ASSET SERVICING

Launching a Tax Transparent Pooling Vehicle

A case study from BNY Mellon and Aon

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"The Irish CCF has a strong cross-border appeal from an investor perspective, and is very competitive in the market when compared to the other European products available."

Foreword

BNY Mellon and Aon are delighted to be launching an Irish Common Contractual Fund (CCF).

The CCF is the Irish version of what are commonly referred to as tax transparent funds (TTFs) and are available in Ireland, Luxembourg, the Netherlands and the UK. CCFs provide investors with the benefit of withholding tax savings ranging from 30 to 50 basis points.

The deep and longstanding relationship between BNY Mellon and Aon has enabled us to work closely together on the deployment of this CCF, Aon's first in the Irish market. The BNY Mellon tax and operational teams have deep knowledge of TTFs, which, coupled with the latest technology, enables BNY Mellon to service Aon in a highly automated and operationally efficient manner.

We are seeing significant growth in TTFs due to the many advantages they present, including operational efficiencies and withholding tax benefits that ultimately benefit clients' underlying investors.

We look forward to working closely together and evolving our product offering as the market continues to expand and grow.

Gail Weiss
Aon Trust's President and Chief Trust Officer

Caroline Butler
BNY Mellon's Global Head of Custody, Tax and Network Management

What are the Benefits of a Tax Transparent Pooling Vehicle?

Pooling is the term used to describe the aggregation of different investors' assets into a single fund vehicle. It offers investors the opportunity to diversify their portfolios and spread portfolio risk, achieve centralized administration, enhance governance and risk management, and extract cost savings from economies of scale.

Pooling can take place either through a vehicle that is opaque for tax purposes, or through a vehicle that is regarded as tax transparent. The pooling of assets in a fund that is transparent for tax purposes means that each investor's gains accrue in proportion to their holding in the fund without changing their character, source and timing. In other words, the fund is "looked through," and investors are treated for tax purposes as if they held their proportionate share of the underlying investments directly.

TAX TREATIES

The benefit of transparency is that investors should be able to access the treaty benefits of their home jurisdiction, provided that the jurisdiction of both the investor and the investment view the fund as tax transparent. If viewed as tax transparent, investors can take full advantage of the relevant double tax agreement as if they had invested directly, while achieving the administrative benefits and scale efficiencies of pooling.

Where the pooling vehicle is regarded as tax transparent, withholding tax rates are applied based on the double taxation treaties concluded between the country of the investor and the country of the underlying investments. This allows investors such as pension funds, which are often eligible for a reduced withholding tax rate, to benefit from that rate as if they held the investments directly. A benefit can be seen, for example, with the difference of up to 30% withholding tax on U.S. income for pension funds investing in a tax transparent fund versus an opaque fund.

GROWING MARKET

The ability to achieve a range of operational and cost efficiencies while not creating the tax drag, which may arise with the use of a non-tax transparent pooling vehicle, has undoubtedly contributed to the growing market in tax transparency over the past decade. In that time, the number of tax transparent funds has increased significantly.

IRISH COMMON CONTRACTUAL FUND (CCF)

An Irish CCF can be suitable for large institutional investors, such as pension funds and insurance companies, looking to maximize their withholding tax treatment in a cost efficient pooled fund structure. It can also be attractive to charities and sovereign wealth funds looking to capitalize on the scale efficiencies of pooled fund usage.

The decision regarding what type of tax transparent fund to use is not only influenced by the advantages and disadvantages of each product, but also by other related factors. For example, the strategic location of the management company may be a determining factor, as may the location where the company has the most concentrated knowledge and expertise in tax transparent pooling.

It is important that the countries in which the TTF invests and the country of the investor recognise the vehicle as tax transparent in order to allow investors to obtain the full benefit of the relevant double tax agreements. For example, the Irish CCF has a strong cross-border appeal from an investor perspective, and is competitive in the market when compared to the other European products available.

