax barriers to cross-border trade and investment between the contracting States.\textsuperscript{35} Tax treaties achieve this purpose, in part, by allocating taxing rights with respect to cross-border income. In the case of dividends, interest, and capital gains (\textit{i.e.}, income from financial assets), the taxing rights of the source State are limited and, in certain cases, taxing rights are allocated solely to the residence State.\textsuperscript{36}

To qualify for treaty benefits, in general the claimant must be a person that is resident for tax purposes in the treaty partner jurisdiction, and that is the beneficial owner of the income with respect to which benefits are being claimed. In addition, the claimant must satisfy any anti-abuse rule and, under U.S. treaties, the person claiming treaty benefits generally must satisfy the limitation on benefits (\textit{“LOB”} provision. We discuss these requirements below.

1. Is the CIV a “Person”?

The 2014 OECD Model Tax Convention on Income and on Capital (the “OECD Model Tax Convention”)\textsuperscript{37} provides that the convention applies “to persons who are residents of one or

\textsuperscript{34} But see BEPS Action 6 2015 Final Report, ¶¶ 12 – 13 (including pension funds in the discussion of the work on non-CIV funds).

\textsuperscript{35} See Commentary on Article 1 of the OECD Model, ¶ 7.

\textsuperscript{36} See, e.g., 2016 U.S. Model, Article 11(1) (allocating taxing rights on interest income exclusively to the residence State).

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more Contracting States.”\(^{38}\) Similarly, both the U.S. Model Income Tax Convention of November 5, 2006 (the “2006 U.S. Model”), and the 2016 U.S. Model Income Tax Convention (the “2016 U.S. Model”) provide that the convention applies “only to persons who are residents of one or both of the Contracting States, except as otherwise provided in” the Convention.\(^{39}\) The term “person” is defined generally as including “an individual, an estate, a trust, a partnership, a company, and any other body of persons.”\(^{40}\)

Under the OECD’s definition of a CIV, a CIV may or may not be a person for treaty purposes. CIVs can be organized in many different legal forms. In Canada and the United States, both companies and trusts are commonly used. In Australia, New Zealand and Japan, the trust is the predominant form.\(^{41}\) In European countries, joint ownership vehicles (such as \textit{fonds communs de placement}) or companies (such as \textit{sociétés d’investissement à capital variable}) may be used.\(^{42}\)

A CIV structured as a company clearly qualifies as a person. A CIV that is organized as a trust may or may not qualify as a person. In most common law countries, the trust, or the trustees acting in their capacity as such, constitutes a taxpayer, even though it may not legally constitute a person. Countries in which trusts are common often include trusts in the definition of “person” in their bilateral treaties. The OECD CIV Report suggests that countries that use trusts may want to continue including trusts in the definition of person in their treaties.\(^{43}\)

A CIV that is treated merely as a form of joint ownership, and not as a person, under the tax law of the State in which it is established would not constitute a person for purposes of tax treaties.\(^{44}\) The OECD CIV Report does not provide additional guidance regarding treaty benefits in the case of a CIV that is not a person.

Based on the discussion in the OECD CIV Report, paragraph 6.10 of the Commentary on Article 1 of the OECD Model acknowledges that various jurisdictions treat different CIVs differently, but asserts that in most cases, the CIV would be treated as a taxpayer or person for

\(^{38}\) OECD Model Tax Convention, Article 1.


\(^{40}\) 2016 U.S. Model, Article 3(1)(a); 2006 U.S. Model, Article 3(1)(a). The OECD Model Tax Convention defines a person as including “an individual, a company, and any other body of persons.” OECD Model Tax Convention, Article 3(1)(a).

\(^{41}\) See OECD CIV Report, ¶ 23.

\(^{42}\) See OECD CIV Report, ¶ 23.

\(^{43}\) See OECD CIV Report, ¶ 26.

\(^{44}\) See OECD CIV Report, ¶ 25.
purposes of the tax law of the state in which it is established. Paragraph 6.10 of the Commentary on Article 1 of the OECD Model also suggests that countries may want to modify the definition of person to include explicitly the types of CIVs that they have in their jurisdictions. In other words, countries may or may not need to include a special provision in their treaties regarding whether CIVs in their jurisdiction constitute persons.

2. Is the CIV a Resident of a Contracting State?

A resident of a Contracting State is defined to mean “any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature”, but does not include a person who is liable to tax only in respect of income from sources in that Contracting State. The Commentary on the OECD Model excludes from the definition of a resident of a Contracting State foreign held companies exempted from tax on their foreign income by “privileges tailored to attract conduit companies.” However, the Commentary on the OECD Model states that the definition of a resident of a Contracting State is not intended to exclude residents of a jurisdiction that adopts a territorial principle in its taxation. The Commentary on the OECD Model also provides:

In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organisations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. Most States would view such entities as residents for purposes of the Convention.

The United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 5, 2006 (the “2006 U.S. Technical Explanation”) provides additional guidance stating that:

Certain entities that are nominally subject to tax but that in practice are rarely required to pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, a U.S. Regulated

45 OECD Model Tax Convention, Article 4(1). The 2016 U.S. Model and 2006 U.S. Model include citizenship and place of incorporation as additional enumerated criteria for residence. See 2016 U.S. Model, Article 4(1); 2006 U.S. Model, Article 4(1).

46 Commentary on Article 4 of the OECD Model, ¶ 8.2.

47 Commentary on Article 4 of the OECD Model, ¶ 8.3.

48 Commentary on Article 4 of the OECD Model, ¶ 8.6.
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Investment Company (RIC) and a U.S. Real Estate Investment Trust (REIT) are residents of the United States for purposes of the treaty. Although the income earned by these entities normally is not subject to U.S. tax in the hands of the entity, they are taxable to the extent that they do not currently distribute their profits, and therefore may be regarded as "liable to tax." They also must satisfy a number of requirements under the Code in order to be entitled to special tax treatment. 49

Based on the definition of a resident under the OECD Model Tax Convention, a fiscally transparent entity is not treated as a resident, because it is not liable to tax. Some CIVs are fiscally transparent; that is, the holders of interests in the CIV are liable to tax on the income received by the CIV, rather than the CIV itself being liable to tax on such income. 50 If a CIV is fiscally transparent, it generally is not treated as a resident of a Contracting State for treaty purposes. Instead, the investors in the CIV would need to claim any treaty benefits to which they are entitled.

Other CIVs are subject to tax, but are exempt in practice if the CIV fulfils certain criteria with regard to its activities, its distribution practice, its sources of income, and sometimes its sectors of operation. Other types of CIVs, such as U.S. RICs, are subject to tax, but the tax base is reduced for distributions made to investors, in which case little or no tax is actually paid. Other jurisdictions tax CIVs but at a special low or zero tax rate. Finally, some CIVs may be taxed, but with integration at the investor level through an exemption or credit for the investor to avoid double taxation of the income of the CIV. 51

The OECD CIV Report and the Commentary on the OECD Model conclude that a fiscally opaque CIV may be “liable to tax”, and therefore a resident of a Contracting State, even if no tax is actually imposed on the CIV. 52 A CIV that is treated as opaque in the Contracting State in which it is established will be treated as a resident of that Contracting State even if the specific items of income it receives are exempt from taxation, it receives a deduction for dividends paid to investors, or it is subject to a lower rate of tax on its income. However, a CIV that is totally and unconditionally exempt from income taxation (e.g. without regard to the type of income it receives or its distribution policy) will not be treated as a resident of its Contracting

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50 For example, an Irish Common Contractual Fund is treated as fiscally transparent for Irish tax purposes. See Section 739(I)(2)(b) of the Irish Taxes Consolidation Act, 1997.

51 See OECD CIV Report, ¶ 28.

52 See Commentary on Article 4 of the OECD Model, ¶ 8.6 (referring to the treatment of pension funds, charities, and other exempt organizations).
State. Moreover, some countries may take the view that any entity that is exempt from tax in practice would not be “liable to tax” within the meaning of Article 4, and therefore would not be treated as a resident unless the term “resident” is modified in the bilateral treaty to include those entities. The OECD CIV Report therefore recommends addressing the issue of CIVs directly in bilateral negotiations.

Based on the recommendations in the OECD CIV Report, paragraphs 6.11 through 6.13 of the Commentary on Article 1 of the OECD Model acknowledge that jurisdictions accomplish tax neutrality for CIV investors in different ways, from fiscal transparency, to exemption at the fund level, to dividends paid deductions. The Commentary suggests that the majority view is that a CIV should be treated as a resident for treaty purposes, even if the CIV generally does not pay any tax on its income, unless the jurisdiction of establishment treats the CIV as fiscally transparent. Paragraph 6.13, however, suggests that some countries take the position that CIVs that do not practically pay any tax should not be treated as residents for treaty purposes, and recommends that jurisdictions address the issue in their bilateral negotiations. Therefore, countries may or may not need special provisions in their treaties with respect to the residence of CIVs.

3. Is the CIV the Beneficial Owner of the Income?

To qualify for treaty benefits with respect to investment income such as dividends, interest, and royalties, the claimant must also be the beneficial owner of the income. Because the term “beneficial owner” is not defined in the OECD Model Tax Convention, it has the meaning that it has under the law of the State applying the Convention, unless the context otherwise requires.

Paragraph 12 et seq. of the Commentary on Article 10 of the OECD Model provides that the provisions regarding beneficial ownership are meant to allow source countries to deny treaty benefits when a recipient of income acts as a nominee, agent, or a conduit company. Paragraph 12.4 of the Commentary on Article 10 of the OECD Model clarifies that the typical distribution

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53 See OECD CIV Report, ¶ 29.

54 See Commentary on Article 4 of the OECD Model, ¶ 8.7.

55 See OECD CIV Report, ¶ 30.

56 See OECD Model Tax Convention, Articles 10(2), 11(2), 12(1); 2006 U.S. Model, Articles 10(2), 11(1), 12(1); 2016 U.S. Model, Articles 10(2), 11(1), 12(1).

57 See OECD Model Tax Convention, Article 3(2).

58 See Commentary on the OECD Model, Article 10, ¶ 12.2, 12.3.
obligations of a pension fund or CIV would not prevent the pension fund or CIV from being the beneficial owner of the income it receives.

The 2006 U.S. Model and the 2016 Model also do not define the term beneficial owner. However, the 2006 U.S. Technical Explanation provides the following guidance with respect to beneficial ownership:

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the income is attributable under the laws of the source State. Thus, if a dividend paid by a corporation that is a resident of one of the States (as determined under Article 4 (Residence)) is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the Commentary to Article 10 of the OECD Model. . . .

Either the CIV or the investors in the CIV may be treated as the beneficial owner of an item of income earned by the CIV even if it is treated as fiscally transparent pursuant to the laws of either of the Contracting States pursuant to treaty provisions similar to Art. 1(6) of the 2006 U.S. Model.59 That article provides:

For the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only to the extent that the item is treated for purposes of the taxation laws of such Contracting State as the income, profit or gain of a resident.60

The Technical Explanation to the 2006 U.S. Model states that “[t]he intention of paragraph 6 is to eliminate a number of technical problems that arguably would have prevented investors using such entities from claiming treaty benefits, even though such investors would be subject to tax on the income derived through such entities.”61 The discussion regarding


60 2006 U.S. Model, Art. 1(6).

beneficial ownership of an item of income paid to a fiscally transparent entity in the Technical Explanation to the 2006 U.S. Model confirms that beneficial ownership is one of referenced technical problems. That discussion provides that:

“[s]pecial rules, however, apply to shares that are held through fiscally transparent entities. In that case, the rules of Article 1(6) will apply to determine whether the dividends should be treated as having been derived by a resident of a Contracting State. If so, then the source country rules will apply to determine whether that person, or another resident of the other Contracting State, is the beneficial owner of the income. …”

Thus, the Technical Explanation suggests that while source country principles are applied for purposes of determining whether a person is a beneficial owner, such principles are not applied for purposes of determining which person (i.e., the CIV or the investors) should be tested as the beneficial owner in the case of an item paid to a CIV that is fiscally transparent under the laws of either Contracting State. In this case, article 1(6) is applied first to identify the person who derives the item of income and the source state requirements of the beneficial ownership are applied to such person.

This paradigm is particularly problematic in cases where the CIV is fiscally transparent in its State of organization and is not resident is the same Contracting State as its investors. The Technical Explanation states that:

[I]t may be that the person who “derives” the income under Article 1(6) is not the same person as the “beneficial owner” under Article 10. This will not prevent a claim for treaty benefits, so long as each of the requirements is met by one or more residents of the other Contracting State.

However, if the CIV is not a resident of the investor’s jurisdiction (i.e., the other Contracting State), the Technical Explanation suggests that the CIV may be treated as the beneficial owner, while the investor is treated as the person who derives the item of income. This is because, for example, the term “beneficial owner” has been generally defined for U.S. federal tax purposes by case law and administrative guidance to mean a person that has dominion and control over the income. This appears to be a legal, not a tax, standard. Thus, the investor may be treated as deriving the item of income but not be treated as the beneficial owner under the laws of the

62 Technical Explanation to the 2006 U.S. Model, Art. 10(2).

63 Id.

64 See Aiken Indus. v. Comm’r, 56 T.C. 925 (1971); Del Comm. Prop., Inc. v. Comm’r, 251 F.3d 210 (D.C. Cir. 2001), aff’g, 78 T.C.M. 1183 (1999). See also Technical Explanation to the 2006 U.S. Model, Art. 10(2) (stating the beneficial owner of a dividend is the person to which the income is attributable under the laws of the source State. Thus, the beneficial owner is not a person that receives a dividend as a nominee or an agent on behalf of a nonresident).
source state because the CIV, not the investor, legally has dominion or control over the item of income.

The Technical Explanation has tried to work around this issue by treating the investor and the fiscally transparent CIV as a combined entity for purposes of determining beneficial ownership.\(^65\) This approach appears to be a workable solution only if the investor and the CIV are resident in the same Contracting State and not in cases where the CIV is not a resident of the investor’s Contracting State. However, it seems clear that the investor should be entitled to treaty benefits where it is a resident of a Contracting State and derives the item of income. In other words, the basic treaty construct is that there should be reduced source state taxation, but only if the residence state currently taxes the income. Whether a CIV in a third jurisdiction has direct dominion and control over the income (\textit{i.e.,} beneficial ownership) does not appear to be relevant.

The OECD CIV Report tries to establish a consistent position regarding whether a CIV is the beneficial owner of the income it receives, though it is not clear that the OECD has been successful in this regard, even with respect to fiscally opaque CIVs. Some jurisdictions have denied CIVs treaty benefits because they take the position that the CIV is not the beneficial owner of the income it receives.\(^66\) Those jurisdictions generally take the view that, because the CIV distributes its income regularly and pays little or no tax at the entity level, essentially the CIV is acting as a conduit and not as the beneficial owner of the income.\(^67\) The OECD CIV Report, however, notes that the position of an investor in a CIV is significantly different from the position of an investor who owns the underlying assets directly. While an investor in a CIV may have a right to receive its proportionate share of the assets of the CIV on liquidation, an investor in a CIV generally has no legal or tax right to the CIV’s assets.\(^68\) Similarly, an investor in a CIV generally cannot direct the sale or purchase of particular securities. In the case of CIVs, the manager of the CIV has discretionary powers to manage the assets within the parameters of the offering documents.\(^69\)

In addition, the tax situation of an investor in a CIV usually is significantly different than it would be if the investor owned the assets directly. For example, an investor who sells its

\(^{65}\) Technical Explanation to the 2006 U.S. Model, Art. 10(2).

