Investment Funds – How the Taxation Environment in Ireland continues to Lead the Way

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Introduction

Ireland has long been recognised as a destination of choice for investment funds. As an international fund domicile, Ireland ranks amongst the most flexible and advantageous in the onshore world due in no small part to the wide variety of investment fund vehicles which may be established under the Irish regulatory system. Ireland has in its favour; a developed national infrastructure, a highly competent and skilled workforce, political stability, the regulatory system and most importantly the willingness on the part of the Irish regulatory and tax authorities specifically the Irish Financial Regulator (FR), the Irish Stock Exchange (ISE) and the Irish Revenue Commissioners (IRC) to adapt and develop regulations to keep pace with international developments.

Ireland now services over $1.7 trillion in investment fund assets and is a fund domicile of choice for over 350 fund promoters. It is also a leading jurisdiction for money market funds and a leading exchange traded funds administration centre. As at June 30, 2008, 3,124 investment funds with an estimated Net Asset Value of US$1,468 billion were being serviced in Ireland. It is estimated that over 30 percent of global hedge funds are serviced in Ireland, making it the largest hedge fund administration centre in the world. This represents in excess of one third of global alternative investment fund assets and over half of European hedge fund assets.[0]

Ireland – Investments Funds

Fund types

Ireland's regulatory regime provides for the establishment of a plethora of investment fund types (referred to herein as "fund" or "funds"). Fund categories can be broadly split between UCITS and non-UCITS funds. UCITS operate on the basis of their availability to the "man in the street" and their investment and borrowing restrictions are generally not negotiable. However, UCITS III[2] extended the range of assets that can be invested in by a UCITS by allowing investments in money market instruments, derivatives, funds of funds, bank deposits and index tracker funds. UCITS III was transposed into domestic law in late May

2003 by the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2003 (as amended).

On the other hand, Ireland has non-UCITS funds, which include retail schemes, professional investment funds (PIFs) and qualifying investment funds (QIFs), the latter as the name suggests only available to qualifying investors i.e. in the case of individuals any individual with a minimum net worth in excess of Euro 1.25 million (excluding principal private residence/contents) or in the case of institutions any institution which owns or invests on a discretionary basis at least Euro 25 Million or the beneficial owners of which are qualifying investors in their own right. The FR and indeed the ISE dis-apply their general investment restrictions to varying degrees depending on the type of non-UCTIS fund, the QIF incurring the least restrictions.

Non-UCITS can be further broken down into their respective categories e.g. feeder funds, fund of funds, money market funds, private equity funds, venture capital funds, hedge funds, real estate funds, emerging markets funds etc.

1. New Irish QIF Regime

In 2007 the FR introduced a new authorisation process for QIFs. This is a prime example of how the FR and the Funds Industry are actively working to maintain the competitive edge which Ireland currently enjoys. QIFs are the vehicles which are most frequently used in the alternative space – hedge funds, fund of hedge funds, venture capital/private equity, etc – and are a mainstay of the non-UCITS Irish domiciled product offering. The new authorisation regime provides that, subject to meeting pre-agreed parameters, a QIF is now capable of being authorised by the FR on a filing only basis so that once a complete application for authorisation is received by the FR on Day X, a letter of authorisation for the QIF can be issued by the FR on Day X +1. There will no longer be a prior review process.

Fund Legal structures

There are various structures that funds may take, from units trusts to corporate funds (variable or fixed capital), investment limited partnerships to common contractual funds (CCF's). Although from an administrative point of view each vehicle (other than the fixed capital product, which is rarely used) functions in a similar way, with the value of its shares/units/participations fluctuating in line with the value of its underlying assets, each vehicle is subject to different legislative provisions.

a. *Corporate Funds* – A fund which is structured as a variable capital investment company may be established pursuant to (i) the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2003 (as amended) (the "UCITS Regulations") (for UCITS vehicles); or (ii) the provisions of Part XIII of the Companies Act, 1990 (for non-UCITS vehicles). A fund which is structured as a variable capital investment company must be incorporated as a public limited company. Such corporate funds are incorporated entities with separate legal personality. They have the capacity to enter into contracts and to sue and be sued. Their day-today management and control is provided by a board of directors with ultimate control resting with shareholders.