Different Types of TTFs

Tax Transparent Funds (TTFs) have been used by institutional investors for almost 20 years, however it is only in recent years that the size of the market, and popularity of these funds, has significantly increased.

There are TTFs in a number of markets, the most common vehicles being the Irish Common Contractual Fund (CCF), the Luxembourg Fonds Commun de Placement (FCP), the UK Authorised Contractual Scheme (ACS) and the Dutch Fonds voor Gemene Rekening (FvGR). The FvGR is mostly seen as a domestic fund product with Dutch investors. The CCF and FCP are more often used for cross-border distribution, as is the ACS, although to date the ACS has been used primarily for UK institutional investors.

The FCP and CCF were first used as investment pooling vehicles for multinational pension funds where global corporate groups sought benefits of economies of scale, and better governance and investment decisions, for their pension funds throughout the world. These groups needed a fund vehicle that would, as much as possible, provide the same tax answer as the pension funds investing directly in the underlying assets. CCFs and FCPs were typically selected, and from this initial use case, investment managers also launched TTFs to attract institutional investors, especially for U.S. and global equity mandates.

The UK launched the ACS as an equivalent UK-based vehicle to the CCF and FCP in 2013, and this has acted as a catalyst for growth in the TTF market, not only for the ACS, but also for the CCF. Assets under management within CCF products have grown significantly over recent years and many managers have considered including a TTF in their fund range. The ACS has been used to pool UK local government pension investments, and has been used by a number of insurers to provide operational efficiency or increase distribution options.

The TTF is an attractive fund vehicle for institutional investors. The types of investors who are interested in these products are broadening, and the asset classes being considered are also expanding. We expect the trend of growth in the TTF market to continue, both for the CCF and other jurisdictions of TTF.

Katherine Worraker
Tax Partner, Deloitte LLP

Operating a Tax Transparent Pooling Vehicle

Various complexities arise from the operation of a tax transparent pooling vehicle and addressing these complexities requires the interaction and alignment of the global custodian, fund administrator and transfer agent.

The transfer agent or fund accountant—depending on the model used—needs to confirm to the global custodian the percentage ownership of fund units by each different investor type. This is so that the ownership of securities and resultant income entitlements can be correctly allocated to each different category of investor, and withholding tax applied on the basis of their individual tax profiles.

OWNERSHIP RATIOS

As a result, it is important that as ownership ratios change—whether through subscriptions or redemptions by participating investors—these changes are tracked and communicated to the global custodian and, in turn, that the income entitlements of each investor are updated. This takes place through a number of notional trades between the various participating investors and is known as rebalancing.

As withholding tax is applied by the global custodian based on investors' individual tax profiles, it is usual for the TTF to have separate share classes–one for each respective investor tax profile. This can be achieved by allocating a class of share to each category and location of investor. There may also be various shares in different currencies incorporated. In all cases, distributions by the fund need to follow the share class allocation that is adopted.

FUND ACCOUNTING

For fund administration and accounting, tax tables are required within the accounting function to reflect the withholding tax attributed in the custody model in terms of the country and tax profile of investor, the country of investment, and the type of security invested in. The net asset value of the fund needs to include and reflect these various tax rates. The fund accounting team will, for an opaque fund, pass the price (which may be calculated daily or based on another frequency as per the fund prospectus) of the units to the transfer agent in order to arrive at the percentage ownership referred to above. This ownership calculation may be carried out by either the fund accountant or the transfer agent through sharing of fund price and investor unit information.

THIRD-PARTY ADMINISTRATOR

In order to achieve economies of scale in terms of operational cost, a third-party administrator is often used to provide the services described above. BNY Mellon has extensive experience in pooling across Europe, and each pooling structure needs to be considered on a case-by-case basis to accommodate the requirements of each individual scenario, taking account of client requirements, jurisdictional laws and compliance, and current market nuances.

