

# Engineering Pass-Throughs in International Tax: The Case of Private Equity Funds

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## I. INTRODUCTION

After the news stories that Google saved \$60 billion in U.S. taxes using the so-called Dutch Sandwich scheme<sup>1</sup> and that the European Commission ordered Apple in 2016 to reimburse Ireland over \$13 billion for tax benefits received by its Irish subsidiaries,<sup>2</sup> even a casual news reader understood that Apple, Google, and many other multinational companies used a tax planning strategy that shifted profits offshore to a tax-friendly country to reduce its tax liability in the United States and abroad. Because so many multinational companies engage in this type of investment in a foreign country, referred to as foreign *direct* investment (FDI), tax scholars frequently examine the strategies employed by multinational companies when routing FDI into a foreign country.<sup>3</sup>

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1. See, e.g., Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 707–14 (2011); Jesse Drucker, “Dutch Sandwich” Saves Google Billions in Taxes, BLOOMBERG BUSINESSWEEK (Oct. 22, 2010, 1:26 AM), [http://www.nbcnews.com/id/39784907/ns/business-us\\_business/t/dutch-sandwich-saves-google-billions-taxes/](http://www.nbcnews.com/id/39784907/ns/business-us_business/t/dutch-sandwich-saves-google-billions-taxes/) [https://perma.cc/4R8E-3CFV]; Jesse Drucker, *Google 2.4% Rate Shows How \$60 Billion Is Lost to Tax Loopholes*, BLOOMBERG (Oct. 21, 2010, 3:00 AM), <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html> [https://perma.cc/NNY3-MLLS].

2. See generally Chris William Sanchirico, *As American as Apple Inc.: International Tax and Ownership Nationality*, 68 TAX L. REV. 207 (2015). In regard to Apple’s tax strategy, see, for example, *Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.) Before the Permanent Subcomm. on Investigations of the Sen. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong., 152–91 (2013), <http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/html/CHRG-113shrg81657.htm> [https://perma.cc/8QZG-CU2C]; Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES (Apr. 28, 2012), <http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html> [https://perma.cc/D3GA-HZDZ]; James Kanter & Mark Scott, *Apple Owes \$14.5 Billion in Back Taxes to Ireland, E.U. Says*, N.Y. TIMES (Aug. 30, 2016), <https://www.nytimes.com/2016/08/31/technology/apple-tax-eu-ireland.html> [https://perma.cc/76WD-7NB8].

3. FDI is usually defined as ownership of foreign investors of a controlling form, typically at least 10% of voting stock in the local investing entity. Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 547 (2003). There is plenty of traditional international tax scholarship accumulated with regard to FDI, so the examples of multinational enterprises (MNEs) are easily caught by international tax policy radar screens, attracting constant attention from the public and academia. For FDI in general, see for example, Pol Antràs, Mihir A. Desai & C. Fritz Foley, *Multinational Firms, FDI Flows, and Imperfect Capital Markets*, 124 Q.J. ECON. 1171 (2009); Lars P. Feld & Jost H. Heckemeyer, *FDI and Taxation: A Meta-Study*, 25 J. ECON. SURV. 233 (2011); Roger H. Gordon & James R. Hines Jr., *International Taxation* (Nat’l Bureau of Econ. Research, Working Paper No. 8854, 2002).

But what do we know about the tax strategies of foreign *indirect* investment, or fund investment in usual terms,<sup>4</sup> that is distinguished from FDI? This type of investment happens via multinational funds managed by large investment management firms like Blackstone, KKR, or Apollo Global Management,<sup>5</sup> as shown in Figure 1 below. Figure 1 is publicly disclosed in a financial statement of Apollo Global Management. However, it is hard to understand the exact fund investment structure by just looking into Figure 1. Moreover, plenty of resources focus on the multinational companies' tax strategies in foreign direct investment, both to attack and to defend such strategies,<sup>6</sup> but little research has been done to date analyzing the tax consequences of foreign indirect investment managed by multinational fund managers. On the one hand, are there any harmful tax practices in multinational indirect investment comparable to FDI? On the other, are there any disadvantageous aspects of tax law for multinational indirect investment?

Existing rules and literature gradually have come to recognize the lack of systemic rules for foreign *indirect* investment as part of an issue in portfolio investment.<sup>7</sup> However, given that portfolio investment refers to a passive feature of investment with less than 10% ownership and does not necessarily overlap with indirect or fund investment, the existing studies do not offer clear answers to the above questions relating to fund investments in particular.<sup>8</sup>

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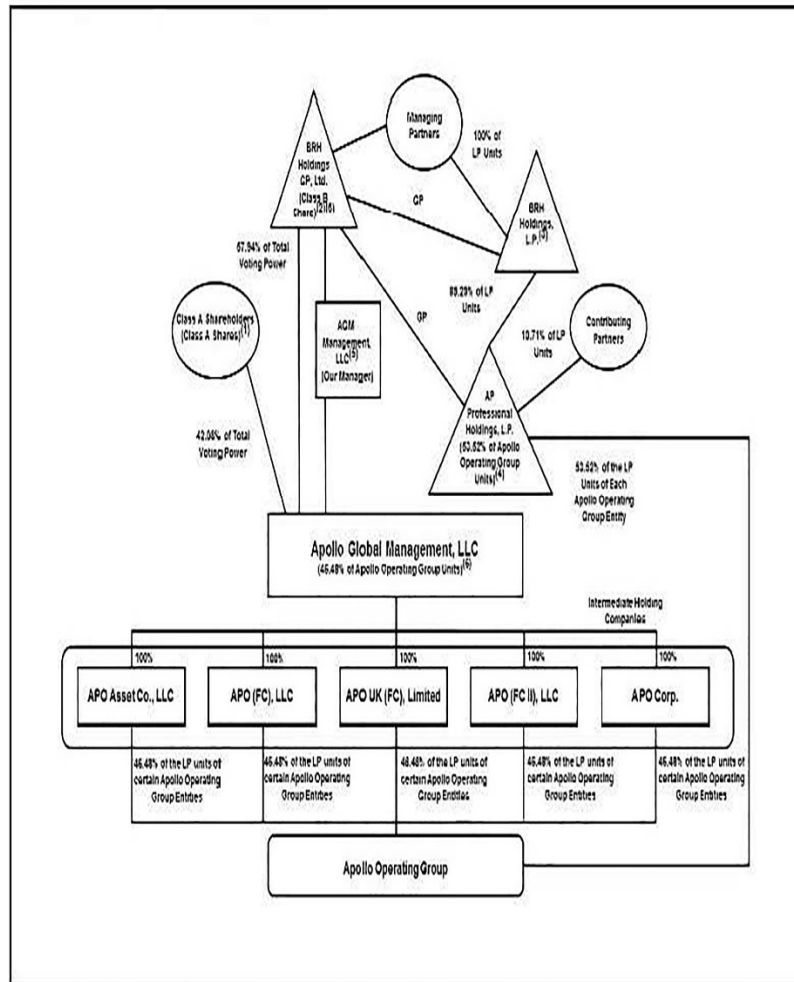
4. In this Article, "indirect investment" refers to an investment that pools capital for investment from multiple investors and invests in the underlying assets through vehicles, such as funds, trusts, or other entities. It is commonly called "fund investment" or "collective investment," although the definitions of each do not necessarily refer to the same thing.

5. Blackstone, KKR, and Apollo Global Management, LLC are New York-based private equity houses, ranked at second, third, and fourth, respectively, in 2018 in PRIVATE EQUITY INT'L, PEI 300, at 24 (2019), [https://d16yj43vx3i1f6.cloudfront.net/uploads/2019/07/300\\_PEI\\_Jun\\_Digi.pdf](https://d16yj43vx3i1f6.cloudfront.net/uploads/2019/07/300_PEI_Jun_Digi.pdf) [<https://perma.cc/F9DT-73Q2>].

6. See *supra* note 3 and accompanying text.

7. See, e.g., DORON HERMAN, TAXING PORTFOLIO INCOME IN GLOBAL FINANCIAL MARKETS 201 (2002); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1331 (1996); Graetz & Grinberg, *supra* note 3, at 547–48; Yaron Z. Reich, *Taxing Foreign Investors' Portfolio Investments in the U.S.: Developments & Discontinuities*, 16 TAX NOTES 1975, 1976 (1998) (focusing on inbound Foreign Portfolio Investment).