b. *Unit Trusts* may be established in Ireland pursuant to the Unit Trusts Act, 1990 (for non-UCITS vehicles) and pursuant to the UCITS Regulations (for UCITS vehicles). A Unit Trust is a fund vehicle created by a written agreement between a manager and a trustee known as a trust deed. A unit trust does not have a separate legal existence, does not have the capacity to contract and cannot sue or be sued.
The assets of a unit trust are held by its trustee (in its capacity as custodian) and are managed by its manager who may appoint one or more investment managers/advisers to assist it. Contracts in relation to the management and administration of the trust fund are entered into by the manager whereas the trustee will enter into contracts in relation to the assets themselves such as bank deposits, security agreements etc.

c. *Investment Limited Partnership* - is a partnership between one or more general partners and one or more limited partners. The principal business of an investment limited partnership is expressed in the partnership agreement. It should be noted however that this type of structure is rarely used.

d. Common Contractual Fund – See below

Taxation of Irish Investment Funds

Fund Level Taxes

The taxation treatment of regulated funds in Ireland is one of the key factors to the success of the Irish funds industry. Funds are not subject to any taxes on their income (profits) or gains arising on their underlying investments.

While dividends, interest and capital gains which a fund receives with respect to its investments may be subject to taxes, including withholding taxes, in the countries in which the issuers of investments are located, these foreign withholding taxes may nevertheless be reduced or eliminated under Ireland's network of tax treaties to the extent applicable.

Similar to other jurisdictions, the qualification of funds under double tax treaties between Ireland and other countries is ambiguous. Indeed, depending on the jurisdiction of the investments a distinction is sometimes made between funds having a legal personality of their own (e.g. corporate funds) and common law trusts (e.g. unit trusts). While a detailed discussion of treaty accessibility for funds is not within the ambit of this article, from practical experience corporate funds as opposed to trusts have typically been more successful in accessing treaty benefits due to the very nature of their structure (i.e. opaque). In addition, there is evidence of Irish funds (including perhaps surprisingly unit trusts) obtaining treaty benefits either at source or more commonly through a refund procedure.

Ireland obviously welcomes the work currently been undertaken in relation to the accessibility of collective investment vehicles (worldwide) to treaty benefits.[3]

Treaty Access

Nevertheless, where treaty access is important there are structuring solutions that may be used to facilitate treaty benefit claims for investment funds. One such innovative structure combines the favourable investment funds regime with the favourable Irish securitisation regime (for which Irish tax neutrality can be effectively achieved through the use of profit strip securities). Essentially, the fund finances the securitisation vehicle ("SPV") (which will be a 100 percent subsidiary of the fund) by taking up a profit participating security issued by the SPV and the SPV uses the monies raised through the issue of the profit participating security to purchase the investments (in the normal manner) as set out in the investment funds' policies documentations. As the SPV is a fully taxable vehicle in Ireland (albeit it's taxable profits can be managed to a desired level including taxable profits of zero if so desired - through the use of the profit participating securities) and the SPV is the entity making the investments, it typically removes one of the obstacles to tax-exempt regulated funds obtaining treaty benefits, which is whether the fund is "liable to tax" . In many treaties (including the standard OECD Model Treaty) liable to tax is used to define a resident of the Contracting States for the purposes of the relevant tax treaty.[4]

An additional benefit of this structure is that it should eliminate any chance of a foreign tax exposure for the fund as a result of being deemed resident or to have a PE in a foreign jurisdiction by the very reason that the Irish investing vehicle, the SPV, should clearly be liable to tax in Ireland and a resident thereof for the purposes of the relevant treaty.

