ICI Global

35 New Broad Street
London EC2M 1NH
UK
+44 (0) 203 009 3100
www.iciglobal.org

Suite 715–717, Level 7
Two Exchange Square
8 Connaught Place
Central, Hong Kong
+852 2168 0882

1401 H Street, NW
Washington, DC 20005
USA
+001 202 326 5800
www.ici.org

Keith Lawson
SENIOR COUNSEL, TAX LAW

+001 202 326 5832
MOBILE: +001 202 957 7226
lawson@ici.org

By Electronic Delivery

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Marlies de Ruiter
Head of Division
Tax Treaties, Transfer Pricing and Financial Transactions
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue André Pascal - 75775 Paris Cedex 16

RE: *CIVs, Their Managers, and BEPS Action 7*

Dear Ms. de Ruiter:

ICI Global,[1] on behalf of our collective investment vehicle (CIV)[2] industry members, urges that the final Base Erosion and Profit Shifting (BEPS) Action 7 Report[3] not impact several rules, discussed below, for determining whether a taxpayer has created a permanent establishment (PE). These well-established rules provide CIVs, their investors, and their managers with tax certainty.

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[1] The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.2 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

[2] A CIV is defined for this purpose consistently with the OECD's Report entitled "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles" (the "CIV Report") – http://www.oecd.org/tax/treaties/45359261.pdf. Specifically, CIVs are defined 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." CIV Report, page 3, paragraph 4. Funds that are not treated as CIVs in the CIV Report (and that are not addressed in our comments) include "investments through private equity funds, hedge funds or trust or other entities that do not fall within the [Report's] definition of CIV." *Id.*

[3] The OECD public consultation document to which these comments relate is entitled "BEPS Action 7: Preventing the Artificial Avoidance of PE Status" – http://www.oecd.org/ctp/treaties/action-7-pe-status-public-discussion-draft.pdf.

Support for OECD's BEPS Initiative

Base erosion and profit shifting concerns, we have stated repeatedly,[4] should be addressed globally on a consensus basis. As the OECD is uniquely positioned to achieve this goal, we support strongly the OECD's leadership of the BEPS project.

Summary of ICI Global's BEPS Action 7 Concerns and Specific Recommendations

The PE rules contained in Article 5 of the OECD Model Tax Convention on Income and on Capital (the OECD Model Tax Convention)[5] were crafted to implement sound tax policy. Most specifically, the PE rules strike a balance between a business' tax responsibilities to a jurisdiction and the benefits that the business receives from its activities within that jurisdiction.

The current PE rules prevent a business with limited activities within a jurisdiction (and little revenue from those activities) from incurring the substantial administrative and compliance costs associated with a PE. Instead, the current rules limit the incursion of these costs to situations in which the expected tax revenue to the PE-asserting jurisdiction is significant. We submit, for the reasons explained below, that any possible tax revenue from expanded PE rules will be substantially less than the incremental costs imposed on the CIV industry.

We acknowledge, of course, that governments should be concerned if wholly-artificial structural arrangements can be crafted to avoid paying tax that fairly is due. The appropriate solution, however, would be targeted fixes rather than the more fundamental changes being advanced in the discussion draft.

Our specific recommendations, which address only legitimate arrangements with respect to questions asked regarding the OECD Model Tax Convention, are that:

- BEPS Action 7's option H should be rejected –
  - (*i.e.,* Article 5, Paragraph 4(d) – relating to information collection – should be maintained);
- BEPS Action 7's option E should be rejected –
  - (*i.e.,* Article 5, Paragraph 4 should not be amended to condition its application in all cases on activities being preparatory or auxiliary); and
- BEPS Action 7's options I and J should be rejected –
  - (*i.e.,* separate entities created for sound business reasons, as provided in effect by Article 5, Paragraph 7, should be respected).

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[4] *See, e.g.,* ICI/ICI Global submission on BEPS Action 6, dated 8 April 2014 (http://www.ici.org/pdf/28024.pdf); ICI/ICI Global submission on BEPS Action 2, dated 2 May 2014 (http://www.ici.org/pdf/28095.pdf).