Launching the Aon Irish CCF

Aon had an existing global equity fund that aimed for long-term total returns in excess of the MSCI World Index Total Return Index. The fund was operating as a sub-fund of an Irish PLC—a tax opaque structure—and was therefore achieving standard tax treaty reliefs available to such an opaque entity, resulting in a 30% withholding tax on U.S. dividends. The investors in the fund were a mix of institutional investors across a number of jurisdictions, including Belgium, Ireland and the UK.

DETAILED REVIEW

Aon has been monitoring the continued development of tax transparent funds. Working with BNY Mellon and Deloitte, Aon conducted a detailed withholding tax drag analysis across their existing portfolio, looking at the current withholding tax suffered by the opaque fund in comparison to the entitlements of each investor type, were they to invest directly in the relevant markets.

The analysis highlighted two points:

- Significant savings could be achieved in a number of markets by utilising a tax transparent fund.
- The tax benefits due to underlying investors varied across a number of markets, so that any move to a tax transparent structure would need a solution that accounted for a number of different investor profiles. This would require a separate NAV to be made available for each investor entity type taking into consideration their specific tax entitlements.

A cost benefit analysis showed that while the savings would vary per investor type and the weighting to each market of investment, the benefits were approximately 40 basis points for the Aon fund. The potential benefit to investors from moving to a tax transparent structure outweighed the cost of launching a new umbrella fund.

KEY OPERATIONAL CONSIDERATIONS

Once a decision was made to move ahead with the launch of the tax transparent fund, Aon worked with BNY Mellon and Deloitte to identify the key operational considerations for the fund. These included:

- The markets in which the fund would seek to apply for transparency treatment – as some markets may not recognize transparency, or may not provide any material benefit.
- The process for applying for reduced rates in those markets for the investors.
- The number of investor profiles to be created for launch.
- Any reporting requirements for the underlying investors.

Once the model was agreed, a detailed launch project was initiated. This was a significant joint effort between Aon, Carne and BNY Mellon – as well as Aon's legal and tax advisors, Eversheds Sutherland and Deloitte, respectively.

Legal Aspects of CCFs Compared to Irish ICAVs and PLCs

The CCF is an Irish tax transparent fund structure first established in Ireland in 2003. The equivalent fund in the UK is the ACS, with the first being launched in July 2013 with BNY Mellon as administrator and depositary.

Unlike other Irish fund structures such as Irish Collective Asset-management Vehicles (ICAVs), public limited companies (PLCs), unit trusts and investment limited partnerships, the CCF was specifically developed to enable asset managers and asset owners to pool their investments—primarily in the context of pension fund assets—in a tax efficient manner. Currently there are 27 Alternative Investment Fund (AIF) CCFs with 102 sub-funds/portfolios authorised by the Central Bank of Ireland as Qualifying Investor AIFs (QIAIF). The Aon CCF is a QIAIF.

The CCF is an unincorporated body and is established by an Irish management company, or Alternative Investment Fund Manager (AIFM) in the case of an AIF, and depositary pursuant to a deed of constitution. A CCF has no legal personality and contracts through its AIFM or depositary as applicable. Investors in CCFs as unitholders participate and share in the underlying investments of the CCF. Each investor in the CCF is deemed to hold an undivided co-ownership interest in the underlying investments of the CCF as tenant in common with other investors.

Units issued in a CCF are not shares but serve to determine the proportion of the underlying investments of the CCF to which the investor is beneficially entitled. CCFs can be established as AIFs or Undertakings for Collective Investment in Transferable Securities (UCITS). The table to the right summarizes the key differences between a CCF, ICAV, and PLC QIAIFs, with PLCs and ICAVs being the most common fund structures in Ireland for both UCITS and AIFs.[1]

Deborah Hutton
Partner and Head of Asset Management and Financial Services Regulation, Eversheds Sutherland, Ireland

