NEW YORK
CITY BAR

COMMITTEE ON
TAXATION OF BUSINESS ENTITIES

ALAN J. TARR
CHAIR
345 PARK AVENUE
NEW YORK, NY 10154
Phone: (212) 407-4900
Fax: (212) 937-3703
atarr@loeb.com

DAVID A. SAUSEN
SECRETARY
425 PARK AVENUE
NEW YORK, NY 10022
Phone: (212) 836-8569
Fax: (212) 836-6737
dsausen@kayescholer.com

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VIA EMAIL AND REGULAR MAIL

Jeffrey Owens
Director
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Developmemt
2, rue Andre Pascal
75775 Paris
France

Douglas Rankin
Senior Policy Advisor –Treaty Negotiations and Interpretation
Customs and International
HM Revenue and Customs and
Chair, Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors
Committee on Fiscal Affairs
Organisation for Economic Cooperation and Development
100 Parliament Street
London
United Kingdom

Re: Entitlement of Collective Investment Vehicles for Tax Treaty Benefits – Treaty Eligible Third State Investors

Dear Mr. Owens and Mr. Rankin:

I am writing to you as chair of the New York City Bar Committee on Taxation of Business Entities. Our committee has followed with great interest the workings of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors (the "ICG"), established by the Committee on Fiscal Affairs (the "CFA") of the OECD in 2006 for the purpose of examining the issues relating to the eligibility of collective investment vehicles ("CIVs") for tax treaty benefits.[1] To that end, our prior chair and certain other members of our committee have held several informal meetings and telephone calls with Patricia Brown to discuss various aspects of the project. It is our present intention to comment on the report that will be submitted by the ICG to the CFA, which we understand is tentatively scheduled for publication in January 2009. However, there is one

[1] The principal authors of this letter are Mark Stone, Michael Miller, Jeffrey Trossman and Peter Blessing.

discreet aspect of the project, raised in the OECD's July 18, 2008 update, that Ms. Brown has asked us to address now in the hopes of aiding the ICG in its deliberations.[2]

The ICG Alternate Proposal and Third State Treaty Eligible Investors

In particular, the July 18th update indicates that the ICG is contemplating recommending that a CIV that does not otherwise qualify for benefits under existing tax treaty provisions between the source State and the State where the CIV is organized (e.g. because the CIV is not a resident of the latter State), be permitted to so qualify, in whole or in part, if some specified threshold of the CIV's investors are qualified residents of such State and therefore would have been eligible for such treaty benefits had they invested directly. The specific question presented is whether such qualified investor status should be limited to residents in the State where the CIV is organized or extended to treaty-eligible residents of third States. We do not address at the present time the propriety of the underlying tentative proposal to permit the CIV to claim such benefits, but simply accept the proposal for purposes of commenting on the investor eligibility.

Recommendation

In General

It is our view that treaty-eligible residents of third States, that is investors in third States which have concluded comparable favorable tax treaty benefits with the source State, be counted in determining whether the CIV has the requisite threshold of treaty-eligible investors required under the proposal. In making our recommendation, we are guided by the basic principle in the Commentary to Article 1 of the OECD Model Tax Convention on Income and Capital, under the general heading titled "Improper Use of the Convention" which provides that:

> 7. The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax evasion and avoidance.

In furtherance of the specific tax avoidance scheme that might arguably arise from the extension of benefits to third State residents, Paragraphs 8 and 9 of the same Commentary provide:

> 8. It is also important to note that the extension of double taxation conventions increases the risk of abuse by facilitating the use of artificial legal constructions aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation conventions.
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> 9. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly.

[2] We understand that the ultimate objective of the project is to add language to the Commentary on the OECD Model Tax Convention regarding treaty eligibility of CIVs or their investors.

The ICG proposal assumes that the source State permits the grant of treaty benefits on payments to the CIV, which would not otherwise qualify for benefits, where the resident investors would otherwise be eligible for the same benefits if the relevant item of income were derived directly by the investor. Our understanding is that the ICG may recommend that a CIV qualify for treaty benefits whether or not the resident investors are actually taxed by the resident State, at any time, on their shares of the income earned through the CIV.[3] The mere wrapping of the investment income in a legal entity, the argument goes, should not alter the benefits otherwise available to the investors.[4] The underlying principle of the ICG proposal is that, in recognition of the widespread use of and commercial benefits provided by CIVs, investors resident in one State who have chosen to invest in the source State through a CIV, rather than directly, should not, for that reason alone, be subject to source State taxation in excess of that which otherwise would have arisen.

