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Cross-Border Considerations For UCITS: US Tax And Regulatory Concerns For Offering UCITS In The United States

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I. Introduction

UCITS ("*Undertakings for Collective Investment in Transferable Securities*") are a type of collective investment vehicle and, like many collective investment vehicles, they may be difficult to fit into existing tax and regulatory schemes. Although UCITS were developed to facilitate cross-border investments, including resolving possible tax issues, the model US and model OECD treaties are only recently beginning to effectively address collective investment vehicles. In addition, the US regulatory scheme for securities limits the way UCITS sponsors may offer UCITS securities in the US.

II. What Are UCITS?

Investment funds allow investors to gather together their assets and invest them in a diversified pool of assets. Essentially, the structure allows non-professional investors to spread the overhead costs of investing and investment decisions over the pool of investors, thereby reducing the average cost for the investor and gaining access to professionally-managed financial assets.

UCITS are a type of investment funds that were devised to facilitate cross-border investments within the European Union ("*EU*"). Prior to the development of UCITS, regulations and tax laws in individual countries effectively limited the ability of funds to make cross-border investments and distributions. The goal of the UCITS directive was to remove barriers to the cross-border marketing of units of collective investment funds within the EU by allowing funds to invest in a broader range of financial instruments and conforming the regulations between the countries. In other words, UCITS originated in one country can now be sold in other EU Member States without a requirement for additional authorization; cross-border distributions from UCITS can be made simply by notifying the regulators in the receiving countries; and UCITS generally receive favorable domestic tax treatment by EU Members.

Depending on where UCITS are formed, a fund may have several formation options. For example, in Ireland, UCITS could be formed as a corporation, a trust (which is a look-through entity) or a partnership.

Demand for UCITS reached its highest level ever in 2015 with net sales of EUR573bn (USD651.6bn). It was also a record year for the EU investment fund industry as EU investment fund assets ended the year over EUR12,000bn for the first time at EUR12,581bn. The largest portion of this figure included net assets of UCITS of EUR8,168bn, a 13 percent increase over net assets of UCITS from the prior year.[1] UCITS were designed for retail investors in the EU; however a number of characteristics of UCITS have made them attractive to institutional investors in the EU and globally outside the US. While firms in the EU are also interested in selling regulated investment funds in the US and UCITS may be attractive to US institutional investors, firms in the EU must navigate a number of issues that have limited such opportunities.

III. UCITS And Treaty Qualification

UCITS, like other collective investment vehicles, face challenges under domestic tax laws and tax treaties because they may not fit neatly into existing tax law schemes. The crucial question is whether income from UCITS can qualify for beneficial treatment under treaties. In other words, is the income from UCITS received by persons in another country entitled to favorable treatment under tax treaties? The OECD Model Treaty (the model treaty from the Organisation for Economic Co-operation and Development) and the 2016 US Model Treaty both provide guidance for US investors who would like to invest in UCITS.

"Person"

The threshold treaty qualification question is whether UCITS are "persons" under the applicable treaty because generally only a "person" can be a resident and therefore eligible for most benefits under the treaty.[2] But the definition of person may vary from treaty to treaty. Fortunately, the 2016 US Model Treaty includes both trusts and companies in the definition of person.[3] "Company" means any body corporate or any entity that is treated as a body corporate for tax purposes according to the laws of the state where it is organized.[4]

Unfortunately, some treaties do not include "trusts" in their definition of persons. For example, the model treaty from the OECD defines person as "an individual, a company and any other body of persons" and does not explicitly include trusts.[5] However, the OECD Commentary states that the definition of the term "person" in the OECD Model is not exhaustive and should be given a very wide sense.[6] It also provides a foundation as an example of an arrangement that may fall within the meaning of the word "person" because it is treated as a body corporate for tax purposes.[7]

In summary, UCITS that are organized as a corporation would likely be categorized as a person. A UCITS that is organized as a trust may also be categorized as a person, but taxpayers should make sure that the applicable treaties and domestic laws are not adverse to that conclusion. In addition, UCITS that are organized as some other form of joint ownership under domestic law may not clearly constitute a person

"Residence"

Residence is also generally required in tax treaties in order to be eligible for treaty benefits. Can UCITS be considered "residents" of a country under a treaty? Under both the OECD Model and the 2016 US Model Treaty, a person must be "liable" to tax in a contracting state in order to be considered a resident.[8] Other treaties instead define resident as any person who is resident in the contracting state for the purposes of the tax of that state.[9]

The treaties which require liability to tax are more difficult to satisfy than the treaties which merely require residence under domestic tax laws. The difficulty is that many countries do not apply tax at the fund level, thus some tax authorities may not accept that a fund is "liable to tax."