8. See generally Young Ran (Christine) Kim, *Carried Interest and Beyond: The Nature of Private Equity Investment and Its International Tax Implications*, 37 VA. TAX REV. 421 (2018).

FIGURE 1. ORGANIZATIONAL STRUCTURE OF APOLLO GLOBAL MANAGEMENT<sup>9</sup>

9. Apollo Glob. Mgmt., LLC, Annual Report (Form 10-K) 80 (Feb. 13, 2017).

Furthermore, the recent tax reform in the Tax Cuts and Jobs Act (TCJA) of 2017 adopted many changes in the U.S. international tax system, including many provisions that exempt U.S. taxpayers foreign source income from taxation.<sup>10</sup> However, such change is again limited to FDI, and the tax reform is silent on the foreign indirect investment by multinational funds.<sup>11</sup>

To fill the gap in the underdeveloped international tax law for indirect fund investments, this Article proposes a general rule of pass-through taxation in international tax law and demonstrates the feasibility of its implementation in the case of private equity funds (PEFs) in particular.<sup>12</sup> The Article primarily deals with taxation on multinational fund investments involving intermediary entities in one or more jurisdictions.

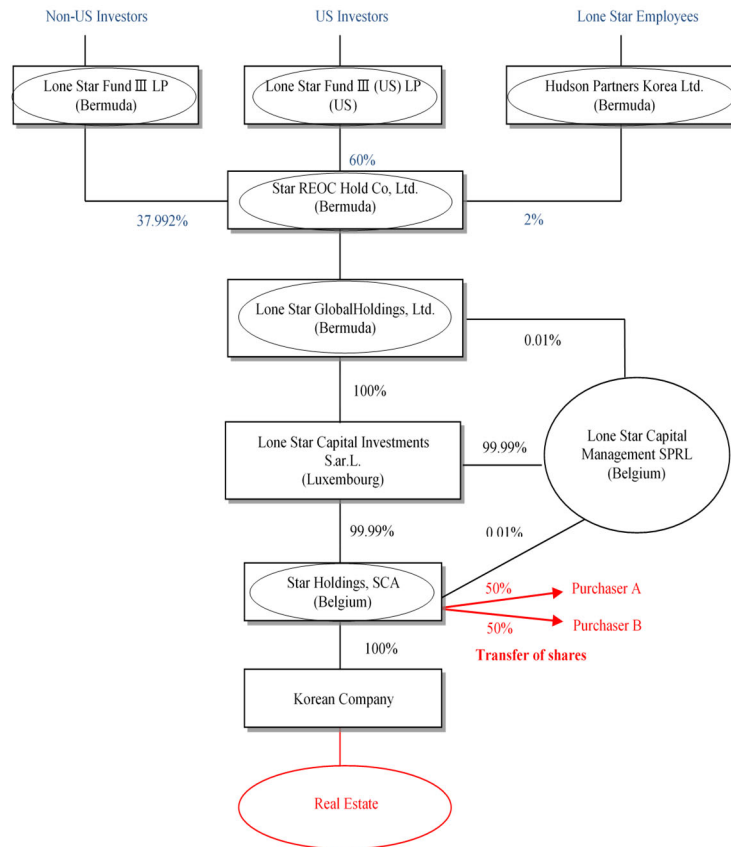
For example, Figure 1 depicts a simplified version of a PEF's firm structure. It shows multiple offshore portfolio companies at the bottom of the structure but does not clearly show the specific intermediary entities in foreign countries in the middle of the structure. If one picks a vertical slice of the structure for one portfolio company and expands it with greater detail, the picture looks like Figure 2.

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10. See I.R.C. § 245A (2012). For general introduction to the international tax provisions in the TCJA, see generally Susan C. Morse, *International Cooperation and the 2017 Tax Act*, 128 YALE L.J.F. 362 (2018). Such change made the U.S. international tax system depart from the worldwide tax system that taxes U.S. taxpayers' worldwide income. However, the TCJA did not fully embrace the territorial tax system that entirely exempts U.S. taxpayers' foreign source income from taxation, because it maintains the Subpart F regime and adds a minimum tax on global low-taxed intangible income (GILTI). *Id.* at 368.

11. The TCJA of 2017 introduced provisions where dividends received by a U.S. corporation from foreign subsidiaries are generally exempted from tax. See I.R.C. § 245A. However, this change does not apply to dividends received by noncorporate taxpayers, such as PEFs and their individual partners. JASON FACTOR & MEYER FEDIDA, CLEARY GOTTlieb, TAX CUTS & JOBS ACT: CONSIDERATIONS FOR FUNDS 5 (2018), <https://www.clearygottlieb.com/~media/organize-archive/cgsh/files/2017/publications/tax-cuts-and-jobs-act-2017/updates-1-2-18/tcja-summary--private-equity-jan-2.pdf> [<https://perma.cc/49JW-ZPPP>].

12. Cf. Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 327 & n.254 (2001) (arguing that international tax policies on FDI and foreign indirect investment should be studied separately, and noting that a proposal of appropriate rules for venture capital funds abroad has rarely been made). This Article focuses on PEF among various types of investment funds because the information hurdles discussed in Part V would be easier to overcome in the PEF context than in others. Furthermore, the nature of PEF is distinguished from other investment funds, especially mutual funds, in many aspects. See generally Kim, *supra* note 8.

FIGURE 2. STRUCTURE OF THE *LONE STAR* FUND CASE<sup>13</sup>

13. This chart is reconstructed by the author based on the chart in Appendix 2, Table 2 of the 2009 Seoul Administrative Court case. Seoul Administrative Court [Seoul Admin. Ct.], 2007Guhap37650, Feb. 16, 2009, (app. 2, tbl.2), *aff'd*, Seoul High Court [Seoul High Ct.], 2009Nu8016, Feb. 12, 2010, *aff'd*, Supreme Court [S. Ct.], 2010Du5950, Jan. 27, 2012 (S. Kor.). Lone Star Funds is a Texas-based private equity house, ranked twentieth in PRIVATE EQUITY INT'L, THE 300 BIGGEST PRIVATE EQUITY GROUPS ON THE PLANET PEI 300, at 44 (2014), [https://view57.book118.com/?readpage=B6hsvb\\_jMgOceYoVaxt4Zg==&furl=o4j9ZG7fK94rVJzZe@iWioCk0LM3IOMw34OPBWskxqDFf25WiQZ3v5VZxzNexkULJuUDLCM@MpF8Veuu1BT3bAv@SY\\_W9@jVK@HLP9Lz8jMKO\\_v1o8tL9Q==&n=1](https://view57.book118.com/?readpage=B6hsvb_jMgOceYoVaxt4Zg==&furl=o4j9ZG7fK94rVJzZe@iWioCk0LM3IOMw34OPBWskxqDFf25WiQZ3v5VZxzNexkULJuUDLCM@MpF8Veuu1BT3bAv@SY_W9@jVK@HLP9Lz8jMKO_v1o8tL9Q==&n=1) [https://perma.cc/G4D6-TNAR].

This Article analyzes the investment structures of multinational funds and offers paradigm cases to lay the groundwork for proposing pass-through taxation. In the paradigm cases, there are at least three relevant tax jurisdictions: (1) the source country where the income is produced—South Korea in Figure 2; (2) the residence country where investors who realize the foreign-source income are residing—United States, among others, in Figure 2;<sup>14</sup> and (3) the intermediate country where intermediary entities are allegedly residing—Belgium, Luxembourg, and Bermuda in Figure 2. The consequence of pass-through taxation within international tax regimes will be to eliminate the tax relevance of entities in those intermediate countries.

In domestic tax systems, indirect investment like fund investment typically does not entail entity-level taxation.<sup>15</sup> Investors thus enjoy tax neutrality between indirect and direct investment because most countries offer pass-through tax systems, such as partnership taxation, for fund investment.<sup>16</sup> In other words, an individual person investing in stock of a company through a fund vehicle pays the same amount of tax on the investment return, such as dividends and capital gains, as they would have had they invested in that stock directly without using a fund vehicle.

