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Master Thesis

Problems of taxation of investment funds and underlying investors

by

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Abbreviation list

Art.	Article
CIV	Collective investment vehicle
e.g.	*Exempli gratia*, for example
CJEU	Court of Justice of the European Union
EEA Agreement	The Agreement on the European Economic Area
EU	European Union
EU Treaty	Treaty on European Union
i.e.	*Id est*, that is
OECD	Organisation for Economic Co-operation and Development
OECD Commentary	OECD Commentaries on the Articles of the Model Tax Convention 2010
OECD Model Tax Convention	Articles of the OECD Model Tax Convention on Income and Capital
p.	Page
Para.	paragraph
Paras.	paragraphs
pp.	Pages
Sec.	Section
TFEU	Treaty on the Functioning of the European Union
UCITS	Undertakings for Collective investment in Transferable Securities
UK	United Kingdom

1. Introduction

1.1. Background

Investment fund is a well known vehicle with that has number of advantages. This financial intermediary allows small investors to invest their savings in the market with a high quality supervision of management with ability to diversify risks. With an ageing of populations in recent years governments are calling for new ways of financing future pensions instead of sole reliance on public pension systems. Investment funds are often mentioned as one of the serious alternatives for the arrangement of pension schemes.[1] They are highly liquid and allow withdrawals as needed by retirees.[2] Therefore we can say that the role of investment funds in society is considerable, and the growth of these financial intermediaries is not surprising. [3]

However, in spite of the old history of development of investment funds, there is number of problems still exists. OECD Model Tax Convention, which lay the foundation for most of the modern tax treaties, does not provide clear answers for every question raised. There are number of disagreements in a way of granting access to the tax treaty benefits. Various legal forms and types of investment funds, as well as different attitude to funds by different countries, bring extra uncertainty in this area.

Different treatment of investment fund has a result of double taxation or non-taxation. “The Court of Justice of the European Union[4] has stated that in principle, juridical double taxation is not in itself unlawful, as there is no obligation for Member States to adapt their own tax systems to the different systems of tax of other Member States in order to eliminate the double taxation arising from the exercise in parallel of their fiscal sovereignty. Nevertheless, juridical double taxation represents an obstacle to cross-border activity and investment within the EU, thus distorting the effective functioning of the Internal Market.”[5] Establishment of Internal Market is one of the goals of EU Treaty. Internal market shall guarantee unfettered movement of capital and freedom of establishment within the European Union. If investment funds would face

[1] p. 2 Tomi Viitala “Taxation of investment funds in the European Union”, 2005

[2] Para. 10 of the Report of the Committee on Fiscal Affairs “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles” 23 April 2010

[3] p. 2Tax Law Design and Drafting (volume 2; International Monetary Fund: 1998; Victor Thuronyi, ed.) Chapter 22, Taxation of Investment Funds

[4] Cases C-513/04 Kerckhaert and Morres of 14 November 2006, C-67/08 Block of 12 February 2009 and C- 128/08 Damseaux of 16 July 2009

[5] Sec. 3 “Taxation problems that arise when dividends are distributed across borders to portfolio and individual investors and possible solutions” Public Consultation Paper, European Commission (28 January 2011)

obstacles in the form of double juridical taxation none of these fundamental rights would be safeguarded.

The Santander[6], OESF[7] and Commission v. Belgium[8] are some of the many cases of the CJEU that show that the violation of the EU Law in investment fund industry is an up-to-date problem.

And of course, neutrality of the tax system should be secured. Investors should be taxed equally regardless whether they invest directly or through investment fund. While this problem is resolved in most of the countries in purely domestic situation, there are many challenges on international market are still waiting to be resolved.

1.2 Purpose

In light of the aforementioned in this paper I will analyse tax treatment of investment activity. The main focus will be given to the conditions for granting tax treaty benefits to investment fund. I will also discuss whether underlying investors have the right to such benefits in case of failure to satisfy any treaty requirement by investment fund. Other conditions of access to treaty benefits will be investigated.

Market neutrality as well as infringement of fundamental freedoms in investment fund sphere will also be discussed. These questions are very important to understand the whole complexity of the question raised.

1.3. Methodology and Materials

The topic raised by this paper is very complex and require deep investigations. I will use OECD Model Tax Convention and OECD Commentary as primary sources. OECD Model Tax convention is a prevailing basis for the tax treaties concluded between OECD and some non-OECD countries. A great majority of countries negotiate and conclude their agreements based on the OECD Model Tax Convention. OECD Commentary, however, does not have definite legal status. Every country treats this document differently. Some domestic courts use it as a main

[6] Joined Cases C-338/11 to C-347/11 Santander Asset Management SGIIC SA and others v. Directeur des résidents à l'étranger et des services généraux of 12 May 2012

[7] Case C-194/06 Staatssecretaris van Financiën v. Orange European Smallcap Fund, 20 May 2008

[8] Case CJEU C-387/11 Commission v. Belgium, 25 October 2012

basis for interpretation for the tax treaties, whereas others do not relay on it in its judgments, but use them only as supplementary information. Moreover, it is not agreed among scholars whether it should be used the latest version of the OECD Commentary or the version that was valid on the day of concluding the treaty between countries. However, the main aim of the Commentary is to give a common understanding of the treaty provisions, "to be a great assistance in the application and interpretation of tax treaties"[9]. In the author's point of view if the representatives come up to the agreement of reading specific articles in a specific way, then it should be applicable even to already existent treaties.[10]

Some CJEU cases will be analyzed to find out the position of the Court to controversial situations. Cases will be chosen based on their relevance to the topic. I will also examine scholars' articles devoted to the subject in question.

Descriptive and comparative approaches are the most sufficient for this task. I find the most appropriate for our analysis is to describe highlights. Deep investigation of the norm as well as comparison of different way to tax investment funds will be done to present to reader the full picture of the situation described. I find law-and-economics methodology quite appropriate for this analysis.

Study of every material mentioned is necessary to make deep and extensive approach to the problem in question.

1.4 Delimitation

In this paper I took OECD Tax Model as basis for my analysis. It is a prevailing basis for the tax treaties concluded between countries. A majority of countries conclude their agreements based on the OECD Model Tax Convention. Thus this work covers great number of treaties concluded, but does not include situation while double tax treaty concluded on the basis of other tax treaty model. I will analyze OECD approach towards situations mentioned as well as will look on opinions of different authors regarding these issues. Domestic legislation of any country will not be described, however some examples from different states will be presented.

