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Cross-Border Tax Problems of Investment Funds

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INTRODUCTION

Cross-border investment and acquisition activity may be carried on by strategic investors looking to expand or modify their existing business markets or lines, or by financial investors looking more opportunistically for ways to turn a (usually relatively short-term) profit. By far the largest class of financial investors consists of investment funds, broadly defined.

At its most basic, an investment fund is simply an aggregation of investors (who themselves may be individuals, corporations, trusts, partnerships, or other types of entities) who pool their money to make investments. This Article distinguishes between two kinds of investment funds. The first is a class of funds that are truly open-ended, that are managed by a professional investment manager for a fee, and that generally invest in liquid securities or in real estate. These types of entities are usually designed to attract investment from large numbers of retail investors and thus are usually regulated by the securities oversight bureaus of one or more countries. In the United States, the most common form of this type of collective investment fund is a regulated investment company (RIC or simply, mutual fund) or its cousin, the real estate investment trust (REIT). In Europe, such entities are often referred to generically as “UCITS,” which is an acronym derived from the EU Directive on Undertakings for Collective Investment in Transferable
Securities.

The second class of investment funds generally consists of private equity and venture capital funds, closed-end entities that invest in illiquid securities of portfolio companies over which they exercise some degree of supervision and control. Interests in a private equity fund are designed to be sold only to accredited or qualified investors such that the fund is not usually subject to regulation. These funds can be conceptualized as groups of sophisticated investors who pool their money, contract with a team of individuals to invest it on their behalf and negotiate a contract (*i.e.*, the partnership agreement) among themselves, pursuant to which all of this will occur. At the risk of over-generalizing, private equity funds invest the monies of identified investors in selected portfolio companies, whereas public funds manage investment portfolios.

Regardless of the form an investment fund takes, U.S. tax law has long accepted and encouraged a model that would tax income earned by investment funds only once, at the level of the investor. This occurs automatically where the partnership form is used. Where an entity is formed as a corporation, tax transparency must be engrafted by statute

onto this country's otherwise classical double taxation system for corporations. In the case of mutual funds and REITs, this is done by Subchapter M of the Code.

Almost all countries agree that investment income ought to be subject to tax only once, in the hands of the investor. Countries may disagree over whether various items of investment income should be taxed once by the source country, once by the residence country, or shared between them. But all countries agree, in principle at least, that regardless of whether investment income is taxed at source or at residence, there should be no second-level tax with respect to the same item of income imposed on the fund or financial intermediary through which the investment is made. However, different countries seek to achieve this result in different ways. Because different regimes for achieving a single level of tax are often not well coordinated, even by treaty, the single-level-of-tax model tends to break down where investments are made across national borders.

Except with respect to dividends (as described more completely *infra* Part III), cross-border tax inefficiencies are generally more pronounced for private investment funds than they are for mutual funds. Mutual funds ordinarily limit themselves to investing in publicly traded securities, and most countries do not impose local source-based tax on the sale of stock of corporations traded on a local stock exchange. Where taxes are imposed on dividends, various relief from double taxation may be available, although mutual funds are able to pass them along to their investors only in limited circumstances. Moreover, for reasons explored in more detail in Part III, interests in mutual funds tend to be held by locally resident investors.

Private equity funds are less likely to earn dividend income than mutual funds but face serious tax hurdles when investing across borders. For a U.S.-based private equity fund, one set of obstacles is presented by domestic law. Because private equity funds usually acquire—alone or in combination with other funds—a controlling interest in the foreign portfolio company, funds have to negotiate the Code's subpart F regime. The rule that treats a domestic partnership as a "U.S. person" for purposes of testing the status of a foreign corporation as a "controlled foreign corporation" (CFC) constitutes a marked departure from the U.S. norm of treating partnerships as aggregates rather than as entities, and is particularly galling as applied to investment partnerships because it is inconsistent with treating investors exactly as they would be treated had they invested directly. The usual solution to this problem, forming the fund outside the United States, gives rise to collateral tax distortions described in more detail later in Part IV.A.

Another set of obstacles may be presented by the laws of the target company's residence. From the investor's point of view, by far the largest risk of investing in a foreign portfolio corporation is the risk that the investor's share of the fund's capital gains from the sale of the foreign corporation's stock will be subject to tax in the country in which that corporation is domiciled. This risk is doubly significant to an investor liable to pay tax on the same gain in his country of residence because in many cases the investor's country of residence will not grant a foreign tax credit for any source country tax imposed on the investor's return. It is also of huge significance to an investor, such as a U.S. pension fund, that is exempt from tax on capital gains in its home country.

