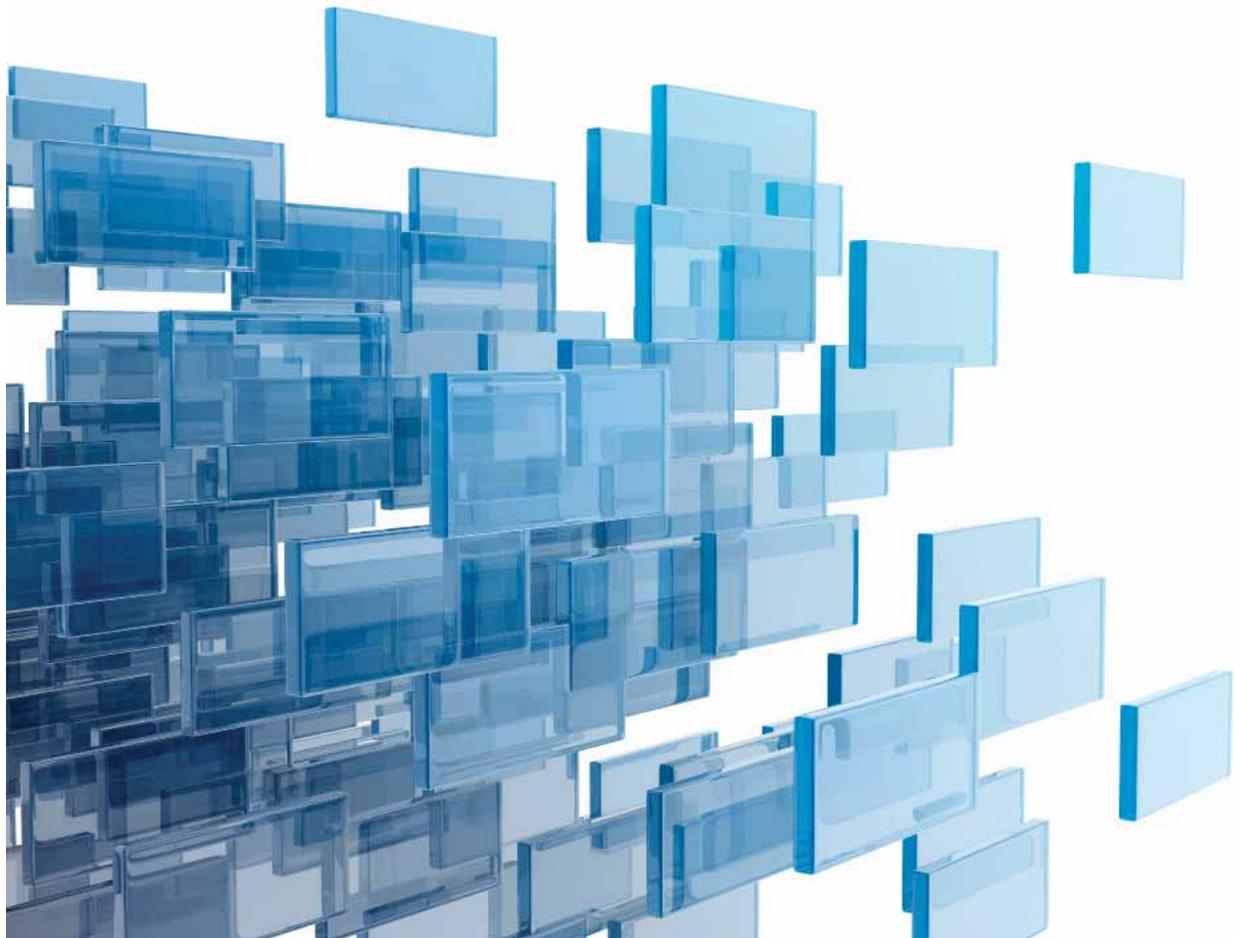




Tax-Transparent Investing Via Common Contractual Funds

Overcoming tax inefficiencies via asset pooling

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In this article, we aim to define what is meant by 'asset pooling'. We also seek to outline the benefits available to institutional investors who choose to invest their assets via a tax-transparent pooling structure such as the Irish Common Contractual Fund (CCF). Properly establishing the infrastructure to support a CCF requires a degree of effort, but the benefits make these efforts worthwhile.

