The HEDGE FUND LAW REPORT

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TAX

Treaties Offer Fund Managers Means to Reclaim Overpayments but Require Updating to Keep Pace With the Market

By Michael Washburn

The Hedge Fund Law Report

Due to the inability of some foreign governments to determine beneficial owner identities, many funds undertaking cross-border investments lose more money in tax payments than strictly required by law. Governments have attempted to ameliorate this problem by adopting bilateral tax reclamation treaties with other governments, but this has proved a partial solution at best. Treaty-making is stymied in the U.S. Congress and some foreign legislative bodies, and instances of fraud – including a massive scandal costing the nation of Denmark billions – have soured some to the very idea of tax reclamation. In many instances, the variety and complexity of investment vehicles add further layers of difficulty and opacity to the process.

Nevertheless, tax reclamation can be indispensable for funds and investors to regain money that rightfully belongs to them. To help readers understand the myriad issues involved in cross-border tax payment and reclamation, The Hedge Fund Law Report has interviewed Len Lipton, managing director of tax reclamation service provider GlobeTax, and this article presents his insights. For earlier commentary from Lipton on this topic, see "How Can Hedge Funds Recoup Overwithholding of Tax on Non-U.S. Source Interest and Dividends?" (Sep. 12, 2013).

For more on tax issues affecting private funds, see "How Managers Can Structure Direct Lending Funds to Minimize U.S. Tax Consequences to Foreign and U.S. Tax-Exempt Investors: 'Season and Sell' and Blocker Structures (Part One of Two)" (May 18, 2017).

HFLR: In the September 2013 interview with The Hedge Fund Law Report, you noted that certain countries were entering into tax treaties with the aim of alleviating over-taxation of cross-border investments. With a bit of hindsight, how much progress has been made on this issue?

Lipton: There has certainly been global growth in tax treaties. We have noticed over the last few years that emerging, and even frontier, markets have engaged in treaty negotiations and put treaties in place with a number of more developed markets, primarily across Europe.

The unfortunate situation in which U.S. residents find themselves, however, is that the U.S. Senate has not considered any treaty for ratification in a number of years. That has to do with one particular senator's having put a hold on these things (new treaty ratification). That senator takes a very negative view of certain aspects of the U.S. Foreign Account Tax Compliance Act (FATCA) passed during the early part of the prior presidential administration and, as a result, has essentially halted any new tax treaty implementation for the U.S. Therefore, U.S. residents have not benefited from any new treaties over the course of, roughly, the last six or seven years.

[For more on FATCA, see "FATCA Implementation

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Summit Identifies Best Practices Relating to FATCA Reporting, Due Diligence, Withholding, Operations, Compliance and Technology" (Feb. 14, 2013); "What Impact Will FATCA Have on Offshore Hedge Funds and How Should Such Funds Prepare for FATCA Compliance?" (Feb. 1, 2013); and "The Nuts and Bolts of FATCA Compliance: An Interview With James Wall of J.H. Cohn Concerning Due Diligence, Document Collection, Reporting and Other Operational Challenges" (Jul. 26, 2012).]

HFLR: Given the pro-business and anti-regulation stance of the new U.S. administration, can we expect progress on this issue?

Lipton: We are hopeful, but we have not seen any movement on it thus far. There has been scant discussion in the public sphere about this issue, although it does tend to come up at tax conferences from time to time.

Treaty negotiations with Ireland have been ongoing, but the document has not yet been finalized. We do not expect it to be enacted in the near future, given the current hold.

On the other hand, Chile and Peru have recently put new treaties in place with some major countries. Some African countries, as well as a number of Southeast Asian countries, have also had success adopting treaties with other countries. Pakistan, for example, has also put several new treaties in place.

[For more on the Trump administration, see "BakerHostetler Panel Analyzes the Trump Effect on the SEC's Initiatives and Enforcement Efforts" (May 4, 2017); and "Ways the Trump Administration's Policies May Affect Private Fund Advisers" (Mar. 2, 2017).]

HFLR: As you have pointed out, one problem is that tax is paid through intermediaries who often do not know who the ultimate recipient of the income will be. The investor, therefore, is stuck going back to the local government to prove that it is a resident of a certain market for tax purposes and thus entitled to a reduction on that basis. Is this a difficult process for the investor?