Common Contractual Funds (CCF's)

Another example of Ireland's innovative fund's industry was the introduction of the bespoke vehicle, the CCF in 2003 to enable pension funds and trustees or custodians of pension funds to pool their investments (asset pooling) in a tax efficient manner. Originally devised as a UCITS structure limited to pension funds (or trustees or custodians of such pension funds), the CCF was further enhanced in 2005 by the Investment Funds, Companies and Miscellaneous Provisions Act, 2005, which provided for the establishment of a non-UCITS CCF and allowed for an expansion in the investor base (essentially to include all pension funds, institutional investors and corporate entities).

A CCF is constituted under contract law by means of a deed of constitution executed under seal by a management company. The deed provides for the safekeeping of assets of the CCF by a custodian who is also a party to the deed and specifies the fiduciary responsibilities of the Custodian which are equivalent to those of custodians of other UCITS and Non-UCITS schemes.

Importantly, the CCF is an unincorporated body and does not have legal personality. Because a CCF does not have legal personality, it may act only through the manager (or investment manager, if authority is delegated to an investment manager). Participants in the CCF hold their participation as co-owners and each participant holds an undivided co-ownership interest as "tenant in common" with other participants.

The central rationale for establishing a CCF is the capacity to provide participants with a tax transparent vehicle, where participants should be treated as investing directly in the pool of assets, and which benefits from all of the advantages of investing via a pooled arrangement including:

- economies of scale:
  - larger pools are able to negotiate lower custody fees;
  - larger pools increases capacity to net flows and reduce transaction costs;
  - large pools reduce administration costs
- centralised investment approach;
- centralised deal placing;
- centralised risk management/compliance.

Central to the CCF offering is that it is more than just entity (as opposed to virtual) pooling, it is *transparent* entity pooling, the CCF having been designed with a number of features to support transparent treatment quite apart from express provisions of Irish tax law.

Some of the many advantages of the CCF include:

- As a tax transparent vehicle, a CCF should facilitate direct access to tax treaty relief in the investor's home country. As a result there should be no tax drag arising from the application of withholding taxes, with each investor in the position to benefit from home country treaty benefits.
- It is a fund domiciled in Ireland where the standard of service provided by managers, custodians, administrators, legal and tax professionals is high;
- Multiple unit classes can be included in the CCF;
- No capital duty or subscription tax generally applicable to the CCF;
- No VAT is applied to key services received by the CCF including investment management, administration, etc (i.e. treated from a VAT perspective in a similar manner to other regulated funds – see Section C below) generally applicable to the CCF;
- No withholding taxes.

Subscription Tax and Capital Duty

No stamp or capital duty - (subscription tax) is payable in Ireland on the issue, transfer, repurchase, redemption, etc of units/shares in a fund.

Value Added Tax ("VAT")

From a VAT point of view, VAT Directive 2006/112/EC provides an exemption applicable to the "management of special investment funds as defined by Member States". There is no legal definition of what is meant by this exemption however, from an Irish VAT perspective, the VAT exemptions are wide ranging with regard to the provision of services to funds (e.g. administration, transfer agency, investment management). Indeed, the long held view of the IRC with regard to various services was reinforced by the decision of the European Court of Justice (ECJ) in the *Abbey National* case (C-169/04) on the scope of the VAT exemption for management of special investment funds. The ECJ held that the VAT exemption for management of special investment funds may apply to services performed by a third-party manager in respect of investment management and the administrative management of the fund. This is consistent with other ECJ decisions on outsourcing in the financial services sector, such as *Sparekassernes Datacenter* (C-2/95) and *CSC Financial Services (C/235/00)*, in that it is the nature of the service being provided which is crucial to its VAT treatment, not the characteristics of the person providing it. However, in order for the supply of outsourced management services of special investment funds to fall within the VAT exemption, the services supplied *"must, viewed broadly, form a distinct whole, fulfilling in effect the specific, essential functions"* of the exemption (i.e. management of the fund). The supply of IT services or other *"mere material or technical supplies"* does not fall within the exemption. This overturned the position of the European Commission and the UK government that the supply by a third party of purely administrative services which do not include investment management does not fall within the exemption.

Another relevant judgment was that of the ECJ in the *JP Morgan Fleming Claverhouse Investment Trust* case (C-363/05) where it was confirmed that investment trusts were special investment funds for the purposes of the aforementioned VAT exemption.