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[9] R. Russo "Fundamentals of International Tax Planning", 2007., p. 18
[10] See R. Russo "Fundamentals of International Tax Planning", 2007., pp. 18-21

1.5 Outline

In the first part of this thesis I will present general information regarding investment funds. Here I will discuss some advantages of such investment intermediaries. Several types of the investment funds are also covered by that chapter, which is necessary as background information related to the research topic. It is important to have this knowledge before the beginning of analysis of the tax issues. Next part provides overview of taxation of investment funds. Here the reader can learn the problems exist in this area. Three different taxing events, such as on the investment level, investment fund level and on the level of investors, are presented. The following chapters analyze every of these events in details. At first I will examine taxation of investment funds in a source state of income. We will learn the ways countries tax investments made by investment funds. Then study will be done on the level of investment fund: both domestic and foreign residence. The major issue here is to find out whether investment fund can claim tax treaty benefits in a cross-border context. I will evaluate whether investment fund can constitute a person, a resident and a beneficial owner under the provisions of a tax treaty. And finally, taxation of investments on the investors' level is analyzed. I will discuss eligibility of investors for tax treaty benefits in case investment fund fail to do so. Market neutrality as well as infringement of fundamental freedoms in investment fund sphere will also be discussed. These questions are very important to understand the whole complexity of the tax issues of investment funds.

2. Investment funds

In this chapter we will learn general information regarding investment funds and find out advantages related to such investment intermediaries. Several types of the investment funds will be presented as background information related to the research topic.

2.1. Concept of Investment fund and advantages for investors

Investment funds are financial institutions which obtain money from investors and use it to purchase financial assets.[11] The investment fund acts as an intermediary between the

[11] p.17 Tomi Viitala "Taxation of investment funds in the European Union", 2005

individual investor and the ultimate user of the capital[12]. They help individual investor to collect money in a single common pot and then reinvest these resources in a large number of securities. Investors receive a right on income produced by the fund with a use of their investments. At the same time risk is spreading among investors.

Directive 85/611/EEC[13] the first time ever established investors' protection in the European Union. That fact enhances investors' confidence in the investment fund mechanism. Good economical situation during later years also plays an important role in the growth of popularity of this vehicle[14]. In recent decades, investment funds have grown in importance[15]. Advantages related to making investment via investment funds increase a popularity of this investment vehicle. Professional management is the first advantage. Qualified manager with a main task to invest effectively available funds into different securities reduces the necessity to be familiar with different markets' situations. This also decreases the cost and time on information preceding that is attributable to investment activity. Second – it gives an opportunity to diversify the risk of individual investors even with modest financial resources by investing in many securities.[16] Another advantage is that investment fund provides much broader opportunities to investors, by providing access to number of markets, sometimes inaccessible to individual investors that prefer to invest directly[17]. And also it is worth mentioning a governmental supervision as an indisputable advantage.

This investment vehicle fits perfectly to the demand of the investors, willing to diversify their risks. It provides an opportunity to invest both in equity and debt securities, real estate, and other assets, in domestic companies and across international markets. In addition it provides an opportunity to change their risk-return securities according to their life plans. Individual investor that will try to make it without usage of financial intermediary would be required to have

[12] p.2 Tax Law Design and Drafting (volume 2; International Monetary Fund: 1998; Victor Thuronyi, ed.) Chapter 22, Taxation of Investment Funds,

[13] Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities

[14] p.2 Tomi Viitala "Taxation of investment funds in the European Union"

[15] Para. 1 Giampaolo Genta "Dividends Received by Investment Funds: An EU Law Perspective – Part 1", European Taxation, 2013 (Volume 53), No. 2/3, 01 February 2013

[16] Para. 9 Report of the Committee on Fiscal Affairs "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles" 23 April 2010

[17] Para. 8 Report of the Committee on Fiscal Affairs "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles" 23 April 2010

sophisticated knowledge in this area, spent enormous amount of time and cover transaction costs.[18]

2.2. Types of investment funds

Legislation of different countries determines different kinds of funds. Some countries provide more flexibility in the term of form in which fund can be established, whereas the others restrict them only to a few business forms that are the most secured for investors. Now classification of investment funds will be provided.

Investment funds can be established in a variety of legal forms depending on the laws of the state in which they are established. They can be structured as a corporation, a trust, a co-ownership arrangement or a partnership.[19] The legal form of the fund is one of the issues that have impact on its taxation. The taxation of investment fund will be discussed later.

On the basis of administrative policy investment fund can be divided on open-end and close-end funds. Open-end fund – is an investment fund where the amount of share capital is variable, i.e. typically, a fund that is required to repurchase its shares or units at the request of the investor[20]. Open-end fund in most of the cases obliged to redeem units on request of its investor. Investor can easily buy and sold units in an open-end fund despite the any circumstances on the market.

Closed-end funds - investment fund where the amount of share capital is fixed, e.g. typically, a fund that is not required to repurchase its shares or units at the request of the investor[21]. In contrast to the open-end investment fund this type does not give to investors so broad flexibility. However, it has its own advantage - their shares are treated on a stock exchange, similarly to any other public listed company. Consequently, the value of shares does

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[18] OECD "Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-border Investors on Possible Improvements to Procedures for Tax Relief for
Cross-Border Investors" 12 January 2009

[19] Sec 1 Nigel Johnston "International Collective Investment Vehicles", Bulletin for International Taxation, 2012 (Volume 66), No. 7, Published: 07 June 2012

[20] IBFD Tax Research Platform, 'Glossary' accessed online via <http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=%252Fcollections%252Fitg%252Fhtml%252Fitg_open_ended_fund.html&q=%2522open-ended+fund%2522&WT.z_nav=Navigation&colid=4949&hash=itg_open_ended_fund> on 02/05/2013

[21] IBFD Tax Research Platform, 'Glossary' accessed online via <http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=%252Fcollections%252Fitg%252Fhtml%252Fitg_open_ended_fund.html&q=%2522open-ended+fund%2522&WT.z_nav=Navigation&colid=4949&hash=itg_open_ended_fund> on 02/05/2013

not have to correspond to the net asset value of the fund, but rather is determined by supply and demand.[22]

Investment funds can also be classified on the basis of their geographical focus on those that concentrate on investment within the border of the country of their residence, and internationally oriented one.

There are number of other types of investment funds exist. For the purpose of this work I have presented only the main kinds that will be necessary for our future analysis.

In this chapter we learned general idea of investment fund, its types and advantages provided to investors. In the next chapter we will discuss taxation issues regarding this investment vehicle.

3. Taxation of investment funds

After being familiar with main issues about investment funds we can make another step in our investigation. Taxation of investment funds is a main focus in this chapter. We will study three different taxing events related to investments and will find out some existing problems in this area.