Lipton: Yes, and unfortunately it does not appear to be getting any easier. In some respects, it's actually getting more difficult. A handful of things over the past few years have led to this. The background for a lot of these discussions is the Organisation for Economic Co-operation and Development (OECD) and its work around the Base Erosion and Profit Shifting (BEPS) initiative.

The BEPS initiative addresses a variety of tax issues such as transfer pricing, permanent establishments and where tax is paid. From a withholding tax perspective, the goal of BEPS was to "harmonize" tax processes and lower barriers to cross-border investment.

There seems to be an inverse relationship between a discussion on harmonization and what actually happens on the ground, however. Economic leaders from various nations attend global meetings, where they all sing from the same hymn sheet and say, "Wouldn't it be great if we could lower the barriers to cross-border trade and investment and harmonize our tax systems, thereby decreasing the burdens to market participants?" Upon returning home, however, while everyone agrees that harmonization would be nice, each continues to prioritize the fact that it is a sovereign country and wants to maintain control over its own taxation system in order to satisfy its own revenue requirements.

Consequently, the claim process has become more

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difficult in practice. As countries develop, they tend to implement certain obligations – Social Security-type programs and so forth. In order to fund these commitments, the government has to grow revenue, which can lead to an increase in rates of taxation and perhaps, raised barriers to tax-refund processes.

Another issue is that several countries have suffered under the tax treaty regime from fraud as well as dividend-enhancement schemes. An example of one such alleged model is the "Cum/Ex trades," which regulators claim led to illicit tax refunds. Cum/Ex trades are tax-driven transactions involving the claiming of tax refunds around the date of a company's dividend. For example, an investor may swap share ownership on or immediately prior to a dividend record date so that it can demonstrate, for example, that a tax-preferred investor, such as a pension fund, held the securities at the record date.

What happens is that, instead of taxing the dividend at the 15 percent treaty rate, zero percent of the dividend payment is taxed because of the pension fund's tax-preferred status. The pension fund retains a portion of that additional benefit; the investor gets to keep some of it; and the trading desk that arranged the transaction also gets to keep a piece. The government is out that 15 percent, however, and it never intended to forgo that revenue based on the spirit of the treaty. For these reasons, governments are not always in favor of these types of transactions.

[For more on the BEPS initiative, see "Steps That Alternative Investment Fund Managers Need to Take Today to Comply With the Global Trend Toward Tax Transparency (Part One of Two)" (Apr. 7, 2016); and "Steps That Alternative Investment Fund Managers Need to Consider to Comply With the Global Trend Toward Tax Transparency (Part Two of Two)" (Apr. 14, 2016).]

HFLR: What other factors might be making people averse to tax reclamation processes?

Lipton: It can be difficult for investors to do this on their own. The existence of fraud around the reclamation process has also become a big deterrent. What I mean is that, due to some very large frauds, the process has become so onerous in some markets that it deters participants. Denmark was recently the victim of a massive fraud in the range of $3.5 billion resulting from abusive and fraudulent reclaim applications that did not require a lot of proof around claims.

The tax authorities talk about the issues they are facing. As a backdrop, you have the BEPS discussions and the FATCA regime that the U.S. imposed on the world (and certainly made no friends among the Swiss banking community in doing so). There may be some political blowback out there as well. All of those things have caused the claim process to become more difficult.

HFLR: Looking at this issue on a global level, how much does BEPS come into play?

Lipton: A sliver of BEPS applies here. While the whole of the BEPS initiative is much more focused on profit shifting and transfer pricing (of multinational firms' corporate profits), the withholding tax issues are there and being addressed at the same time essentially by the same group.

Part of those discussions have to do with what type of entity it is in the treaty/counterparty market, versus what kind of entity it is here. Broadly speaking, in the world of tax reclamation, an entity can be one of two things: it can be opaque, or it can be transparent. Examples of opaque counterparties include an entity with a single beneficial owner; a pension fund; a mutual fund; a high net worth individual; or an endowment or foundation. By and large, opaque entities are treated as single beneficial owners and can file a claim for the entity, recovering money as that entity would be entitled to.