The provision of custodian (trustee) services to funds are also typically VAT exempt. While there is no exact statutory exemption from Irish VAT for custodial fees (unlike for management fees) the IRC have agreed the significant component parts of such a service are fundamentally VAT exempt and while some of the component services provided by a fund custodian may be taxable, they typically constitute a negligible part of the total cost of supplying the custody service.

Although investment funds are generally seen as taxable persons from an Irish tax perspective, from a practical perspective such funds are relieved from registering for Irish VAT purposes unless they are liable for self-assessing Irish VAT on the receipt of certain taxable services (*e.g.* tax and legal services rendered by suppliers established outside Ireland). In the specific case of unit trusts, the investment fund cannot obtain a VAT number. The VAT registration is achieved by the management company.

Nevertheless, regardless of whether the funds are registered for Irish VAT or not, the funds can still offset/recover Irish VAT on the purchase of services from suppliers based on the funds recovery rate. The recovery rate is based on either (i) the extent that securities of the fund are invested outside the EU or (ii) the extent that the investors in the fund are located outside the EU. The generally preferred route of the IRC is (i) location of investment (because of the practical difficulties of determining the location of investors who invest for example via intermediaries etc). Furthermore, on a similar basis the fund can also look to recover Irish VAT suffered on fees such as Irish legal and audit (where VAT will automatically have been imposed on the invoice).

Taxation of Investors from the perspective of the Investment Funds

Non-Residents

No Taxes – As outlined above Irish investment funds are not subject to any taxes on their income (profits) or gains arising on their underlying investments. In addition, there are no Irish withholding taxes in respect of a distribution of payments by investment funds to investors or in relation to any encashment, redemption, cancellation or transfer of units/shares in respect of investors who are neither Irish resident nor ordinarily resident in Ireland and who have provided the fund with the appropriate relevant declaration of non-Irish residence.

Irish Residents

a) *Exempt Investors*

No Taxes – Again, no Irish withholding taxes in respect of a distribution of payments by funds to such investors (which would include approved pension schemes, charities, other investment funds, etc) or any encashment, redemption, cancellation or transfer of units/shares in respect of investors and who have provided the fund with the appropriate relevant declaration .

b) *Non-Exempt Investors*

If an investor is Irish resident and not an Exempt Irish investor, tax at 23 percent will be required to be deducted by the fund on distributions (where payments are made annually or at more frequent intervals) and tax at 26 percent will have to be deducted by the fund on any other distribution or gain arising to the investor on an encashment, redemption, etc of units/shares by an investor who is Irish resident or an ordinary resident in Ireland. While this tax will be a tax liability of the fund, it is effectively incurred by investors out of their investment proceeds.

This taxation component can prove useful when a fund is trying to obtain treaty benefits.

Units held in a recognised clearing system

Any payments to an investor or any encashment, redemption, cancellation or transfer of units/shares held in a Recognised Clearing System (as defined in Irish tax legislation) will not give rise to a chargeable event in the fund. Thus the fund will not have to deduct any Irish taxes on such payments regardless of whether they are held by investors who are Irish Residents or Ordinarily Resident in Ireland, or whether a non-resident investor has made an appropriate relevant declaration. Nevertheless, investors who are Irish Resident or Ordinarily Resident in Ireland or who are not Irish Resident or Ordinarily Resident in Ireland but whose units/shares are attributable to a branch or agency in Ireland may still have a liability to account for Irish tax on a distribution or encashment, redemption or transfer of their units/shares.

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1 Source IFIA www.irishfunds.ie.

2 UCITS III Directive (Directive 85/611/EEC as amended by Directives 2001/107EC and 2001/108/EC).

3 For more information on this please see http://www.oecd.org/dataoecd/34/26/41974553.pdf.

4 This structure works in the majority of treaty partner jurisdictions, however one treaty jurisdiction where this structuring would not be of any additional benefit is the US due to the complexity of Article 23 (Limitation of Benefits clause) of Ireland/US DTA

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