Applying this same principle, investors who are residents of third countries having tax treaties with the source State that have provisions that are no less favorable for the item of income in question than the corresponding provisions of the tax treaty between the source State and the State of organization of the CIV similarly should not be deprived of the treaty benefits that would have been available had they invested directly in the source State, rather than through the CIV. Assuming that the extension of treaty benefits contemplated by the ICG proposal is not conditioned on resident State investor taxation of profits earned through the CIV, the only potential issue that we can see with the extension of qualified investor status to treaty-eligible residents of third States is whether there is any difference to the source State in granting benefits to the CIV. Since the source State would be in the same position of permitting equivalent benefits to both resident State investors and third State investors if they invested in the source State directly, rather than the CIV, it should not matter to the source State if such third State investors are also eligible to qualify the CIV for treaty benefits. Considering extending treaty benefits in such a case would reflect the practical reality of cross-border marketing of CIVs.

CIVs may tend to be formed in particular jurisdictions for a variety of non-tax reasons. Investors' investment decisions would be inappropriately distorted if they faced higher withholding taxes merely because they chose to invest in a source State through a CIV established in another State, rather than directly or through a CIV established in their own State. It is a fundamental principle of tax policy that, to the extent possible, tax rules should not unduly distort legitimate investment decisions. If a particular jurisdiction has a comparative non-tax advantage as a State for organization of CIVs, treaty-eligible investors resident in third countries should be able to invest in a source State through CIVs organized in such favorable jurisdiction without becoming subject to increased source State tax or incremental double taxation.

The second goal of the Commentary is called into issue once third State investors are counted towards the granting of benefits to the CIV. Does their inclusion give rise to tax avoidance, in particular with respect to source State tax? Our committee believes that once the ICG premise that a CIV not otherwise treaty-eligible may qualify in the interest of reducing

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[3] We offer no opinion on such favorable treaty treatment at the present time.

[4] The wrapper, however, may permit the funds to accumulate at the entity level without taxation and without obligation to distribute at any particular time. While some States may find this objectionable, others may feel that it is up to the residence State to determine when or whether to tax its residents. We offer no opinion at the present time.

source State tax or double taxation is accepted, it should not matter to the source State that an investor in a third State with which it has also concluded a treaty providing equally favorable benefits is an investor in the CIV. The source State is generally in the same tax position whether the investor is resident in the CIV organized State or in a third State. More to the point raised by the Commentary, the third State resident has not used the other State CIV to achieve tax benefits it would not otherwise be entitled to obtain.

Treaty shopping is a term often used to describe the tax-avoidance concern raised in the Commentary to Article 1. Under the umbrella of treaty shopping, the source State may invoke under its internal tax laws the principles of "substance over form", "sham transaction", "conduit financing" and other anti-abuse principles, all designed to prevent the grant of treaty benefits in situations where a resident of one State employs an entity formed in another State to achieve tax treaty benefits not otherwise attainable from the source State. There is, however, no opportunity in the ICG proposal for such abuse because no treaty shopping objective by an investor resident in a third State, the relevant treaty of which provides equally favorable benefits, would be accomplished. Such investor is in the same tax treaty position whether the CIV is organized in its State or in the State where actually organized.

Treaty Eligible Third State Investor

A more difficult question is to what extent, if any, to allow third State investors who are not eligible for equally favorable treaty benefits to count towards meeting CIV eligibility. That is, how should the proposed Commentary on CIVs address the standards for "treaty-eligible" residents? For example, if a resident State individual or entity investor is eligible for a 10% rate of tax on portfolio dividends from the source State, but the third State investor is eligible only for a 15% rate of tax with the source State, should the third State investor be a qualified investor under the ICG proposal? Alternatively, should the investor in that scenario be counted in a look-through treaty basis to provide a blended rate of source State tax imposed on the CIV?[5] Should the third State treaty investor not be counted at all? Suppose the CIV also receives minor amounts of interest income which is subject to different source State rates of tax in the resident State and the third State.[6] Would the third State investor be counted in that scenario?

Our committee has previously addressed similar issues in a report we recently submitted to the United States Senate Foreign Relations Committee in connection with "derivative benefits" provisions found in certain "limitation on benefits" ("LOB") articles of certain U.S. income tax treaties.[7] In summary, the LOB article is designed to prevent treaty shopping abuse from a resident of one country by forming an entity in a third State which has a favorable treaty with the source State. However, the derivative benefits provision included in certain LOB articles recognizes that treaty benefits should not necessarily be denied to an entity if its owners are residents of other States that have comprehensive treaties with the source State and that

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[5] This scenario typically should not arise in the portfolio dividend payment setting since most bilateral tax treaties provide for a 15% withholding tax rate on such income.