\(^{66}\) See OECD CIV Report, ¶ 31.

\(^{67}\) See OECD CIV Report, ¶ 32.

\(^{68}\) See OECD CIV Report, ¶ 32.

\(^{69}\) See OECD CIV Report, ¶ 33.
shares in a CIV usually is taxed on the investor’s gain in the shares, not on its share of the income earned by the CIV or the investor’s share of the CIV’s gain in its assets.\textsuperscript{70}

The OECD CIV Report therefore concludes that a CIV should be treated as the beneficial owner of the income it receives if the managers of the CIV have discretionary powers to manage the assets.\textsuperscript{71} That conclusion assumes that the CIV is a resident and is not otherwise acting as a nominee or agent. This conclusion is incorporated in to paragraph 6.14 of the Commentary on Article 1 of the OECD Model.

Paragraphs 6.15 and 6.16 of the Commentary on Article 1 of the OECD Model, however, recognize that not all jurisdictions currently treat CIVs as the beneficial owner of income, and suggests that jurisdictions may want to negotiate a mutual agreement clarifying the treatment of certain types of CIVs in their respective jurisdictions. Paragraph 6.16 of the Commentary on Article 1 of the OECD Model suggests that the authorities might adopt one or more different models:

- Simply confirming that a certain type of CIV satisfies the requirements of being a person resident in the treaty jurisdiction and the beneficial owner of its income, and is therefore entitled to treaty benefits in its own right;
- Providing an administratively feasible way to make claims with respect to treaty-eligible investors; or
- Providing that a CIV is to be treated as an individual resident in the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual had received the income in the same circumstances, the individual would have been considered to be the beneficial owner thereof).\textsuperscript{72}

Here, again, the Commentary on the OECD Model provides multiple possible approaches, rather than a single recommended approach.

B. Addressing Treaty Shopping

While the BEPS Project has increased the focus on treaty shopping, some countries have always been concerned that a CIV that is not subject to tax in the jurisdiction in which it is established could be used for treaty shopping. The concern is that, if such a CIV is granted treaty benefits on its own account and without regard to the treaty entitlement of its investors, investors

\textsuperscript{70} See OECD CIV Report, ¶ 34. See, e.g., § 851(a) (providing that a RIC is treated as a domestic corporation).

\textsuperscript{71} See OECD CIV Report, ¶ 35.

\textsuperscript{72} See Commentary on Article 1 of the OECD Model, ¶ 6.17.
who are not entitled to treaty benefits could inappropriately receive treaty benefits by investing through the CIV.\textsuperscript{73}

The Commentary on the OECD Model suggests a number of potential anti-abuse provisions that could be included in treaties to prevent granting benefits in inappropriate cases.\textsuperscript{74} One is a look-through approach that would deny treaty benefits to companies that are owned by persons that are not resident in the other Contracting State.\textsuperscript{75} An exception to the look-through approach might apply if the recipient of the income is subject to tax on the income.\textsuperscript{76} Alternatively, the look-through approach might apply only if the recipient violates an anti-base erosion test.\textsuperscript{77} Other exceptions, such as a \textit{bona fide} business purpose test, an activities test, or a regularly traded test, might also apply.\textsuperscript{78} Similarly, an anti-abuse provision could apply to entities or income that benefits from a preferential tax regime.\textsuperscript{79} Finally, benefits might be denied to a transaction or arrangement that has as its main purpose obtaining treaty benefits.\textsuperscript{80}

The OECD CIV Report suggests that whether and what type of anti-abuse rule should be included depends on the economic characteristics of the types of CIVs used in each Contracting State. For example, a CIV that is not subject to any taxation may present a higher risk of treaty shopping than a CIV that is subject to tax or that withholds on non-resident investors.\textsuperscript{81} In other words, if the CIV bears an actual tax in its jurisdiction of residence and/or withholds on distributions to nonresident investors, treaty shopping is less of a concern. This makes sense from a treaty policy perspective. If residence country tax is actually borne on the income, the source country should reduce its withholding tax, per the general bargain in tax treaties. This model is described in more detail with respect to U.S. regulated investment companies (“RICs”), in Section V.C, below.

Countries that are concerned about treaty shopping might include in their treaties either a general anti-abuse rule, or a specific rule that deals with CIVs. In either case, an anti-treaty

\textsuperscript{73} See OECD CIV Report, ¶ 52.

\textsuperscript{74} See Commentary on Article 1 of the OECD Model, ¶¶ 13 – 24.

\textsuperscript{75} See Commentary on Article 1 of the OECD Model, ¶ 13.

\textsuperscript{76} See Commentary on Article 1 of the OECD Model, ¶ 15.

\textsuperscript{77} See Commentary on Article 1 of the OECD Model, ¶ 17.

\textsuperscript{78} See Commentary on Article 1 of the OECD Model, ¶ 19.

\textsuperscript{79} See Commentary on Article 1 of the OECD Model, ¶¶ 20 – 21.3, 21.5.

\textsuperscript{80} See Commentary on Article 1 of the OECD Model, ¶ 21.4.

\textsuperscript{81} See OECD CIV Report, ¶ 53.
shopping provision generally looks at whether a specific proportion of the owners of the CIV are residents of the Contracting State in which the CIV is established. In some cases, the anti-abuse rule might be liberalized to look to whether the owners of the CIV would have been entitled to equivalent treaty benefits if they had invested in the CIV’s assets directly (generally referred to as a “derivative benefits provision”). A derivative benefits provision helps ensure greater neutrality between direct investment and investment through a CIV, because it allows a CIV to claim benefits that are similar to those that the investors in the CIV would have been able to achieve if they had invested in the CIV’s assets directly.\textsuperscript{82} A derivative benefits provision also potentially increases economies of scale by allowing investors from different jurisdictions to invest in a single CIV.

On the other hand, some countries are concerned that taking into account residents of countries other than the source country and the country of the CIV undermines the bilateral nature of tax treaties.\textsuperscript{83} In practice, this concern seems to be focused primarily on the potential for deferral or non-taxation of the investors with respect to their shares of the CIV’s income due to potential mismatches in the three jurisdictions’ rules. For example, assume that an investor in State Q invests in a CIV in State R. CIV, in turn, invests in shares of companies resident in State S. If CIV is exempt from State R tax on its investment income and CIV does not distribute its income currently, the State Q investor can benefit from deferral. Of course, in this situation, it is not clear that State R investors could not also benefit from deferral, unless they are imputed income through an anti-deferral regime or some other mechanism.

Alternatively, some anti-abuse rules (such as the 2016 U.S. Model LOB) provide a qualifying category for companies the stock of which is publicly traded in the Contracting State in which it is established, without regard to the residence of its investors. The OECD CIV Report justifies this approach by asserting that a publicly traded company cannot be used for treaty shopping because the shareholders cannot individually exercise control over its investments.\textsuperscript{84} A subsequent OECD discussion draft, however, argues that even widely held investment funds might be used for treaty shopping purposes.\textsuperscript{85} It is possible that the OECD is drawing a distinction between CIVs the shares of which are regularly traded and other CIVs that are widely held but not listed on an exchange; however, it is hard to understand the policy basis for such a distinction. In both cases, the investor cannot control the investments of the CIV. In both cases, however, the investor may receive the economic benefit of treaty benefits that the investor would not have received if it had invested in the assets of the CIV directly.

\textsuperscript{82} See OECD CIV Report, ¶ 55.

\textsuperscript{83} See OECD CIV Report, ¶ 55.

\textsuperscript{84} See OECD CIV Report, ¶ 57.

NOTE: This is an incomplete working draft. The draft omits certain information, and may contain inaccuracies. The views expressed in this draft do not reflect the views of KPMG LLP.

The recommendations of the OECD CIV Report, as incorporated into the Commentary on Article 1 of the OECD Model, essentially list a wide array of possible anti-abuse rules. Paragraph 6.21 of the Commentary on Article 1 of the OECD Model, for example, suggests that concerns about treaty shopping could be dealt with by including a provision that treats a CIV as an individual resident of a Contracting State only to the extent that the beneficial interests in the CIV are owned by “equivalent beneficiaries”. For this purpose, an “equivalent beneficiary” is defined as a resident of the Contracting State in which the CIV is established and a resident of any other State with which the source State has an income tax convention that provides for effective and comprehensive information exchange who would, if he received the income, be entitled to benefits under that convention (or the domestic law of the source State) to a rate of tax that is at least as low as the rate claimed by the CIV.\(^6\)

The Commentary on Article 1 of the OECD Model suggests that this “equivalent beneficiary” approach (granting benefits to a CIV to the extent that the investors in the CIV would be entitled to equivalent benefits) ensures neutrality as between direct investments and investments through a CIV.\(^7\) While that statement has some superficial appeal, it is not quite accurate, or at least it is not accurate in all cases. In particular, the investors in the CIV may comprise investors who are entitled to treaty benefits, and investors who are not. If the CIV cannot allocate the benefits of the reduced withholding to the investors who would have been entitled to treaty benefits (i.e., the CIV must pay the same distribution with respect to each unit or share), then none of the investors achieve neutrality. That is, the investors that would have been entitled to treaty benefits if they had invested directly will suffer too much withholding, and those that would not have been entitled to treaty benefits if they had invested directly receive a windfall. Similarly, the investors in the CIV may change during the time between when the CIV earns or receives the income and when the CIV makes a distribution to its investors. More or fewer of the new investors might have been entitled to treaty benefits if they had invested directly, but they would be subject to the blended rate based on the old investor base of the CIV. The foregoing discussion, of course, assumes that the CIV can even determine its investor base at the time the income is earned and at the time it makes a distribution. As discussed in 0 below, that assumption often does not hold true, because interests in CIVs often are held through one or more intermediaries.

Paragraph 6.26 of the Commentary on Article 1 of the OECD Model suggests that some countries may believe that taking into account equivalent beneficiaries would undermine “the bilateral nature of tax treaties”, and those countries might prefer to provide benefits to a CIV only to the extent that the interests in the CIV are owned by residents of the Contracting State in which the CIV is established. Limiting benefits to the proportion of CIV investors that are resident in the same jurisdiction as the CIV, of course, suggests that CIVs should only accept investors that are resident in that jurisdiction, or at least makes it administratively difficult for a

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\(^6\) Paragraph 6.21 of the Commentary on Article 1 of the OECD Model Tax Convention.

\(^7\) Paragraph 6.23 of the Commentary on Article 1 of the OECD Model Tax Convention.
CIV to accept investors from other jurisdictions. As described in the prior paragraph, if a CIV cannot allocate the treaty benefits to particular investors (because, for example, it is required to make equal distributions with respect to each share), it also may provide too much benefit to some investors and too little for other investors, as compared with direct investment by the investors. This approach also requires the CIV to determine the residence of its owners, which may not be feasible with existing structures. The Commentary on Article 1 of the OECD Model attempts to address at least some of these issues by suggesting that a Contracting State might want to consider granting treaty benefits to all of the CIV’s income if more than a threshold percentage of the CIV’s interests are held by residents of the CIV’s state or by residents of that state and equivalent beneficiaries.88

Some States may want to take an entirely different approach – allowing the CIV to claim treaty benefits on behalf of its investors.89 Again, this approach has some intuitive appeal. In theory, it would provide each investor with the withholding rate that the investor would have received if it had invested directly. Such an approach would only be feasible, however, if the CIV were able to allocate the right withholding amount to each investor, for example, by issuing a different class of shares to different classes of investors. As with all of the other approaches discussed so far, it also requires the CIV to determine the treaty eligibility of each of its investors and monitor changes over time. Again, due to the intermediated structure of CIV ownership, that often is not possible.

Each of the anti-abuse rules described above would require a CIV to identify its investors, and most would require an analysis of the treaty eligibility of the investors. The Commentary on Article 1 of the OECD Model proposes several solutions to the issue of identifying the investors in the CIV. For example, in some countries (including the United States), the overwhelming percentage of investors in CIVs are resident in the State in which the CIV is established, due to regulatory or economic (including withholding tax) factors. In those cases, it may be appropriate to assume that all of the interests in the CIV are held by residents of that State, if the CIV has limited the distribution of units to that State.90 Paragraph 6.31 of the Commentary on Article 1 of the OECD Model suggests that, if interests in the CIV are also held by residents of other countries, the CIV could determine the identity of its investors on a periodic (but no more frequently than quarterly) basis.

Alternatively, States may want to provide that a CIV that is publicly traded is entitled to treaty benefits without regard to the residence of its investors. The theory behind this is that a publicly traded CIV cannot be used for treaty shopping because the shareholders of the CIV

88 See Paragraph 6.27 of the Commentary on Article 1 of the OECD Model Tax Convention.

89 See Commentary on Article 1 of the OECD Model, ¶ 6.28.

90 See Paragraph 6.30 of the Commentary on Article 1 of the OECD Model Tax Convention.
cannot individually exercise control over it. As discussed above, however, if a resident of a third jurisdiction (that does not have a treaty with the source State) invests in a publicly traded CIV for purposes of getting the benefit of a treaty between the State in which the CIV is established and the source State, that could be seen as treaty shopping. Indeed, subsequent OECD documents have suggested that widely held investment funds can be used for treaty shopping. Finally, the OECD suggests an anti-abuse rule may not be needed if the CIV is itself subject to an entity-level tax or if distributions to non-resident investors are subject to withholding tax. The Commentary on Article 1 of the OECD Model thus suggests a menu of different provisions that States might include in their treaties, and even suggests that a single bilateral treaty might treat CIVs in the two treaty partners differently.

C. Preventing Deferral by Investors

Some source States are concerned about investors deferring recognition of their share of the CIV’s income, especially when the CIV is subject to no or low taxation. Specifically, use of a CIV may result in deferral if the CIV does not pay tax in its jurisdiction of residence, is not fiscally transparent for purposes of the owner’s taxing jurisdiction, and does not distribute its income currently. If neither the investment vehicle nor the investor is subject to tax on a current basis, a source country may not want to grant treaty benefits, because deferral (over a long enough period) can be viewed as equivalent to non-taxation. The view of States concerned about deferral is that benefits to the CIV should be limited to the proportion of the CIV’s investors who are currently taxable on their share of the income of the CIV – i.e., those investors that treat the CIV as fiscally transparent or, potentially, that are subject to anti-deferral regimes. In the view of some States, anti-deferral regimes may not be sufficient, and full fiscal transparency would be needed. They worry that, if the investment vehicle is not viewed as transparent, the character of the income recognized by the investor may be different than the income realized by the investment vehicle, and the investor may be subject to preferential taxation on the income. This is especially important if the investor sells its interest in the investment vehicle before the investment vehicle distributes any income, because the gain from the sale of the interest may be exempt from tax by the investment vehicle’s jurisdiction of residence. Capital gain also may

91 See Paragraph 6.32 of the Commentary on Article 1 of the OECD Model Tax Convention.
93 See Commentary on Article 1 of the OECD Model, ¶ 6.20.
94 See Commentary on Article 1 of the OECD Model, ¶ 6.22.
95 See OECD CIV Report, ¶ 58.
96 See OECD Model Tax Convention, Article 13(5); see also 2016 U.S. Model, Article 13(6).
be subject to exemption or preferential rates in the investor’s home jurisdiction. Because the intermediated ownership structures of CIVs make administration of a fiscal transparency approach difficult, however, the OECD CIV report suggests that countries that are concerned about deferral might include provisions in their treaties to extend benefits only to those CIVs that are required to distribute earnings currently.