Background On Asset Pooling

Asset pooling arrangements or structures allow many different investors to pool their assets in order to co-invest. Asset pooling allows investors to spread their exposure and reduce portfolio administration expenses because the co-investors share costs such as investment management fees, administration expenses and custodial fees.

Asset pooling is a common arrangement employed by investment companies to offer investors of varying scale access to specialised investment products. These companies create investment pools such as mutual funds, UK OEICs, Irish VCCs and investment trusts, and distribute them to individual and institutional investors.

Rationale For Using Pooled Funds

When investors pool their assets and invest collectively, they benefit from lower asset management, transaction and other related expenses, when compared with investing separately and individually. The investor will generally also realise other economic benefits, such as reduced brokerage expenses, because the asset manager executes larger trades. When coupled with the reduced charges incurred for custodial services, there can be a significant reduction in the overall unit cost involved when buying and holding pooled funds, by comparison with the expense of maintaining segregated portfolios.

Certain pooled funds may also be subject to reduced or zero value-added tax (VAT) charges for specific portfolio management and administration services, when compared with separately managed accounts. In addition, pooled funds offer smaller investors access to specific asset management capabilities and specialist mandates that might normally be outside their grasp as a result of costs or high minimum investment sizes.

During the past decade, institutional pension investors have increasingly used pooled arrangements as a part of their overall plan structure. Using pooled arrangements, pensions can centralise the administration of multiple pension fund schemes, eliminating duplicate administrative and custodial services in multiple jurisdictions. In the US, pension plan sponsors use Master Trust arrangements to pool the assets of their various pension plans. Noting the efficiency of the Master Trust structure in the US, many pension plan sponsors have sought a similar vehicle to enable the pooling of their global (or pan-European) plan assets in order to gain similar efficiencies. However, creating a pan-European pooled vehicle is a complicated undertaking, as each EU country is governed by its own set of laws and requirements.

Tax-Transparent Pooled Funds

Tax-transparent pooled funds have the quality of offering beneficial owners (investors) from different domiciles the opportunity to retain their current (home state) tax profile. This benefits tax-exempt investors, who may enjoy attractive treaty rates between their home market and the countries of investment within their portfolios. In addition, multinational companies which sponsor pension schemes in several countries now have the potential to 'pool' their pension assets in a single fund without suffering incremental tax expense. The pooled fund then invests in assets on behalf of the investing pension funds.

In Europe, investors have a wide variety of pooled fund vehicles to choose from to meet their investment objectives. UCITS-compliant vehicles such as the Irish Common Contractual Fund (CCF) and its Luxembourg equivalent, the Fonds Commun de Placement en valeurs mobilières (FCP) are often described as the first viable tax-transparent vehicles for global institutional pension plans. The Fonds voor Gemene Rekening (FGR) in the Netherlands provides another example. The UK's HM Treasury announced in its March 2011 budget that it will consult on a new tax-transparent authorised fund regime in June 2011, with the new regime due to be implemented in 2012. The remainder of this paper focuses on the Irish CCF as a specific example of such a tax-transparent structure.

CCF Product Structure And Features

The CCF is a contractual arrangement established under a deed under which investors participate as co-owners of the assets of the fund. A CCF is not a separate legal entity and is considered to be transparent for Irish legal and tax purposes. Investors in a CCF are treated as if they own a proportionate share of the underlying investments, rather than shares in an entity which then owns the underlying investments.

The ownership interests of participants are constituted as 'units' which are issued and redeemed by the manager in a manner similar to a unit trust.