	CCF QIAIF	ICAV QIAIF	PLC QIAIF
STRUCTURE	A CCF is an unincorporated body established by a management company under a contractual deed whereby the investors participate as co-owners of the assets of the fund. Its characteristics are closely aligned to that of a unit trust.	An ICAV is a tailor-made corporate fund vehicle for both UCITS and AIFs and is an incorporated entity governed by a board of directors and owned by shareholders.	A PLC is a corporate vehicle incorporated as a public limited company. The liability of shareholders is limited to the amount, if any, unpaid on shares held by them.
CONSTITUTIONAL DOCUMENT	A CCF is established pursuant to Deed of Constitution between the AIFM and the depositary. The Deed of Constitution also governs the terms and constitutions that apply to the AIFM and the depositary. This means there is no requirement for a separate AIFM and depositary agreement.	An ICAV is established /registered pursuant to an instrument of incorporation (IOC). The AIFM and depositary agreements are separate to the IOC.	A PLC is established / incorporated pursuant to a memorandum and articles of association (M&A). The AIFM and depositary agreements are separate to the M&A.
LEGAL PERSONALITY	A CCF does not have a separate legal personality which means that it cannot assume liabilities. From a practical perspective, this means that a CCF cannot enter into contracts on its own behalf, which is similar to a unit trust. Rather, a CCF contracts through its AIFM or depositary which acts on behalf of the CCF.	An ICAV has a separate legal personality. This means that an ICAV can enter into contracts on its own behalf.	A PLC has a separate legal personality. This means that a PLC can enter into contracts on its own behalf.
INVESTORS	Investors in a CCF are referred to as unitholders. A CCF is limited to institutional investors - currently natural persons cannot invest in a CCF without negatively affecting its Irish tax transparent status, this is tax restriction. The Irish tax authorities must view a CCF as a transparent vehicle for Irish tax purposes and holdings/ units in a CCF should not be freely transferable but are redeemable.	Investors in an ICAV are referred to as shareholders. An ICAV (subject to any restrictions set out in the prospectus) is open to investment by both natural persons and institutional investors, subject to such investors meeting the definition of a 'qualifying investor' in accordance with the requirements of the CBI and as set out in the AIF Rulebook.[2]	Investors in a PLC are referred to as shareholders. A PLC (subject to any restrictions set out in the prospectus) is open to investment by both natural persons and institutional investors, subject to such investors meeting the definition of a 'qualifying investor' in accordance with the requirements of the CBI and as set out in the AIF Rulebook.
TAXATION	A CCF is tax transparent and profits are treated as accruing or arising to the investors as if they had not passed through the CCF.	An ICAV is not tax transparent. However, it benefits from a "tick the box" feature for US tax purposes to be treated as a "pass through" entity.	A PLC is not tax transparent.
IRISH LEGISLATION	Investment Funds, Companies and Miscellaneous Provisions Act 2005.[3]	Irish Collective Asset-management Vehicles Act 2015.[4]	The Companies Act 2014.[5]

The Outlook for CCFs

The Irish CCF has been in existence since 2003, so it has taken some time to become an overnight success. Growth in the last five years has been very strong with assets growing by approximately 200%[6], and reaching $150 billion by the end of November 2020.[7] Ireland now has over 150 CCFs across more than 40 different umbrellas. This trend has been mirrored in other locations with the launch of the ACS in the UK, which now number almost 200 sub-funds, and the continued growth of FCPs in Luxembourg.

In an environment where it is difficult to generate returns and where there is increasing pressure on margins, the interests of investors and asset managers are aligned in seeking to increase returns by reducing unnecessary tax drag. The Irish Funds Association has estimated that investors can save as much as 39 basis points in tax drag for a global equity portfolio and as much as 18 basis points for a European equity fund by structuring funds as a CCF rather than a standard corporate fund.[8]

As we continue to operate in an increasingly competitive environment we see demand for tax transparent structures continuing to increase. Asset managers who do not have an ability to provide transparent structures may be challenged by institutional investors who will increasingly demand it.

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Global Head of Product
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Learn More

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