Other States have less concern about the potential for deferral. In many countries, the tax rate with respect to investment income is not significantly higher than the 10 – 15 percent withholding rate on dividends, so there would be little residence-country tax deferral. Others view the risk as being addressed by anti-deferral regimes in the investor’s country of residence. Moreover, many CIVs either are required to distribute income on a regular basis or have economic incentives to do so, for example because the compensation of the manager depends on the cash return realized by investors.

D. CIVs Claiming Treaty Benefits on Behalf of Investors

In some cases, the CIV will not qualify for treaty benefits in its own right, based on the criteria above. If the investment vehicle does not qualify for treaty benefits, the investment vehicle’s investors might claim treaty benefits if the investor is treated as a resident of a treaty partner, the investor is treated as the beneficial owner of the income, and the investor meets any other criteria (such as LOB). If a CIV is not entitled to treaty benefits in its own right, the risk of double taxation suggests that investors should be able to claim treaty benefits whether they are resident in the same jurisdiction in which the CIV is established, or in another jurisdiction that entitles them to benefits from the source State. Some jurisdictions argue, however, that allowing investors in third countries to claim benefits is inconsistent with the bilateral nature of treaties. In particular, they argue, there may not be a significant risk of double taxation if neither the CIV nor the investors in third States are currently taxable on the income received by the CIV — i.e., they are concerned about deferral or double non-taxation.

The OECD CIV Report acknowledges, however, that investors in a CIV claiming benefits on their own behalf generally is not feasible, for three reasons. First, because a CIV has a diversified portfolio and often has thousands of individual investors, each individual claim would be for small amounts. Investors generally would not be willing (and often it is not

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97 See, e.g., § 1(h).
98 See OECD CIV Report, ¶ 58.
99 See OECD CIV Report, ¶ 59.
100 See Commentary on Article 1 of the OECD Model, ¶ 6.25.
101 See OECD CIV Report, ¶ 36.
102 See OECD CIV Report, ¶ 36.
economically rational) to make a separate claim, particularly a refund filing. Second, because of
the intermediated structures through which interests in CIVs are held, investors may not be able
to prove that they bear the relevant withholding taxes. In addition, for investors to claim treaty
benefits on their own behalf, conceptually the investors would need to treat the CIV as fiscally
transparent in order to be treated as the recipients and beneficial owners of the income. A CIV
also would need to be able to allocate specific items of income it receives and the withholding on
that income to specific investors, which can be tremendously complex and expensive.

Allowing a CIV to claim treaty benefits on behalf of its investors may be a more
administrable approach, but would require additional guidance and procedures by governments.
Most importantly, CIVs would need practical procedures, officially recognized by governments,
for determining the ownership of interests in the CIV held through intermediated structures.
We discuss a possible basis for such procedures in more detail in Section IV.B, below.

Alternatively, a source country might decide that it will grant treaty benefits to a CIV on
behalf of its investors if the CIV industry in the treaty partner jurisdiction is largely limited to
domestic investors. For example, a CIV might restrict sales of interests in the CIV to investors
in specific countries that would benefit from a treaty with the source country. Alternatively, a
CIV could establish separate classes of interests for those investors entitled to treaty benefits and
for those investors who are not. In either case, a source country might be willing to grant treaty
benefits to the CIV on the basis of those restrictions.

E. Avoiding Double Taxation Through Foreign Tax Credits

In theory, potential double taxation with respect to income earned by a CIV could be
relieved by the residence country of the investor providing a foreign tax credit for any source
country tax withheld. That approach often is not possible, however, if the investor’s country
of residence does not view the CIV as transparent. In that case, the jurisdiction in which the
investor is resident generally would not apply its treaty with the source country, because the
investor’s residence jurisdiction would view the CIV – and not the investor – as the beneficial
owner of the income.

103 See OECD CIV Report, ¶ 37.


105 See OECD CIV Report, ¶ 40.

106 See OECD CIV Report, ¶ 44. For example, under U.S. law, foreign tax credits generally are not available to
shareholders of a domestic corporation with respect to foreign taxes paid by the domestic corporation, such as a
RIC. Instead, the RIC itself is entitled to a foreign tax credit. See § 901. However, a RIC that meets certain criteria
may make an election to pass the foreign taxes that it pays to its shareholders, so that the shareholders may claim a
foreign tax credit. See § 853.
The OECD CIV Report suggests that countries might consider a provision in the treaty between the investor’s residence jurisdiction and the CIV’s jurisdiction to require the investor’s jurisdiction to provide the investor with a credit for taxes paid by the CIV to a third, source country.\footnote{See OECD CIV Report, ¶¶ 44 – 45.} The OECD CIV Report acknowledges that such a provision raises a number of concerns. First, the treaty provision would be between the investor’s residence jurisdiction and the CIV’s jurisdiction, so it may not involve the source jurisdiction. Therefore, there may not be any obligation on the source jurisdiction to provide similar benefits. Moreover, the CIV may be subject to greater withholding from the source jurisdiction than the investor would have been if the investor had invested directly. The provision therefore could be inconsistent with the allocation of taxing rights in the treaty between the investor’s jurisdiction of residence and the source jurisdiction.\footnote{See OECD CIV Report, ¶ 46.}

In summary, the OECD CIV Report recommends numerous different options for jurisdictions to clarify the treatment of CIVs under their treaties. Specifically, special provisions may or may not be appropriate to clarify whether or when a CIV is a person, a resident, or the beneficial owner of income. Anti-abuse rules may or may not be appropriate, and many different models of anti-abuse rules may be pursued. Further, jurisdictions may want to allow CIVs to claim treaty benefits on behalf of their investors in certain circumstances. While the various options have been described in the Commentary on the OECD Model, jurisdictions generally have not incorporated them into the bilateral tax treaties to clarify the entitlement of CIVs.

F. BEPS Action 6 2015 Final Report

Subsequent to the adoption of the OECD CIV Report, Action 6 of the BEPS Project identified treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns.\footnote{See OECD CIV Report, ¶ 46.} The BEPS Action 6 2015 Final Report defines treaty shopping as involving strategies through which “a person who is not a resident of a State attempts to obtain benefits that a tax treaty concluded by that State grants to residents of that State.”\footnote{See BEPS Action 6 2015 Final Report, Executive Summary.} The BEPS Action 6 2015 Final Report suggests two reasons that treaty shopping is a problem. The first is that treaty shopping may reduce the incentive for States to enter into bilateral tax treaties, because their residents may be able to receive the benefit of the treaties between other States through treaty shopping.\footnote{See BEPS Action 6 2015 Final Report, ¶ 25, draft Commentary on Article [X] Concerning the Entitlement to Treaty Benefits, ¶ 3.1.} The second is that it may be inappropriate to grant treaty benefits indirectly to the
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residents of a State that does not tax the income in question, because the assumption underlying income tax treaties is that both Contracting States otherwise would tax the income.\textsuperscript{112}

The BEPS Action 6 2015 Final Report recommends three basic approaches to combat treaty shopping:

- First, a clear statement that the States that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements will be included in tax treaties . . . .

- Second, a specific anti-abuse rule, the limitation-on-benefits (LOB) rule, that limits the availability of treaty benefits to entities that meet certain conditions will be included in the OECD Model Tax Convention. These conditions, which are based on the legal nature, ownership in, and general activities of the entity, seek to ensure that there is a sufficient link between the entity and its State of residence. Such limitation-on-benefits provisions are currently found in treaties concluded by a few countries and have proven to be effective in preventing many forms of treaty shopping strategies.

- Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule described above, a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or “PPT” rule) will be included in the OECD Model Tax Convention. Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.\textsuperscript{113}

As a result of BEPS Action 6, countries have committed to a minimum standard to prevent treaty shopping, which requires the express statement that their intention is to eliminate double taxation without creating opportunities for non-taxation, as well as: (i) the combined approach of an LOB and PPT rule; (ii) the PPT rule alone; or (iii) the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax

\textsuperscript{112} See BEPS Action 6 2015 Final Report, ¶ 25, draft Commentary on Article [X] Concerning the Entitlement to Treaty Benefits, ¶ 3.1.

\textsuperscript{113} BEPS Action 6 2015 Final Report, Executive Summary.
treaties.\textsuperscript{114} The minimum standard is expected to be implemented in the multilateral instrument negotiated pursuant to BEPS Action 15, as well as in bilateral negotiations of future treaties.

The LOB in the BEPS Action 6 2015 Final Report (the “OECD LOB”) largely follows the LOB in the 2006 U.S. Model, with some modifications. The OECD LOB is separated into a simplified version and a detailed version, but both have the same basic mechanics. Under the OECD LOB, a person is not entitled to treaty benefits unless the person satisfies one of the tests of the LOB.\textsuperscript{115} There are three tests under the LOB that may be useful to investment vehicles. The first is the publicly traded test, which applies if the investment vehicle’s shares are listed on a recognized stock exchange, and, in the case of the detailed provision, the shares are regularly traded and meet certain other criteria.\textsuperscript{116}

The second test under the OECD LOB that is relevant to investment vehicles is the ownership-base erosion test. The simplified version requires only that more than 50 percent of the interests in the entity are owned by qualified residents of the Contracting State. The detailed version requires that more than 50 percent of the interests in the entity are owned by qualified residents of the Contracting State and less than 50 percent of the entity’s gross income is paid or accrued in the form of deductible payments to persons who are not qualified residents of the Contracting State.\textsuperscript{117}

The OECD LOB also includes a derivative benefits provision. The simplified version requires that more than 75 percent of the interests in the entity are held by equivalent beneficiaries. The detailed version requires that at least 95 percent of the interests in the entity are held by seven or fewer equivalent beneficiaries and that less than 50 percent of the entity’s gross income is paid or accrued in the form of deductible payments to persons who are not equivalent beneficiaries.\textsuperscript{118}

Finally, the OECD LOB provides a specific category for pension funds to qualify for treaty benefits.\textsuperscript{119}

The PPT provides that treaty benefits will not be granted if it is reasonable to conclude that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted in the benefit, unless granting the benefit is in accordance with the object and

\textsuperscript{114} BEPS Action 6 2015 Final Report, Executive Summary.

\textsuperscript{115} See BEPS Action 6 2015 Final Report, ¶ 25, Article [X].

\textsuperscript{116} See BEPS Action 6 2015 Final Report, ¶ 25, Article [X].

\textsuperscript{117} See BEPS Action 6 2015 Final Report, ¶ 25, Article [X].

\textsuperscript{118} See BEPS Action 6 2015 Final Report, ¶ 25, Article [X].

\textsuperscript{119} See BEPS Action 6 2015 Final Report, ¶ 25, Article [X].
NOTE: This is an incomplete working draft. The draft omits certain information, and may contain inaccuracies. The views expressed in this draft do not reflect the views of KPMG LLP.

For purposes of the PPT, the term “arrangement or transaction” is to be interpreted broadly, to include the establishment or acquisition of an entity that is a treaty resident to derive the income. The term “one of the principal purposes” means that obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction; it is sufficient that at least one of the principal purposes was to obtain the benefit.

The work on Action 6 has raised a number of concerns about how the LOB and PPT would impact the eligibility of investment vehicles for treaty benefits. The LOB and PPT raise different kinds of concerns for investment vehicles. The LOB does not provide a category of qualified person that clearly would apply to most funds. For example, CIVs generally are not regularly traded (though some CIVs such as ETFs may be regularly traded). Similarly, non-CIV investment funds generally are not regularly traded. While many investment vehicles may be able to qualify under the “ownership-base erosion” test, an investment vehicle may not be able to establish its ownership due to an intermediated ownership structure, or may have investors from outside its jurisdiction of establishment. The “active trade or business” test generally will not apply, because investing is specifically excluded from being an active trade or business. The simplified derivative benefits provision could be helpful, but the detailed version requires seven or fewer equivalent beneficiaries own 95 percent of the investment vehicle, which would not apply to most investment vehicles.

The PPT, by its very terms, is a subjective test, based on the principal purposes of a transaction or arrangement. Applying the PPT in the context of an investment vehicle may be difficult, and governments are likely to take a range of approaches to it. Investment vehicles, including holding companies or special purpose vehicles (“SPVs”) generally are established both for non-tax commercial purposes and tax purposes. Most basically, an entity often is required to pool capital from various investors that are resident in different jurisdictions. By definition in those cases, the investment vehicle must be established in a jurisdiction that is different than the residence jurisdiction of one or more of the investors, and the fact of setting up the vehicle has nothing to do with tax or treaty benefits. By contrast, the specific jurisdiction in which the investment vehicle is established may be determined to a large extent by tax considerations, including the availability of treaty benefits. In the absence of clear guidance regarding how the

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120 See BEPS Action 6 2015 Final Report, ¶ 26, Article [X].

121 See BEPS Action 6 2015 Final Report, ¶ 26, Commentary on Article [X], ¶ 9.

122 See BEPS Action 6 2015 Final Report, ¶ 26, Commentary on Article [X], ¶ 12.


124 See BEPS Action 6 2015 Final Report, ¶ 25, Article [X].
PPT is to be applied to such an investment vehicle, there is a significant risk that treaty benefits may be denied by the source country under the PPT.

The BEPS Action 6 2015 Final Report provides limited guidance on the intended eligibility of certain types of investment vehicles, with most of the guidance focused on CIVs. With respect to CIVs, as defined in the OECD CIV Report, the conclusions of the OECD CIV Report are incorporated into the draft LOB provision. The conclusions of the OECD CIV Report also remain incorporated into the Commentary on Article 1 of the OECD Model Tax Convention. Governments therefore concluded that no additional changes were needed to address issues related to CIVs, although they noted that implementation of the recommendations of the TRACE Project are important for the practical application of the OECD CIV Report.125

Drawing on the conclusions of the OECD CIV Report, the BEPS Action 6 2015 Final Report incorporates several different models of allowing benefits to CIVs under the LOB provision. For example, if a treaty includes a provision treating a CIV as an individual resident in a Contracting State as suggested in paragraph 6.17 of the Commentary on Article 1 of the OECD Model, the BEPS Action 6 2015 Final Report points out that the CIV would be treated as a qualified person under the LOB (because individuals are qualified persons).126 The BEPS Action 6 2015 Final Report also contemplates that a special provision for CIVs could be included in the LOB provision, to treat CIVs as qualified persons to the extent agreed by the Contracting States.127 The approaches could include providing that a CIV is a qualified person:

- in all cases, in which case the treaty should define the vehicles that qualify as CIVs;
- to the extent that the interests in the CIV are owned by residents of the Contracting State in which the CIV is established or by equivalent beneficiaries;
- if the principal class of shares in the CIV is listed and regularly traded on a recognized stock exchange; or
- if the CIV is required to distribute earnings currently.128

The 2016 U.S. Model LOB provision has not incorporated any of these suggestions other than the regularly traded company test, and that test is not limited to CIVs or investment entities. We discuss the 2016 U.S. Model LOB in more detail in Section V.C.4, below.

