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Report of the Subcommittee on Updating the United Nations Model Double Taxation Convention between Developed and Developing Countries

Tax Policy Considerations related to the Tax Treaty Treatment of Collective Investment

Note by the Secretariat

A. Collective investment vehicles

6. As indicated in note E/C.18/2018/CRP.7,[1] a collective investment vehicle (CIV) can be defined as a fund that pools the investment of many investors and is therefore widely-held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established. This note deals with collective investment vehicles separately from pension funds, real estate investment trusts and so-called "non-CIVs" even though all these are used for collective investment (i.e. the pooling of investments by a group of investors).

1. Should a developing country include provisions on collective investment vehicles in its tax treaties?

7. The first policy issue that a developing country should address in relation to the application of tax treaties to CIVs is whether it should seek to deal with CIVs in its tax treaties. Apart from a passing reference to collective investment vehicles in Article 29 (Entitlement to treaty benefits), the articles of the UN Model, like those of the OECD Model, do not address expressly CIVsrpr-1 (r)1 (V)ac 0.0

such as a contractual arrangement (such as a "*fonds commun de placement*") and a trust (depending on the treaty definition of "person" and the domestic tax treatment of trusts).

14. Second, does the CIV qualify as a "resident of a Contracting State"? Assuming that a CIV falls within the treaty definition of a "person" and having regard to the various mechanisms described in paragraph 11 above, it is not entirely clear that all states would agree that a CIV would be considered to be "liable to tax" in the situations described in cases c), d) and e).

15. Third, if the respective domestic laws of the two states take different views as to the tax treatment of the CIV (e.g. where one state considers the entity as fiscally transparent while the other treats it as a taxpayer) and the relevant treaty does not include the transparent entity provision of Art. 1(2) of the UN Model, it is not clear how the treaty reliefs would be applied to the income derived through the CIV.

16. Fourth, assuming that the CIV qualifies as a "resident of a Contracting State" under the relevant treaty, it is unclear whether all countries would consider it to be the beneficial owner of its income, especially if almost all that income must contractually be distributed to investors.

17. Despite the legal analysis, however, the basic policy question that any country should address is whether treaty benefits ***should*** be granted to CIVs and if yes, under which conditions. If CIVs exist in different forms in each of the two states that have concluded a tax treaty, it would seem inappropriate to leave the issue of the treaty entitlement of each CIV to a purely legal analysis to the extent that this could result in most of the CIVs established in one state being entitled to treaty benefits while most of the CIVs established in the other state are not.

18. Another set of policy issues arise where a CIV does not, in its own right, qualify as a resident of Contracting State. In that situation, the first question is whether and how treaty benefits may behethefit

their investment income is exempt from tax until it is distributed as pension benefits raise the issue of whether pension funds can be considered to be "liable to tax", which is a requirement for being a "resident of a Contracting State" under the wording of paragraph 1 of Article 4.

25. This issue is dealt with in paragraph 6 of the Commentary on Article 4 of the UN Model, which quotes the following two paragraphs from the Commentary of the 2014 OECD Model:

> 8.6 Paragraph 1 refers to persons who are "liable to tax" in a Contracting State under its laws by reason of various criteria. 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 (see, for example, paragraph 1 of Article 10 and paragraph 5 of Article 11).
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> 8.7 In some States, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws. These States may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention. Contracting States taking this view are free to address the issue in their bilateral negotiations.

26. Given the uncertainty resulting from the two opposite views reflected in these paragraphs and in light of the importance of cross-border investment by pension funds, the OECD decided, in 2017, to modify paragraph 1 of Article 4 to provide expressly that a "recognized pension fund", as defined in a new subparagraph 1 (*i*) of Article 3 (General definitions), is a resident of the state in which it is established.

27. These changes have yet to be considered by the UN Committee. The policy question that arises for the Committee and for developing countries is therefore whether it would be appropriate to generally provide that pension funds, as defined for that purpose, qualify as "resident of a Contracting State". If there were no agreement to do so, the next policy question would be whether and how to reconcile the opposite views reflected in paragraphs 8.6. and 8.7 above so as to provide greater certainty as regards cross-border investment by pension funds.

28. As in the case of CIVs, a subsidiary policy issue that arises with respect to the treaty entitlement of pension funds is whether they present treaty-shopping risks and how to deal with such risks. This issue is addressed in subparagraphs *e*subpaubpaubpabove-1[(s)-1 (ubpa6 (gb(s)-1 (ubpa6 ii9 (c)

countries and their capital markets are small, such exemptions would not provide reciprocal benefits to the two contracting states.