In contrast, investors in international fund investment may not enjoy tax neutrality between direct and indirect investment. As a formal matter, current international tax rules do not entirely eliminate entity-level taxation in indirect investment, especially when the investment structure is spread across multiple countries.<sup>17</sup> The opacity of fund vehicles in intermediate countries makes it hard to look through the vehicles and tax investors in a residence country,

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14. The category of source country versus residence country maps very roughly on to that of developing versus developed country in non-tax terminology. Although the parallels are not exact, a large number of source countries are developing countries, such as Brazil, Russia, India, and China (BRIC), and a large number of residence countries are developed countries, such as the members of the OECD. See TAX JUSTICE NETWORK, TAX JUSTICE BRIEFING: SOURCE AND RESIDENCE TAXATION 2–3 (2005), [https://www.taxjustice.net/cms/upload/pdf/Source\\_and\\_residence\\_taxation\\_-\\_SEP-2005.pdf](https://www.taxjustice.net/cms/upload/pdf/Source_and_residence_taxation_-_SEP-2005.pdf) [<https://perma.cc/762R-8QQL>].

15. See DONALD J. MARPLES, CONG. RESEARCH SERV., RS22689, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGER 2–3 (2014).

16. Therefore, investing through a pass-through entity was preferred to a taxable corporation before the TCJA. However, the TCJA reduced the statutory corporate tax rate from 35% to 21%; thus, investing through a taxable corporation can sometimes be better than investing directly, at least domestically. See, e.g., Joshua Franklin, *Private Equity Firm KKR Opts To Become C-Corp After U.S. Tax Reform*, REUTERS (May 3, 2018, 4:01 AM), <https://www.reuters.com/article/us-kkr-results/private-equity-firm-kkr-to-convert-to-a-corporation-after-u-s-tax-reform-idUSKBN1I4164> [<https://perma.cc/9H9S-F6J4>]. Nonetheless, this explanation on comparing taxable corporations and pass-through entities for tax purposes does not uphold in the multi-jurisdictional analysis, as explained in the next paragraph of the text, especially when the intermediary entity is usually required to promptly distribute funds.

17. See, e.g., Kim, *supra* note 8, at 443–45.



as income is distributed from the source country. Thus, investors may not claim tax treaty benefits mitigating potential double taxation<sup>18</sup> that ought to be available in direct investment, and they end up with tax consequences worse than direct investment.

As a result, investors have created many strategies to reduce tax liabilities in relevant countries to achieve the tax consequences that they would have enjoyed in a domestic tax environment.<sup>19</sup> Such planning might be understood as a sort of self-help path to tax neutrality between direct investment and indirect investment.

Sometimes, however, investors take further steps to continue to minimize their tax liability by taking advantage of underdeveloped and unclear rules. Such aggressive practices include treaty shopping,<sup>20</sup> the use of a hybrid instrument or entity that produces a mismatch in tax treatment in different countries—hybrid mismatches,<sup>21</sup> and tax secrecy.<sup>22</sup> Most of these practices are offered by the intermediate countries rather than by traditional source or residence countries.<sup>23</sup> These practices have been criticized for jeopardizing tax bases,<sup>24</sup> but it is hard to eradicate them piecemeal because they often

18. Double taxation occurs in international tax when a source country and residence country levy tax on the same declared income. See Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 133 (2001). Many countries enter into income tax treaties to avoid such double taxation. Under the tax treaties, source countries offer the reduced withholding tax rates for aliens' income from domestic sources, whereas residence countries offer tax exemption or credit to foreign-source income. See CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT, AND PROBLEMS ¶ 1240, at 63 (4th ed. 2011).

19. See Gregg D. Polsky, *A Compendium of Private Equity Tax Games*, 146 TAX NOTES 615, 616 (2015).

20. See *infra* Sections III.A.2, III.C.2.

21. OECD defines a hybrid mismatch arrangement as “a profit shifting arrangement that utili[z]es a hybrid element in the tax treatment of an entity or instrument to produce a mismatch in tax outcomes in respect of a payment that is made under that arrangement.” OECD, BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS (RECOMMENDATIONS FOR DOMESTIC LAWS) 8 (2014); see *infra* Sections III.A.2, III.C.2.

22. See *infra* Sections III.A.2, III.C.1.

23. See Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source Is the Linchpin*, 65 TAX L. REV. 535, 543–44 (2012).

24. See, e.g., Niels Johannesen & Gabriel Zucman, *The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown*, 6 AM. ECON. J. 65, 66 (2014). See generally OECD, COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY, TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE, ACTION 5–2015 REPORT (2015), [https://read.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report\\_9789264241190-en](https://read.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en) [https://perma.cc/

comply with legitimate tax rules of the intermediate countries. Thus, instead of attacking individual planning techniques one by one, a new, systematic approach to international fund investment is needed.

Recognizing this need to develop a general rule of pass-through taxation in multinational fund investments, the Organisation for Economic Co-operation and Development (OECD) has attempted to develop one since the 1990s. The first outcome, released in 1999, is the OECD Partnership Report, which did not address the problem because it still tried to apply traditional bilateral rules to more complicated situations.<sup>25</sup> Then, the OECD released a report on Collective Investment Vehicles (CIVs), which refers to mutual funds, in 2010.<sup>26</sup> However, the report did not address non-CIV funds, such as private equity or hedge funds, that are of this Article's interest. In 2016, as part of its Base Erosion and Profit Shifting (BEPS) project,<sup>27</sup> the OECD began discussing non-CIV funds.<sup>28</sup>

The bright side of these efforts is that the OECD is endeavoring to accomplish tax neutrality in multinational fund investment. For example, a discussion

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9UEF-LAKN]; OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, ACTION 2–2015 FINAL REPORT (2015), [https://read.oecd-ilibrary.org/taxation/715neutralizing-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report\\_9789264241138-en#page1](https://read.oecd-ilibrary.org/taxation/715neutralizing-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report_9789264241138-en#page1) [https://perma.cc/SRK3-CHHR]; OECD, PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES, ACTION 6–2015 FINAL REPORT (2015), [https://read.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report\\_9789264241695-en](https://read.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en) [https://perma.cc/V76G-496D].

25. See generally OECD, THE APPLICATION OF THE OECD MODEL TAX CONVENTION TO PARTNERSHIPS (1999), [https://read.oecd-ilibrary.org/taxation/the-application-of-the-oecd-model-tax-convention-to-partnerships\\_9789264173316-en#page1](https://read.oecd-ilibrary.org/taxation/the-application-of-the-oecd-model-tax-convention-to-partnerships_9789264173316-en#page1) [https://perma.cc/S3FH-ZBS6]; OECD, *The Application of the OECD Model Tax Convention to Partnerships*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 2010, at R(15)-1 (2012), [https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2010\\_9789264175181-en#page1](https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2010_9789264175181-en#page1) [https://perma.cc/C4SR-APMR] [hereinafter OECD, PARTNERSHIP REPORT].

26. See generally OECD, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 2010, *supra* note 25, at R(24)-1 [hereinafter OECD, CIV REPORT].

27. Base erosion and profit shifting (BEPS) refers to tax strategies that enable Multinational Enterprises (MNEs) to avoid paying tax on their global income to any country, or only to pay tax at nominal rates, by eroding their tax base through generating—or double-dipping—deductions or credits, or by shifting profits to low-tax jurisdictions. See OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING 5–6 (2013), [https://read.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting\\_9789264192744-en#page7](https://read.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page7) [https://perma.cc/6EMV-ACSW]. G20 and the OECD regarded this problem seriously and launched a project to address it through global cooperation in February 2013. See *id.*

28. See, e.g., OECD, PUBLIC DISCUSSION DRAFT: TREATY ENTITLEMENT OF NON-CIV FUNDS (2016), <https://www.oecd.org/ctp/treaties/BEPS-consultation-treaty-entitlement-non-CIV-funds.pdf> [https://perma.cc/5K8U-H3NY] [hereinafter OECD, NON-CIV DISCUSSION DRAFT]; see also OECD, BEPS ACTION 6: DISCUSSION DRAFT ON NON-CIV EXAMPLES (2017), <http://www.oecd.org/tax/treaties/Discussion-draft-non-CIV-examples.pdf> [https://perma.cc/74FF-38H2] [hereinafter OECD, DISCUSSION NON-CIV EXAMPLES].

draft on the OECD's policy for non-CIV funds suggests that as long as a fund distributes 100% of its income to its investors on a regular basis, its tax consequences would be eliminated.<sup>29</sup> Jointly, the tax consequences of the investors would be determined by considering only the source country and residence country.<sup>30</sup> However, the discussion regarding both CIV and non-CIV funds is limited to only the tax treaty entitlement issue. Tax treaties, for instance, are an important source of international tax law. Yet, when the fund investment is spread across multiple countries, it is highly likely that at least some of the countries do not have treaty networks with other countries involved in the investment structure. Focusing on treaty entitlement may resolve the treaty shopping issue, but that is only a partial solution to the overall problem of multinational indirect investment.