The BEPS Action 6 2015 Final Report also includes an example describing when a CIV can satisfy the PPT. In Example D, the CIV holds 15 percent of its portfolio in shares of companies resident in State S. A majority of investors in the CIV are residents of State R (in which the CIV is resident), and while the CIV’s investment decisions take into account the existence of tax benefits under State R’s tax convention network, RCo’s investment strategy is not driven by the tax position of its investors. The CIV also annually distributes almost all of its income to its investors. As defined by the OECD, the CIV is also widely held. The example concludes that in those circumstances, it would not be reasonable to deny the CIV treaty benefits under the PPT, unless the CIV’s investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention.129

While Example D is clearly not the only example of a CIV that would satisfy the PPT, it provides approval of a very narrow set of circumstances, and it is not clear that many CIVs would satisfy the conditions of the example. In particular, the example appears to require three things that may be difficult for CIVs to meet. First, it requires that the majority of investors are resident in the same jurisdiction as the CIV. That may not be true for CIVs that pool capital from investors in multiple jurisdictions, and it may be hard for a CIV to prove even if it is true. Second, the example requires that a small minority of the CIV’s investment portfolio is in securities of companies resident in State S. This appears to preclude a CIV with an investment mandate to invest in companies in State S. Finally, the example requires the CIV to distribute almost all of its income annually.

As noted above, the BEPS Action 2 2015 Final Report also includes a proposal to include in the OECD Model Tax Convention a provision that would clarify the treatment of fiscally transparent entities, including fiscally transparent investment vehicles. That provision, which would be inserted as Article 1(2) of the OECD Model Tax Convention, provides that:

For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.130


This new provision would allow investors to claim treaty benefits to which they are entitled when they invest through entities that their jurisdiction of residence treats as fiscally transparent. The BEPS Action 6 2015 Final Report suggests that the provision should be a help to investment vehicles that do not qualify as CIVs and that are treated as fiscally transparent. In many cases, however, investment vehicles are established as entities that are not fiscally transparent due to commercial considerations such as requirements by third-party lenders. Moreover, a number of practical difficulties would need to be overcome in order to make such an approach work for a broad segment of investment vehicles: (i) all relevant jurisdictions would need to treat the investment vehicle as fiscally transparent to ensure neutrality; (ii) source countries would need to provide clear procedures for how investors can claim treaty benefits; (iii) source countries would need to establish “relief at source” mechanisms to reduce withholding to the appropriate amount, given the complexity of claiming a refund through an intermediated structure; and (iv) jurisdictions would need to provide consistent rules for allocating and reporting income and withholding tax among investors.

More generally, the guidance in the BEPS Action 6 2015 Final Report regarding treaty benefits for investment funds has three significant limitations. First, it is limited almost exclusively to CIVs as narrowly defined in the OECD CIV Report. Second, jurisdictions have not incorporated those recommendations into their treaties, and the recommendations will not be incorporated into treaties as part of the multilateral instrument that incorporates the PPT into bilateral treaties. Third, the guidance requires CIVs to be able to determine the identity – and often the treaty entitlement – of their owners. As discussed below, this raises a number of practical difficulties, and is probably the basis for the statement in the BEPS Action 6 2015 Final Report that the implementation of the TRACE Project is important to the practical applications of the guidance with respect to CIVs.

III. Intermediation

As we have seen, a key policy concern regarding the treaty entitlement of investment vehicles is ensuring that the investors in investment vehicles are identified and are entitled to treaty benefits in their own right. Unfortunately, the structures through which interests in investment vehicles are held makes identifying the investors complicated. In almost all markets, direct purchases and holdings are only a small proportion of the investments in CIVs. Instead,

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most interests are held through one or more intermediaries, such as brokers, banks, and independent financial advisors.\textsuperscript{135} Indeed, interests in CIVs may be held through multiple layers of intermediaries.\textsuperscript{136} The CIV, in turn, may hold securities through one or multiple levels of intermediaries. In many cases, the intermediary may not be in the same jurisdiction as the CIV or the jurisdiction of the issuer of the securities.\textsuperscript{137} An illustration of a typical flow of distributions by an issuer of securities (which could include a CIV) is depicted below:


Interests in CIVs held through intermediaries often are registered on the books of the CIV in the name of the intermediary, commonly referred to as being held “in street name”. An important reason for this is that intermediaries view their customers’ identities as valuable competitive information.\textsuperscript{138} In addition, holding in street name can also result in efficiencies through aggregating purchases and sales of interests, so that only the net purchase or sale of all

\begin{footnotesize}
\footnote{\textsuperscript{135} OECD CIV Report, ¶ 17.}
\footnote{\textsuperscript{136} OECD CIV Report, ¶ 19.}
\footnote{\textsuperscript{137} OECD CIV Report, ¶ 19.}
\footnote{\textsuperscript{138} OECD CIV Report, ¶ 18.}
\end{footnotesize}
of the intermediary’s customers is effected in the intermediary’s account. Because information about the investors generally is not passed through the chain of intermediaries, CIVs often do not know who their investors are. In some cases, this may make it impossible for the CIV to claim treaty benefits, and it raises concerns for governments regarding the potential for treaty shopping.

Interests in non-CIV investment vehicles also may be held through intermediaries, with similar effect. In addition, non-CIV investment vehicles may invest in other investment vehicles (so-called “fund of funds”). In this situation, the ultimate investor information is viewed as competitively valuable information, and is not passed through the chain. The lack of information again raises potential treaty shopping concerns, and may make it difficult or impossible for non-CIV investment vehicles to claim treaty benefits to which they or their investors may be entitled.

These same issues regarding financial intermediation impact the ability of portfolio investors to claim treaty benefits more generally. In most markets, the vast majority of securities are held through one or more Centralized Securities Depositories, and through one or more financial intermediaries. Typically, the financial intermediary holds securities in street name, and does not provide information regarding its customers who invest in the security.

1. U.S. QI and NQI Regimes

The United States has attempted to address the withholding tax issues raised by financial intermediation. A full description of the U.S. withholding tax regime is beyond the scope of this article; however, there are a few key elements that are relevant. First, the U.S. operates a relief at source system, which allows a withholding agent to reduce withholding if the withholding agent receives valid documentation claiming a reduced rate. A relief at source system makes it much more practical for an intermediary to claim treaty benefits on behalf of its customers, because it avoids the need for each investor to file a refund claim. Second, an intermediary may make claims on a pooled, no names basis if it enters into an agreement with the Internal Revenue Service (“IRS”) to become a qualified intermediary (“QI”) and undertake certain customer due diligence, reporting, and withholding obligations. Like an intermediary, a partnership or other fiscally transparent entity can become a QI and provide a pooled claim for treaty benefits on

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139 OECD CIV Report, ¶ 18.


141 ICG Procedures Report, ¶ 8.

142 See Treas. Reg. §§ 1.1441-1T(b)(1), 1.1441-6T(b)(1).

143 See Treas. Reg. § 1.1441-1T(b)(2)(vii)(C), (e)(5).
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behalf of its interest holders. A partnership or trust can also enter into an agreement with the IRS to become a withholding partnership or a withholding trust. If an intermediary or fiscally transparent entity does not enter into a QI, withholding partnership, or withholding trust agreement, it can claim treaty benefits on behalf of its customers or interest holders by providing the withholding agent documentation from its customers or interest holders.

The appropriate rate of withholding is determined based on documentation received from the payor’s counterparty, and does not require the withholding agent to have privity with the ultimate beneficial owner of the income. These elements, together, allow for financial intermediation by allowing a withholding agent to rely on documentation from its direct counterparty. If an intermediary or fiscally transparent entity enters into an agreement with the IRS, the intermediary or fiscally transparent entity can identify its own investors or account holders and provide the withholding agent with pooled information, rather than the competitively valuable information about the intermediary’s or fiscally transparent entity’s own investors.

2. OECD TRACE System

The OECD has undertaken work, known as the TRACE Project, that builds on the U.S. QI regime to provide a multilateral system for addressing financial intermediation. The TRACE Project culminated in an Implementation Package that, if implemented, would allow an “Authorised Intermediary” (or “AI”) to make pooled claims for treaty benefits on behalf of its customers. The AI, then, would not have to pass up the identities of its customers to the withholding agent (or next intermediary in the chain). The system envisioned by the TRACE Implementation Package is commonly referred to as the “TRACE system” or “AI system”.

There are five key elements of the TRACE system. First, the AI must be approved by the relevant source country to act as an AI. A financial intermediary that wants to become an AI would make an application to the source country. To be eligible to be an AI, an intermediary would have to be subject to anti-money-laundering/know your customer (“AML/KYC”) principles. The intermediary also would have to agree to undertake certain customer due diligence to ensure that the customer is entitled to treaty benefits, perform specified reporting, and be subject to an independent review of its compliance.

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144 See Treas. Reg. § 1.1441-6(b)(2)(ii).

145 See Treas. Reg. § 1.1441-5T(c)(2), (e)(5)(v).


148 TRACE IP, Introduction, pg. 7.
The second major element of the TRACE system is that investors would be able to indicate their treaty benefits by providing a standard investor self-certification to the AI, rather than having to obtain a certificate of residence from a tax authority. The self-certification would be backstopped by the customer due diligence requirements of the AI, including an obligation to monitor for changes in circumstances.\textsuperscript{149}

The third major element of the TRACE system is that the AI would make claims for treaty benefits on behalf of its investors on a pooled basis. That is, the AI would provide the withholding agent with the withholding tax rate that should be applied to the payment, but would not provide the withholding agent with information regarding the AI’s customers.\textsuperscript{150} In general, relief would be granted through relief at source.

Fourth, the AI would report to the source country, on a customer-specific basis, the payments made to its customers and the tax withheld with respect to those payments. The information to be provided to the source country would include details of the income received, the name and address of the investor, and, if applicable, the investor’s residence country taxpayer identification number (“TIN”).\textsuperscript{151} The source country generally would be expected to exchange the payee-specific information that it receives with the residence jurisdiction of each investor to confirm that the investor is, in fact, resident in that jurisdiction.\textsuperscript{152}

Finally, the AI would be subject to an independent review of its compliance with its customer due diligence and reporting obligations.\textsuperscript{153}

Under the TRACE system, a fiscally transparent entity is treated as an intermediary and therefore might become an AI.\textsuperscript{154} While the TRACE IP states that fiscally transparent entities would not generally be expected to become AIs, there is no obvious reason that an investment entity that is fiscally transparent could not become an AI.

While no jurisdiction has yet implemented the TRACE system, the conditions for its implementation have improved due to the implementation of the U.S. provisions commonly

\textsuperscript{149} TRACE IP, Introduction, pg. 6.
\textsuperscript{150} TRACE IP, Introduction, pg. 6.
\textsuperscript{151} TRACE IP, Introduction, pg. 7.
\textsuperscript{152} TRACE IP, Introduction, pg. 7.
\textsuperscript{153} TRACE IP, Introduction, pg. 7.
\textsuperscript{154} TRACE IP, Introduction, pg. 11.
known as FATCA,\textsuperscript{155} and the implementation of the OECD’s Standard for the Automatic Exchange of Financial Account Information in Tax Matters (commonly referred to as the “Common Reporting Standard” or the “CRS”).\textsuperscript{156} FATCA and the CRS generally require financial intermediaries, such as brokers and custodians, as well as certain investment entities to document their account holders and to report certain information related to those account holders and their accounts so that the information can be exchanged with the account holder’s jurisdiction of tax residence. FATCA and the CRS both also rely principally on self-certification by the account holder, backstopped by the financial institution’s AML/KYC obligations, to determine the account holder’s status and jurisdiction of tax residence.\textsuperscript{157} FATCA and the CRS generally also generally require the financial institution with the direct customer relationship to do the customer due diligence and reporting, because of the recognition that information regarding customers generally is not passed to other intermediaries in the chain.\textsuperscript{158}

Many of the key elements of the TRACE system therefore are already being implemented by financial institutions due to FATCA and the CRS. Financial institutions are collecting self-certifications from their customers, and those self-certifications could be modified to include a certification of treaty eligibility for purposes of the TRACE system. Financial institutions are already doing significant reporting, and governments are exchanging that information on an automatic basis. The reporting schema for FATCA, the CRS and the TRACE system have already been substantially aligned, which may reduce the burden of implanting the reporting systems necessary for the TRACE system. In addition, a source country’s authorization for a financial intermediary to act as an AI could depend, in part, on whether the intermediary is a reporting financial institution under FATCA or the CRS, which would ensure that an investor’s jurisdiction of residence receives the information about the investor.

We note that the principles of the TRACE system also could be extended to fiscally opaque investment vehicles that are treated as financial institutions under FATCA and the CRS. FATCA and the CRS require “Investment Entities” to conduct the same customer due diligence as other financial institutions to identify the status and jurisdiction of residence of their investors.\textsuperscript{159} Investment Entities also must report information regarding their investors, to be exchanged with the jurisdiction of residence of those investors. In theory, then, a fiscally opaque CIV that is an Investment Entity for purposes of FATCA or the CRS could establish the treaty

\textsuperscript{155} \S\S 1471 – 1474. “FATCA” generally also refers to the system of intergovernmental agreements entered into by the United States to facilitate the implementation of FATCA.


\textsuperscript{157} See Treas. Reg. § 1.1471-3T(d); CRS, Sections IV(A), VI(A).

\textsuperscript{158} See Treas. Reg. § 1.1471-5T(a)(3); CRS Section VIII(E)(1).

\textsuperscript{159} See Treas. Reg. § 1.1471-5(e)(4); CRS Section VIII(A)(3), (6).
eligibility of its investors (and, therefore, its own eligibility under the LOB or similar treaty rules) by collecting self-certifications from its investors or could rely on self-certifications from the intermediaries through which the investors hold their interests in the CIV.

IV. A More Inclusive Framework for Investment Vehicles

The OECD CIV Report and the resulting changes in the Commentary on Article 1 of the OECD Model are an important step forward in allowing CIVs and their investors to claim treaty benefits. However, the OECD CIV Report does not explain how the criteria for qualification as a CIV address the policy concerns that source countries have regarding granting treaty benefits to investment vehicles. Those concerns center primarily on the ability of investors to treaty shop through investment vehicles and the ability of investors in investment vehicles to defer recognition of their share of the investment vehicle’s income. Being a CIV – i.e., being widely held, being subject to regulation, and investing in a diversified portfolio of securities – does not address either of those policy concerns. Arguably, the fact of being widely held means that the CIV is not established for the purpose of allowing treaty shopping, but that does not mean that an investor cannot use a widely held investment entity to gain treaty benefits that the person otherwise would not have obtained. Indeed, a follow-up discussion draft dealing with BEPS Action 6 suggested that governments are concerned about the use of widely held investment vehicles for treaty shopping by investors. Nor do the criteria for being a CIV directly address whether the investment vehicle is a person, a resident of a Contracting State, or the beneficial owner of the income.

Another possible explanation for the OECD CIV Report’s reliance on the criteria is that the criteria help distinguish between CIVs that might qualify for treaty benefits, and other types of conduit companies that should not qualify for treaty benefits. CIVs are, from a certain point of view, conduit companies used by investors to invest in the underlying assets held by the CIV. Implicitly, the view of governments must be that CIVs that qualify under the OECD definition of a CIV are “good” conduits as opposed to “bad” conduits. However, the OECD CIV Report states that at least some governments continue to be concerned about the possible use of CIVs to achieve treaty benefits that the investors could not achieve directly – in other words, that CIVs could be used as “bad” conduits.