33. A state that would agree to such an exemption for pensions funds established in another state should ensure that the meaning of the term “pension fund” is clear so as to avoid situations where the exemption would be requested for investments though vehi[illegible] may be set up to provide a pension to one or more individuals but that would [illegible] recognized as such in the state of residence. One way of doing so

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state of residence as it unduly penalizes residents who worked abroad and, therefore, have contributed to foreign pension funds. Such taxation could also result in economic double taxation if the same investment income, when subsequently distributed as part of a pension, is fully taxed in the hands of the pensioner.

39. Some tax treaties expressly address that issue by preventing a state from taxing a resident on that resident's share of the investment income of a foreign pension fund as long as that income is not distributed. This is the case of paragraph 1 of Article 19 (Pension Funds) of the Vietnam-United States treaty (2015, not yet in force), which reads as follows:

> Where an individual who is a resident of a Contracting State is a member or beneficiary of, or participant in, a pension fund established in the other Contracting State, income earned by the pension fund may be taxed as income of that individual only when, and, subject to paragraph 1 of Article 18 (Pensions, Social Security, Annuities, Alimony, and Child Support) of this Agreement, to the extent that, it is paid to, or for the benefit of, that individual from the pension fund (and not transferred to another pension fund in that other Contracting State in a transfer that qualifies as a tax-

44. The tax policy issues related to the application of tax treaties to REITs have been analyzed in the 2008 OECD Report entitled “Tax Treaty Issues Related to REITs”.[12]

45. The main source of income that a foreign REIT would derive from a country is rental income derived from immovable property that would be covered by Article 6 (Income from immovable property) of the UN Model. A [illegible]

the reduced rate applicable to portfolio dividends or the even lower rate applicable to direct dividends would seem inappropriate; such distributions should be subjected to the full tax rate provided by domestic law.[13]

50. As indicated in the OECD report, implementing the above policy conclusion would require the inclusion of specific provisions in a tax treaty.

51. Developing countries that have introduced REIT regimes in their domestic law or that are considering doing so should consider whether this policy conclusion is appropriate in their circumstances and whether such provisions should be included in their treaties. They should, in particular, consider the conclusion that distributions to a foreign investor that holds a large participation in a domestic REIT set up as a company should not be entitled to the reduced rate applicable to portfolio dividends or the even lower rate applicable to direct dividends under paragraph 2 of Article 10 of the UN Model.

52. Another policy issue related to the application of tax treaties to foreign investors in a domestic REIT arises when the foreign investor realizes a gain upon the alienation of its interest in such a REIT. Since the main assets held by a REIT are immovable property, it is likely that the provisions of paragraph 4 of Article 13 would apply upon the alienation of interests in a REIT set up as company, partnership or trust (whereas the provisions of paragraph 1 of Article 13 would apply in the case of a REIT set up as a contractual arrangement). As explained in the OECD Report,[14] some countries consider that result to be entirely consistent with the purpose of paragraphs 1 and 4 of Article 13, while other countries consider that a small investor's interest in a REIT should be treated as a gain on a security not covered by paragraphs 1 and 4 of Article 13 because that would be more consistent with the policy view that distributions from a REIT should be treated as Tw [(s)-0D4 0 T Tw -33.10 (a) (vi)-2 (e)4 96 -0 0(b)-1t3(ppl)2e10 (a) (v81 (bqc)4 (os)-1 (e)4 ( )]TJ0
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set up and manages the fund. It could also include a venture capital fund that would be similarly structured to seek private equity participations in start-up enterprises with growth potential.

55. While non-CIVs raise many of the same treaty issues as CIVs, countries have been less inclined to clarify how treaties would apply to them. Nevertheless, since the application of anti-treaty-shopping rules is a particular concern for non-CIVs with investors in many different countries, example M included in the Commentary on the general treaty anti-abuse rule of paragraph 9 of Article 29 of the UN Model and OECD Model presents a situation where the rule should not apply to a non-CIV. No specific exception has been provided, however, with respect to the anti-treaty shopping rules of paragraphs 1 to 7 o Article 29 of the UN Model.

56. One specific issue that often arises with respect to non-CIVs (but which can also arise with respect to CIVs) is whether the location of the fund's key employees outside the state where the fund is established (e.g. in the case of a venture capital fund, in order to provide advi

ANNEX 1

Mutual agreement between the Netherlands and Switzerland concerning the application to CIVs of the 2010 treaty between these countries

Preamble

The competent authorities of Switzerland and the Netherlands (hereinafter: 'the competent authorities') have reached the following mutual agreement regarding the application of the Convention between the Kingdom of the Netherlands and the Swiss Confederation for the avoidance of double taxation with respect to taxes on income signed at The Hague on February 26th, 2010 and the related Protocol ('the Convention') with respect to a Netherlands fiscal investment institution (*fiscale beleggingsinstelling*, 'FBI'), by a Swiss contractual fund (*fonds commun de placement*, FCP') and a Swiss open ended investment fund (*société d'investissement*

For FBI

Provided that persons who are residents according to Article 4 of the Convention of a Contracting