Many countries tax nonresident investors on gains from the sale of shares of local corporations, at least where such corporations are not publicly traded and locally listed. Although treaty relief from local source taxation may in principle

be available, many countries will not accord treaty benefits to partnerships or their partners, and this is especially true where the partnership, to avoid the Code's aberrant CFC rule, is formed in a tax haven. As a result, private equity funds are almost always forced to interpose one or more holding companies, formed in a tax-friendly jurisdiction such as Luxembourg, between themselves and the foreign target, thereby creating tax risk and distorting the natural allocation of taxing rights.

Private equity funds attract investors from all over the world. Yet a third set of obstacles may be presented by the laws of a foreign investor's home country. If, as is sometimes the case, the home country does not recognize the fund as a tax-transparent partnership, it may seek to tax the foreign investor on a punitive basis, as if the investor were investing in an offshore tax haven or "passive foreign investment company" (PFIC).

This Article argues that in order to make private investment work across borders, countries should adopt two sets of rules. First, countries should distinguish between three types of foreign funds: those organized as tax-transparent partnerships, those organized as opaque entities that are required to distribute their income currently to investors, and those opaque funds that are not required to distribute income currently. Once these distinctions are made, countries should adopt tax rules to treat them appropriately such that, to the maximum extent reasonably practicable, only one level of tax is imposed on investment returns. The goal should be to tax investors in funds as nearly as possible in the same way they would be taxed if they invested their money directly, without intermediation. The stakes involved in getting this wrong are significant, both for investors and, as this Article argues, for local tax authorities.

The second condition for private investment to flourish unimpeded by artificial structures is the elimination of local source taxes on capital gains from stocks and securities, in favor of taxation by the state of residence. Unlike the manner in which countries agree by treaty to share in the taxation of dividends and other periodic income, countries do not agree to share taxing power over capital gains. The taxation of capital gains is an all-or-nothing proposition. The reason that virtually all tax treaties source capital gains by residence is that residence countries are unwilling to cede taxing jurisdiction over such potentially large and erratic gains from the investment of capital by their own residents. Moreover, the principled argument for sourcing capital gains based upon where a particular investee company happens to be incorporated or reside is weak. While it can be argued that the true source of a capital gain is where the investee company produces widgets, it is in many cases impossible to apply such a test, for example to companies that conduct operations in more than one country. And finally, it is notoriously difficult to enforce and collect a tax from a nonresident investor who may sell its shares of a local company without ever subjecting itself to local country jurisdiction.

It is axiomatic that private capital will not flow directly into a country that lacks a workable system for imposing a single level of tax and does not exempt stock gains earned by nonresident investors. It is surprising how many countries make the mistake of thinking that one but not both of these conditions will encourage private equity investment. Some countries try to encourage private equity investment by exempting a defined class of capital gains from local tax but fail to extend the privilege to tax-transparent entities. Other countries have adopted a fairly workable set of tax-transparency rules but insist on taxing the capital gains of partners who hail from nontreaty countries (or worse, deny the benefits of the regime altogether in the case of tax-transparent entities formed under

the laws of tax haven countries). These legislative creations always fail to accomplish the ambitious goals set for them because they do not recognize that private capital will not accept double taxation of capital gains and will for this reason continue to invest through holding companies in much the same way they always have.

This Article is divided into five main parts. Part II provides some background on the basic differences between the partnership model and the exemption model for taxing investment funds. Part III suggests an approach to taxing open-ended, nontransparent mutual funds and UCITS. Part IV addresses the tax problems faced by investment funds organized as partnerships, and recommends that they be treated as tax-transparent without regard to treaties. Part V focuses on the local taxation of capital gains from dispositions of investment assets. Finally, Part VI considers certain aspects of the U.S. stock and securities safe harbor, suggesting some changes to make it better coordinate with some of the other recommendations herein.

The themes addressed in this paper necessarily require some comparative analysis of foreign laws that the author is obviously not qualified to expound upon at any length. Most of the characterizations of foreign laws herein have been taken from published articles and from practical experience, and a few have been vetted with some of the author's foreign colleagues. The ultimate goal is to see the big picture.

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