Levying of taxes from investment activity, especially in a cross-border situation, is a complex question. Every country that involved in this relationship has an opportunity to tax income. The source country wants to tax income derived on its territory, whereas the country of residence taxes world-wide income of its residents.

Therefore, we can distinguish tree different taxing events of investment activity:

1) on the investment level (taxation of investment in the source state of income);
2) on the fund level (taxation of investment fund in the residence state);
3) on the resident level (taxation of income in the state of residence of investor).[23]

In case every country would exercise its right to tax double- or even triple taxation may occur. “Discrimination may arise at one or more levels of the investment structure (i.e. at the level of the country where the company invested in is resident, at the level of the country where the investment fund was established, and/or at the level of the country where the investors

[22] p. 24 Tomi Viitala “Taxation of investment funds in the European Union”, 2005
[23] See p. 4 Tomi Viitala “Taxation of investment funds in the European Union”, 2005

reside).”[24] If dividends paid between associated companies of members of EU, then they are covered by Parent-Subsidiary Directive[25] (provided that certain requirements are met), and withholding tax is not charged. However, if these requirements are not met double taxation may occur. Double taxation hampers development of internal market within European Union, which is one of the goals mentioned in EU Treaty[26].

Countries conclude double taxation convention to eliminate or mitigate the negative effect on the functioning of the internal market resulting from the coexistence of national tax systems[27] [28]. After acquiring information about taxation of investment fund in general we will concentrate on taxation of investment fund in a source state of income.

4. Taxation of investment fund in a source state of income

Some investment companies prefer to make their investments only within the borders of its residence, whereas other may work on international market, getting benefits provided worldwide. After emerging of investment fund institutions and grow of awareness about better risk-return benefits available, the number of investors willing to make their investments internationally increased. In order to invest outside of home country one should have more sophisticated knowledge than while investing within one country. Advantages available to investors investing via investment funds, such as professional management and accessibility of different securities, as well as diversification of risks, made these intermediates the most popular investment vehicles on international arena.

Cross-border approach to investment raises several tax issues due to the potential interaction between the taxing jurisdictions of the states involved, i.e. the country of the company invested in, the country where the fund is established, and the country of the investors.[29]

[24] Para. 1 Giampaolo Genta “Dividends Received by Investment Funds: An EU Law Perspective – Part 1”, European Taxation, 2013 (Volume 53), No. 2/3, 01 February 2013

[25] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation application in the case of parent companies and subsidiaries of different Member States, amended by Council Directive 2011/96/EU of 30 November 2011

[26] Art. 3 (3) Treaty on European Union

[27] Para. 26 Case of CJEU C-67/08 Block of 12 February 2009

[28] Para. 21 Case of CJEU C-513/04 Kerckhaert and Morres of 14 November 2006

[29] Para. 1 Giampaolo Genta “Dividends Received by Investment Funds: An EU Law Perspective – Part 1”, European Taxation, 2013 (Volume 53), No. 2/3, 01 February 2013

Tax system established in a country usually succeeds in achieving of tax neutrality between direct investments and investment through a fund in case of single-country location of every participant. However, if investor, investment fund or a source company has located in different countries, complications frequently arise.[30] Juridical double taxation is one of the major problem in this context. "The Court of Justice of the European Union[31] has stated that in principle, juridical double taxation is not in itself unlawful, as there is no obligation for Member States to adapt their own tax systems to the different systems of tax of other Member States in order to eliminate the double taxation arising from the exercise in parallel of their fiscal sovereignty. Nevertheless, juridical double taxation represents an obstacle to cross-border activity and investment within the EU, thus distorting the effective functioning of the Internal Market."[32]

Tax treatment of cross-border investments should be neutral. Post-tax rate imposed on underlying investors of investment fund should be the same as if they would make their investment directly. Otherwise it will influence investors' behaviour in favour of one of these ways to invest, in spite of the income on investments before tax can be higher.

It is still the case that some jurisdictions treat dividends distributed to investment funds differently, which a result of a higher tax burden is borne by foreign investment funds. European Union, through infringement proceedings that eventually come before the Court of Justice of the European Union and national courts, that refer the compatibility of domestic provisions to the CJEU are trying to prevent such practices[33].

In case the investment fund is resident in the same state where the income arises, only domestic tax law of the state concerned must be considered. As it was discussed earlier, domestic investment funds are typically subject to specific tax rules which aim to a greater or lesser extent, to neutralize the tax impact of the investment fund between the investor and underlying investments.

In a cross-border context there are much more issues to concern regarding taxation of investment fund investments. In this case we deal with at least two states that have the right to tax income. Resident state has the right to tax worldwide income of its residents, whereas source

[30] See Art 1 para. 6.8 OECD Commentaries on the Articles of the Model Tax Convention 2010
[31] Cases C-513/04 Kerckhaert and Morres of 14 November 2006, C-67/08 Block of 12 February 2009 and C- 128/08 Damseaux of 16 July 2009.
[32] Sec. 3 "Taxation problems that arise when dividends are distributed across borders to portfolio and individual investors and possible solutions" Public Consultation Paper, European Commission (28 January 2011)
[33] Para. 1 Giampaolo Genta "Dividends Received by Investment Funds: An EU Law Perspective – Part 1", European Taxation, 2013 (Volume 53), No. 2/3, 01 February 2013

state has the right to levy taxes on income derived within its borders. In this regards I should notice that a country have no right to levy taxes based only on the provisions of tax treaty. Tax treaty can only restrict country's right to withhold taxed on some types of income.

The right to tax dividends and interest of the source state may be limited based on articles 10 and 11 OECD Model Tax Convention. To eliminate double taxation state of residence uses either exemption or credit method[34].

Some disagreements may arise in evaluating type of income. According to the OECD Model Tax Convention only the state of residence has the right to tax capital gains[35]. It is common situation of different treatment of income in different states.

OECD Model Tax Convention does not describe the way reduced tax rate should be applied. It is under the obligation of the country to elaborate efficient way to withhold taxes. There are two most common procedures usually applied. The first is application of reduced tax based on the tax treaty provisions at the time of levying the tax. Another way a bit more complicated, but is used by several countries. Contracting state levies taxes on a full rate, and after this give right to a person to apply for refund.

So in the previous chapters we learn that in a cross-border context it is highly important to know whether investment fund is a separate entity liable to pay taxes or not. We find out how countries reduce taxes to eliminate juridical double taxation in domestic and international context. Therefore, our next question to discus is whether investment fund treated as a taxable entity, separated from investors. If investment fund treated as separate entity, then it will be another tax subject liable to pay taxes. In order to avoid the double taxation tax relief must be given either at the fund or the investor's level.[36] In this regard we come closer to another aspect of this thesis – whether investment fund can claim tax treaty benefits. We will analyse this question in details and will find out whether this concept satisfy all requirements prescribed by the treaty.