Under the 2016 US Model Treaty, a person is a resident of a country if the person is subject to tax there by reason of domicile, residence, citizenship, place of management, place of incorporation or any other similar criterion.[10] The US Model Explanation clarifies that entities that are nominally subject to tax, but that in practice are rarely required to pay tax, would generally be treated as residents and therefore accorded treaty benefits.[11] For example, a US Regulated Investment Company or US Real Estate Investment Trust are residents of the United States although income earned by those entities normally is not subject to tax unless they do not currently distribute their profits.

Furthermore, under the OECD Model Explanation, collective investment vehicles, such as UCITS, may be "liable to comprehensive taxation even if the Contracting State does not in fact impose tax." [12] For example, pension funds and charities may be exempted from tax under domestic tax law, but they are exempt only if they meet specific exemption requirements.[13] However, as an OECD Report on treatment of collective investment vehicles commented, the mechanism by which neutrality is accomplished will affect the treaty analysis.[14] UCITS may be tax neutral because they are treated as transparent, or because they comply with certain exemption requirements or because generous deductions are allowed for dividends to investors.

Therefore, the determination of whether UCITS are residents under a tax treaty depends on the language of the treaty as well as the mechanism for neutrality under domestic tax law. If the treaty provides that UCITS must be liable to tax in order to qualify as resident, then tax advisors should examine the domestic tax law to make sure that UCITS are not wholly transparent for tax purposes or that they may be liable to tax if they do not qualify for an exemption.

Limitation On Benefits

Under the US Model Treaty and other treaties, there is an additional limitation on the availability of treaty benefits. Under a Limitation on Benefits article, UCITS must be "qualified persons" in order to qualify for treaty benefits.

For purposes of the US Model Treaty, if UCITS are organized as corporations and regularly traded on a stock exchange, then they may be qualified persons if they are either (i) regularly traded on a recognized stock exchange located in their country of residence, or (ii) regularly traded on a recognized stock exchange and the primary place of management and control is in the resident state of the UCITS.

UCITS (whether organized as corporations or trusts in their countries of residence) may also be qualified persons if their shares or beneficial interests are owned by certain kinds of qualified persons and not deductible by certain non-qualified persons. Specifically, two requirements must be met. First, at least 50 percent of the beneficial interests in the fund must be owned, directly or indirectly, by one of the following: individuals, one of the contracting states (or a political subdivision thereof), companies that are regularly traded and meet the requirements in the previous paragraph, or certain pensions.

Second, less than 50 percent of the fund's gross income (and less than 50 percent of the "tested group's" income) must be paid in the form of payments that are deductible in the state of the income recipient to (A) persons that are *not* included in one of the groups of the first requirement (individuals, one of the contracting states (or a political subdivision thereof), companies that are regularly traded and meet the requirements in the previous paragraph, or certain pensions), or (B) certain persons who are related by 50 percent ownership. Since UCITS are generally widely held by individuals, it is unlikely that 50 percent of their income would be beneficially held by a person who is related by 50 percent ownership.

For purposes of the second test, the "tested group" generally means the resident that is applying the test and any intermediate owner of the resident that is a resident of the same country as the tested resident and a member of a tax consolidation regime.

Therefore, in general, UCITS should be able to qualify under the 2016 US Model Treaty's Limitation on Benefits article by either being regularly-traded companies or having at least 50 percent of their beneficial interests owned by individuals, government units, regularly-traded companies or certain pensions.

Beneficial Owner

Under numerous international treaties, including the 2016 US Model Treaty and the OECD Model Treaty, recipients of interest (and in some cases dividends) must "beneficially own" that income in order to benefit from preferential rates and treatment granted under those treaties.[15] "Beneficial owner" is not defined in either model. It is ordinarily given the meaning that it has under the law of the country applying the convention.[16] Therefore, UCITS may be denied treaty benefits if the source country has taken the position that UCITS cannot be a beneficial owner of the income it receives.

