PODCAST

'The power of three':

Using Common Contractual Funds to improve tax outcomes for investors

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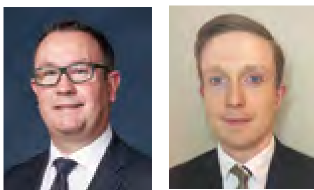

AMX Head of Platform Solutions, Aaron Overy**, and AMX Product Tax Specialist,** Kevin Duggan**, discuss with European Pensions Editor,** Natalie Tuck**, about the options to help ensure good withholding tax outcomes for institutional investors**

Large asset owners are still investing in equities in a way where they are taxed on their income. The implication of this is that they get a poorer return. They need to, and can, improve this, but how? Aaron, to begin, how can this need be fulfilled for investors?

Aaron Overy (AO): At AMX we are very tax aware, and we work with large investors on how they can set up pooled funds. Pension funds are tax exempt, and as the beneficial investor of these pooled funds, there's always the potential that they're not set up in a way that is withholding tax efficient, and this is the first of this 'power of three'.

Last year we did a study where we looked at how much UK defined benefit plans were losing by investing in the wrong type of fund structure. That came out to about £250 million a year potentially lost because of these fund choices, which was about 40 basis points of withholding tax drag on global equity dividends. By making a choice of a fund type that is tax transparent, where you can 'look through' to the underlying beneficial investor, you can ensure that this withholding tax is not lost. You can therefore improve performance and return for the investor but also performance for the manager.

People often use Open Ended Investment Companies (OEICs), Société d'investissement à Capital Variables (SICAVs), Irish Collective Asset-management Vehicles (ICAVs), Undertakings for the Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs) as pooled funds, which are perfectly good funds but, because they're not tax transparent, you do get this withholding tax drag. Funds such as the Irish Common Contractual Fund (CCF) enable pension funds to get to where they should be as per the treaties between them as the investor and the investment markets. We've seen this work in the UK, South Africa, Germany, Canada, The Netherlands, and Switzerland. There are plenty of places for investors to use these fund structures – these tax transparent funds – in underlying global investor markets.

And so that works for investors but what about the actual funds?

Kevin Duggan (KD): Number two in the 'power of three' covers fund level relief; in certain countries domestic investment funds meet qualification conditions for reductions or exemptions from local withholding tax on dividends received. The conditions, for example, could be based on the legal form of the investment fund or the European Union (EU) regulatory status. Following several EU court decisions, the principle of EU fund equivalency continues to grow, to effectively ensure EU funds achieve the same treatment as domestic funds.

For example, there's been precedents in Spain, but we have also seen this in Sweden, Norway, France, and Greece – the number of countries is continuing to grow. As we explored in a recent AMX article on EU equivalence rulings and how they are changing and how dividend withholding tax applies to institutional funds, post-Brexit we've seen many UK funds impacted in these countries because the EU/EEA establishment condition is no longer valid. This will likely add some basis points of withholding tax drag to performance.

And are there any other options other than look through and fund level relief?

KD: Yes, number three in our power of three applies to sovereign wealth funds and supranational entities, whereby you look to relevant domestic tax codes in each investment jurisdiction. This is best illustrated by way of an example. Section 892 of the US Federal Tax Code provides certain tax benefits to foreign sovereigns that invest in US assets. It effectively exempts from US Federal Income Tax the income of a foreign government derived from investments in stocks, bonds or other domestic securities owned by such foreign government. This third method achieves exemption from US dividend withholding tax for qualifying sovereign entities investing through CCFs simply by applying section 892 to their holdings.

AO: We spoke about investors being tax aware and these supranational entities and sovereign wealth funds are often able to claim immunity from taxation; they are very large organisations with lots of money in equities. Yet, I've seen examples of sovereign wealth funds using Cayman corporates in a way that results in withholding tax drag. And, with the size of their investments, this is millions of dollars every year. Again, this is simply because they've not chosen the correct fund structure and instead have only thought about how they are investing. Perhaps the investment managers haven't thought about how their clients may get to this better outcome using a better fund structure.

That's three great outcomes for investors – how does this work in real life? Do you have any examples of how using tax efficient structures can open up opportunities?

AO: Absolutely, we've spoken about the power of three; looking through to beneficial investors, the use of fund level relief and the use of section 892 exemption. We're talking to investment managers and investors all the time and we've helped them. With one of our managers, we obtained a Canadian opinion from our tax adviser for the fund structure, for the CCF for Canadian investors. They were then able to compete against domestic funds as a global equity manager.

On the investment side we've worked with the Japanese Tax Agency to confirm transparency of the CCF for UK investors in Japanese equities. Japanese equities in a world mandate is very often the second largest market. They would have potentially been paying 15.315 per cent withholding tax. The treaty between the UK and Japan can get back down to zero and so, in large markets with sizeable potential withholding tax drag, the confirmation of the transparency of the CCF means that they don't have to pay that, nor should they, and they can get down to zero withholding tax in Japan.

Are there any final points you'd like to make about the value of using CCFs?

KD: One final point I would like to make is the benefit of risk management. CCFs are complex structures, which require considerable operational expertise to run efficiently. There are high volumes of data, there are requirements for timely fast and accurate calculations. Different jurisdictions will have their own specific withholding tax rules and tailoring will be required to the jurisdictions of the different investors. Operational oversight of the tax services provided by the administrator is very important. Schemes and investment funds need to work with a partner who has the necessary knowledge and expertise. The robust accounting systems and technology to make this work smoothly and manage those inherent risks so we see the benefits of good risk management through the use of the CCF.

AO: I think it's about good governance; regulators are looking closely at the moment at whether funds are being run well and if the different actors are truly being transparent and providing good governance. That includes the management company, the trustees, the managers and ensuring the best possible outcome for investors. If the fund is being run in a way that does impact those investors, because of withholding tax for example, then perhaps that's not good governance. We've got these three options, the 'power of three': looking through to the beneficial owners, having that tax transparent fund and using the fund level equivalence across the EU and the EEA, or the sovereign exemption. There are these options available for those that are tax aware to implement and therefore to give the best possible outcomes to investors to provide good governance. ■

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