Furthermore, the OECD's approach basically gives intermediate countries primary authority to determine overall tax consequences of non-CIV funds, collect tax on behalf of both the source and residence countries, and then remit the tax to each of them.<sup>31</sup> Its approach requests the source and residence countries to comply with the so-determined result. However, considering that many aggressive tax planning techniques—such as the treaty shopping, hybrid mismatches, and secrecy discussed above—are mostly offered by the intermediate countries themselves, it is difficult to justify their primary taxing power in multinational fund investment.

This Article offers a new alternative proposal (the Proposal) for non-CIV funds. Under the Proposal, as long as a fund distributes 100% of its income to its investors, it shall qualify for international pass-through taxation. The source country and residence country shall determine whether the fund is qualified for such international pass-through taxation. These countries shall each collect tax as if the investment was made directly from the residence country to the source country. Multinational indirect investors will achieve tax-neutral consequences, just as if they had invested directly. Intermediate countries are required to cooperate in the process. The end result of the Proposal would be the same as that of the OECD's approach, but the Proposal serves as a more effective alternative because it grants the primary right to tax to source and residence countries that are entitled to the tax, rather than the countries interposed between them. In that regard, the Proposal for

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29. See OECD, NON-CIV DISCUSSION DRAFT, *supra* note 28, at 10.

30. This is called a "Global Streamed Fund" regime. *Id.*; see *infra* notes 225–32 and accompanying text.

31. See *infra* Section IV.C.

pass-through taxation is a multilateral approach that looks through intermediate countries—an approach not available in the traditional model built upon bilateral tax treaties.

To further illustrate the feasibility of the Proposal, this Article describes how the Proposal will be implemented with respect to PEFs. PEFs, which are essentially privately held partnerships, are a representative example of the non-CIV investment vehicle.<sup>32</sup> Because PEFs often involve multiple layers of pass-through entities and corporate-type special purpose vehicles spread across multiple jurisdictions, they are less transparent to the public than FDI and CIVs, and the information is less available even to the domestic regulatory agencies because reporting requirements have been limited.<sup>33</sup>

However, if the administrative authorities tried to obtain information on the individual investors behind the investment vehicles, it would be easier to do so for PEFs than for CIVs. This is because PEFs tend to have only a handful of high-profile investors, who rarely change during the lifetime of a fund,<sup>34</sup> “while CIVs generally have many more, including private retail investors.”<sup>35</sup> Information on such investors are now more available to governments through public and private databases as well as the newly enhanced exchange of tax information system.<sup>36</sup>

Considering that a prerequisite to implementing pass-through taxation is for the relevant tax authority to look through the fund vehicle and obtain the information of the investors behind the vehicle, PEFs with a small and manageable number of investors relative to CIVs allow for pass-through taxation because of the possibility of collecting the relevant information for source and residence countries. Thus, it may make sense to begin with PEFs—perhaps as “low-hanging fruit”—in engineering pass-through taxation in international tax.

This Article proceeds as follows. Part II examines tax neutrality between direct and indirect investments in a domestic tax system. It also explains why tax neutrality should be a normative goal for fund investment internationally. Part III analyzes the challenges in taxing multinational fund investments

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32. See Kim, *supra* note 8, at 427–29.

33. See Sanchirico, *supra* note 2, at 264–65. However, the Dodd-Frank Act now imposes disclosure requirement on the managers of hedge funds, private equity funds, and venture capital funds. See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of U.S. Code); ELI TALMOR & FLORIN VASVARI, INTERNATIONAL PRIVATE EQUITY 17 (2011).

34. Interest in PEFs is “an intrinsically illiquid asset class” so that partners in PEFs rarely change during the lifetime of PEFs. See TALMOR & VASVARI, *supra* note 33, at 187. Although the recent development of the secondary market for trading interests in PEFs to provide liquidity will give greater complexity, it is still true that the change in partners is relatively less common in PEFs than in CIVs. See *id.*

35. Kim, *supra* note 8, at 447.

36. See *infra* Section V.A.

and shows how and why tax neutrality fails for multinational fund investments using three paradigm cases. Part IV reviews the efforts to develop a general rule of pass-through taxation. It also develops the Proposal for non-CIV funds. Part V offers the prospect of implementing the Proposal in the case of PEFs. It presents empirical data on the number of investors in PEFs. Finally, Part VI concludes with suggestions for the future.

## II. TAX NEUTRALITY FOR FUND INVESTMENTS

This Part examines what tax neutrality between direct and indirect investment means and why it should be a normative goal for taxing both domestic and multinational fund investments. To help understand the rules for fund investment, this Article introduces three paradigm cases.

### *A. Outline of the Paradigm Cases*

Paradigm Case 1.1 is the case of purely pooling capital from multiple investors via a “pass-through entity,” such as a partnership, limited partnership, or in some cases, a limited liability company (LLC). Pass-through entities of this kind are typically not taxable entities.<sup>37</sup>

Paradigm Case 1.2 involves the use of a special purpose company (SPC) or “holding company” as an investment vehicle. Such a company does not have substance but is established for the special purpose of that particular investment, such as acquiring a target company.<sup>38</sup> An SPC is, in principle, a taxable entity as a corporation, subject to comprehensive entity-level taxation. However, if certain requirements with respect to purpose, operation, or activities are met, an SPC’s income is fully exempt. That is, it is treated as a conduit and disregarded for tax purposes.

Paradigm Case 1.3 is a combination of cases 1.1 and 1.2. Here, the pass-through vehicle is established to pool the capital from multiple investors, and such a vehicle establishes a holding company for specific investment purposes.

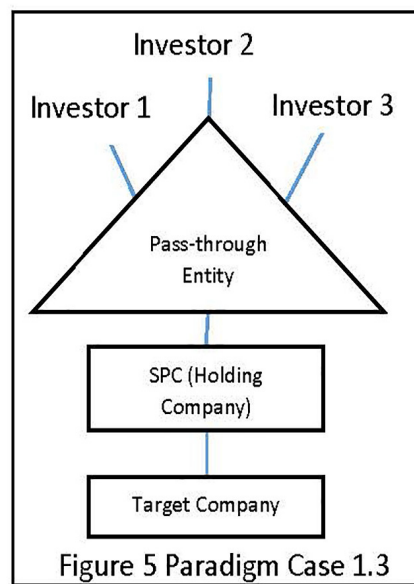
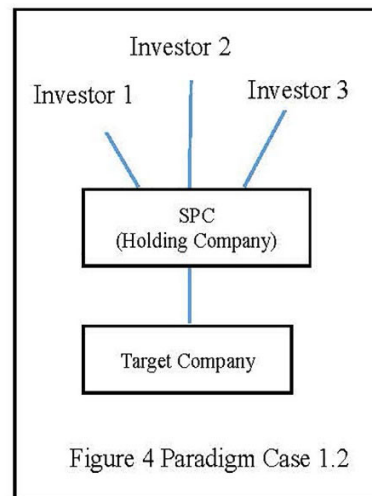
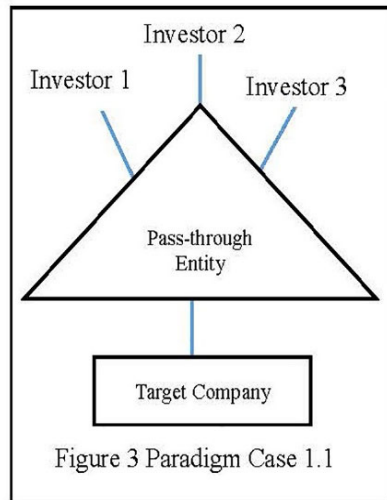
In all three cases, the target company is the only entity that is generating of the target company relating to its business but on the investment by, and distribution to the investors via, investment vehicles. This Article will analyze such tax consequences, implications, and the problems of each

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37. See RICHARD M. LIPTON ET AL., *PARTNERSHIP TAXATION* 5 (2d ed. 2008).