CCFs And Taxation

For many years, investors in certain markets have been penalised from a withholding tax perspective when using pooled funds, compared with investing directly in the underlying assets. For some, this has meant that administrative and management savings gains can be wiped out by the loss in tax benefit. As a result, investors need to ensure they are not in a tax-disadvantaged position if they choose to pool their assets.

The CCF helps to alleviate this problem as it facilitates direct access to tax treaty relief in an investor's home country. There should be no incremental tax expense (commonly referred to as 'tax drag') arising from the application of withholding taxes across the pool, because investors in the pool will continue to benefit from the relevant home country treaty benefits as if they had invested on a segregated basis.



To enable participants to access double taxation treaty (DTT) benefits, the CCF must be treated as a fiscally transparent entity for tax purposes. In practical terms this means that:

- The CCF itself must not suffer tax in Ireland.
- The character and source of the income or gains received by the CCF should not be 're-categorised' on distribution to participants. Such income and gains should be subject to the same tax treatment in the hands of the participants as if they had been received directly by them, rather than via the CCF. Participants in the CCF must be taxed on a current basis on any income derived from the CCF. In other words, the income and gains will be treated as arising or accruing to each participant in the CCF in proportion to the units owned by them.
- The tax authorities in the jurisdictions in which the investors are domiciled must be satisfied that they can certify any DTT claims made by the CCF participants, even though the income for which DTT relief is claimed is being derived through the CCF. (Our understanding is that the CCF structure will enable such certification.)
- The source country tax authorities (i.e. the country of issue of the relevant security) must grant double tax treaty relief to the CCF participant (not the pooled vehicle) in respect of income or gains.

Legal Features Of A CCF Required To Facilitate Tax Transparency

To assist in achieving tax transparency, a CCF should have the following characteristics. These characteristics differentiate a CCF from a corporate body, which is not tax transparent.

- Income derived through the pooling vehicle should be distributed on a mandatory basis annually, pro rata to each participant's investment in the CCF. This ensures that the income is both accounted for and taxed on an 'arising'/current basis.
- The CCF participant should be provided with an annual breakdown of income on investments by type and source.
- No redemption charge should be levied on participants.
- No 'investor' meetings (i.e. meetings similar to shareholder meetings) should be permitted.
- The Irish tax authorities must view a CCF as a transparent vehicle for Irish tax purposes.
- Holdings/units in a CCF should not be freely transferable, but are redeemable. It has however been accepted that units may be transferred in limited circumstances, i.e. with the prior consent of 100% of unitholders and the manager.
- A CCF should not be a separate legal entity having its own legal capacity/personality. Factors influencing the CCF's legal status will include the CCF's capacity to: (a) acquire rights and assume obligations; (b) hold assets and liabilities; and (c) enter into agreements.
- Assets should be jointly held by participants pro-rata to their investment.

Care needs to be taken to ensure that commercial negotiation or legal redrafting does not water down these provisions.

CCF Treatment In Other Jurisdictions

The overriding question is whether the tax authorities in the investor's jurisdiction and the tax authorities in the jurisdiction where the assets are located will accept the transparency of the CCF. This acceptance is required to entitle the participating pension funds to access the DTT between their home jurisdiction and that of the jurisdiction where the assets are located.

Determining how foreign tax authorities would view a CCF takes two principal forms. In some cases rulings have been obtained from tax authorities (such as in the UK and Netherlands). In other cases, such as in the US, investors rely principally on tax opinions from local tax advisers. While sponsors of a CCF will need to obtain rulings and/or tax opinions in relation to their own CCF products, the tax transparency of the CCF should generally be viewed positively in North America, in Australia and by most Northern European countries.