[5] http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-2010_9789264175181-en#page39.

More generally, we recommend that any changes to the PE rules be accompanied by:

- clear and appropriate rules for attributing income and expense; and
- enhanced dispute resolution techniques and tools including mandatory binding arbitration.

Overview of the CIV Industry

Our PE recommendations are informed by CIV industry experiences in the global marketplace and the resulting tax controversies. In the BEPS Action 7 context, it is instructive to consider the nature of a CIV, the reliance on third-party service providers, the roles and responsibilities of these service providers, and the organization of the CIV manager.

The Nature of a CIV

A CIV is a pooled investment vehicle widely used by individuals to cost-effectively access the securities markets. The important advantages provided by CIVs include professional management, asset diversification, liquidity, and robust governmental regulation and oversight.

All functions of the CIV, which does not have employees of its own, are performed by third-parties. The asset manager that has created the CIV often will perform many of these services. A CIV's officers typically will be employees of the asset manager. The typical CIV is overseen by a board of directors or trustees responsible for ensuring that the CIV is operated in accordance with its organizational documents, local law, and the best interests of its investors.

A CIV's investment objective (*e.g.,* stocks or bonds; country-specific, regional, or global; etc.) is prescribed in its offering document. Most CIVs disavow any interest in exercising any control over a company in which they invest. The CIV's portfolio management team decides which specific securities to buy and sell and initiates the securities trades.

Investors' interests in a CIV are acquired either directly from the CIV (with the purchase reflected directly on the CIV transfer agent's/recordkeeper's books) or through a third-party distributor. All CIV investor transactions are effected at the CIV's net asset value (NAV), which is determined each day by calculating the CIV's assets and liabilities and dividing by the number of outstanding interests. Because of this precise calculation requirement, certainty regarding a CIV's tax liabilities is essential.

CIVs may be organized for distribution to one or more specific types of investors (*e.g.,* individuals, pension funds, corporates, etc.). Depending on the type of targeted customer, different methods will be utilized for promoting the CIV and distributing CIV interests. Intermediaries (*e.g.,* banks, broker dealers, financial planners) typically are heavily involved in the distribution process.

The tax treatment provided to CIVs effectively recognizes that CIVs do not carry on business activities. To ensure that CIV investors receive tax treatment comparable to that provided to direct investors, for example, countries typically provide some mechanism to exempt a CIV's income from tax; the exemption mechanism may be an express tax exemption or a targeted tax

deduction for amounts distributed to investors. The only tax borne by the typical CIV on its portfolio transactions is any withholding tax that may be imposed when the CIV is a nonresident investor.

A CIV is separate and distinct from the asset manager that created it. The CIV and the asset manager have different owners, their assets are totally separate, and they bear no responsibility for each other's liabilities (including tax liabilities).

Management Companies and Other Service Providers to CIVs

The typical CIV asset manager offers its customers a wide range of financial products and provides them with an array of valuable services. The products may include CIVs, other investment pools (*e.g.,* hedge funds) that are not widely-held, insurance, and banking services. The services provided, in addition to offering these products, may include distribution, investment education, investment advice, wealth management, and/or estate planning.

The services that an asset manager may provide to a CIV could include:

- portfolio selection (which may involve portfolio managers (PMs), analysts, and research assistants);
- asset acquisition and disposition (often through multiple securities dealers);
- assistance in arranging asset custody (typically through a global custodian and regional/local subcustodians);
- regulatory compliance;
- investor recordkeeping (through a "transfer agent"); and
- investor communications (including transaction confirmations and periodic account statements).

Many asset managers create separate entities to distribute CIV interests. These distributors may contact investors directly or work through unrelated third-parties (*e.g.,* broker-dealers). Because the global CIV industry is highly intermediated (*i.e.,* CIV interests typically are acquired through third parties), arm's-length pricing comparables are available for "in-house" distribution activities.

Many management companies operate globally – although their specific activities may vary widely. Companies may distribute their products locally, regionally, or globally. Some may invest globally – even if they distribute only locally or regionally. Still others may consolidate various functions in one (or more) locations to achieve economies of scale.
The manner in which a management company is organized and/or structures its operations also may vary widely. Even within one country, a company may create separate entities; different business lines subject to different regulatory regimes and/or supervised by different regulators frequently will be placed in separate entities. Operations in multiple countries likewise often will be performed by separate companies.