The disconnect between the expressed policy concerns and the criteria for being a CIV likely is partially responsible for the inability of the OECD CIV Report to prescribe a coherent

160 See OECD CIV Report, ¶ 57; see also Commentary on Article 1 of the OECD Model, ¶ 6.32.


163 OECD CIV Report, ¶ 52.
approach to the treaty entitlement of CIVs. This suggests that other criteria should be used to determine the treaty eligibility of CIVs, and potentially non-CIV investment vehicles.

With respect to non-CIV investment vehicles, the BEPS Action 6 2015 Final Report notes that further work is needed with respect to the treaty eligibility of other types of investment vehicles, which the BEPS Action 6 2015 Final Report terms “Non-CIV Funds”.164 In particular, governments agreed that the conclusions of the 2008 OECD report “Tax Treaty Issues Related to REITS” should be incorporated into the Commentary on the LOB provision of the OECD Model Tax Convention.165 The changes state that often a REIT would be treated as a resident of a Contracting State, but that the diversity of views among jurisdictions means that the treaty entitlement of REITs is an issue that would need to be clarified on a bilateral basis.166 The changes also would provide for limited benefits with respect to cross-border distributions by REITs.167

The BEPS Action 6 2015 Final Report also states that further work is to be done to ensure that a pension fund is considered to be a resident of the State in which it is constituted, regardless of whether that pension fund benefits from a limited or complete exemption from taxation in that State.168 Importantly, the BEPS Action 6 2015 Final Report includes the discussion of pension funds in the broader discussion of Non-CIV Funds, which suggests at least an implicit recognition that pension funds raise similar issues as other investment vehicles.

Finally, the BEPS Action 6 2015 Final Report states that further work will be needed with respect to other Non-CIV Funds. The BEPS Action 6 2015 Final Report suggests that the new treaty provision on transparent entities that is included in Part 2 of the Report on Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements, OECD, 2015a) will be beneficial for Non-CIV Funds that use fiscally transparent entities. In addition, the BEPS Action 6 2015 Final Report notes that the possible inclusion of a derivative benefits provision in the LOB rule would also address some of the concerns regarding the treaty entitlement of Non-CIV Funds.169 However, the BEPS Action 6 2015 Final Report reiterates that governments continue to be concerned about the possibility of Non-CIV Funds being used to provide treaty benefits to

167 Commentary on Article 10 of the Model Tax Convention, ¶¶ 67.1 – 67.7.
investors that are not themselves entitled to treaty benefits (i.e., treaty shopping) and that investors may defer recognition of income on which treaty benefits have been granted.\footnote{\textit{Action 6 2015 Final Report}, ¶ 14.}

A. Policy concerns

Based on the foregoing discussion, there are a number of potentially competing policy considerations with respect to granting treaty benefits to investment vehicles. A primary purpose of income tax treaties is to promote international trade and investment by eliminating international double taxation.\footnote{Commentary on Article 1 of the OECD Model, ¶ 7.} Similarly, a primary objective of investment entities is to avoid creating an additional level of tax beyond the tax that investors would have borne if they had invested in the underlying assets directly. At the same time, jurisdictions are concerned about the potential use of investment vehicles for treaty shopping – i.e., investors who would not have been entitled to treaty benefits from the source jurisdiction nevertheless receiving treaty benefits by investing through an investment entity in a third jurisdiction. In addition, jurisdictions increasingly do not want to grant treaty benefits with respect to income if the investor may defer recognition of its share of that income.

Taken together, these policy concerns suggest that the tax treatment of investment vehicles, including with respect to treaty benefits, should try to approximate as closely as possible the treatment that an investor would have received if it had invested directly in the underlying assets of the investment vehicle. In general, treating the investment vehicle as fiscally transparent provides the closest approximation to direct investment. The first factor in determining whether and how an investment entity should qualify for treaty benefits thus should be whether the investment entity is fiscally transparent or fiscally opaque. In general, an entity is fiscally transparent if the interest holder in the entity is required to take into account currently the interest holder’s share of the entity’s income regardless of whether the entity distributes the income, and if the source and character of the income in the interest holder’s hands are the same as if the investor had recognized the income directly.\footnote{See, \textit{e.g.}, Treas. Reg. § 1.894-1(d)(3)(ii)(A).} An entity might be fiscally transparent under the laws of its own jurisdiction, but not under the laws of the investor’s jurisdiction, or \textit{vice versa}. For purposes of this article, an entity is “fiscally opaque” if it is not fiscally transparent.

If an investment vehicle is fiscally transparent, it cannot qualify for treaty benefits in its own right because it is not liable to tax. (For purposes of simplicity in this initial discussion, we assume that all relevant jurisdictions treat the investment vehicle as fiscally transparent.) Indeed, in some cases, an investment vehicle may not even qualify as an entity or as a person.\footnote{See OECD CIV Report, ¶¶ 23 – 25.} In that

\footnote{Action 6 2015 Final Report, ¶ 14.}

\footnote{Commentary on Article 1 of the OECD Model, ¶ 7.}

\footnote{See, \textit{e.g.}, Treas. Reg. § 1.894-1(d)(3)(ii)(A).}

\footnote{See OECD CIV Report, ¶¶ 23 – 25.}
case, eligibility for treaty benefits must be determined on the basis of whether the investors in the investment vehicle qualify for treaty benefits with respect to their shares of the investment vehicle’s income. If all jurisdictions treat the entity as fiscally transparent, the policy objectives with respect to investment vehicles may be accomplished in a relatively straightforward manner. There would be no entity-level tax, and investors would recognize their share of the investment vehicle’s income on a current basis – i.e., there would be no deferral, and investors would be taxed in a manner similar to how they would have been taxed if they had invested directly in the underlying assets.  

Similarly, concerns about treaty shopping would be addressed, because treaty benefits would be granted to the investors directly, as appropriate.

This simple scenario is almost never realized in reality. In most cases, some jurisdictions may treat the investment vehicle as fiscally transparent, while others treat the investment vehicle as fiscally opaque. In addition, there may be multiple tiers of investment vehicles or intermediaries through which the interests in the investment vehicle are held. In those circumstances, determining eligibility for treaty benefits is significantly complicated. Moreover, if the investment vehicle has many investors from multiple jurisdictions, the administrative complexity and costs may undermine the efficiencies of collective investment. In particular, investors in different jurisdictions may require different accounting of their share of the investment vehicle’s income, and sales and redemptions of interests in the investment vehicle may require daily closings of the investment vehicle’s books.

If the investment vehicle is fiscally opaque, it may be treated as a resident and able to claim treaty benefits in its own right. In this case, though, a number of questions remain. In most cases, the entity-level tax on the investment vehicle is eliminated, either by exempting the investment vehicle’s investment income from tax or by providing a deduction for distributions to investors. Some jurisdictions take the view that in those cases, the investment vehicle is not a resident, because in practice it does not pay tax. Similarly, tax or regulatory requirements may require the investment vehicle to distribute most or all of its income on a regular basis. Some jurisdictions therefore question whether the investment vehicle is the beneficial owner of its income. Finally, many states are concerned that fiscally opaque entities allow for treaty shopping or deferral by investors. Somewhat counterintuitively, the fact that some investment vehicles are required to distribute most or all of their income on a regular basis may reduce the possibility of deferral and the opportunity for treaty shopping, but may undermine the investment vehicle’s claim of beneficial ownership in the view of some governments. A requirement for the CIV to distribute its income on a regular basis therefore may be seen as a positive factor in determining whether it is eligible for treaty benefits.

Whether an investment entity is fiscally transparent or fiscally opaque, the second major factor in determining eligibility for treaty benefits is identifying the investors in the investment entity. In the case of fiscally transparent investment vehicles, this issue is foundational, because

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174 Investing through a fiscally transparent entity does not always result in exactly the same treatment as investing directly. See, e.g., §§ 741, 751 of the Code.
there can be no determination of the treaty benefits to be provided to the investor unless the
investors are identified. For fiscally opaque investment vehicles, identifying investors is
important to protect against treaty shopping. There are at least two complicating factors in
identifying the investors in an investment vehicle. The first is financial intermediation – i.e., the
fact that interests in an investment vehicle often are held through one or more intermediaries or
through an upper-tier investment vehicle. Often, these intermediaries or other investment
vehicles are not willing to provide information about the investors to entities down the chain,
because the investors are the customers of the upper-tier entity (i.e., it is competitively valuable
information). The second complicating factor is related to the first, and it is that it may not be
obvious at what level treaty entitlement should be tested. In other words, should an entity that
owns an interest in an investment vehicle be tested for treaty eligibility as an investor or as
another investment entity the investors in which must be identified?

B. Possible Treaty Definition of Investment Vehicle

As discussed above, the definition of a CIV does not appear to address the treaty policy
concerns that governments have. In addition, investment vehicles that do not meet the narrow
definition of a CIV raise very similar treaty entitlement issues. These non-CIV investment
vehicles also are intended to pool capital to allow investors access to professional management
and a diversified investment portfolio without creating an additional level of tax over what the
investor would have borne if it had invested in the underlying assets directly. These non-CIV
investment vehicles include hedge, private equity, alternative investment, and pension funds. As
discussed below, there are administrability issues that may lead to different treatment for CIVs
that are widely held, but the basic policy issues are the same regardless of whether the
investment vehicle is widely held.

The factors defining an investment vehicle for treaty purposes should follow the policy
concerns of governments. On that basis, the key criteria for qualifying as an investment vehicle
appear to be that the entity is:

- Engaged in investing in financial assets or real estate;\(^{175}\)
- Fiscally transparent or is required (either legally or economically) to distribute all or
  most of its income on a regular basis; and
- Able to identify its investors’ eligibility for treaty benefits.

FATCA and the CRS each provide a definition of “Investment Entities” that address
some of the criteria above, and could be the basis of a more inclusive framework for investment
vehicles. The focus of these definitions is on the activities of the entity itself and not the type of
investors nor the number of investments made by the vehicle. The type of investor should be

\(^{175}\) This criterion is important to distinguish an investment vehicle from an operating business.
viewed as irrelevant because investment vehicles for the pooling of capital are used both by individuals and by large sophisticated investors to make diversifying investments (from the investor’s perspective). The number of investments made by the entity also should be viewed as irrelevant. A vehicle may have a single investment, but the investment may be too large for even a single large investor to undertake. The investor obtains diversification with respect to all of its other investments as whole through investment in the vehicle.

FATCA defines three types of Investment Entities. Under FATCA, an entity is an Investment Entity if:

- The entity primarily conducts as a business one or more of the following activities or operations for or on behalf of a customer—(1) Trading in money market instruments (checks, bills, certificates of deposit, derivatives, etc.); foreign currency; foreign exchange, interest rate, and index instruments; transferable securities; or commodity futures; (2) Individual or collective portfolio management; or (3) Otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons;

- The entity's gross income is primarily attributable to investing, reinvesting, or trading in financial assets . . . and the entity is managed by [a financial institution]. [A]n entity is managed by another entity if the managing entity performs, either directly or through another third-party service provider, any of the activities described [above]; or

- The entity functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.¹⁷⁶

The CRS sets forth a definition of Investment Entity that is similar to that under FATCA. Under the CRS, an Investment Entity is an entity:

- that primarily conducts as a business one or more of the following activities or operations for or on behalf of a customer: (i) trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading; (ii) individual and collective portfolio management or (iii) the investing, administering, or managing funds, money, or financial assets on behalf of other persons; or

¹⁷⁶ Treas. Reg. § 1.1471-5(e)(4)(i).
An Investment Entity under FATCA or the CRS generally is required to identify its direct investors and to provide certain reporting about those investors. The customer due diligence and reporting requirements of FATCA and the CRS could be leveraged to identify the treaty qualification of investors. Specifically, an Investment Entity could collect self-certifications from its direct investors indicating each investor’s treaty qualification. If the direct investor is another Investment Entity or a financial intermediary, the investor could provide a self-certification that indicates the percentage of the investor’s interest that is ultimately attributable to owners who are entitled to treaty benefits. In other words, the Investment Entities could leverage the principles and procedures of FATCA, the CRS, and TRACE.

From a source country perspective, then, the starting point for granting treaty benefits to an investment vehicle could be whether the vehicle is a Reporting Financial Institution that is an Investment Entity for FATCA or CRS purposes. For this purpose, the definition of an Investment Entity perhaps should be expanded to include entities that would be an Investment Entity if Financial Assets included direct interests in real property (to include, for example, REITs). The method for such an Investment Entity to claim treaty benefits then would depend on whether the investor’s jurisdiction of residence treats the Investment Entity as fiscally transparent.178

If the Investment Entity is treated as fiscally transparent by its investors, the Investment Entity would claim treaty benefits on behalf of its investors. Procedurally, this would work best if the source country had implemented relief at source (as opposed to a refund system), and if the principles of the TRACE system were implemented. Specifically, the Investment Entity would provide pooled information regarding the treaty entitlement of its investors to the withholding agent, and the withholding agent would apply the appropriate pooled rate of withholding. The information about the investors’ treaty eligibility would be based on the self-certifications that the Investment Entity receives from its direct investors, which might include other fiscally transparent Investment Entities or financial intermediaries. Those entities would collect self-certifications from their investors or account holders, and provide pooled information to the lower-tier Investment Entity. Each fiscally transparent Investment Entity and each financial intermediary would report on a payee-specific basis to the source country regarding the portion

177 CRS, Section VIII.A.6.a, b.

178 Investment Entities might have some investors that treat the Investment Entity as fiscally transparent and some that treat it as fiscally opaque, but for this discussion we assume consistent treatment.
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of each payment and withholding tax allocated to each direct payee. These types of procedures can be seen as analogous to the TRACE system or the QI regime in the United States.

Some commentators have suggested that the TRACE system would not work for non-CIV investment vehicles. These comments suggest that managers of private equity funds, for example, are not able to collect the information required to operate TRACE. The basis for this claim is unclear. As discussed above, TRACE requires that an entity receives a self-certification from its direct counterparty, at least when each entity in the chain is treated as an AI. Procedurally, TRACE is the same as the FATCA and CRS documentation procedures that private equity funds already undertake. TRACE does require additional information beyond that required by FATCA and the CRS – namely, the treaty eligibility of the counterparty – but the self-certification and information collection procedures are the same.

If an Investment Entity is fiscally opaque, on the other hand, many of the same concepts could apply, but protecting all of the relevant policy considerations in an administrable way becomes more difficult. A fiscally opaque Investment Entity could be treated as a resident of a Contracting State and as the beneficial owner of the income it receives. With respect to protecting against treaty shopping, a procedure similar to that for fiscally transparent entities and financial intermediaries could apply. Specifically, the Investment Entity would collect self-certifications from its investors regarding their treaty entitlement. If the direct holder of the interest in the Investment Entity were another Investment Entity or a financial intermediary, the self-certification would be based on the pooled information of the upper-tier Investment Entity or intermediary’s investors or account holders.