Multinational Corporation Case Study

Asset managers and global service providers have developed the legal, tax and fund administration infrastructure necessary to support the CCF. With the infrastructure now in place, the CCF has become an appealing investment vehicle for institutional investors seeking a tax-efficient pooling vehicle. Multinational corporations with employees and funded retirement plans located in multiple jurisdictions probably have the most to gain by investing in the CCF structure. CCFs offer multinationals tax efficiency, asset diversification, improved risk management and centralised corporate governance.

To help illustrate these benefits, we will look at a case study involving a multinational corporation's investment into alternative investment vehicles. In this scenario, a multinational has funded employee pension plans in the UK (US\$300 million), the Netherlands (US\$300 million) and Switzerland (US\$300 million) and wishes to invest these assets in a US equity mandate yielding 2% in dividend income. The three country pension plans independently have a number of different investment vehicle options within both their local jurisdiction and other jurisdictions. We analyse three such investment vehicle options: the Irish Variable Capital Corporation (VCC), a separately managed account (SMA) and the Irish CCF. The first factor that we analyse is the tax efficiency of each vehicle.

1. Tax Efficiency

Eighteen million US dollars in dividend income is generated annually on a US\$900 million investment yielding 2%. Being a pooled corporate vehicle, the VCC is subject to withholding tax when dividend income is received by the fund. For an Irish VCC, the withholding tax rate on income generated by US equities is 30%, resulting in a withholding tax impact of US\$1.8 million for each pension plan, or a total of US\$5.4 million for the multinational, which cannot be reclaimed.

A second investment option is for each pension plan to hold the US equities directly within their own SMA, where



the withholding tax consequences are much more favourable than those of the Irish VCC because the pension plans can access more favourable tax treaty rates. In this case, all three pension plans are subject to a 0% withholding rate because the double tax treaties between the jurisdiction of each pension plan and the jurisdiction of the source income (US) is 0%. The end result is that the multinational can retain the entire US\$18 million in dividend income generated from their investment (US\$6 million for each pension plan). However, although the SMA is a tax efficient option, there are additional financial and administrative drawbacks. See below.

The CCF was designed as a tax transparent vehicle, meaning that withholding tax applies to the underlying investors rather than to the fund itself. When established appropriately, the CCF yields identical tax treatment to that of the SMA option, resulting in the multinational corporation receiving the entire US\$18 million in dividend income. In this scenario, we look only at US equities as an example, but other asset classes can also be held within a CCF.

custody and administration costs independently, generally resulting in higher costs within the SMA structure than in a pooled vehicle such as the CCF or VCC.

We looked at modest-sized country pension funds in three domiciles. However, large multinationals may have ten or more pension funds of varying sizes and domiciles. This example highlights the benefits to larger pension plans. However, smaller pension plans may have the greatest opportunity to benefit from economies of scale. The smaller country pension plans may be limited in their asset allocation and/or asset manager options, which inherently increases risk and cost. The CCF's asset pooling capabilities offer these smaller country pension plans access to more diversified investment mandates and a broader pool of asset managers, reducing cost and diversification risk.

3. Diversification And Corporate Governance

The trustees of local pension plans have to make many critical investment decisions, covering the investment vehicle structure, asset allocation strategy, investment

Figure 1

| Investment Vehicle Comparison Summary | | | |
|--|---|--|--|
| | Irish VCC | SMA | Irish CCF |
| Dividend Withholding Tax Efficiency | US\$5.4 million withheld from multinational | ✓ Multinational receives entire US\$18 million | ✓ Multinational receives entire US\$18 million |

2. Economies Of Scale

Multinationals should consider whether or not they can gain economies of scale. Pooling the assets of multiple individual pension schemes in a single vehicle such as the CCF means asset managers often incur lower transaction costs by netting investor cash flows, which reduces the need to trade. Pooling also enables asset managers to reduce brokerage costs by placing larger trades. Asset managers and service providers can often negotiate lower custody and administration fees due to the larger pools of serviced assets. Within the SMA structure, each individual pension plan would incur the transaction, brokerage,

mandates, investment policies and asset manager evaluation, selection and monitoring. Providing strong corporate governance across all local country pension plans can be logistically challenging, resource-intensive and costly.