38. ROLF EICKE, *REPATRIATION OF US PROFITS FROM EUROPE: CONCEPTS, STRATEGIES, STRUCTURES* 37 (2009).

Paradigm Case under the three jurisdictional models—single, bilateral, and multinational—step by step.



### B. Domestic Tax Rules

Domestic tax policy with respect to fund investments is designed to eliminate double taxation so as to accomplish tax neutrality between direct investment and indirect investment.

#### 1. Paradigm Case 1.1: Pass-Through Vehicle

Paradigm Case 1.1 involves a pass-through entity, typically a partnership, to pool capital from multiple investors. In the United States, as a general rule, the Internal Revenue Code (the Code) does not view a partnership as a separate taxable entity but treats it as a pass-through entity in which its owners—partners—not the partnership itself, are subject to tax.<sup>39</sup> Of course, it is possible to tax partnerships themselves, and some foreign countries currently tax partnerships as taxable business entities.<sup>40</sup> However, unless every business entity of any size or any formation is subject to entity-level taxation, there will always be certain types of business entities that are “effectively taxed to their owners directly and not to the entity itself.”<sup>41</sup> Paradigm Case 1.1 deals with business entities of this kind, whether called partnerships or something else.

The effect of the pass-through regime can be justified from the efficiency perspective insofar as it eliminates double taxation in the indirect investment structure—taxing both the entity and the investor—and thus accomplishes neutrality between direct investment, in which the investors invest in the target directly, and indirect investment, in which the investors invest in the target through intermediary business entities.<sup>42</sup>

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39. LIPTON ET AL., *supra* note 37, at 5.

40. *Id.*

41. *Id.*

42. In domestic tax literature, it is explained as minimizing “the role of taxes on the choice of the form [of entities].” STEPHEN SCHWARZ & DANIEL J. LATHROPE, *FUNDAMENTALS OF CORPORATE TAXATION* 5 (9th ed. 2016). With no double taxation, investing through a pass-through entity was preferred to a taxable corporation before the TCJA. However, the TCJA reduced the statutory corporate tax rate from 35% to 21%; thus, investing through a taxable corporation can sometimes be better than investing directly, at least domestically, especially if distributions from a taxable corporation will be deferred for a period of years. Franklin, *supra* note 16. In other words, the corporate tax rate cut reduces the tax burden at the entity level, the deferral in effect halts the tax burden at the investor level, and the overall effective tax rate would be 21%. However, the pass-through investment is usually required to promptly distribute funds to investors, and, thus, there will be immediate taxation at the investor level. Assuming that an investor is an individual and the top marginal tax rate for an individual is 37%, the overall effective tax rate would be 37%.

## 2. Paradigm Case 1.2: Holding Company

Paradigm Case 1.2 involves an SPC. An SPC is, in principle, a taxable entity as a corporation, such that investments through an SPC entail double taxation—once at the entity level, and once at the shareholder level. If certain requirements are met, however, the SPC is treated as a conduit and disregarded for tax purposes.<sup>43</sup>

Even where the SPC is disregarded for tax purposes, it is still bankruptcy-remote and respected as a separate entity from investors for corporate law purposes, unless the corporate shell is denied by corporate law principles such as piercing the corporate veil.<sup>44</sup> Hence, the difference between Paradigm Cases 1.1 and 1.2 is that the investment vehicle for the former case is transparent for both tax and corporate law purposes, while the vehicle for the latter case is usually transparent for tax purposes but not transparent for corporate law purposes.

## 3. Paradigm Case 1.3: Combined Structure

Paradigm Case 1.3 combines Paradigm Cases 1.1 and 1.2. For fund investment, such as investment via CIVs or non-CIVs, Paradigm Case 1.3 is the most common structure. Here, the pass-through vehicle is established to pool the capital from multiple investors. This vehicle then establishes a holding company by which the investment, such as acquiring a target company, is made. The investment proceeds generated by the target company will flow through the holding company and the pass-through entity until they reach investors.

The key tax consideration here is to keep entity-level tax away. This is due to the indirect investment technique being derived from partnership

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Therefore, in today's rate environment, investing through an entity treated as a corporation might actually be more favorable than investing directly. Nonetheless, this explanation on comparing taxable corporations and pass-through entities for tax purposes does not uphold in the multi-jurisdictional analysis, especially when the intermediary entity is usually required to promptly distribute funds. *See id.* Thus, Section II.B. intends to offer a general explanation of domestic tax rules for fund investments as a groundwork before discussing international taxation, rather than addressing a transitional phenomenon caused by the tax rate change in the TCJA.

43. *See generally* Brad A. Birmingham & James M. Bandoblu, Jr., *Disregarded Entities: To Be or Not to Be?*, 11 BUS. ENTITIES 12 (2009). One of the most popular requirements is the minimum distribution to the shareholders or investors, such as distributing more than 90% of proceeds to shareholders every year. Eric M. Zolt, *Taxation of Investment Funds*, in 2 TAX LAW DESIGN AND DRAFTING ch. 22, at 5 n.14 (Victor Thuronyi ed., 1998). The rationale behind the policy to acknowledge conduits as a disregarded entity in the investment structure is to reduce the economic distortion. *Id.*

44. *See* William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 237, 268–70 (2007).



investment with the aim of taking advantage of pooling capital while eliminating double taxation. The pass-through entity is not subject to tax from the beginning. As long as the SPC qualifies as a conduit that is not subject to tax, the goal of eliminating entity-level taxation can be achieved.

In sum, domestic tax policy with respect to pass-through entities or SPCs is designed to eliminate entity-level taxation, accomplishing tax neutrality between direct investment and indirect investment. An important rationale is that it is not necessary to impose double taxation in such an investment structure because its commercial function and character are different from those of the corporate regime, and that it is nonetheless beneficial to allow a fiscally transparent entity for the purpose of pooling capital as a means to raise funds on a large scale.<sup>45</sup>

### C. Tax Neutrality and International Fund Investments

Now let us expand the picture into international settings and discuss what would be a proper international tax policy for fund investments. Because examining how domestic tax law is designed for three Paradigm Cases offers insight into the normative framework for international tax policy, this Article argues that international tax policy should also seek to achieve tax neutrality between direct investment and indirect investment.

Tax neutrality generally means the absence of tax-related distortion affecting decision-making between different types of investment, such as FDI and foreign indirect investment.<sup>46</sup> Thus, if the features of international investment funds are functionally equivalent to the investments through a partnership or a pass-through entity, eliminating entity-level taxation of investment funds even in the international setting and taxing investors only would be a proper policy for foreign indirect investment.<sup>47</sup> The OECD also endorses the tax neutrality between direct and indirect investment in the international setting.<sup>48</sup>

Domestic tax rules offer a way to achieve the goal of tax neutrality by eliminating entity-level taxation for indirect investments through pass-through tax regime or partnership tax.<sup>49</sup> The goal of tax neutrality is also being

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45. See, e.g., LIPTON ET AL., *supra* note 37, at 7.

46. OECD, CIV REPORT, *supra* note 26, at 3–4.

47. See generally OECD, POLICY FRAMEWORK FOR INVESTMENT USER'S TOOLKIT: CHAPTER 5. TAX POLICY (2013), <http://www.oecd.org/investment/toolkit/policyareas/41890309.pdf> [<https://perma.cc/AU2Q-3SKZ>] [hereinafter OECD, POLICY FRAMEWORK].