In the case of a fiscally opaque entity, however, the withholding tax might not be allocated among the investors in accordance with their treaty entitlement. For example, an Investment Entity may be required to make equal distributions to its shareholders, regardless of whether they would be entitled to different treaty benefits with respect to the source country. There are a number of theoretical ways to address this issue. One would be for the source country to provide that an Investment Entity that is fiscally opaque would qualify for treaty benefits only if it could allocate the withholding tax burden among its investors in a way that causes the investors to bear the withholding that they would have borne if they had invested directly. Such an approach, however, would disqualify many Investment Entities. Alternatively, the source country might provide that an Investment Entity that is fiscally opaque qualifies for treaty benefits based on the least beneficial rate for which an investor in the Investment Entity would qualify if it invested in the underlying assets directly. Finally, the source country could grant treaty benefits at a rate for which some high proportion of the Investment Entity’s investors – say, 90 percent – qualify.

To protect against deferral, the source country could provide that a fiscally opaque Investment Entity qualifies for treaty benefits only if it is required (either legally or economically) to distribute all or most of its income on a regular basis, perhaps quarterly. While such a requirement may call into question whether the Investment Entity is the beneficial owner of the income it receives, source countries could clarify in domestic law or in their treaties that the Investment Entity is treated as the beneficial owner of the income.

Not all policy interests are completely protected in the regime just described for fiscally opaque Investment Entities, but that will always be the case for any cross-border regime involving fiscally opaque investment vehicles. Specifically, the timing and character of the income received by the investor from a fiscally opaque investment vehicle often will be different than the income received by the investment vehicle. That may result in a better – or worse – tax treatment for the investor. Additionally, the interest holders in the investment vehicle may change from the time that the investment vehicle received the income to the time that the investment vehicle distributes the income. Some of the proposals for more fundamental changes described in Section VI.D attempt to address these challenges, but none of them completely resolves the challenges.

The U.S. treaty framework incorporates many – though not all – of the concepts above, and we explore that next.

V. U.S. Treaty Policy Regarding Investment Vehicles

The 2016 U.S. Model does not include special provisions addressing the treaty entitlement of investment vehicles, and U.S. tax treaty policy generally does not provide special rules for investment vehicles, other than the statement in the 2006 U.S. Technical Explanation that RICs and REITs should be treated as residents of the United States for treaty purposes. The generally applicable U.S. treaty rules therefore apply to determine the treaty eligibility of investment vehicles.

A. Fiscally Transparent Entities Investing Into the United States

1. In General

A foreign partnership that is an investment vehicle and that invests into the United States will almost certainly earn U.S source fixed, determinable, annual or periodical ("FDAP") income (e.g., dividends and interest). U.S. source FDAP that is not effectively connected with a

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181 A foreign partnership is an entity that is classified as a partnership for U.S. federal income tax purposes that that is organized outside of the United States. § 7701(a)(2), (5).
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U.S. trade or business (“ECI”) is subject to a 30 percent gross basis tax\(^{182}\) that is enforced through a 30 percent gross basis withholding tax under chapter 3 (I.R.C. § 1441, et seq.\(^{183}\))\(^{182}\) \(^{183}\)
Investment vehicles by their nature are not often engaged in a U.S. trade or business and, as a result, U.S. source FDAP earned by investment vehicles would not often be ECI. Thus, an investment vehicle’s U.S. source FDAP is very likely to be subject to 30 percent gross basis withholding absent the application of a treaty.

The payor of U.S. source FDAP income (a “withholding agent”)\(^{184}\) that is paid to a foreign person must withhold 30 percent of the amount of the payment unless the withholding agent has documentation upon which it can rely, prior to the payment, to treat the payment as made to a U.S. person or as made to a foreign beneficial owner that is entitled to a reduced rate of withholding.\(^{185}\)\(^{184}\)\(^{185}\)
In the investment vehicle context, a claim of benefits under an income tax treaty by a beneficial owner will generally be required to claim a reduced rate of withholding.\(^{186}\)
A withholding agent must receive a withholding certificate (i.e., a Form W-8BEN from an individual and a Form W-8BEN-E from a corporation) from the beneficial owner of the payment prior to the payment that contains the information necessary to support a claim of treaty benefits.\(^{187}\)

A claim of benefits under an income tax treaty is available only to the extent that the payment is derived and beneficially owned by a resident of a contracting state that satisfies the limitation on benefits (“LOB”) article of the income tax treaty under which benefits are claimed.\(^{188}\)
In the case of an investment vehicle that is a foreign partnership for U.S. federal income tax purposes, whether the investment vehicle is a “resident of a contracting state” and is treated as having “derived” the item of income should be analyzed first. The 2016 U.S. Model provides that “the term ‘resident of a Contracting State’ means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, and also includes

\(^{182}\) §§ 871(a); 881(a).

\(^{183}\) §§ 1441; 1442.

\(^{184}\) See Treas. Reg. § 1.1441-7.

\(^{185}\) Treas. Reg. § 1.1441-1(b)(1).

\(^{186}\) We note that investment vehicles may also be entitled to a withholding rate reduction to the extent that the payment is characterized as interest for U.S. federal income tax purposes and such interest is portfolio interest within the meaning of Sections 871(h) or 881(c). We do not discuss the application of the portfolio interest exception herein.

\(^{187}\) Treas. Reg. § 1.1441-6T(b)(1). The requirements for claiming treaty benefits are described below.

\(^{188}\) See Treas. Reg. § 1.1441-6T(b)(1).
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that State and any political subdivision or local authority thereof.”

The investment vehicle is unlikely to meet this requirement to the extent that the investment vehicle is a partnership for purposes of its jurisdiction of residence.

Regulation section 1.894-1(d) provides:

[the tax imposed by sections 871(a), 881(a), 1443, 1461, and 4948(a) on an item of income received by an entity, wherever organized, that is fiscally transparent under the laws of the United States and/or any other jurisdiction with respect to an item of income shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party only if the item of income is derived by a resident of the applicable treaty jurisdiction. For this purpose, an item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity or, in certain circumstances, both. An item of income paid to an entity shall be considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity’s jurisdiction, as defined in paragraph (d)(3)(ii) of this section, with respect to the item of income. An item of income paid to an entity shall be considered to be derived by the interest holder in the entity only if the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income and if the entity is considered to be fiscally transparent under the laws of the interest holder’s jurisdiction with respect to the item of income, as defined in paragraph (d)(3)(iii) of this section. Notwithstanding the preceding two sentences, an item of income paid directly to a type of entity specifically identified in a treaty as a resident of a treaty jurisdiction shall be treated as derived by a resident of that treaty jurisdiction.]

Under this regulation, the key test is whether the investment vehicle is “fiscally transparent” under the laws of the entity’s jurisdiction. If the investment vehicle is fiscally transparent under the laws of its jurisdiction, it cannot derive the item of income, although the partners in the investment vehicle could be treated as deriving the item of income to the extent that they are not fiscally transparent. Generally, an entity is fiscally transparent if the country in which the investment vehicle is organized does not require the investment vehicle to include the payment in income and instead treats the owners of the investment vehicle as separately including their respective share of the income paid to the investment vehicle whether or not such income is distributed. Like the residence test discussed above, an investment vehicle is unlikely to be

189 2016 U.S. Model, Art. 4(1).

190 Treas. Reg. § 1.894-1(d)(1).

191 Treas. Reg. § 1.894-1(d)(3)(ii) (An entity is fiscally transparent in its jurisdiction “to the extent that the laws of that jurisdiction require the interest holder in the entity, wherever resident, to separately take into account on a current basis the interest holder’s respective share of the item of income paid to the entity, whether or not distributed
treated as deriving an item of income to the extent that it is treated as a partnership in its jurisdiction.

A foreign entity that is a partnership for U.S. federal income tax purposes may claim treaty benefits to the extent that the entity is treated as not fiscally transparent under section 894.192 In such case, the foreign partnership would provide a Form W-8BEN-E to the withholding agent with the information necessary to support the claim.193 A foreign entity that is both a partnership for U.S. federal income tax purposes and fiscally transparent under section 894 will not, however, be treated as the beneficial owner of the payment.194 Such an entity would be required to provide a valid flow-through withholding certificate (i.e., a Form W-8IMY) that includes a withholding statement that allocates the payment to the partners of such entity.195 Attached to such flow-through withholding certificate would be the withholding certificates of partners who are beneficial owners and additional flow-through withholding certificates if the partners in the partnership were themselves fiscally transparent under section 894. Ultimately, the package of withholding certificates will be a mix of withholding certificates and flow-through withholding certificates that allocate 100 percent of the payment to beneficial owners.

Assuming that the foreign partnership is treated as fiscally transparent, the owners of the foreign partnership that are beneficial owners of the income earned by the partnership could claim treaty benefits to the extent that they are not fiscally transparent (i.e., they derive the item of income) and satisfy all of the other requirements of the relevant treaty. As noted above, these owners would provide completed Forms W-8BEN or W-8BEN-E to the foreign partnership. The foreign partnership would attach these forms to Form W-8IMY along with a withholding statement allocating the payment received by the partnership among such owners. This packet of withholding documentation would be sufficient documentation for a withholding agent to reduce the amount of withholding on the payment made to the partnership to the rate provided for in the applicable treaty. If the fiscally transparent investment vehicle is a QI, the investment vehicle can provide the withholding agent with pooled information regarding the appropriate withholding rate for its investors, rather than providing investor-specific information.196 A QI

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192 Treas. Reg. § 1.1441-6T(b)(2)(i).
193 Treas. Reg. § 1.1441-6T(b).
194 Treas. Reg. § 1.1441-1(c)(6); Treas. Reg. § 1.1441-6T(b)(2)(i).
196 See Treas. Reg. § 1.1441-6(b)(2)(ii).
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generally is limited to Investment Entities and other kinds of financial institutions as defined under FATCA.197

In a tiered structure, the analysis starts with the question of whether the investment vehicle is treated as fiscally transparent by its owner or owners. If it is, the investment vehicle is treated analogously to an intermediary, and must provide documentation with respect to its owners. The analysis is then repeated at the owner level to determine whether the owner is treated as fiscally transparent. If the owner is not fiscally transparent, qualification for treaty benefits is tested at that level, and the fiscally transparent investment vehicle must pass documentation regarding the owner to the withholding agent. If the owner is treated as fiscally transparent, the analysis continues up the chain.

Conversely, if the investment vehicle is treated as fiscally opaque, in order to claim treaty benefits it must satisfy the requirements for treaty eligibility, including the relevant LOB provision. The LOB provisions most commonly relevant to investment vehicles are the “ownership-base erosion” and “derivative benefits” tests in the LOB. Both of these tests require that a requisite percentage of the interests in the investment entity be directly or indirectly owned by residents of particular jurisdictions that themselves satisfy certain tests in the LOB. For example, the ownership-base erosion test of the 2016 U.S. Model requires that individuals, corporations that are regularly publicly traded within the meaning of the LOB, subsidiaries of such publicly traded corporation, or the Contracting State “own directly or indirectly, shares or other beneficial interests representing at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of the person, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner.”198 This ownership threshold is unlikely to be met to the extent that the investment vehicle has diverse ownership, which is often the case.

As a result, structuring an investment vehicle to be fiscally transparent is often beneficial from a treaty qualification perspective, because treatment of the investment entity as fiscally transparent would allow the owners to claim treaty benefits on their own behalf. On the other hand, the investment vehicle would need to collect documentation from each of its owners and provide it to the withholding agent, which may be difficult for the investment entity to do. In certain cases, the beneficial owners may not be willing to provide the information required by the W-8BEN or W-8BEN-E. For example, individual beneficial owners may raise a privacy concern because the information required by the W-8BEN is of a sensitive nature. Additionally, certain beneficial owners are sensitive to completing a form issued by the IRS, despite the fact that the form itself is never sent to the IRS. A withholding agent would be required to withhold on the payment to the foreign partnership to the extent the payment is allocable to beneficial owners who refuse to provide a complete beneficial owner withholding certificate. In addition, if the

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197 See Treas. Reg. § 1.1441-5(e)(5).

investment vehicle is widely held, allocations of income and reporting may be very complex, not least because investors from different jurisdictions may have different accounting, allocation, and reporting requirements with respect to a transparent entity.

If the withholding agent does not receive proper documentation from the beneficial owner of the payment, the withholding agent is required to withhold 30 percent of a payment of U.S. source FDAP. In that case, a beneficial owner that satisfies all of the requirements of the applicable treaty and section 894 still would be entitled to the benefits of the treaty and could claim the benefit of the applicable treaty by filing a return and requesting a refund from the IRS. In practice, however, if the withholding agent does not receive the appropriate documentation from the beneficial owner of the payment, the beneficial owner often will not be able to establish that it bore the relevant withholding tax and is entitled to the credit.

2. Withholding Partnerships

The withholding foreign partnership regime can be beneficial in cases where the beneficial owners of the foreign partnership investment vehicle are sensitive to having their information provided to a third party payor. Under the withholding foreign partnership regime, a foreign partnership can enter into an agreement with the IRS to assume responsibility for withholding on U.S. source FDAP payments allocable to its partners. The foreign partnership may then provide solely a Form W-8IMY to a withholding agent and, if complete, the withholding agent is relieved of its duty to withhold with respect to the U.S. source FDAP paid to the foreign partnership. Because the foreign partnership has assumed primary withholding responsibility, the withholding certificates of the beneficial owners of the income paid to the foreign partnership are not provided to the payor.

A withholding foreign partnership is treated as a withholding agent. The foreign partnership will therefore be required to withhold 30 percent of the amount of any U.S. source FDAP allocable to a foreign partner unless the foreign partnership receives documentation upon which it can rely to reduce the amount of the withholding. Thus, the withholding foreign partnership rather than the payor will collect the documentation discussed above.

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199 § 1464; Treas. Reg. § 1.1464-1(a); Rev. Rul. 61-207, 1961-2 CB 139. See I.R.C. Publication No. 515. A foreign individual would file a Form 1040-NR and a foreign corporation would file a Form 1120-F.


201 Treas. Reg. § 1.1441-1T(b)(1); Treas. Reg. §1.1441-5(c)(1)(ii)(A).


203 Id.
3. **U.S. Partnerships**

A withholding agent is not required to withhold 30 percent of the amount of a U.S. source FDAP payment made to a U.S. partnership.\(^{205}\) Withholding is not required because a payment of U.S. source FDAP made to a U.S. partnership may be treated as made to a U.S. payee.\(^{206}\) The U.S. partnership would provide a Form W-9 to the payor of the U.S. source FDAP to evidence its status as a U.S. payee.

Although an investment vehicle in the form of a U.S. partnership is not itself subject to chapter 3 withholding, the U.S. partnership is required to withhold on amounts of U.S. source FDAP earned by the partnership that are includable in the gross income of a partner that is a foreign person.\(^{207}\) The partnership withholds on these amount on the earliest of the date that the U.S. partnership distributes amounts allocable to U.S. source FDAP income of the partnership, the date that the Schedule K-1 is provided to the partners, or the due date for furnishing the Schedule K-1 to the partners.

In effect, a U.S. partnership functions similarly to a withholding foreign partnership in that the partnership itself acts as the withholding agent. The U.S. partnership must collect the documentation described above from its partners and withhold at the required rate. A U.S. partnership is also often used in investment vehicle structures because it allows partners in the partnership to avoid providing withholding certificates to third parties and avoids the need for the partnership to enter into and comply with a withholding agreement with the IRS.