The ability to manage and monitor pension plan assets as a larger consolidated investment pool (for example, within an Irish VCC or CCF) provides trustees with greater diversification of investment options and reduces administrative costs. It also enables the pension staff to perform more effective operational control and corporate governance. In a pooled structure, the trustees of multiple local pension plans are presented with consistent asset

Figure 2

| Investment Vehicle Comparison Summary | | | |
|--|---|--|--|
| | Irish VCC | SMA | Irish CCF |
| Dividend Withholding Tax Efficiency | US\$5.4 million withheld from multinational | ✓ Multinational receives entire US\$18 million | ✓ Multinational receives entire US\$18 million |
| Economies Of Scale | ✓ Lower total costs incurred by multinational | Higher total costs incurred by multinational | ✓ Lower total costs incurred by multinational |



Figure 3

| Investment Vehicle Comparison Summary | | | |
|--|--|---|--|
| | Irish VCC | SMA | Irish CCF |
| Dividend Withholding Tax Efficiency | US\$5.4 million withheld from multinational | ✓ Multinational receives entire US\$18 million | ✓ Multinational receives entire US\$18 million |
| Economies Of Scale | ✓ Lower total costs incurred by multinational | Higher total costs incurred by multinational | ✓ Lower total costs incurred by multinational |
| Investment Diversification | ✓ Greater diversification of investment opinions | Restrictions on investment options are typical and vary by country | ✓ Greater diversification of investment opinions |
| Corporate Governance | ✓ Allows for oversight of a consolidated asset pool and reduces administrative costs | Oversight performed at local plan level and increased administrative costs to report to multinational | ✓ Allows for oversight of a consolidated asset pool and reduces administrative costs |

class, investment mandate and investment policy options, enabling them to implement consistent investment decisions, while also retaining the flexibility to meet local needs. Trustee oversight is also more efficient within the pooled structure, due to the consistency of processes and reports provided by asset managers and custodians. This benefit becomes increasingly important for multinationals with smaller size country pension funds.

Case Study Conclusion

Multinational corporations seeking tax efficient investments for their country pension plans are no longer required to make cost inefficient stand-alone investments within each jurisdiction, selecting from a limited choice of investment options and governed by independent committees. Regulatory changes have provided the framework for the tax-efficient pooling of assets. Asset managers and custodians are now working together to develop product solutions to take advantage of these regulatory changes. The Irish CCF is such a product solution, combining the tax-efficient nature of separate accounts with the economies of scale, diversification, corporate governance and cost savings benefits of pooled vehicles.

Benefits To Other Institutional Investors

Other institutional investors can also benefit from investing in a CCF. Single country pension plans, corporate

entities and government agencies can all take advantage of the tax-transparent nature of the CCF. These entities investing in a CCF should receive tax withholding treatment consistent with that of a segregated account. Add the potential VAT savings, economies of scale and investment diversification options that a regulated pooled vehicle such as the CCF offers and they can achieve considerable cost savings while also reducing risk.

Similarly, insurance companies which own and write business in multiple jurisdictions have historically borne the inefficiencies of managing diverse portfolios, which they must legally maintain to support the future liabilities that they may incur. Just as pension schemes can use vehicles such as the CCF to derive cost efficiencies and scale, insurers can also use such vehicles to manage their assets on a global basis, improving their risk profile.

Conclusion

In order to create an optimal investment vehicle that will deliver the maximum benefits to investors, asset managers and custodians must work together with law firms and tax advisors to obtain tax rulings, develop the operational and systems infrastructure necessary to support the framework and ensure that all regulatory requirements are met. However, the benefits that the CCF has to offer, as outlined in this paper, greatly outweigh the effort associated with creating the investment solution.



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