48. OECD, CIV REPORT, *supra* note 26, at R(24)-10 to -11, R(24)-17 to -19.

49. OECD, *Commentaries on Articles of the Model Tax Convention*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 2010, *supra* note 25, at C(1), C(1)-5 [hereinafter

achieved in relatively simple cross-border transactions if only two jurisdictions are involved. As shown in Part III, however, the goal is not achieved in multinational settings where more than two countries are involved. For those cases, this Article's proposed approach will help achieve the tax neutrality of multinational fund investments by way of overcoming the opacity of the intermediary in the investment structure and finding the ultimate investors in the residence country.

### III. FAILED TAX NEUTRALITY FOR MULTINATIONAL FUND INVESTMENTS

This Part examines the challenges that the current international tax regime faces in taxing fund investments. Using three paradigm cases, this Part also examines how and why tax neutrality fails for multinational fund investments.

#### *A. Overview of Inadequate Rules and Harmful Practices*

Most observers would likely agree that a tax system should provide a valid set of guidelines to distinguish legitimate tax planning from tax avoidance and to prevent the latter, which harms tax efficiency and equity.<sup>50</sup> However, too often a gray area exists in which aggressive tax planning can occur. Most of the time, aggressive tax planning results from the fact that the law is not simple, clear, and coherent, or because the law does not always keep pace with changes in the world.<sup>51</sup>

The international tax regime, which is embodied in the network of tax treaties and the domestic international tax law of major trading countries,<sup>52</sup> has been notorious for not providing such a guideline for a number of reasons.

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OECD, *Commentaries on Model 2010*] (explaining that the goal of a domestic tax system dealing with indirect investment is “to provide tax neutrality between direct investments and investments through a [vehicle],” so the investment vehicles for such indirect investment are usually a pass-through entity, which is not subject to entity level taxation).

50. Two widely accepted criteria for a good tax system are efficiency and equity. Some tax scholars consider simplicity as an additional criterion for a good tax system, and provide three criteria: efficiency, equity, and simplicity. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 27–30 (7th ed. 2013).

51. See, e.g., EUROPEAN COMM’N, *AGGRESSIVE TAX PLANNING INDICATORS FINAL REPORT* 22–23 (2017), <https://www.politico.eu/wp-content/uploads/2018/03/Study-on-ATP-indicators.pdf> [<https://perma.cc/D4QC-P374>] (providing evidence of the aggressive tax planning structures in Europe).

52. There is a debate on whether an international tax regime even exists. See REUVEN S. AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME* 1 (2007). In this regard, I assume for my purposes that there is an international tax regime in the form of the network of tax treaties and domestic international tax law of various countries.

First, this body of law has a relatively short history of full-fledged development compared to the long and rich history of domestic tax law. The modern international tax rules have their roots in model bilateral income tax treaties drafted in the early twentieth century under the auspices of the League of Nations.<sup>53</sup> Despite the short history, these model treaties have served as the foundation for more than 2,000 bilateral income tax treaties in force throughout the world.<sup>54</sup> The main purposes of such model treaties are to allocate the tax jurisdictions among countries and to eliminate potential double taxation on the same income by the source country and the residence country.<sup>55</sup> But these treaties only provide the rough principle of allocation, under which business income is primarily taxed by the source country and portfolio income by the residence country.<sup>56</sup>

Second, notwithstanding its short history, the principles and concepts of the international tax regime have not been updated adequately to keep pace with rapid changes.<sup>57</sup> The formative period of international tax principles and concepts was 1918–28.<sup>58</sup> Clearly, in that era, there was no e-commerce, no financial derivatives, far less mobility of capital across borders, far less developed emergence of tax havens, and less sophisticated cross-border investment structures.

One reason for this delay in reforming the international tax regime lies in the fact that the primary source of law is bilateral income tax treaties, which can be much harder to amend than domestic tax laws.<sup>59</sup> Moreover, it is difficult to reach a global consensus on the direction nations wish to advance. For instance, developed countries and developing countries have different interests. Nearly every country, meanwhile, has different ideas about how international tax law should be revised. Furthermore, although one country may decide to revise its own international tax law and treaties

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53. See *id.* at 182.

54. See Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1023 (1997); see also Graetz, *supra* note 12, at 262.

55. Double taxation here refers to the exercise of tax jurisdiction twice—one by the source country and the other by the residence country. See *supra* note 18. This is different from double taxation that occurs due to the entity level taxation, such corporate tax—one at the entity level and the other at the investor level. See OECD, POLICY FRAMEWORK, *supra* note 47, at 23, 34.

56. Graetz, *supra* note 12, at 262.

57. See *id.* at 262–63.

58. *Id.* at 315–16.

59. See *id.* at 261–62.

in its own way, it cannot deviate too much from the global standard due to a concern for reciprocity.<sup>60</sup>

The above is a basic picture of the challenges under the traditional international tax regime. The next question is how such challenges are amplified in the era of a globalized economy with more sophisticated investment techniques, particularly in the context of multinational fund investments.

### *1. Over-Taxation*

The current international tax regime built upon bilateral tax treaties may result in over-taxation for investors in multinational fund investments. This over-taxation occurs—relative to direct investment—essentially because investors may not claim treaty benefits mitigating double taxation by source country and residence country, which would normally be available through direct investment.<sup>61</sup> The opacity of fund vehicles in intermediate countries makes it difficult to look-through the vehicles and see investors in residence countries as income is distributed from the source country.

A possible solution for such over-taxation might be to allow treaty benefits to investors and every fund vehicle in intermediate countries. However, this solution is difficult to attain for the following reasons.

First, tax treaties, which provide the most important rules for taxing cross-border transactions, are by nature bilateral.<sup>62</sup> These treaties are limited in their ability to resolve the frequent cases that involve more than two jurisdictions. In these cases, the investors, investment, and investment vehicles are each located in three or more different countries. Pass-through vehicles are mainly domiciled in countries that do not have an extensive tax treaty network.<sup>63</sup> Such non-treaty countries then cut the chain of bilateral tax treaties from investors in the residence country through the investment in the source country. This omission makes it difficult for investors to claim treaty benefits. Without a tax treaty, investors must resort to the domestic tax law of each country involved, but, ironically, domestic tax law largely parallels tax treaties, and thus does not help resolve these complicated cases.

Second, even if an intermediate country has a tax treaty with a source country or residence country, it is not entirely clear whether a multinational fund vehicle is entitled to treaty benefits under the current international

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60. *See id.* at 300. An important function of international tax law is to eliminate international double taxation, which can effectively be eliminated by reciprocally respected international tax principles. *See id.* However, if one country acts arbitrarily, it breaks the balance of reciprocity and comity, causing antagonism from the global community, with possible retaliation in various ways. *See id.*

61. Warren, *supra* note 18, at 137.

62. *See id.* 132–34.

63. *See infra* Section III.C.1.

tax regime.<sup>64</sup> Despite the increasing volume of cross-border investments through multinational funds, existing bilateral tax treaties, as well as the OECD's Model Convention with respect to Taxes on Income and on Capital (OECD Model), do not contain specific provisions relating to whether such fund vehicles are entitled to treaty benefits.<sup>65</sup> Thus, the traditional rule simply relies on general principles or theories of international tax law. Under these traditional principles, a fund should be: (1) a person, (2) a resident of a country which has a tax treaty with the source country, and (3) the beneficial owner of the income it receives.<sup>66</sup> However, in many cases, the treaty entitlement of a fund vehicle would be challenged with respect to the residence requirement and the beneficial ownership requirements.

Third, the existing rule only provides for binary all-or-nothing application of the treaty to the fund vehicles.<sup>67</sup> In other words, under the current system, an entity receives either: (1) *full* treaty benefits, if it meets all requirements for treaty benefits, or (2) *no* treaty benefits, if it fails to meet even one requirement.<sup>68</sup> Therefore, if a fund vehicle is not entitled to treaty benefits, the traditional rule merely creates a cliff by denying the treaty benefits to investors, who otherwise would have been entitled to treaty benefits, had they received the income directly from the source country.<sup>69</sup> As a result, investors in the funds, or indirect investors, in other words, are placed in a worse position than they would be in the case of direct investment. This does not serve the goal of tax neutrality between direct investment and indirect investment.<sup>70</sup>

In short, the traditional international tax rules do not provide sufficient guidance to determine coherent tax consequences once treaty benefits have been denied to multinational funds. In contrast, domestic tax law, when it challenges the tax consequences of original transactions by applying anti-avoidance rules, has mechanisms to determine the adjusted tax consequences

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64. Treaty benefits typically refer that certain types of income, such as dividends, interest, rentals, royalties, pensions, and annuities, received by a resident of a contracting state may be exempt from tax of the other contracting state or may be subject to a reduced rate of tax of the other contracting state. See, e.g., OECD, POLICY FRAMEWORK, *supra* note 47, at 34.