[34] Art. 23A, 23B OECD Model Tax Convention on Income and Capital 2010
[35] Art. 13 (5) OECD Model Tax Convention on Income and Capital 2010
[36] p. 51Tomi Viitala "Taxation of investment funds in the European Union", 2005

5. Investment funds and tax treaties

Every country has its own history, political structure and legislation. Therefore there are so many legal forms in which investment funds can be established. With a growth of cross-border transactions number of question regarding treatment of different entities in different countries increased. Legal form of one entity can be treated differently in different contracting states, or even worse, can be left unknown in the legislation of one of the states. This situation can cause problems especially in a context of access to double tax treaty's benefits.

In this chapter we will learn two different approaches to grant tax treaty benefits: to investors and to investment funds. But the main focus will be given to determining requirements, satisfaction of which will grant tax treaty benefits on the investment fund level. We will analyse in details whether investment fund meets every criterion to constitute a person, a resident and beneficial owner.

Access to treaty benefits for investment fund will have an important influence on establishment of single financial market within EU. Double taxation hinders international cooperation and attaches persons to their residence. To make investment market as natural as possible we should grant benefits either on investment fund level either on the level of underlying investors. The concept of market neutrality will be discussed later in this paper.

So we can distinguish two different approaches to grant treaty benefits. According to the first one, benefits provide to underlying investors, not to the investment fund. Based on the residence of investor benefits would be determined. Tax treaty concluded between country of source and country of residence of investor would determine applicable benefits. In this case investment fund should be treated as absolutely transparent entity without the right to any tax treaty benefits.

According to another approach the right to treaty benefits granted to the investment fund. In this regard investment fund treated as a separate entity, which has the right to claim aforementioned benefits.

Let's look at the Art.1 Model Tax Convention that mentioned first two requirements satisfaction of which is necessary to be eligible to double tax treaty benefits.

"This Convention shall apply to *persons* who are *residents* of one or both of the Contracting States". *(emphasize added)*

If we talk about dividends and interests, then the main attention should be made to articles 10 and 11 Model Tax Convention. In these articles reduction of tax rate is possible "...if the *beneficial owner* of the dividends/interest is a resident of the other Contracting State".

Therefore in order to be eligible for tax treaty benefits investment fund should meet three criteria: constitute a person, constitute a resident, and in case of dividends and interest to be a beneficial owner of the income it receives.

In the following we will discuss each of these criteria in details.

5.1. Whether investment fund constitute a person according to the meaning of tax treaty?

The analysis of whether investment fund meet all criteria to constitute a person it is better to start with the provisions of the OECD Model Tax Convention and OECD Model Commentary.

Article 3(1) (a) OECD Model Tax Convention stated:

> "[T]he term 'person' includes an individual, a company and any other body of persons"

OECD Model Commentary:

> "The definition of the term 'person' ... is not exhaustive and should be read as indicating that the term 'person' is used in a very wide sense. The definition explicitly mentions individuals, companies and other bodies of persons." [37]

Explanation of the term 'company' we can find in Article 3 (1) (b) OECD Model Tax Convention:

> "[T]he term 'company' means any body corporate or any entity that is treated as a body corporate for tax purposes"

And in OECD Model Commentary:

"...the term 'person' includes any entity that, although not incorporated, is treated as a body corporate for tax purposes." [38]

> "The term "company" means in the first place any body corporate. In addition, the term covers any other taxable unit that is treated as a body corporate according to the tax laws of the Contracting State in which it is organised." [39]

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[37] Art 3 (1) para. 2 OECD Commentaries on the Articles of the Model Tax Convention 2010

[38] Art 3 (1) para. 2 OECD Commentaries on the Articles of the Model Tax Convention 2010

[39] Art 3 (1) para. 3 OECD Commentaries on the Articles of the Model Tax Convention 2010

Therefore the term 'person' under the meaning of tax treaty includes any entity that is treated as a legal person under the law of the Contracting State.

But the main difficulty arises while two contracting states treat investment fund under their national laws differently: one as a taxable person, other as a fully transparent unit. However, it should be remembered, that investments funds can be established in different legal forms, so it can be very problematic to find solution.

At the first stage of analysis in a specific case we should look at the legal form of the fund. As we discussed in a previous chapters they are varies from country to country. Some countries give the right to establish investment fund in a form of a company, whereas in others they can have a contractual arrangements. If investment fund established in a form of corporation, then it would meet the criterion to constitute a company, and as a consequence – a person. In case investment fund established in another form it still can be treated as a company if it is treated as a legal person for tax purposes. And finally, we should make an investigation whether it could be treated as 'other body of persons'.[40]

Another type of investments fund is based on contractual arrangements between investors and management. This type of arrangements also treated differently in different countries[41]. In situation where they are not treated as a legal person under the domestic tax law, then further examination should be done.

It is also important to look at economic approach to the situation. Management of the company is in charge of all assets available to the fund. It has enormous amount of rights and obligations by doing that activity. It has the right to execute even broader obligations then every separate investor. Therefore, investment fund constitute a separate from its investors person. On this basis some authors claim that irrespective of the legal form, investment fund should be treated as a 'person' for treaty purposes.[42]

Let's look at concrete examples. Domestic legislation of the UK, German and Finland treated investment funds as corporations for tax purposes. Therefore, they are treated as companies and, consequently, as persons within the meaning of tax treaties. French and Luxembourg legislation does not give us so clear answer. They are not treated as legal persons for tax purposes. However, these countries do not disregard treatment of funds as a person either.

[40] See p. 80 Tomi Viitala "Taxation of investment funds in the European Union", 2005
[41] p. 81 Tomi Viitala "Taxation of investment funds in the European Union", 2005
[42] See Para 3.2. "Changes to the OECD Commentary on Collective Investment Vehicles Proposed by the OECD Committee on Fiscal Affairs", Bulletin for International Taxation, 2010 (Volume 64), No. 3, 03.02.2010

They give the right to accumulate income in these entities. Nevertheless such quality left unclear whether it is enough to constitute a person or not.[43]

Finally, it is worth mentioning that in any case investment fund could claim its eligibility for 'other bodies of persons' concept, mentioned in OECD Model Commentary[44]. More interesting is that legal entities are not the only units covered by the term ‘person’. In the Commentary[45] we can find that partnership is also included in the definition of this term.