Partners in the partnership may claim treaty benefits with respect to the U.S. source FDAP income earned by the partnership. To claim these benefits, the partners must derive and beneficially own the item of income and satisfy the LOB of the applicable treaty. Whether they meet that test depends on whether the partner’s jurisdiction of residence treats the U.S. partnership as fiscally transparent. While most treaty partners would treat a limited partnership organized in the U.S. as fiscally transparent, a U.S. limited liability company treated as a partnership for U.S. federal income tax purposes may not be seen as fiscally transparent by many treaty partners. As a result, the members may not be entitled to treaty benefits because they do not derive the income on which treaty benefits are claimed within the meaning of Regulation section 1.894-1(d). In 2015, however, the Supreme Court of the UK held that a UK resident should be taxed under UK law on his share of a Delaware LLC’s profits, and should be entitled to a credit against his UK tax for the U.S. federal income tax he paid with respect to his share of...
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the LLC’s profits. In effect, the case treated the LLC as fiscally transparent, based on the treatment under Delaware law and the LLC agreement. In response, HMRC published a practice announcement stating that it intends to treat the case as specific to its facts. HMRC stated that “where US LLCs have been treated as companies within a group structure HMRC will continue to treat the US LLCs as companies, and where a US LLC has itself been treated as carrying on a trade or business, HMRC will continue to treat the US LLC as carrying on a trade or business.”

4. Publicly Traded Partnership

A publicly traded partnership will be treated as a corporation for U.S. federal income tax purposes if less than 90 percent of its gross income for any taxable year during its existence is qualifying income. Qualifying income includes interest, dividends, and capital gain from the disposition of property that gives rise to dividends and interest. Investment vehicles often will earn solely these types of qualifying income and, as a result, are unlikely to be treated as a corporation for U.S. federal income tax purposes. Thus, these investment vehicles will be treated as partnerships for chapter 3 purposes and should apply the rules discussed above in the same manner as a foreign or U.S. partnership, as the case may be. Special withholding rules apply, however, to publicly traded partnerships that earn ECI.

The ever changing make-up of a publicly traded partnership’s partners would appear to favor using a U.S. partnership as the investment vehicle because it allows the partnership itself to

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208 See George Anson v. Commissioners for Her Majesty’s Revenue and Customs, (2015) UKSC 44.


211 A publicly traded partnership is any partnership that has interests that trade on an established securities market or are readily tradable on a secondary market (or a substantial equivalent). § 7704(b)(1), (2).

212 §§ 7704(a), (c); Treas. Reg. § 301-7701-2(b)(7).

213 §§ 7704(d)(1)(A), (B), (F).

214 Treas. Reg. § 1.1441-(c)(27) (Defining “partnership” by reference to an entity treated as a partnership under Regulation section 301.7701-2 or -3).

5. Consistency with Inclusive Framework

With respect to inbound investment into the United States by fiscally transparent investment vehicles, the United States incorporates many of the key elements of the inclusive framework described earlier. The United States operates a relief at source system. Fiscally transparent investment vehicles may document their direct investors and claim treaty benefits on their behalf. In addition, if the investment vehicle qualifies as a QI, it may claim treaty benefits on behalf of its investors by providing pooled reporting to the withholding agent.

B. U.S. Investors Investing Outbound Through Fiscally Transparent Entities

As described above, provisions in income tax treaties similar to article 1(6) of the 2006 U.S. Model can be used by U.S. investors investing outbound through fiscally transparent CIVs. Again, the U.S. investor may be treated as deriving the item of income to the extent that the CIV is a partnership or is treated as a partnership pursuant to the U.S. check-the-box regulations for U.S. federal income tax purposes. 216

Many treaty partners require that the IRS certify that the person claiming treaty benefits is a resident of the U.S. This certification is provided on Form 6166, which is a computer-generated letter printed on stationary bearing the U.S. Department of the Treasury letterhead, and the facsimile signature of the Field Director, Philadelphia Accounts Management Center. The efficacy of this approach is limited, however, to the extent that the source jurisdiction does not have a method for such U.S. investor to provide the certification at the time of payment. For example, the source jurisdiction may require withholding at the time of payment if the amount is paid to an entity that is opaque for the tax purposes of the source jurisdiction and require the U.S. investor to obtain a refund of the withheld tax. Whether a claim would be successful appears highly dependent on the source country’s ability to trace the payment upon which withholding was collected to the U.S. investor. The Form 6166 does not itself provide this information.

C. RICs

The two major categories of fiscally opaque investment vehicles in the United States are RICs and real estate investment trusts (“REITs”). We focus here on RICs, but many of the issues discussed also apply to REITs.

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216 We note that the entity could also be treated as fiscally transparent to the extent that the entity is treated as a disregarded entity for U.S. federal income tax purposes. However, a CIV is unlikely to be treated as a disregarded entity because it likely has more than one unrelated investor.
1. Legislative History

Prior to the introduction of the predecessor of the RIC provisions, pooled investments were largely structured as unincorporated entities that were not subject to entity-level tax.\(^\text{217}\) However, *Morrissey Trust v. Commissioner* ("Morrissey Trust")\(^\text{218}\) held that an unincorporated investment trust was an “association taxable as a corporation” rather than a trust. In addition, the Revenue Act of 1935 reduced the dividends-received deduction from 100 percent to 90 percent.\(^\text{219}\) The practical effect was that previously unincorporated pooled investment trusts were now subject to corporate taxation.

The Revenue Act of 1936 created “mutual investment companies” that were exempt from the normal profits tax levied on corporate entities. Mutual investment companies were subject to requirements that are similar to the current RIC requirements, including the diversification and distribution requirements.\(^\text{220}\) Mutual investment companies essentially maintained the status quo for pooled investment trusts, in that investors were able to pool capital to invest across multiple investments without being subject to a second tax layer. To avoid the corporate level tax, mutual investment companies received a tax credit for dividends paid.\(^\text{221}\)

2. RIC Domestic Tax Treatment

A regulated investment company is defined under Subchapter M of the Code as a domestically organized corporation registered under the Investment Company Act of 1940,\(^\text{222}\) which derives at least 90 percent of its gross income from dividends, interest, and certain other investment income (the “income test”),\(^\text{223}\) and meets asset diversification requirements (the “diversification” test).\(^\text{224}\) An entity meeting these requirements may elect to be treated as a RIC and will be granted preferential tax treatment for dividends paid to investors during the taxable year. Congress and the Treasury have continually revised the rules governing the taxation of RICs and their shareholders in order to more closely align the taxation of investors in the RIC

\(^{217}\) *See Crocker v. Malley*, 249 U.S. 223 (1919) (holding that a simple trust was not subject to the corporate income tax).

\(^{218}\) 296 U.S. 344 (1935).


\(^{221}\) Revenue Act of 1936, Pub. L. No. 74-740, § 27.

\(^{222}\) § 851(a)(1).

\(^{223}\) § 851(b)(2).

\(^{224}\) § 851(b)(3).
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with the taxation the investor would have received if it had invested directly in the assets owned by the RIC.

An entity meeting the requirements for RIC status is subject to tax under the rules of Subchapter M, rather than corporate tax. Under Subchapter M, a RIC is subject to income taxation on its investment company taxable income and undistributed net capital gains. A RIC that distributes all of its taxable income will not be subject to taxation on its ordinary income or short-term gains, while any undistributed income will be subject to corporate income taxation. Likewise, a RIC is subject to tax on its net capital gains, but the RIC’s net capital gains are reduced by the capital gain dividends distributed by the RIC. Finally, a RIC is subject to an excise tax under § 4982 if the RIC distributes less than 98 percent of its ordinary income plus 98.2 percent of the RIC’s capital gain for the year.

At least 90 percent of the corporation’s gross income must be derived from dividends, interest, payments with respect to securities loans, gains from the sale of stock or securities, or foreign currencies, or other income. The American Jobs Creation Act of 2004 (the “2004 Jobs Act”) expanded the categories of good income to include income and gains from qualified publicly traded partnerships (“PTPs”).

In addition to the various income tests, the RIC must meet two investment requirements (the “diversification test”). At the end of each quarter, at least 50 percent of the corporation’s assets must be invested in cash, government securities, RIC securities, and certain other types of securities. In addition, no more than 25 percent of the value of the RIC’s total assets may be invested in securities of one issuer (other than government or other RIC securities), or two or

225 § 852(b)(1).
226 § 852(b)(2).
227 § 852(b)(1), (2).
228 § 852(b)(3)(A).
229 § 4982.
230 § 851(b)(2).
232 § 851(b)(3)(A).
more issuers of which the RIC owns 20 percent or more, and which are in similar or related businesses, or in securities of qualified PTPs.233

Finally, the RIC must satisfy the current distribution requirement. To qualify as a RIC, the RIC must make ordinary distributions during the year that equal or exceed the sum of (1) 90 percent of its investment company taxable income computed without regard to the dividends paid deduction, and (2) 90 percent of the excess of tax-exempt interest on government and qualified scholarship bonds over related deductions.234 To satisfy the requirement, only distributions out of current earnings and profits or accumulated earnings and profits will qualify under the test,235 but distribution of stock dividends and stock splits may qualify if they are taxable transactions and meet certain requirements.236

A RIC is entitled to a credit or deduction for foreign taxes paid for the year.237 A RIC that meets certain requirements may elect to pass its foreign tax credit through to its investors.238 Each shareholder includes its share of the foreign taxes paid as gross income and treats the total of the foreign taxes and distributions as their own foreign-source income.239 The Regulated Investment Company Modernization Act of 2010 extended the pass-through of foreign tax credits to qualified funds of funds, which means a RIC with at least 50 percent of the value of its total assets represented by interests in other RICs.240 A RIC typically receives tax-free treatment upon complete distribution of its income.

233 § 851(b)(3)(B).

234 § 852(a).

235 §§ 562(a), 316, 301.

236 See PLR 9211052, PLR 9051024 for private rulings holding deduction was appropriate when shareholders had the option of receiving cash. See also Rev. Proc. 2010-12, 2010-1 C.B. 302, extending dividend treatment to distributions of stock where each shareholder could elect to receive cash or stock, in addition to other considerations.

237 §§ 164, 901. See also Treas. Reg. § 1.853-1(a), including withholding taxes deemed paid by the RIC under an applicable U.S. income tax treaty.

238 Treas. Reg. § 1.853-2(b).

239 § 853(a), (b).

240 § 852(g) (1)(B).
3. Treaty Benefits for Non-U.S. Investors in RICs

In general, non-U.S. investors are subject to a 30 percent tax on U.S. FDAP that is not ECI.\textsuperscript{241} Such tax is typically collected at the source of payment under the withholding tax regime.\textsuperscript{242} Foreign investors generally are not subject to U.S. federal income tax on non-U.S. source income or capital gains that are not ECI or treated as ECI.\textsuperscript{243} In addition, foreign investors generally are not subject to U.S. federal income tax on certain “portfolio interest”.\textsuperscript{244}

Distributions by RICs out of earnings and profits generally constitute U.S. source dividends subject to 30 percent withholding (or lower treaty rate) regardless of the source of the RIC’s income. Thus, a non-U.S. investor generally is subject to U.S. withholding tax on distribution by a RIC, even if the RIC’s income consists solely of non-U.S. source dividends, on which the foreign investor would not have been subject to U.S. federal income tax if received directly. In addition, prior to changes made by the 2004 Jobs Act, a foreign investor in a RIC faced U.S. federal income tax on a distribution attributable to interest that would have been exempt portfolio interest if the investor had received the interest directly. The 2004 Jobs Act helped mitigate the issue by permitting RICs to designate “interest-related dividends” and “short-term capital gain dividends” that are exempt from U.S. federal income tax in the hands of foreign investors.\textsuperscript{245} To qualify as an interest-related dividend, the income must consist of qualified interest income (“QII”), including original issue discount on an obligation payable within 183 days, interest on an obligation in registered form, interest on deposits, and interest-related dividends received from other RICs.\textsuperscript{246} To qualify for the withholding exemption, the RIC must determine what percentage of the RIC’s total income comprises QII and short-term capital gain and designate the distributions accordingly. Certain RIC distributions that are attributable to the sale of a U.S. real property interest also are given pass-through treatment, although in this case the distributions are taxable because the sale of a U.S. real property interests are treated as ECI and subject to U.S. federal income tax.\textsuperscript{247}

Tax treaties between the United States and foreign countries have provided limited benefits to foreign investors. Such treaties provide for a reduced rate of tax, typically down from

\textsuperscript{241} §§ 871(a), 881(a).

\textsuperscript{242} §§ 1441, 1442.

\textsuperscript{243} §§ 865(a)(2), 871(a), 881(a).

\textsuperscript{244} §§ 871(h), 881(c).

\textsuperscript{245} §§ 871(k)(1)-(2); 881(e)(1)(A).

\textsuperscript{246} § 871(k)(1), § 881(e)(1).

\textsuperscript{247} See § 897(a), (h)(1), (h)(4).
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30 percent under standard rates to 15 percent on dividends. This is the same rate that a treaty-qualified foreign investor would have received on a portfolio dividend from a U.S. corporation if the foreign investor had invested directly in the U.S. corporation. By contrast, a foreign investor that invested directly in shares of a foreign corporation would not be subject to U.S. federal income tax on the receipt of dividends from that corporation, but would suffer 15 percent U.S. withholding tax if it invests in a RIC that invests in a foreign corporation.

4. Treaty Benefits for RICs Investing Outside the United States

As discussed above, the 2006 U.S. Technical Explanation states that a RIC is a U.S. resident for treaty purposes. Not all jurisdictions agree, however. Similarly, some jurisdictions take the position that a RIC is not the beneficial owner of its income because it is required to distribute most of its income annually.

Conceptually, it seems pretty clear that a RIC should qualify for treaty benefits. RICs are subject to U.S. federal income tax and actually bear tax on any undistributed income. Therefore, a RIC is a U.S. resident for treaty purposes. Moreover, U.S. shareholders pay U.S. tax on dividends paid by the RIC. Foreign shareholders also pay withholding tax on dividends paid by a RIC. Therefore, all of the income of the RIC bears U.S. tax. The fact that U.S. withholding on a distribution to a foreign shareholder can be reduced under a U.S. treaty is a bit anomalous, however, in the case of a RIC that has income from outside the United States. In that case, the source country might think that the non-U.S. investor is not paying full U.S. tax, and may not want to grant the RIC treaty benefits. However, the RIC generally will bear 15 percent withholding from the source country, and will withhold 15 percent U.S. tax on a distribution to a foreign shareholder. The foreign investor, then, bears almost 30 percent tax, which in most cases is what a non-treaty eligible investor would bear.

Most U.S. income tax treaties include an LOB provision. RICs must satisfy the LOB to receive treaty benefits when investing outside the United States. The LOB provides that a resident of a Contracting State is not entitled to treaty benefits unless the resident is a “qualified person” or meets certain other tests. This discussion focuses on the 2016 U.S. Model LOB provision. While that provision does not match the LOB provision of any treaty now in force, it represents the latest articulation of the treaty policy of the U.S. Department of the Treasury.

248 See 2016 U.S. Model, Article 10(4)(a).

249 See 2016 U.S. Model, Article 10(2)(b).


251 See Commentary on Article 1 of the OECD Model, ¶ 8.7.

252 See OECD CIV Report, ¶ 31.
The LOB sets forth a number of categories of qualified person. There are two main categories of qualified person that might be relevant to RICs and other investment vehicles: (i) the “regularly traded company” category; and (ii) the “ownership-base erosion” category. A company qualifies under the regularly traded company category if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and either: (i) its principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or (ii) the company’s primary place of management and control is in the Contracting State of which it is a resident.\footnote{2016 U.S. Model, Article 22(2)(c); 2006 U.S. Model, Article 22(2)(c)(i).} This category generally would apply only to a specific subset of RICs the shares of which are traded on a securities exchange, generally referred to as ETFs. While all RICs are widely held, most RICs do not have shares that are listed on an exchange.