As for transparent entities, tax authorities understand partnership structures quite well. As a result, whether it is a partnership or a trust, the entity holds none of the assets for its own benefit. All of those assets are the property of the underlying partners, members or beneficiaries of the trust. The tax authority, therefore, is not concerned with the domicile of the trust or partnership; rather, it wants to know the domicile of the underlying beneficial owners. The partnership or trust has to disclose all of those owners, and in a lot of cases, it can be difficult for the entity to obtain this information completely, because it would also have to look through the partnership structures of some of its own investors. There are also documentation requirements at the partner level that can make the process even more difficult.

[See "Hedge Funds Organized As Delaware LLCs May Be Transparent for U.K. Tax Purposes" (Jul. 16, 2015).]

HFLR: What is an example of a specific type of investor that can greatly complicate the process?

Lipton: Funds of funds are one example. The cascading nature of ownership can make it extremely difficult for the sponsor or investment manager of the limited partnership seeking tax reclamation to determine the ultimate beneficial owners of all of its limited partners.

While the entire pool working together can benefit greatly from everyone supporting the process, most investors in the partnership lack a large incentive to participate in the process. This is because the individual claim amounts at the investor level are typically quite small. In the aggregate, they can be quite meaningful at the fund level and can even move the needle of performance 20 or 30 basis points (depending on the allocation and strategy).

HFLR: Have you seen hedge funds begin to attempt to file claims to get back funds that they lost because of over-taxation?

Lipton: GlobeTax has been managing reclaims on behalf of hedge funds since the mid-1990s and manages reclamation work for many fund clients today. Occasionally, we will come across a fund that files some of its own claims. The value of those claims is typically so large that the funds could not afford to ignore them. In many cases, the funds hired accounting firms to try and deal with those claims.

Generally speaking, however, we do not generally encounter funds going out and doing this themselves. Historically, global custodians of public funds will manage this process for their clients, but we have even seen these custodial service providers begin to pull back from supporting the custodian in every single market.

Whether it's the Swiss, Germans or Danes, foreign tax authorities are consistently adding additional requirements to the reclamation process. In many cases, it is no longer sufficient to have a copy of a certificate of residence; now you have to submit the original. This is a prime example of the inverse relationship that I mentioned earlier. While the marketplace generally agrees that reducing these sorts of burdens is desirable, the realities on the ground, in terms of the murky administrative process of tax reclamation, do not reflect this tenet. The tax authorities are all under pressure, because when something like the Danish scandal hits the press, heads roll and bureaucrats are then expected to impose enough control to eliminate opportunities for fraud in the future.

HFLR: What specific external factors, or contractual provisions, might be limiting the effectiveness of tax-reclamation treaties?

Lipton: The tax authorities are usually looking for a demonstration of entitlement based on the beneficial owner's status and domicile. In theory, the process appears to be very simple. For example, assume that an investor is a U.S. resident that invests in Market A, which maintains a tax treaty with the U.S. Once we are able to confirm the investor's tax residency and tax ID number, we can demonstrate to the tax authority in Market A why the investor, as a beneficial owner, is entitled to treaty benefits.

The issue with the treaties is that each was negotiated based upon the facts and circumstances that existed at the time the treaty was adopted. Because tax is such a fluid and dynamic subject matter, the treaties do not always keep up with the complexities that develop in the marketplace.

When you think about the hedge fund space, there are a lot of smart people looking at every aspect of a trade or investment strategy. At the same time, funds have teams of service providers, accountants and attorneys thinking about how to structure transactions to mitigate excess taxation and perhaps to take advantage of the provisions within treaties. What often results are complex structures that were not necessarily foreseen or intended when the treaty was put in place, which in turn can confuse the various tax authorities that opine on tax reclamation claims.

For example, in a commingled vehicle structure, the domicile of the investment fund – often the Cayman Islands, Luxembourg or Ireland – is unlikely to match the domicile of the underlying investors. The tax authorities then have to determine if the investment fund's claim under the treaty is valid or, based on a possible provision within the treaty called a limitations on benefits clause, invalid.