Particularly within the heavily-regulated financial services industry, regulatory considerations often will be the primary (if not exclusive) driver for structuring decisions. Local regulatory requirements, for example, frequently require that a locally-organized CIV be managed by a local

management company. To the extent that one country's regulatory regime applies to an entire entity, companies often will establish separate subsidiaries so that the applicable regulatory regime will apply only to the relevant business activities. When different jurisdictions have different, and potentially inconsistent, regulatory requirements, it often is necessary to set up separate entities (*e.g.,* distributors) in each jurisdiction. Separate entities become even more important when country-specific securities licenses or other permissions are required.

CIV Industry Competitiveness

The CIV industry is extremely competitive. CIVs routinely advertise their performance (investment return) both in real terms and relative to their competitors. Independent research firms (*e.g.,* Morningstar*)* often are a primary source for the data required to make these comparisons.

Performance and reputation are key for CIVs and their asset managers. CIVs that generate strong returns and outperform competing investment products are rewarded with shareholder investment inflows. CIVs that underperform face shareholder redemptions. Because an asset manager's fees are calculated based upon assets under management (AUM), managers are incentivized to generate strong performance.

Perhaps the biggest driver on performance (other than portfolio management) is the fee paid by a CIV to its manager. Because all fees paid by a CIV come directly from the CIV's assets, fees have a direct and negative impact on performance. The more a CIV pays in management fees, the lower its investment return. The CIV industry, therefore, is extremely price-sensitive.

Management companies also are incentivized to keep fees low. The lower the CIV's expenses, the higher the returns, and the greater the investor demand for the CIV. The larger the CIV, the higher the gross management fee.

Management Company Expense Considerations

Management companies seek to control all of their expenses. Business efficiency, including consolidating functions operationally and/or geographically, play an important role in cost containment. Costs between related parties are charged by applying the arm's-length standard.

All management company operations, importantly, do not have the same impact on profitability. In the CIV industry, a management company's reputation and success are driven largely by the attractiveness of the CIVs it offers to investors. Developing innovative products (*e.g.,* exchange traded funds) or identifying new investment opportunities (*e.g.,* micro cap stocks) can generate growth. Because performance is key, however, portfolio management (*e.g.,* stock picking) is a key profitability driver. Administration and infrastructure costs (*e.g.,* regulatory compliance such as legal services and accounting, transfer agency, custodial, and information technology costs) are very important to a successful operation and may constitute a significant portion of a CIV's operating costs – but they have less impact on a CIV's performance.

CIV Industry Concerns with the BEPS Action 7 Public Consultation Document

PE Rules Appropriately Limit Unproductive Tax Liability Assertions

Tax controversies, while inevitable, can result in significant time commitments and expense. The PE rules embodied in the OECD Model Tax Convention provide an important check against expensive and ultimately unproductive assertions of tax liability. Any proposed changes to the PE rules should be targeted at artificial constructs. If an entity has such limited contact with a country that assertions of taxing jurisdiction, and the resulting compliance costs, would make it uneconomic to enter the country in the first instance, a PE should not be created.

Any expansion of the PE rules, as discussed below, must be accompanied by fair and administrable profit attribution rules. We are particularly concerned that tax administrators aggressively asserting taxing jurisdiction under any expanded PE rule also will aggressively and inappropriately assert that revenues (and taxable profits) are arising within their borders. These assertions almost surely will result in double taxation of a business' profits.

The Information Collection Exception Should be Retained

First, for the reasons discussed below, we recommend that paragraph 4(d) of Article 5 of the OECD Model Tax Convention – relating to information collection – be retained. Hence, BEPS Action 7's option H should be rejected.

The process of collecting information is precisely the type of "contact" with a country that is too insignificant to justify PE assertions. The information collection activities of CIV asset managers provide an apt illustration of this point.