An entity qualifies under the “ownership-base erosion” category if:

(i) persons that are residents of that Contracting State entitled to the benefits of the Convention under subparagraph (a), (b), (c) or (e) of this paragraph [\textit{i.e.}, because they are individuals, the Contracting State or certain other governmental entities, a regularly traded company, or a pension fund or certain charitable organizations] own, directly or indirectly, shares or other beneficial interests representing at least 50 percent of the aggregate vote and value (and at least 50 percent of the aggregate vote and value of any disproportionate class of shares) of the shares or other beneficial interests of such person, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner; and

(ii) less than 50 percent of the person’s gross income, and less than 50 percent of the tested group’s gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person’s Contracting State of residence (but not including arm’s length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions): (A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph; (B) to persons that are connected persons with respect to the person described in this subparagraph and that benefit from a special tax regime with respect to the deductible payment; or (C) with respect to a payment of interest, to persons that are connected persons with respect to the person described in this subparagraph and that benefit from notional deductions described in...
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subparagraph (e) of paragraph 2 of Article 11 (Interest) [generally, describing notional deductions on equity].

RICs generally would qualify under the ownership-base erosion test. For most RICs, their shareholders overwhelmingly are U.S. residents, so the ownership prong is satisfied. Dividends paid by a RIC are deductible, but because the shareholders are U.S. residents, the base erosion prong also generally will be satisfied, because RICs generally do not have significant debt or other deductible payments. However, because interests in RICs generally are held through brokers and other intermediaries, a RIC may not be able to establish to the satisfaction of a treaty partner jurisdiction that it meets the ownership test. While brokers and custodians are required to document their account holders (i.e., the holders of the interests in the RIC) under chapters 3, 4, and 61 of the Code, their investor information is competitively valuable, and they do not pass that information down the chain to the RIC.

A company also can qualify for treaty benefits under the LOB, regardless of whether it is a qualified person, if it qualifies under the “derivative benefits” provision. A company qualifies under the derivative benefits provision if, at the time when the benefit would be granted and on at least half of the days of a twelve-month period commencing or ending on the date when the benefit otherwise would be accorded:

a) at least 95 percent of the aggregate vote and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner; and

b) less than 50 percent of the company’s gross income, and less than 50 percent of the tested group’s gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company’s Contracting State of residence (but not including arm’s length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions): (i) to persons that are not equivalent beneficiaries; (ii) to persons that are equivalent beneficiaries only by reason of paragraph 5 of this Article or of a substantially similar provision in the relevant comprehensive convention for the avoidance of double taxation; (iii) to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from a special tax regime with respect to the deductible payment, provided that if the relevant comprehensive convention for the avoidance of double taxation does not contain a definition of a special tax

\[254\] 2016 U.S. Model, Article 22(2)(f).
regime analogous to the definition in subparagraph (l) of paragraph 1 of Article 3 (General Definitions), the principles of the definition provided in this Convention shall apply, but without regard to the requirement in clause (v) of that definition; or (iv) with respect to a payment of interest, to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from notional deductions of the type described in subparagraph (e) of paragraph 2 of Article 11 (Interest).  

RICS do not qualify under the derivative benefits provision because they have more than seven owners.

A resident of a Contracting State can also qualify for benefits with respect to an item of income if the resident is engaged in the active conduct of a trade or business in its Contracting State of residence, and the income derived from the other Contracting State emanates from, or is incidental to, that trade or business. This provision of the LOB is unlikely to be useful to RICs and other investment vehicles, however, because making or managing investments is explicitly excluded from being the active conduct of a trade or business.

5. Foreign CIVs Investing in the United States

Foreign entities that are similar to RICs and that invest into the United States also must be resident in the treaty partner jurisdiction, be the beneficial owner of the income, and satisfy the LOB. For entities that benefit from a RIC-like regime, many will not satisfy the LOB. Many cannot meet the ownership-base erosion prong of the LOB, because they pool capital from investors in multiple jurisdictions, and are not more than 50 percent owned by residents of the entity’s jurisdiction. Similarly, the derivative benefits provision often is not available because most investment vehicles are owned by more than seven investors. Many are not publicly traded.

VI. Potential Changes to U.S. and Non-U.S. Treaty Policies

A. Restatement of Policy Considerations

Policy makers face a number of potentially competing considerations in addressing the treaty eligibility of investment vehicles. On the one hand, policy makers want to encourage efficient cross-border investment by allowing investors to pool capital and access professional management, without creating an additional layer of tax. On the other hand, policy makers want to ensure that investment vehicles are not used by investors to receive inappropriate treaty benefits or to defer tax on the income from their investments. Any solution must also take into account

255 2016 U.S. Model, Article 22(4).

256 2016 U.S. Model, Article 22(3).
account many practical and administrative limitations, which include the fact that interests in investment vehicles often are held through multiple tiers of funds or intermediaries, different jurisdictions often treat the same investment vehicle differently (e.g., as fiscally transparent or opaque), and residence and source jurisdictions have different accounting and reporting requirements.

Treating investment vehicles as fiscally transparent appears to be the most theoretically pure way of achieving the various policy goals related to investment vehicles. Under that model, there is no tax at the level of the investment vehicle itself, investors include on a current basis their share of the investment vehicle’s income, and investors claim the treaty benefits to which they are entitled. The fiscal transparency model, however, faces numerous practical challenges that make it difficult to apply, especially for investment vehicles that are widely held.

The RIC model also faces a number of practical challenges, including that in the United States most interests in RICs are held through one or more tiers of intermediaries, which makes identifying the investors difficult. In addition, the tax treatment of RICs does not mesh perfectly with the theoretically “correct” result for investors. The timing and character of the income recognized by investors may not match that of the RIC’s income, and foreign investors may receive a better or worse result by investing in a RIC than by investing directly. The fundamental premise of providing RICs treaty benefits – that the RIC should be granted treaty benefits in its own right, but the tax on its income is paid by the investors in the RIC – is also somewhat of a hybrid treatment, and can create odd results. As a practical matter, however, the theoretical concerns about RICs are probably just that – theoretical. Investors in RICs are overwhelmingly U.S. residents, and mismatches in timing and character, in the aggregate, are probably not very meaningful. The theoretical concerns may be more relevant for RIC-like entities in other jurisdictions that may pool investors from multiple jurisdictions. The most significant issue is identifying the investors in RICs (and investment vehicles more generally).

B. U.S. Changes

The U.S. treaty policy with respect to investment vehicles generally follows the inclusive framework set out in Section IV, above. Fiscally transparent entities can claim treaty benefits on behalf of their owners, either by providing documentation from their owners, or on a pooled basis if the entity qualifies as a QI or withholding partnership or trust.

For fiscally opaque entities, however, establishing that the entity satisfies the LOB can be difficult or impossible, both for RICs investing outside the United States and for similar foreign entities investing into the United States. Treasury should work to ensure that other countries allow RICs to receive treaty benefits, given their overwhelming ownership by U.S. residents, and should grant treaty benefits to similar non-U.S. investment vehicles. If Treasury and its treaty partners decide that proof ownership is necessary, RICs and similar entities should be allowed to determine their ownership based on TRACE principles and the principles of the OECD CIV Report. In addition, U.S. treaties should provide a derivative benefits provision that does not limit ownership to seven or fewer equivalent beneficiaries.
C. Non-U.S. Changes

Proposed new Article 1(2) of the OECD Model Tax Convention will facilitate the ability fiscally transparent entities to claim treaty benefits on behalf of their owners under non-U.S. treaties. To make this applicable to more entities, however, jurisdictions should allow investors to treat Investment Entities as fiscally transparent, regardless of their legal form – i.e., jurisdictions should allow an election to treat investment vehicles (perhaps limited to Investment Entities that are reporting financial institutions under FATCA or the CRS) as fiscally transparent.

Jurisdictions also should implement the principles of TRACE for fiscally transparent Investment Entities, meaning that they should allow Investment Entities to act as AIs, and claim treaty benefits on a pooled basis, relying on self-certifications from their investors and other intermediaries in the chain. Similarly, fiscally opaque Investment Entities should be able to determine their ownership based on TRACE principles.

D. More Fundamental Changes

It is possible to imagine more fundamental changes to address the treaty challenges of investment vehicles. While these changes are unlikely to be adopted in the near term, we describe them briefly below as potential ideas for further development.

1. Tax the RIC

The fundamental theoretical issue with granting treaty benefits to RICs is that the RIC does not usually pay any income tax – the tax is paid by the investors in the RIC based on the distributions by the RIC. That disconnect gives rise to the theoretical concern that third-country investors may be gaining treaty benefits inappropriately, and also gives rise to a change in the timing and character of the income that is being taxed. An obvious (and radical) solution to that fundamental issue would be to eliminate the dividends paid deduction for RICs. Additional protective rules to prevent base stripping may also be necessary. To avoid creating an additional level of tax, however, the distributions by the RIC would need to be exempted from tax. If this solution were adopted, RICs clearly should be entitled to treaty benefits, because they would bear U.S. tax at the entity level. If the RIC bore U.S. federal income tax on all of its investment income, that should address concerns about treaty shopping, although based on the BEPS documents that conclusion is not entirely clear. Governments still might want to ensure that a threshold percentage of investors were U.S. residents or equivalent beneficiaries. Taxing the RIC would also address the concerns about deferral, because the RIC would pay tax on its income on a current basis.

This particular solution, however, is unlikely to be implemented, for at least two reasons. First, exempting investment income is unlikely to be politically popular, and could be viewed as regressive. Of course, the income could be included for purposes of determining the investor’s rate, but that would require additional changes and would be unlikely to solve the optics problems. Alternatively, the dividends could be included in the investors’ income, but the
investors could be entitled to a credit for the tax (including foreign taxes) paid by the RIC. Again, that solution would entail a fair amount of complexity. Second, taxing the RIC would require massive changes to the systems of existing RICs, which invest primarily in U.S. securities. Withholding taxes on foreign investments is highly unlikely to motivate the industry to make the required changes.

2. Global Streamed Fund

A slightly less radical (but still fundamental) change would be for source countries to allow a foreign investment vehicle to act as a withholding agent. The OECD described one version of this approach as a “Global Streamed Fund” in the Public Discussion Draft dated 24 March 2016 on the Treaty Entitlement of Non-CIV Funds (“Non-CIV Discussion Draft”).

As described by the OECD, the key features of the Global Streamed Fund approach are that investment income would be exempt from tax (both income tax and withholding tax) when derived by a qualifying Global Streamed Fund, but the Global Streamed Fund would be required to distribute its income on a regular basis. The Global Streamed Fund would collect withholding tax on its distributions (other than distributions to other Global Streamed Funds) and remit it to the source country from which the relevant income was derived. The amount of the withholding tax would be determined under the rules of the relevant source country, which would take into account the treaty entitlement of the investor under the treaty (if any) between the investor’s residence jurisdiction and the source country. Distributions by one Global Streamed Fund to another would be exempt from withholding tax in order to avoid cascading tax (and therefore allow “fund-of-fund structures”).

The Global Streamed Fund would be a withholding agent for the source country, and therefore the source country’s general rules determining treaty eligibility of the investor would be applied by the Global Streamed Fund. For example, if the Global Streamed Fund recognizes income from a source country that applies an LOB in its treaty with the investor’s jurisdiction of residence, the Global Streamed Fund would apply that LOB to determine whether the investor is entitled to treaty benefits. If no treaty benefits are available, the source country’s full statutory

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258 As described by the OECD, only passive investment-type income would qualify for the exemption. Any business income recognized by the Global Streamed Fund would not qualify for exemption. See Non-CIV Discussion Draft, ¶ 28.

259 See Non-CIV Discussion Draft, ¶ 23.

260 See Non-CIV Discussion Draft, ¶ 23.
The Global Streamed Fund would also apply the documentation rules of the source country.\(^{261}\)

The exemption from source country withholding tax could be provided in the tax treaties of the source country. The treaties also would need to provide that the Global Streamed Fund will apply the source country withholding tax to distributions that the Global Streamed Fund makes.\(^{262}\)

While such a solution would be complicated, and far from perfect, it would address the concerns of source jurisdictions about giving treaty benefits to the “wrong” investors. For example, if a RIC is granted treaty benefits on the basis of the identity of its investors as of Date X, but the RIC does not distribute the income until Date X plus 90, and the identity of the investors have changed, the source country may think that treaty benefits have been provided inappropriately.\(^{263}\) By contrast, if a Global Streamed Fund withholds when the distribution is made to the investors, the appropriate withholding rate could be applied to each investor’s distribution. Frequent distribution requirements would partially address the concerns about deferral. Source countries would need to provide clear procedures to identify investment vehicles authorized to act in this way, as well as clear procedures to determine the treaty benefits to which the vehicle’s investors are entitled. Investment vehicles also would need to be able to track different types of income to determine the appropriate withholding rate for each investor.

The Global Streamed Fund approach is unlikely to be adopted with respect to U.S. RICs. As noted above, the overwhelming majority of investors in U.S. RICs are U.S. residents, and most U.S. RIC investment is in U.S. securities, so the benefit of such an approach for RICs is unlikely to be sufficient to justify the changes in systems that would be required. Depending on the circumstances of the particular RIC, however, a Global Streamed Fund approach may be beneficial, if it were available on a voluntary basis.

For CIVs and non-CIV investment vehicles that pool investors from multiple jurisdictions, on the other hand, the Global Streamed Fund may provide significant benefits, because it could provide assurances to source countries that treaty benefits were being granted on an appropriate basis – i.e., that the withholding rate applied to each investor is the rate that would have applied if the investor had invested directly. As with all of the other approaches, the Global

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\(^{262}\) See Non-CIV Discussion Draft, ¶ 29.

\(^{263}\) As noted above, however, it is not clear that this is as much of a concern as it may at first appear. The RIC should take into account the treaty benefits it receives in its NAV, and thus when the investors sell their shares, they should receive the economic benefits on the sale. Provided that the gain is taxed at rates that approximate the rate they would have paid on a distribution, the overall appropriate tax result should be achieved. Even so, as noted above, a RIC cannot allocate the economic benefits of reduced withholding to particular investors, so any investor as of Date X that would not have been entitled to treaty benefits directly may be receiving inappropriate benefits, in the view of some governments.
Streamed Fund approach would require a practical mechanism for a fund to determine the identity and treaty eligibility of its investors.

E. Conclusion

While there may be no perfect solution to the treatment of investment vehicles, at a minimum addressing the treaty eligibility concerns about investment vehicles will require a mechanism to identify the investors in the investment vehicle, including through fund of funds and other intermediated structures. Recent developments such as FATCA and the CRS, as well as the OECD’s work on TRACE, provide a potentially feasible path forward on these issues. In addition, the new Article 1(2) to be added to the OECD Model Tax Convention may make it easier for investors to claim treaty benefits through fiscally transparent investment vehicles. Significant additional work is needed, however, to ensure that treaty benefits are not inappropriately denied to investment vehicles and their investors.