So we see that despite quite broad definition of the concept of ‘person’ there are number of situations are still left unclear. Every investment fund established in order to manage assets of investors as an independent entity.[46] Therefore, it is important to analyse ‘person’ concept with a conjunction of a ‘residence’ requirements.

In the following chapter we will see at the ‘residence of the contracting state’ requirement mentioned in the OECD Model Convention to access tax treaty benefits.

5.2. Whether investment fund is a resident of the contracting state?

I would like to star analysis from the definition of the term ‘resident of a Contracting State’, stated in Art. 4 (1) OECD Model Convention:

“...any person who, *under the laws of that State*, is *liable to tax* therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.” *(emphasis is added)*

OECD Commentaries in Art 4 para. 4 stated:

“Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as ‘resident’ and, consequently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on ‘residence’ have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws.”

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[43] pp. 81-82Tomi Viitala “Taxation of investment funds in the European Union”, 2005
[44] Art 3 (1) para. 2 OECD Commentaries on the Articles of the Model Tax Convention 2010
[45] Art 3 (1) para. 2 OECD Commentaries on the Articles of the Model Tax Convention 2010
[46] p. 82Tomi Viitala “Taxation of investment funds in the European Union”, 2005

As we can see, OECD Tax Convention refers to domestic legislation of countries in order to determine residence of a person. This idea highlighted the second time in the Art. 4 para. 8 OECD Commentaries.

Whether an investment fund that is qualifies as a person can be treated as a 'resident' depends not only on its legal form, but also on its tax treatment in the State in which it is established.[47]

Therefore, in order to be a resident, a person should have comprehensive tax liability in at least one of the contracting states.[48] However, it is still left unclear whether person should factually pay taxes. The question here refers to entities that are tax exempt. Despite that they have some tax obligations, they do not pay taxes if some requirements are met. OECD Commentary emphasis that different countries treat such situation differently. It stated that "person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax."[49] But in the next paragraph it also mentioned that "[i]n some States, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws." Therefore, treatment of residence completely left under the provisions of domestic tax law of contracting states.

On the next step I would like to see treatment of partnership with regard to 'resident' requirements. The OECD Model Commentary in Art. 4 para 8.8. mentions the following:

> "Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership 'flows through' to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity."

Therefore, if partnership treated as transparent entity under the domestic law of the country, then it does not constitute a resident of that state, and thus cannot claim tax treaty benefits. At the same time Commentary highlighted that partners instead should be treated as

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[47] See Art. 1 para 6.11 OECD Commentaries on the Articles of the Model Tax Convention 2010
[48] Art 4(l) para 8.2 of the OECD Commentaries on the Articles of the Model Tax Convention 2010
[49] Art 4 (2) para. 8.6 OECD Commentaries on the Articles of the Model Tax Convention 2010

residents, and receive the right to claim such benefits on income derived via investment fund. Benefits will be based on the tax treaty concluded between state of source and state of partners' residence.

Of course all these conclusions based on assumption that countries do not have specific provisions related to investment fund. Otherwise we should also examine such provisions.

To summaries everything mentioned we can divide investment funds into three broad categories[50]: separate taxable entities which pay taxes, separate taxable entities that are tax exempt, and fully transparent for tax purposes entity. The first group, that is separate taxable entity that pays taxes, clearly meet condition to constitute a resident. Treatment of investment funds that are separate entity but are tax exempt, is left to contracting states and their domestic legislation. Some provisions, such as legal form or liabilities to provide tax report can influence final decision of the country. However, finding of common decision in case of different treatment by countries is still looks problematic. And the last category of investment funds that are treated as fully transparent entity, they cannot constitute a resident under the tax treaty based on OECD Model Tax Convention; and therefore cannot claim tax treaty benefits. In this case, as it was explained before, we should analyze relationship between state of source and underlying investor. [51]

In this chapter we analysed the criteria to be met by investment fund to constitute a 'resident' under the double tax treaty. We find out that fulfilment of 'resident' requirement depends on legal form of the funds as well as tax treatment under the domestic tax law. We made a general division of investment fund into three categories based on the satisfaction of 'resident' conditions.

In the next chapter we will analyse the last criterion, which should be met by investment fund to claim tax treaty benefits – beneficial ownership.

5.3. Whether investment fund meet 'Beneficial owner' criterion

In the previous chapters we have learned that to be able to claim tax treaty benefits investment fund should constitute a person and a resident of contracting state according to the

[50] p. 85-86See Tomi Viitala "Taxation of investment funds in the European Union", 2005
[51] pp. 82-87Tomi Viitala "Taxation of investment funds in the European Union", 2005

meaning of tax treaty. Beneficial ownership is a final in our series criterion that must be met. I should mention that investment fund have to constitute a beneficial owner only in case it derives income in a form of dividends, interest or royalty. Royalty is not the ordinary way of making income by investment funds, therefore an attention will be given to the first two. In this chapter we will analyse criteria that must be fulfilled to constitute beneficial owner under the tax treaty meaning.

Articles 10 and 11 OECD Model Tax Convention mentioned the obligation to be a beneficial owner to receive tax treaty benefits.

OECD Commentary[52] points out the following:

"The term 'beneficial owner' …should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance."

"It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State…simply acts as a conduit for another person who in fact receives the benefit of the income concerned."

As we can see it is impossible to find definition of the term 'beneficial owner' neither in OECD Model Tax Convention nor in the OECD Commentary. There are number of suggestions supported establishment of an autonomous treaty meaning of the term 'beneficial owner' was provided[53]. However current version of the OECD Tax Model does not have one. But now in order to find real meaning of the undefined term we should refer to the domestic law of contracting state[54]. This is a way to resolve problematic situations stated in the Model Tax Convention. However, another problem occurs when domestic legislation does not define this term either.

We can find an explanation of the term 'beneficial owner' in the United States Model Technical Explanation Accompanying the United States Model Income Tax Convention:

"The beneficial owner of the dividend ... is the person to which the income is attributable under the laws of the source State. Thus, if a dividend paid by a corporation that is a resident of one of the States is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State

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[52] Art. 11 para. 9-10 of the OECD Commentaries on the Articles of the Model Tax Convention 2010

[53] Para. 2 OECD Model Tax Convention: Revised Proposals Concerning the Meaning of "Beneficial Owner" in Articles 10, 11, and 12, 19 October 2012 to 15 December 2012

[54] Article 3(2) of the OECD Model Tax Convention on Income and Capital 2010

would be entitled to benefits. These limitations are confirmed by paragraph 12 of the Commentary to Article 10 of the OECD Model."[55] That means that the concept of beneficial ownership requires a search for the person who economically has the benefit of an item of income[56].