Fund managers routinely collect information regarding investment opportunities for CIVs that they manage. The collected information is transmitted back to the manager's investment office along with information collected from other countries and regions. This information then is analyzed closely, often by a team of investment professionals with diverse responsibilities, before a portfolio manager makes any decision to buy or sell securities.

This information collection activity often will not involve a fixed place of business. Portfolio managers and/or analysts routinely visit operating companies and meet with senior employees to understand better a company's business activities, growth opportunities, etc. Publicly-available financial information also will be collected (sometimes from the internet rather than a visit).

While information has some intrinsic value (otherwise, companies would not incur the costs of collecting it), information-collection activities bear little relationship to management company revenues. Without the detailed examination of the information and data collected, and the rigorous comparisons of different investment opportunities, CIV's investors would not benefit from any information collected. In the CIV industry, profitable activities are the ones that benefit CIV investors.

Moreover, were a PE inappropriately asserted because of this information-collection activity, any small amount of revenue more than likely would be offset by the expenses (including employee

compensation) of collecting this information. The limited amount of potential tax revenue – and the substantial burden of complying with potentially a hundred or more different tax regimes (for a CIV manager investing globally) – help explain why information collection does not create a PE under Article 5 today.

One consequence of inappropriate PE assertions might be a fund manager's decision to curtail or eliminate its information collection efforts and thereby minimize tax assessments and the resulting controversies. This result would be particularly unfortunate for source-country issuers and for a source country's growth potential.

Any perceived abuses regarding the exception for collecting information should be addressed instead through narrowly-targeted rules.

The Collection-of-Information Exception Should Not Be Limited to Preparatory or Auxiliary Activities

Second, for reasons similar to those discussed above, we recommend that paragraph 4(d) of Article 5's information collection exception not be limited to preparatory or auxiliary activities. Hence, BEPS Action 7's option E should be rejected.

Information collection activities, as discussed above, are too insignificant relative to the compliance burdens that would be imposed on a business conducting them. While these activities fairly should satisfy any preparatory or auxiliary activity requirement, adding this subjective requirement to the information collection specific activity exemption would eliminate the objective nature of the standard applied today. Adding a preparatory or auxiliary requirement would invite tax disputes that would generate substantial costs but little if any additional tax revenues.

Before any preparatory or auxiliary requirement is imposed on the specific activities presently covered by Paragraph 4 of Article 5, careful consideration should be given to the meaning of "preparatory or auxiliary" and the specific situations that would not meet this new standard. Given the pace at which the BEPS initiative is being undertaken, the likelihood of successfully completing this careful consideration within the time provided seems remote. Consequently, we urge that any changes in this area be considered more thoroughly post-BEPS (similar to the consideration given to PE issues by WP1 over the past few years).[6]

Separate Entities Created for Sound Business Reasons Should Be Respected for PE Purposes

Third, we recommend that the PE rules be applied by respecting separate entities created for sound business reasons. Hence, BEPS Action 7's options I and J should be rejected.

In the financial services industry generally, and the CIV industry in particular, regulatory obligations routinely cause firms to form separate business entities to perform specific functions and/or to operate in specific countries or regions. These separate entities should be respected.

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[6] *See, e.g.,* the *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)*, dated 19 October 2012.

PE Rules Never Should Attribute Activities of a CIV Manager to a CIV

Critically importantly, PE rules never should attribute activities of a CIV manager to a CIV. As discussed in detail above, a CIV and its manager are neither owned by the same people nor involved in the same activities. A CIV is owned exclusively by its investors; a CIV manager typically will not invest in a CIV it manages (other than possibly to invest "seed money" that is used to "start up" a CIV; this money then is withdrawn after the CIV attracts investors). Similarly, while a CIV manager is an operating business, a CIV is merely an investment pool; the securities held in a CIV's portfolio are non-controlling interests that do not in any way constitute a "business."

Our concern on this point relates to the different requirements that countries impose on CIVs seeking to benefit from CIV-specific tax regimes; these regimes are necessary, as noted above, so that CIV investors are taxed only once (at either the CIV or the CIV investor level) on the CIV's income and gains. If a CIV is treated as having a PE in a country simply because its CIV manager conducts activities in that country, the CIV most likely would incur substantial inappropriately-applied tax. This tax liability concern arises because any CIV not offered to investors in that market would not have been structured consciously to meet that country's requirements for any CIV-specific tax rules.