65. See generally OECD, *Model Convention*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 2010, *supra* note 25, at M-3 [hereinafter OECD Model 2010].

66. OECD, CIV REPORT, *supra* note 26, at R(24)-2.

67. See *id.* at R(24)-19.

68. *Id.*

69. *Id.*

70. This problem also applies to FPI using CIVs. See OECD, *Commentaries on Model 2010*, *supra* note 49, para. 6.8, at C(1)-5.

by recasting the transaction so as to systematically conform to the integrated tax system.<sup>71</sup> As a result, the lack of such rules that adjust tax consequences after a denial of tax benefits remains a huge defect of the international tax regime.

## 2. Under-Taxation

To avoid the over-taxation described above, multinational funds have developed many tax-planning techniques to reduce tax liability in relevant countries. This Subsection discusses the potential under-taxation problem arising from treaty shopping and hybrid mismatch.

First, taxpayers may achieve under-taxation in a source country through treaty shopping.<sup>72</sup> Treaty shopping generally refers to a situation where taxpayers take advantage of more favorable tax treaties between a source country and certain jurisdictions other than their residence country.<sup>73</sup> In most multinational fund investment structures, the intermediate country where holding companies are located offers such an opportunity.<sup>74</sup> Here, treaty benefits mean reduced withholding tax rates under a tax treaty so taxpayers may reduce tax liability in source country by shopping favorable treaties.<sup>75</sup> The reduced tax liability in the source country may result in an outcome better than the tax-neutral benchmark, especially because many investors in multinational funds are tax-exempt organizations in the residence country; the structure of these organizations is irrelevant to the tax liability in the residence country.<sup>76</sup> Even if an investor is not exempted from tax in the residence country, such reduced taxation in the source country may result in overall under-taxation because the investor may not claim full foreign tax credit in the residence country.<sup>77</sup>

Second, taxpayers may achieve under-taxation in residence country via hybrid mismatches—using a hybrid instrument or entity that produces a

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71. See OECD, POLICY FRAMEWORK, *supra* note 47, at 13–14, 19–21, 26. The result of such adjustment is most likely unfavorable to the taxpayers, but there are cases that the outcome is similar to, or even more favorable than, the original transaction. Of course, the latter seldom happens because such possibility that challenging the original tax position will lead to more favorable tax consequences to the taxpayer would function as a negative factor in deciding whether the original transaction would be a tax avoidance or not.

72. See Kenneth A. Grady, Comment, *Income Tax Treaty Shopping: An Overview of Prevention Techniques*, 5 NW. J. INT'L L. & BUS. 626, 627–28 (1983).

73. *Id.* at 627.

74. Wells & Lowell, *supra* note 23, at 543–44.

75. Grady, *supra* note 72, at 627–28.

76. Although tax-exempt organizations are exempted from tax in the residence country, they are subject to tax in the source country, including withholding tax in tax treaties. See *Tax Treaties*, INTERNAL REVENUE SERV., <https://www.irs.gov/individuals/international-taxpayers/tax-treaties> [<https://perma.cc/9XDF-PX22>] (last updated Dec. 18, 2018).

77. See *infra* Section III.C.3, Part VII.

mismatch in tax treatment in different countries.<sup>78</sup> The primary purpose of the hybrid mismatch is to eliminate entity-level taxation in intermediate countries.<sup>79</sup> Eliminating entity-level taxation itself may not be considered harmful because it makes the tax consequences in intermediate countries equivalent to the tax-neutral benchmark. However, taxpayers may further achieve under-taxation in the residence country through hybrid mismatch. For example, a hybrid instrument may convert the ordinary income in the source or intermediate country into dividends or capital gains in the residence country. Because many countries provide preferential tax rates to dividends or capital gains, such conversion may reduce tax liability in the residence country.<sup>80</sup>

Interestingly, hybrid mismatch and the resulting low taxes in intermediate countries make it difficult for some source countries to respect the treaty shopping structure.<sup>81</sup> As discussed in Sections B and C, whether an entity is liable to pay substantial tax in its residence country is a crucial factor to entitle treaty benefits. If a fund vehicle pays substantial tax to the intermediate country, the source country is more likely to respect the tax treaty with that country even if it is treaty shopping. Due to the minimal tax in intermediate country, however, several source countries challenge the treaty benefits in this case and recast the transaction as a non-treaty case. That puts much worse tax consequences on investors than a tax-neutral benchmark, as in the over-taxation case. Appendix A briefly shows this result in hypothetical problems.

International tax rules for multinational fund investments should provide rules not only to analyze entities in each layer separately but also to analyze the ultimate investors. Such rules also should address the treaty benefit analysis on the overall investment structure spanning the multiple jurisdictions. However, the existing regime does not provide clear guidance on these issues, especially about how to deal with the investors behind an investment vehicle

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78. See *supra* notes 21, 24.

79. See *infra* Section III.C.2.

80. Furthermore, if the taxpayer is a tax-exempt organization, the hybrid instrument may convert unrelated taxable business income into passive investment income that is exempted from taxation for such organization, resulting in the under-taxation in the residence country. See JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE TREATMENT OF BUSINESS DEBT 66, 77, 85 (2001).

81. See, e.g., Sebastian Beer, Ruud A. de Mooij & Li Liu, *International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots* 28 (Int'l Monetary Fund, Working Paper No., 2018) (explaining that MNEs exploit mismatches in national tax rules, allowing them to treaty shop in countries with more favorable tax rates).

which is found not to be entitled to treaty benefits. This lack of guidance puts investors at a worse level than the tax-neutral benchmark; it harms the tax neutrality of the indirect investment.

The problem becomes more puzzling if there are a number of intermediaries in multiple jurisdictions, and it becomes even more complicated when some of the investors are funds or institutional investors rather than individuals, making it more challenging to determine the ultimate investors.

Recognizing the lack of rules and flaws in cross-border indirect investment in multinational situation, the OECD<sup>82</sup> and the International Fiscal Association (IFA)<sup>83</sup> have released several reports on the matter. Two such reports—the OECD Partnership Report and the CIV Report—will be discussed in detail in Part IV. The essence of their suggestions is that many investment vehicles or entities themselves will be entitled to treaty benefits, but even if the entities are not so qualified, investors in such entities should be able to claim benefits.

The policy goal of such reports is to achieve tax neutrality between direct investment and indirect investment in international transactions. However, the OECD and IFA reports limited the scope of their suggestions to CIVs,<sup>84</sup> and they did not consider “issues of treaty entitlement with respect to investments through private equity funds, hedge funds or trusts or other entities” until the OECD released a discussion draft in 2017 regarding those funds excluded in the CIV Report, called non-CIVs.<sup>85</sup>

Such explicit exclusion of non-CIVs provoked me to embark on this Article. The current international tax regime, based on bilateral solutions,

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82. For OECD’s discussion, see generally OECD, FIRST MEETING OF THE INFORMAL CONSULTATIVE GROUP ON THE TAXATION OF COLLECTIVE INVESTMENT VEHICLES (2007); OECD, REPORT OF THE INFORMAL CONSULTATIVE GROUP ON THE TAXATION OF COLLECTIVE INVESTMENT VEHICLES AND PROCEDURES FOR TAX RELIEF FOR CROSS-BORDER INVESTORS ON THE GRANTING OF TREATY BENEFITS WITH RESPECT TO THE INCOME OF COLLECTIVE INVESTMENT VEHICLES (2009); OECD, TAXATION OF CROSS-BORDER PORTFOLIO INVESTMENT: MUTUAL FUNDS AND POSSIBLE TAX DISTORTIONS (1999); OECD, CIV REPORT, *supra* note 26.