If the person who receives income obliged to transfer it to another person, then it is hard to agree that this person can constitute beneficial owner. But if this person is able to decide the fate of the income – then we can assume that it is a beneficial owner of the income. Relationship between ownership of assets and income can influence the determination of beneficial owner but does not define it.

From the OECD Model Commentary[57] we can find that investment fund can be treated as the beneficial owner of the dividends and interest that it receives in case managers of the fund have discretionary powers to manage the assets generating such income. However a minor reservation is done, it says that underlying investors residents of the same state would not have been considered to be the beneficial owner.

Investment funds works like an intermediaries between investors and income earned. However, as we see, a specific of their work does not unequivocally refuse them from being treated as beneficial owner. OECD Model Tax Convention stated that beneficial ownership concept depends on the possibility of arises of double taxation, then tax-exempted investment funds can be eliminated from the scope of this term. On the other hand, if we concern ownership of the income, then investment funds, that are fully responsible for its distribution among underlying investors and also can use it for the purpose of the investment fund, can be regarded as intransparent for tax purposes entity and, therefore, be a beneficial owner. Compulsory redistribution rules ('deemed distribution'), imposed by the tax laws of some states, could again bring some uncertainty into this issue.[58]

As we can see from the legal analysis of a case law made by Adolfo Martin Jimenz[59], judges made an investigation of satisfaction of 'beneficial ownership' requirements based on economic/substance-over-form approach. By applying different methods, such as correlation between income received and paid, powers of the intermediate vehicle, whether the income

[55] United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006
[56] Sec. 3.3 A. Martin Jimenz, Beneficial Ownership: Current Trends, World Tax Journal 2010, (Volume 2), №1, published 15 January 2010
[57] Art. 1 para 6.14 OECD Commentaries on the Articles of the Model Tax Convention 2010
[58] See pp. 88-92 Tomi Viitala "Taxation of investment funds in the European Union", 2005
[59] A. Martin Jimenz, Beneficial Ownership: Current Trends, World Tax Journal 2010, (Volume 2), №1, published 15 January 2010

flowed through the intermediary or not, etc. they were looking for a real (final) beneficial owner of the income. However, analysis of the facts and especially legal arrangements between the parties were learned in details as well.

So in this chapter we learn whether investment fund can be treated as a beneficial owner of the dividends/interest it receives. We learned that treatment of this financial intermediated can vary depending on legal arrangements between parties and economic circumstances.

I would like to summaries requirements to tax treatment benefits mentioned in the previous chapters. We come up that in order to have access to benefits the fund must meet all three requirements. It should constitute a person, resident of a Contracting State and to be a beneficial owner.

In the next chapter we will discuss the consequences of failure of investment fund to satisfy any of the aforementioned requirements.

6. Tax treaty access of underlying investors

After careful analysis made in previous chapters regarding access of investment fund to tax treaty benefits, the next step is to find out the consequences for underlying investors in case of not getting access to tax treaty benefits to investment fund. This may occur in two situations: treatment of investment fund as a fully transparent entity or failure to satisfy any of aforementioned requirements by it. The main focus of this chapter is to find out whether investors can claim tax treaty benefits and the problems existent in this area.

As we discussed earlier sometimes investment fund treated as a fully transparent entity under the provisions of domestic tax law of the state of source. In some cases, despite being intransparent unit it anyway fails to satisfy requirements of the tax treaty to be eligible for tax treaty benefits. Moreover, access to tax treaty benefits could be denied based on the special provisions of a tax treaty.[60] In these circumstances the examination of eligibility of investors for tax treaty benefits should be done.

OECD Model Commentary[61] covered this situation and grant underlying investors with this right:

[60] p. 107 Tomi Viitala "Taxation of investment funds in the European Union", 2005
[61] Art. 1 para 6.4 OECD Commentaries on the Articles of the Model Tax Convention 2010

“Where... income has ‘flowed through’ a transparent partnership to the partners who are liable to tax on that income in the State of their residence then the income is appropriately viewed as ‘paid’ to the partners since it is to them and not to the partnership that the income is allocated for purposes of determining their tax liability in their State of residence. Hence the partners, in these circumstances, satisfy the condition, ...that the income concerned is “paid to a resident of the other Contracting State.”

But we should remember, that investor meet all requirements for tax treaty benefits.

Right to receive tax treaty benefits should be available to underlying investors in case of failure to satisfy ‘beneficial owner’ requirements by investment fund. OECD Commentary[62] mentioned the following:

“[T]he limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State”.

The situation will not be so easy in case of different treatment of investment fund by states. Source state may classify fund as a fully transparent entity and give access to investors to tax treaty benefits, whereas state of residence may treat investment fund as intransparent unit. In the later context state of residence will not tax investors on their income. Moreover, an investor would not be able to claim the benefits of the Convention between the two States since that income, is not similarly allocated for purposes of determining the liability to tax on that item of income in the State of residence of that person[63].

OECD Model Commentary[64] provides the following solution:

“6.3 …State of source should take into account... the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident.” However from the practical point of view the source state is not the first one willing to grant tax treaty benefits[65].

In case any of the States does not agree with the interpretation provided, they can negotiate special provisions to avoid potential double taxation[66].

But the situation would be even more complicated when residence of investor and the residence of the investment fund are different. When investment fund treated as a fully

[62] Art. 10 para 12.2 OECD Commentaries on the Articles of the Model Tax Convention 2010
[63] See Art. 1 para 6.2 OECD Commentaries on the Articles of the Model Tax Convention 2010
[64] Art. 1 para 6.3 OECD Commentaries on the Articles of the Model Tax Convention 2010
[65] p. 108 Tomi Viitala “Taxation of investment funds in the European Union”, 2005
[66] See Art. 1 para 6.3 OECD Commentaries on the Articles of the Model Tax Convention 2010

transparent entity then investor should receive tax treaty benefits based on the treaty concluded between source country and the state of investor's residence. However, if investment fund treated as intransparent entity, then the fund can claim tax benefit arising from tax treaty between the source state and the state of investment fund's residence. It means, that both investor and the fund would receive tax treaty benefits based on different tax treaties. OECD Model Commentary in Art. 1 para. 6.5 brings some light on this issue by mentioning that in this situation "State of source may not impose taxation which is inconsistent with the terms of either applicable Convention; therefore, where different rates are provided for in the two Conventions, the lower will be applied".

However, we should be aware that not only double benefits, but also no-benefits situation may occur.

"No benefits will be available under the Convention between the State in which the partnership is established and the State of source if the partnership is regarded as transparent for tax purposes by the State in which it is established. Similarly no benefits will be available under the Convention between the State of residence of the partner and the State of source if the income of the partnership is not allocated to the partner under the taxation law of the State of residence."