Pooled investment vehicles often have to go through a much larger battery of tests in order to justify the claim, and in many cases the issue that the tax authorities are dealing with is the letter of the law versus the spirit of the law, or the letter of the treaty versus the spirit of the treaty. If the facts and circumstances of the specific situation were not envisioned when the treaty was originally put in place, then there is an interpretation risk based on how the tax authority ultimately interprets the treaty. When an interpretation of a particular fund structure is adopted in one jurisdiction, we often see the same view manifest in other markets, because tax authorities tend to talk and share their observations.

[For more on treaty-based investors, see "How Managers Can Structure Direct Lending Funds to Minimize U.S. Tax Consequences to Non-U.S. and Tax-Exempt Investors: Treaty-Based and Registered Fund Structures (Part Two of Two)" (May 25, 2017); and "Hedge Funds As Direct Lenders: Structures to Manage the U.S. Trade or Business Risk to Foreign Investors (Part Two of Three)" (Sep. 29, 2016).]

HFLR: Can you provide an example of this interpretation risk in practice?

Lipton: Switzerland requires a look-through for transparent entities. Consequently, partnerships need to disclose the beneficial owners of the partnership. This is fairly simple if you're only dealing with one partnership and one layer of investment ownership. When you start looking at a partnership with other partnerships that are investors, and you have to look at those investor partnerships as well and go down several layers before you ultimately end up at the level of beneficial ownership, it becomes more complicated. More complicated still is if the fund is domiciled in a country that does not match up with the underlying beneficial owners of that fund. We have to ask, how will the foreign government treat these investors?

Certain types of Irish and Luxembourg vehicles are deemed by certain tax authorities to be transparent. The Swiss, for example, will say, "Well, that's nice that it is an Irish fund, and that you think it is due to get the benefit of the Irish-Swiss treaty. We don't agree. We're the tax authority, and we think that that structure requires being looked through so that you can demonstrate to us that the underlying holders, to whom all these gains in the portfolio will inure, are really entitled to the treaty benefit. And if it's not the Irish-Swiss treaty, then what country are they from, please?"

It becomes this web, and as new entities are formed, tax authorities may take some time to look at them and determine whether to treat them as transparent or opaque, and if transparent, what other types of entity they are most similar to.

You have very smart investors, on the one hand, who are looking for structures through which they can invest on a more tax-advantaged basis. It may be a new structure to the tax authority, and so for a while perhaps, that entity will get the benefit of a favorable treaty. At some point in the future, however, the tax authorities may conclude that the door is open way too wide, that they didn't actually intend it to work that way initially and that they're going to close that particular door.

HFLR: What are some additional applications of this issue in the U.S. funds space?

Lipton: Something has come up recently in the context of the Investment Company Act of 1940 which speaks to this particular issue. U.S. mutual funds are deemed generally to be corporations. They certainly file taxes as U.S. corporations, and the Internal Revenue Service would certify them as corporations resident in the U.S. for tax purposes. The fund would claim that way, historically, into a market like Switzerland that requires a demonstration of underlying ownership on the basis of an attestation that some large percentage of the underlying holders are U.S. residents.

In the open-end mutual space, because of the way the prospectuses are written, and the distribution process works – where the investor buys the mutual fund shares directly either through its broker or from the mutual fund company itself – those mutual fund shares are only meant for U.S. residents. So there was a high degree of certainty that the investors were in fact U.S. residents based on limited distribution channels.

With the explosion of exchange-traded funds (ETF) in recent years, no matter what the prospectus says about the intended consumers of the product and the distribution channel, once the shares are issued, these shares trade freely on an exchange. The fund cannot limit who buys and sells its shares on the exchange. Therefore, the fund does not really know who the underlying holders of the ETF shares are.

The Swiss-imposed requirement noted above – a demonstration of underlying ownership based upon an attestation that some large percentage of the underlying holders are U.S. residents – therefore, is one with which the marketplace cannot keep up. ETF claimants have no way of gathering that information. The Swiss have decided that they do not need to pay these claims, and they are pointing to a provision in the treaty that tends to align with the way the U.S. treats Swiss investment funds. As a result, ETFs holding shares of Swiss companies are in a very difficult situation; they are unable to file for a 20 percent recovery on the high, statutory Swiss dividend withholdings of 35 percent.

This is the path we are currently on. New structures will cause unforeseen issues to arise in the scope of withholding tax.