[6] This assumes that the source State does not have an internal law exemption for portfolio interest income payments.

[7] New York City Bar, "Report Offering Proposals Regarding the "Derivative Benefits" Provisions Found in the Limitation on Benefits Article of Certain U.S. Income Tax Treaties", May 21, 2008, BNA DTR May 28, 2008, also reprinted 119 Tax Notes 1087 (June 9, 2008) and Tax Notes International, July 7, 2008 page 43.

provide benefits that are no less favorable than the benefits provided to the entity in its resident State.

While U.S. tax treaties would deny treaty benefits entirely to the entity in situations where the third State owners do not qualify for a withholding rate as low as the rate to which the entity would be entitled under the treaty between its country of residence and the source State, we proposed in our report that a "look-through" rule be instituted in its place.[8] We recognize that this recommendation, if extended to CIVs, would carry administrative burdens both for the CIV and for the corporation paying portfolio dividends from the source State. A more administrable approach in the CIV setting would be to simply determine whether the third State investor counts towards the requisite threshold determined necessary for CIV qualification under the final ICG proposal. To that end, the ICG might consider imposing the "at least as low as" standard currently found in derivative benefits provisions of certain U.S. income tax treaties or a standard that counts the third State investor if the treaty that its country of residence has with the source State provides a rate that is within an acceptable range of the CIV organized State rate, as determined by the ICG.[9]

As a practical matter, our committee does not anticipate that the matter of equivalent third State benefits will pose substantial difficulties in the CIV setting since most CIV income subject to tax in the source State is likely to be portfolio dividend income, which is fairly uniformly granted a 15% withholding tax rate. To the extent there is interest income subject to tax in the source State at rates that differ between the resident State and the third State, we recommend disregarding such differences to the extent the interest income is considered de minimis as determined by the ICG or bilateral treaty.

Conclusion

For the reasons set forth in this letter, we recommend that third State investors in CIVs who would have qualified for the same reduction in source State taxation had they invested directly be treated as eligible treaty investors for purposes of granting the CIV entitlement to claim treaty benefits in its own right. Should the ICG report, however, contain recommendations not considered in this letter, our recommendations might change. We welcome the opportunity

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[8] For example, suppose that a German holding company, wholly owned by a publicly traded French parent corporation, receives U.S.-source patent royalties that would, if treaty benefits were available, qualify for a complete exemption from U.S. withholding tax under the German treaty. Under the French treaty, however, the withholding rate on patent royalties is 5%. Therefore, the French parent is not considered an "equivalent beneficiary" under the German LOB article and no treaty benefits are available. Consequently, the U.S. internal withholding tax rate of 30% would apply, even though the French parent would be entitled to a 5% withholding rate if it derived the patent royalty directly. We recommended that the LOB treaty provisions adopt a look-through approach to provide the German holding company with the same 5% withholding rate that would have been available to the French parent that it would have enjoyed if the German holding company were not interposed. If instead 50% of the stock of the German holding company were owned by a qualified third State that would have qualified for a 10% withholding rate, then our recommendation was that 50% of the royalty be subject to a 5% withholding rate and the other 50% be subject to a 10% withholding rate, effectively resulting in a "blended" withholding rate of 7.5%. Under the "higher of" approach that we proposed in the alternative, the entire royalty would be subject to a 10% withholding rate.

[9] It is our understanding that derivative benefits arose from concerns raised by certain European treaty partners of the U.S. that LOB provisions might violate the European Community Treaty. See page 18 of our derivative benefits report, fn. 7 infra., and authorities cited therein for more detail.

to discuss our recommendations with the appropriate persons. Please feel free to contact the undersigned at 212-407-4900 or via e-mail at atarr@loeb.com, or Mark Stone at 212-513-3577 or via e-mail at mark.stone@hklaw.com.

Very truly yours,

Alan J. Tarr
Chair

cc: Mary C. Bennett
Jacques Sasseville
Patricia Brown
The Honorable Eric Solomon, Assistant Secretary (Tax Policy), United States Department of the Treasury
Michael Mundaca, Deputy Assistant Secretary, International Tax Affairs, United States Department of Treasury
John L. Harrington, International Tax Counsel, United States Treasury Department