Both double benefits and no-benefits are not in conjunction with the spirit of law.

However, there are also a number of practical problems related to investor's access to tax treaty benefits. Very often investors do not have an opportunity to provide to tax authorities all document needed to claim tax benefits. That is why most of the claims are not reported at all. Moreover, the application procedure requires substantial amount of time. Each individual investor in fact claim relatively small amount of withholding tax refund. Therefore, taking into account amount of time needed, the question whether to apply for refund usually leave out of consideration. Therefore it seems reasonable to give to investment fund the right to aggregate claims of its investors and make a single application for the refund in behalf of underlying investors. This situations, however, is possible only regarding investors, who has the same residence as investment fund. Non-resident investors have to claim benefits personally. Their claims will be based on tax treaty concluded between their state of residence and state of source. Source state in this case usually does not accept claims made by non-resident investment fund.

Therefore we see that it seems unrealistic to put investor's access to treaty benefits on the first place. Despite it seem theoretically correct, practical difficulties that arise will make tax neutrality unattainable.[67]

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[67] See pp. 109-111Tomi Viitala "Taxation of investment funds in the European Union", 2005

So to sum up I want to say that if investment fund does not have an access to tax treaty benefits because of its treatment as a fully transparent entity or failure to satisfy any of the treaty's requirements, then underlying investors should have access to tax treaty benefits. However, in case of different views of contracting states on transparency of the investment fund problems may arise. Two-country situation (in which the residence of the investment fund and underlying investor is the same) can be covered by the provisions of double tax treaty. More sophisticated situation occur when there are three countries involved: state of source, state of residence of the investment fund and residence state of investor. In the later case double-benefit or no-benefits can be a possible result from such relationship. Moreover, practical problems associated with investor's access to tax treaty benefits make it almost impossible to apply.

In the following, we will briefly discuss opportunity to elaborate tax treaties to minimize possible contradictions.

7. Specific provisions concerning investment funds

Most bilateral tax treaties that are based on the OECD Model Tax Convention do not have specific provisions relating to investment funds[68]. Sometimes countries add these provisions to specifically highlight eligibility or non-eligibility of the investment fund for tax treaty benefits. If a treaty does not have any specifications, general analysis must be done to find out whether investment can claim benefits. However it is worth noticing that the number of tax treaties with specific provisions dealing with investment funds has been steadily increasing[69].

Some Contracting State may also to restrict tax treaty benefits in situation when funds can be used in abusive manner. Investment funds can be used to grants tax treaty benefits to investors, which would not receive them in case of making investments directly. In such cases, despite the factual satisfaction by the fund all requirements needed, benefits will not be granted.[70]

[68] See part 2.1 "Changes to the OECD Commentary on Collective Investment Vehicles Proposed by the OECD Committee on Fiscal Affairs", Bulletin for International Taxation, 2010 (Volume 64), No. 3, 03.02.2010
[69] p 73, p 102 Tomi Viitala "Taxation of investment funds in the European Union", 2005
[70] Art. 1 para 6.19 OECD Commentaries on the Articles of the Model Tax Convention 2010

In the next chapter we will look at another problem of taxation of investment activity. Market neutrality, as a predominant principle of establishment of every tax system, will be the main area of interests in the following chapter.

8. Market neutrality

In the previous chapters we have done a detailed investigation of conditions for access to tax treaty benefits by investment fund and underlying investors. We learned the prerequisites for granting such benefits and problems existed in this field. In the following chapters we will look closed to another existing problem in our research area. We will discuss market neutrality and its role in establishing a sufficient tax rules.

It is not a secret anymore that investment fund is important vehicle, which role in society is growing rapidly. Advantages that it provides to underlying investors can hardly be provided by any other financial vehicle. Financial crises force countries to look at its importance more seriously and make another step towards improvement of its legal environment.

There are three main objectives in the establishing of sufficient tax rules for investment funds: first, not to hamper the development of investment funds' industry, second, system should be neutral to other investments, and, third, tax rules should be administered and enforced.[71]

Tax rules should be established in a way to favour the development of investment funds' industry. If they would be treated as a separate entity that is obliged to taxes on a level playing field with other persons, without specific measures taken, it would result in establishment of an additional layer of tax imposed on income. Let's look at the example: Investment Company earns 10 percent of income on their assets. After levying 20 percent corporate tax, only 8 percent (after tax) left. 8% is an amount that investors receives in case of making direct investments (assuming that applicable tax rates are the same). In our case investment company considers to be a separate taxpayer. So while distributing its income to investors it is also subject to 20 percent tax. So we end up with only 6,4 percent. This calculation is done even without taking into account management's fee that is attributable to investment activity. In these circumstances investors would probably avoid usage of investment intermediates to increase an after-tax income.

[71] See p. 1 Tax Law Design and Drafting (volume 2; International Monetary Fund: 1998; Victor Thuronyi, ed.) Chapter 22, Taxation of Investment Funds

Market neutrality means every possibly way of investment activity should be treated in the same way. It should be irrelevant from the tax perspective whether make investments directly, or via investment fund or any other investment vehicle (such as pension fund or life insurance company). Decision of investors should be based on the market factors, but not on the basis of tax considerations.[72] This principle is also known as 'the principle of transparency'. That means that it is a main issue to arrange the transparent relationship between investors and their investments made via investment funds.[73]

Investors make their decisions based on after-tax rate of return on their investments. They would give preference to direct investments with a lower after-tax rate than investments via investment fund. Achievement of full tax neutrality will enhance usage of financial intermediaries with all supplementary benefits provided.

The main aspect of transparency is the aim of eliminating economic double taxation arising from the interposition of the fund between the investor and underlying investments. If investment fund treated as intransparetn entity separated from its investors then it will be a separate tax subject. In order to avoid the economic double taxation tax relief must be given either at the fund or the investor's level.[74] OECD Model Commentary[75] highlighted that a consistent goal of domestic tax system regarding investment activity is to ensure that there is only one level of tax, at either the fund or the investor level.