PE Rules Should Respect Separate Business Entities Created by a CIV Manager

Separate business entities created for legitimate business reasons also should be respected when only the activities of a CIV manager and its various related entities are considered. CIV managers, as discussed above, create separate entities to limit securities-law regulatory requirements to the relevant business unit. The portfolio management activities of a CIV manager are subject to such sufficiently-distinct requirements, for example, that they often are conducted by a separate entity.

Within the CIV industry, it is not necessary to expand the PE rules to collect the appropriate amount of tax from activities conducted within a country's borders. Other than information collection, the separate activities addressed in Article 5 paragraph 4 typically are not carried on within the CIV industry.

Moreover, because most activities performed within the CIV industry are offered by third parties, any activities performed by an entity related to the entity managing CIV portfolios are ones for which arm's-length pricing comparables are available. Hence, any underlying transfer pricing considerations that might arise in the CIV industry context already can be addressed adequately.

Fund distribution is one example of separate entities being created within the CIV industry. Securities distributors typically are subject to stringent requirements designed to protect investors. One way in which CIV managers can control for these requirements is to set up separate distributors. Establishing pricing comparables is not difficult, however, as third parties are used widely to distribute interests of unrelated CIVs. These comparables will ensure that a CIV manager's distribution activities within a country are taxed appropriately – without subjecting entities conducting other activities outside the country to tax within it.

Investor recordkeeping/transfer agency and compliance are other situations in which separate entities often are created. As with distribution, third-party comparables are available for these types of activities. Independent companies provide many different types of businesses (including CIV managers) with customer-service facilities such as "call centers." Because third-party comparables are readily available for these types of entities, a CIV manager cannot create separate entities to manipulate the pricing of services and "hide" revenue that should be attributed to activities within a country.

The business fragmentation proposals – which involve disregarding separate legal entities to address situations in which conglomerates arguably fragment activities to access inappropriately the specific activity exemptions – would set a dangerous precedent. This precedent would be particularly problematic if applied to CIV industry because regulatory considerations routinely lead CIV asset managers to perform business functions within separate entities.

Any Expansion of the PE Rules Should Be Accompanied by Clear and Appropriate Rules for Attributing Income and Expense and by Mandatory Binding Arbitration

Any expansion of the PE rules creates the potential for substantial tax controversy. The potential compliance burdens associated with PE status are a primary reason that the PE rules have been crafted to apply only when sufficient contact with a jurisdiction has been established.

The CIV industry in some jurisdictions already experiences very challenging tax administration difficulties. Highly aggressive interpretations of tax laws and principles – that ultimately are rejected by the courts – are far too common. The costs of defending against these unwarranted tax assertions can be substantial.

To limit the negative impact of any expansion of the PE rules, two separate steps should be taken. First, clear and appropriate rules for attributing income and expense are necessary; these issues are being considered in the context of BEPS Actions 8-10.

These clear and appropriate rules would result in profits being taxed by the jurisdiction in which the activities giving rise to them occur. In the CIV industry context, the investment management function generally is much more important to the CIV manager's success than are the other activities performed by the manager and/or related entities.

Second, mandatory binding arbitration should be available to allow business to resolve unwarranted tax assertions. Other measures, such as advance pricing agreements (APAs) and safe-harbor rules regarding pricing margins between tax treaty partner countries, also will be beneficial. The CIV industry is deeply concerned that the BEPS Action 14 discussion draft on making dispute resolution techniques more effective does not call for mandatory binding arbitration.

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Please feel free to contact me (at lawson@ici.org or 001-202-326-5832) at your convenience if you would like to discuss this issue further or if we can provide you with any additional information. My colleagues Karen Gibian (at kgibian@ici.org or 001-202-371-5432) and Ryan Lovin (at ryan.lovin@ici.org or 001-202-326-5826) also may be called upon for assistance.

Sincerely,

/s/ Keith Lawson

Keith Lawson
Senior Counsel – Tax Law

cc: taxtreaties@oecd.org