The OECD argues that a widely-held collective investment vehicle (a fund which holds a diversified portfolio of securities and is subject to investor-protection regulation in its country) should be treated as the beneficial owner of the income it receives.[17]

OECD BEPS Action Plan

Collective investment vehicles are also discussed in the OECD Action Plan on BEPS ("*Base Erosion and Profit Shifting*"); however, a conclusive recommendation has not been finalized. Action 6, which addresses treaty shopping, states that treaty drafters should consider a subparagraph addressing how collective investment vehicles should be treated.[18] The central issue would be residency and qualification of a collective investment vehicle under the treaty, as discussed above.

Whether or not a subparagraph is added depends on how the treaty applies to collective investment vehicles and on the treatment and use of collective investment vehicles in each state.[19]

IV. US Securities Law Considerations

In addition to the securities-related requirements of the UCITS Directives and any recent or future updates to them, the Investment Company Act of 1940, as amended ("*Investment Company Act*"), the Securities Act of 1933, as amended ("*Securities Act*"), the Securities Exchange Act of 1934, as amended ("*Exchange Act*") and the Investment Advisers Act of 1940 ("*Advisers Act*") present a number of legal hurdles to UCITS sponsors that wish to offer securities in the US. This section discusses the major hurdles presented to UCITS sponsors by these US securities laws and exemptions available to UCITS sponsors that may allow them to overcome these hurdles.

The Investment Company Act

The Investment Company Act requires investment companies that publicly offer securities in the US to register with the US Securities Exchange Commission ("*SEC*") and regulates investment companies registered under the Investment Company Act. The Investment Company Act protects investors by prohibiting certain activities and by imposing substantive requirements, such as corporate governance requirements and disclosure requirements. In addition, Section 7(d) of the Investment Company Act prohibits any non-US investment company from publicly offering securities in the US, unless the SEC issues an order permitting such company to register under the Investment Company Act. To issue such an order, the SEC must find that "it is both legally and practically feasible to effectively enforce" the Investment Company Act against such company.[20]

The requirements for the SEC to find that such an order is appropriate and the additional restraints imposed by being subject to the Investment Company Act have limited the number of non-US investment companies that have made use of this option presented by Section 7(d).[21]Section 7(d) requires an order for public offerings by non-US investment companies, but Section 7(d) does not prohibit private offerings in the US. Therefore, an alternative to seeking an order as described is for a UCITS sponsor to claim one of the private offering exemptions to the Investment Company Act under Section 3(c)(1) or Section 3(c)(7).

Section 3(c)(1) excludes from the definition of investment company any issuer whose outstanding securities are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities.[22] To avoid a public offering of securities, an issuer may only offer securities to accredited investors as defined in the Securities Act and described below.[23] Section 3(c)(7) excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of the issuer's securities, are qualified purchasers as defined by the Investment Company Act, and which is not making and does not at that time propose to make a public offering of such securities.[24]

It is important to note that the staff of the SEC has stated that a non-US investment company may make a private offering in the US under these exceptions as well as a non-US public offering, meaning securities of a single UCITS may be sold privately in the US and publicly in the EU at the same time.[25]

The Securities Act

The Securities Act regulates the offer and sale of securities in the US. The Securities Act makes it illegal to offer or sell unregistered securities in the US unless the security or the transaction is exempt from registration. The regulations and registration requirements imposed by the Securities Act make it difficult to offer UCITS securities in the US. To avoid these requirements, sponsors of UCITS whose securities are sold privately pursuant to an exemption to the Investment Company Act, typically use Section 4(a)(2) of the Securities Act ("*Section 4(a)(2)*") and Rule 506 of Regulation D of the Securities Act ("*Rule 506*").