Different states achieve this goal differently. Some countries prefer to tax investors, while treating investment fund as a fully transparent entity. Other countries treat funds as a liable to tax entity, but their income may be fully exempt or can be reduced to amount of distribution made. That means that no tax is in fact paid. Other States tax investment fund at lower tax rate or in full, but with integration at the investor level to avoid double taxation of the income.[76]

However, economic double taxation is not the only problem that must be solved to achieve market neutrality. The problem of transformation of the type of income on the funds level is also take place. Investment funds can receive income in a many different forms but distributing it as dividends. This transformation may not be a problem only in case equal tax treatment (tax rate, deductions, losses, reliefs) to every possible type of income.[77]

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[72] Pp. 6-7 Tax Law Design and Drafting (volume 2; International Monetary Fund: 1998; Victor Thuronyi, ed.) Chapter 22, Taxation of Investment Funds
[73] p. 50 Tomi Viitala "Taxation of investment funds in the European Union", 2005
[74] p. 51Tomi Viitala "Taxation of investment funds in the European Union", 2005
[75] Art. 1 para 6.11 OECD Commentaries on the Articles of the Model Tax Convention 2010
[76] See Art. 1 para 6.11-6.12 OECD Commentaries on the Articles of the Model Tax Convention 2010
[77] See p. 52 Tomi Viitala "Taxation of investment funds in the European Union", 2005

We should also meet the transparency requirements with regard to the moment of receipt of income. This means that investor should be imposed by taxes at the moment investment fund receives income. If an investment fund does not distribute its income on a yearly basis then this income left untaxed in that period. This situation would not occurred in case of direct investment made my investor. Possible solution is ‘deemed distribution’. Under that rule it is deemed that income distributed on a regular basis despite the factual distribution among investors. Taxation of fund on income that was not distributed among investors is another possible way to prevent hinder of neutrality. However, every of these approaches require separate provisions in a domestic legislation and should be agreed by the parties.[78]

And finally we should remember that any tax rule should to be enforceable. Tax administrations have many problems in collecting and estimating information. Some rules, that can look correct from theoretical perspective, put enormous burden on administrations. It is preferable to collect information and withhold taxes from investment fund. Investigation of millions tax reports given by investors makes the system ineffective. Such system would put extra financial burden on tax payers because of necessity to enlarge tax administration manning level. Expenditures occurred may be even higher than possible revenue.

Thus in this chapter we learned the concept of market neutrality and its versatility. We understand the importance of market neutrality in investment fund industry. The problems that may arise and ways to resolve them taken by different countries were also discussed. Now I would like to get insights into another issue that investment fund can face. Violation of fundamental freedoms will be the main focus of the next chapter.

9. Fundamental freedoms

Another problem of taxation of investment funds is infringement freedom of establishment and free movements of capital. However, in case of involvement non-EU countries, only the free movement of capital can be invoked to challenge a breach of EU law[79].

Art. 26 TFEU stated the aim of establishment of internal market. Under its norms free movement of goods, persons, services and capital have to be ensured. A set of rules was elaborated to ensure implementation of this goal. Art. 49 TFEU stated prohibition of any

[78] See pp. 53-54 Tomi Viitala “Taxation of investment funds in the European Union”, 2005

[79] Para. 2.2 Giampaolo Genta “Dividends Received by Investment Funds: An EU Law Perspective – Part 1”, European Taxation, 2013 (Volume 53), No. 2/3, Published online: 01 February 2013

restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State. Whereas Art. 63 TFEU prohibit all restrictions on the movement of capital between Member States and between Member States and third countries. It is also established case-law that the measures prohibited by Article 63(1) TFEU include those which are such as to discourage non-residents from making investments in a Member State or to discourage that Member State's residents from doing so in other States[80].

Infringement of any of aforementioned rule has a negative effect on development of this industry. Despite the attempts made, number of violations is still exists. Settled case-law of the Court points out that direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with European Union law[81]. Therefore, European Commission on regular basis brigs actions against countries, whose legislation is not in line with EU law.

In a recent case Commission v. Belgium[82] the Court stated that different treatment of resident and non-resident investment companies constitutes a restriction of the free movement of capital and freedom of establishment under both TFEU and the EEA Agreement. Less favourable treatment of non-resident investment fund is in breach of EU Law. Different treatment of investment funds would influence investors' decisions and have a negative effect on the development of European Union in general.

Another interesting case concerning infringement of the free movement of capital principle in the EC Treaty was issued earlier. In OESF Case[83] the Court concluded that it is in breach of EU Law to restrict the amount of the credit for the foreign withholding tax to the extent the company has non-resident shareholders. The Court point out that such action is a disadvantage for all shareholders. This constitutes an obstacle for investment companies to raise capital from other countries that restricts the ability of foreign shareholders to invest in Dutch funds.

In a Santander Case[84] in paras. 16, 17 the Court stated that difference in the tax treatment of dividends according to the UCITS' place of residence may discourage, on the one hand, non-resident UCITS from investing in companies established in France and, on the other, investors resident in France from acquiring shares in non-resident UCITS. Accordingly, that constitutes a restriction on the free movement of capital, prohibited by Article 63 TFEU.

[80] Para 15 Joined Cases C‑338/11 to C‑347/11 Santander Asset Management SGIIC SA, 10 May 2012
[81] Para. 36 Case CJEU C-387/11 Commission v. Belgium, 25 October 2012
[82] Case CJEU C-387/11 Commission v. Belgium, 25 October 2012
[83] Case C-194/06 Staatssecretaris van Financiën v. Orange European Smallcap Fund, 20 May 2008
[84] Joined Cases C‑338/11 to C‑347/11 Santander Asset Management SGIIC SA, 10 May 2012

Therefore, in this chapter we learned another problem of taxation of investment funds. Violation of freedom of establishment and free movements of capital was discussed. We saw the negative results of such actions and studied some related cases of the Court of Justice of the European Union.

10. Conclusion

Investment fund proved to be an important investment vehicle. It provides broad advantages to underlying investors that makes it almost irreplaceable financial intermediary. However, the problems of taxation in this area are still high. Diversity of legal forms as well as different treatment of investment fund by different countries makes taxation of this activity sometimes very complicated. Thus, in order to get tax treaty benefits, investment fund should satisfy all three treaty requirements. It should constitute a person, a resident of a contracting state and a beneficial owner under the meaning of the tax treaty. Moreover, if investment fund does not have an access to tax treaty benefits because of its treatment as a fully transparent entity or failure to satisfy any of the treaty's requirements, then underlying investors should have access to tax treaty benefits. However, in case of different views of contracting states on transparency of the investment fund difficulties may arise. We can also see other practical problems associated with investor's access to tax treaty benefits.

We also learned problems related to market neutrality as well as infringement of fundamental freedoms in investment fund sphere.

Therefore, we see that taxation of investment fund and underlying investors is not the easiest question. Diversity of the legal forms and types of investment funds does not allow us to come up to a common decision. Careful analysis on a case-by-case basis should be done to check whether all requirements are met. Resent cases of the CJEU show that problems of taxation of investment activity are still arise. Implementation of specific provision in the tax treaty is a good practice to minimize disagreements among countries. However further legislation improvement of this sphere is required.

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