Section 4(a)(2) provides an exemption from registration under the Securities Act for transactions by an issuer not involving any public offering.[26] However, precise limits for what is considered a public offering are not defined. Under the Securities Act, the SEC adopted Rule 506, which provides a "safe harbor" under Section 4(a)(2). Under Rule 506, a UCITS may sell securities to as many purchasers that the issuer reasonably believes are "accredited investors" according to Rule 501(a) of the Securities Act and to up to 35 non-accredited investors, if certain other conditions are met.[27] Because the limits of Section 4(a)(2) are undefined, most sponsors of UCITS that are sold to US investors accept only investors that meet qualifications standards well above the accredited investor thresholds.[28]

The Exchange Act

The Exchange Act regulates securities transactions on the secondary market. Section 12(g)(1) of the Exchange Act requires any issuer whose securities trade by interstate commerce, whose assets exceed USD1m, and whose securities are held of record by persons in excess of certain numeric limits, to register with the SEC. The SEC is authorized to exempt securities of foreign issuers from this registration requirement, and to accomplish this the SEC adopted Rule 12g3-2.

Rule 12g3-2 exempts securities of any class issued by a "foreign private issuer" [29] if the class has fewer than 300 holders resident in the US.[30] UCITS that exceed the relatively low asset limit imposed by Section 12(g)(1) of the Exchange Act may rely on Rule 12g3-2 to sell securities in the US and to avoid registering transactions with the SEC under the Exchange Act.

The Advisers Act

The Advisers Act requires any non-US or a US management company that acts as an investment adviser to a registered investment company to register under the Advisers Act. To register under the Advisers Act, an investment adviser must file a form ADV with the SEC and comply with certain recordkeeping and regulatory requirements. To avoid registration as an investment adviser, a UCITS sponsor may qualify for an exemption under the Advisers Act.

Prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank Act*"), Section 203(b)(3) of the Advisers Act provided a "private adviser exemption" from registration for advisers with fewer than 15 clients who met certain other requirements. The Dodd-Frank Act eliminated this private adviser exemption and made it much more difficult for UCITS to be sold to investors in the US. After the "private adviser exemption" was eliminated, two exemptions were created under the Advisers Act. "Foreign private advisers," as defined by the Advisers Act, are exempt from registration; and "private fund advisers," as defined by the Advisers Act, are exempt from registration but are considered "exempt reporting advisers" that must report detailed information to the SEC.

According to Section 202(a)(30) of the Advisers Act, a "foreign private adviser" is any investment adviser who has no place of business in the US; has in total fewer than 15 clients and investors in the US in private funds advised by the investment adviser; has aggregate assets under management attributable to US clients and investors of less than USD25m; and neither holds itself out generally to the public in the US as an investment adviser, nor acts as an investment adviser to any registered investment companies or is a business development company.[31]

The private fund adviser exemption under Rule 203(m)-1 of the Exchange Act exempts an investment adviser with its principal office and principal place of business outside the US, if the investment adviser has no client that is a US person except for one or more qualifying private funds; and all assets managed by the investment adviser at a place of business in the US are solely attributable to private fund assets, the total value of which is less than USD150m.[32] As previously mentioned, an adviser making use of the private fund adviser exemption is required to provide detailed information to the SEC.

While the Investment Company Act, the Securities Act, the Exchange Act and the Advisers Act present hurdles for a UCITS sponsor to offer securities in the US, each of these US securities laws provides an option for UCITS sponsors rather than prohibits UCITS securities sales in the US. Similarly, a UCITS sponsor must consider the hurdles and the options available under US state securities laws, the Employee Retirement Income Security Act of 1974, as amended, the Commodity Exchange Act, and recent or future changes to the US securities laws due to the Dodd-Frank Act.

V. Conclusion

Tax and regulatory concerns may seem numerous, but UCITS are beginning to become more popular for US investors. Recent updates to tax treaty models are beneficial to all collective investment funds; however, US securities laws may continue to hinder US investors from being able to invest in UCITS because securities law exemptions available to UCITS are limited.

Any opinions expressed in this article are opinions of the authors and not necessarily opinions of Chapman and Cutler LLP or any of its other partners.

Endnotes

1 European Fund and Asset Management Association, Quarterly Statistical Release, February 2016. Available at: http://www.efama.org/Publications/Statistics/Quarterly/Quarterly%20Statistical%20Reports/160226_QuarterlyStatisticalReleaseQ42015.pdf

2 United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Article 3, paragraph 1 ("*US Model Explanation*"). (Although the US Model Treaty was updated in 2016, the Technical Explanation from 2006 is still relevant because the Technical Explanation for the 2016 US Model Treaty has not yet been published and the definition of person was not changed in the 2016 update.)

3 United States Model Income Tax Convention (February 17, 2016) ("*2016 US Model Treaty*"), Article 3, Subparagraph 1(a).

4 2016 US Model Treaty, Article 3, subparagraph 1(b).

5 OECD Model Convention on Income and on Capital 2014 ("*OECD Model*"), Article 3, subparagraph 1(a).

[6] OECD Commentary on OECD Model, Article 3, paragraph 2.

[7] *Id.*

[8] 2016 US Model Treaty, Article 4; OECD Model, Article 4.

[9] Convention Between Ireland and Italy for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Article 3, paragraph 1(d)(ii).

[10] 2016 US Model Treaty, Article 4.

[11] US Model Explanation, Article 4, paragraph 2.

[12] OECD Commentary on OECD Model, Article 4, paragraph 8.6.

[13] *Id.*

[14] "The Granting of Treaty Benefits With Respect to the Income of Collective Investment Vehicles," adopted by the OECD Committee on Fiscal Affairs on April 23, 2010 ("*OECD Report*").

[15] 2016 US Model Treaty, Articles 10 and 11; OECD Model, Article 10 and 11.

[16] OECD Report, paragraph 31.

[17] OECD Report, paragraph 35. The OECD Report assumes that the investment manager of the collective investment vehicle has discretionary powers to manage the assets of the fund on behalf of the investors and that it meets the other requirements to be a "person" and a "resident" under the treaty.

[18] OECD BEPS Project, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6, subparagraph 2(f).

[19] OECD BEPS Project, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6, Commentary on the LOB Article, paragraph 31.

[20] Investment Company Act of 1940, Section 7(d).

[21] "Market Access for Regulated Fund Managers in the United States and the European Union," Investment Company Institute, October 2013.

[22] Investment Company Act of 1940, Section 3(c)(1).

[23] According to Rule 501(a) of the Securities Act of 1933, an "accredited investor" includes any person who comes within or who the issuer reasonably believes comes within a number of categories, including: a bank, insurance company, registered investment company, business development company, or small business investment company; an employment benefit plan if a bank, insurance company or registered investment adviser makes the investments decisions, or if the plan has total assets in excess of USD5m; a tax exempt charitable organization, corporation or partnership with assets in excess of USD5m; an individual with a net worth of at least USD1m, not including the value of his or her primary residence; or an individual with income exceeding USD200,000 in each of the two most recent calendar years or joint income with a spouse exceeding USD300,000 and a reasonable expectation of the same income level in the current year.

[24] Investment Company Act of 1940, Section 3(c)(7). According to Section 2(a)(51) of that Act, a "qualified purchaser" includes (i) a natural persons who owns not less than USD5m in investments; (ii) a company that owns not less than USD5m in investments and that is owned directly or indirectly by or for two or more family members, or other entities established by or for the benefit of such family members; (iii) a trust not formed for the specific purpose of acquiring the securities offered where the trustee or other persons authorized to make decisions with respect to the trust and each settlor or other person who has contributed assets to the trust are qualified purchasers; or (iv) a person that owns and invests on a discretionary basis not less than USD25m.

[25] *Supra*, note 21.

[26] Securities Act of 1933, Section 4(a)(2).

[27] Securities Act of 1933, Rule 506 of Regulation D.

[28] "Offering UCITS to US Institutional Investors: A Post Dodd-Frank Overview – Part 1 of 2," *The Investment Lawyer*, August 2012.

[29] According to Rule 3b-4 of the Securities Exchange Act of 1934, a "foreign private issuer" is defined as "any foreign issuer other than a foreign government except for an issuer meeting the following conditions: (1) More than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the US; and (2) Any of the following: (i) The majority of the executive officers or directors are US citizens or residents; (ii) More than 50 percent of the assets of the issuer are located in the US; or (iii) The business of the issuer is administered principally in the US."

[30] Securities Exchange Act of 1934, Rule 12g3-2(a).

[31] Investment Advisers Act of 1940, Section 202(a)(30).

[32] Investment Advisers Act of 1940, Rule 203(m)-1.