83. For IFA’s discussion, see generally 73 INT’L FISCAL ASS’N, STUDIES ON INTERNATIONAL FISCAL LAW: 51ST CONGRESS OF THE INTERNATIONAL FISCAL ASSOCIATION, NEW DELHI 1997 (1997).

84. Collective Investment Vehicles in the literatures of the OECD are an equivalent concept to mutual fund or “regulated investment companies” (RIC) under the Internal Revenue Code. See I.R.C. § 851(f)(1) (2012); OECD, CIV REPORT, *supra* note 26, at R(24)-3.

85. OECD, CIV REPORT, *supra* note 26, at R(24)-4; see *supra* note 28. The OECD CIV Report does not explain why it excludes non-CIV funds from its scope. However, in a subsequent document, the OECD explains that the conclusion in the CIV report cannot apply to the “policy considerations relevant to the treaty entitlement of non-CIV funds.” OECD, PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES, ACTION 6–2015 FINAL REPORT, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT 15 (2015). This implies that the nature of non-CIV funds are distinguished from that of CIV funds. See generally Kim, *supra* note 8.



lacks the proper rules and policy to deal with non-CIVs as well. In 2017, the OECD released discussion drafts on non-CIV funds as part of its BEPS Project, but the scope remains limited to treaty entitlement.<sup>86</sup> In treaty shopping, investors in non-CIVs often structure transactions aggressively to exploit the limits of bilateral solutions. They also often achieve low taxation compared to the hypothetical tax liability if they had invested directly. This behavior poses a major problem relating to non-CIV fund investments. However, the problems indeed go beyond treaty shopping. The bilateral approach also allows source countries to challenge the transactions, in which case the tax burdens increase exponentially, because the countries challenging the transactions may not consider multinational dimensions of their tax policy. Neither of these cases is desirable, because both diverge from tax neutrality between direct investment and indirect investment. Furthermore, hybrid mismatch and tax secrecy relating to intermediary jurisdictions play an important role to harm tax neutrality. Section B discusses the problems of current bilateral approaches that occur when participants apply bilateral tax treaties to multinational fund investment. More detailed analysis on the inadequacy of current rules for non-CIVs takes place in Section C.

### *B. Application of Bilateral Tax Treaties to Fund Investment*

This Section analyzes how the international tax regime—again, which developed based on bilateral solutions—applies to globalized investment funds. In the bilateral jurisdictional frame, two countries are involved: the source country and the residence country. The international tax consequences are determined basically under the domestic tax laws of the two countries, unless an applicable tax treaty modifies the tax result.<sup>87</sup> When a domestic tax code provision conflicts with the applicable tax treaty, many countries solve such conflicts by considering the treaty a higher source of law than a statute.<sup>88</sup>

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86. See generally OECD, DISCUSSION NON-CIV EXAMPLES, *supra* note 28.

87. The Internal Revenue Code provisions “shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.” I.R.C. § 894(a)(1).

88. See *id.* § 7852(d)(1). However, under the U.S. Constitution, “U.S. treaties and federal statutes have equal status as the supreme law of the land and, thus, whenever there is a conflict between the two, the later in time prevails.” GUSTAFSON, PERONI & PUGH, *supra* note 18, ¶ 1295, at 73 (citing U.S. CONST. art. VI, cl. 2). Therefore, there are many cases where newly enacted legislation that is inconsistent with the existing tax treaty provision will prevail, which is called the “treaty override.” See *id.* However, in many instances new legislation

Therefore, in the bilateral jurisdictions frame, it is imperative to determine whether a tax treaty is applicable to the transaction at issue. With respect to the treaty application, the key question is whether the investment funds in question are entitled to the treaty benefits.

Existing bilateral tax treaties as well as the OECD Model do not contain specific provisions relating to whether fund vehicles are entitled to treaty benefits. Thus, the traditional rule simply relies on general principles of international tax law, by which an investment fund should be (1) a person, (2) a resident of a country which has a tax treaty with the source country, and (3) the beneficial owner of the income it receives.<sup>89</sup>

Although there are three prongs, the existing tests mainly focus on the second prong—whether the entity pays taxes to the alleged residence country. For example, with respect to the issue of residency, Article 4(1) of the OECD Model defines the resident of a contracting state as “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.”<sup>90</sup> Furthermore, in making a determination regarding beneficial ownership, the Commentaries on the Articles of the OECD Model provide that if the recipient of the income is *liable to pay taxes* to the residence country, there remains a potential risk of double taxation, so the recipient should be treated as the beneficial owner of such income. In contrast, if the recipient is not liable for taxes, there is no potential double taxation and no need to see the recipient as the beneficial owner of such income.<sup>91</sup>

As such, both residency and beneficial ownership tests rely on whether the entity pays taxes in the alleged residence country. With regard to such a single criterion as whether or not a person has tax liability, residency is determined by the residence country. By contrast, beneficial ownership is determined by the source country. As a result, the source country and the residence country interpret or apply a treaty to the fund in different ways. Furthermore, the existing rules do not answer the question of how to treat an investment vehicle, which is in principle subject to taxation but remains exempt for the purpose of domestic tax policy.

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is not intended to override a treaty, and Congress makes it clear that the new tax provisions should be interpreted harmoniously with existing tax treaties. *Id.*; see RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 115 (AM. LAW INS. 1987).

89. OECD, CIV REPORT, *supra* note 26, at R(24)-2.

90. OECD, ARTICLES OF THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL art. 4, § 1 (2003) (emphasis added), <https://www.oecd.org/tax/treaties/1914467.pdf> [<https://perma.cc/7F2C-QSJ8>].

91. Even though the immediate recipient of the income qualifies as a resident, “no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence.” OECD, *Commentaries on Model 2010*, *supra* note 49, para. 12.1, at C(10)-3.

Considering that the OECD has released reports dealing with CIVs and non-CIVs separately, I will review the traditional rule for these two types of vehicles separately as well.

### 1. Existing Rule for CIVs

The legal forms of CIVs, such as mutual funds, vary from country to country. Most of them can be classified as: (1) a corporation or company, (2) a trust, or (3) a partnership.<sup>92</sup> Sometimes, the determination of each CIV's legal form based on the entity classification theory is the preliminary issue in the application of tax treaties. Once the entity is classified, however, the tax treatment of such CIVs differs depending on the tax laws<sup>93</sup> and treaties of countries. The absence of a unified treatment of CIVs gives rise to undesirable situations, including double taxation or double non-taxation in the international regime.

The OECD and IFA have made efforts to cope with these problems by allowing treaty benefits to CIVs, but their existing studies reveal limits on resolving the fundamental problems.

First, it is not clear whether every type of CIV can be regarded as a person. According to the definition of a "person" in the OECD Model,<sup>94</sup> a CIV taking the form of a company would satisfy the requirement of a legal person.<sup>95</sup> However, it remains unclear whether trusts and partnerships would fall under this definition.<sup>96</sup>

92. For example, the United Kingdom has Authorized Unit Trust as a trust-type entity and Open-Ended Investment Company as a corporate-type entity. António Calisto Pato, Cross-Border Direct Tax Issues of Investment Funds from the Perspective of European Law 8 (Aug. 15, 2007) (unpublished LL.M. thesis, University of Leiden) (on file with University of Leiden). The U.S. law allows CIVs to take any form among corporations, business trusts, or limited partnerships. In addition, Unit Trust as a close-ended investment fund can take the form of a trust. See TOMI VIITALA, TAXATION OF INVESTMENT FUNDS IN THE EUROPEAN UNION 35 (2005); Pato, *supra*, at 8.

93. In many cases, the issue is affected by the source country's concept of beneficial ownership, which is often not defined by code. See Pato, *supra* note 92, at 11.

94. Because Article 3, section 1(a) of the OECD Model defines a person as "an individual, a company and any other body of persons," and the term "company" is further defined in section 1(b) as "any body corporate or any entity that is treated as a body corporate for tax purposes," a CIV which takes the form of a company would satisfy the requirement of a person. OECD Model 2010, *supra* note 65, art. 3, § 1(a)–(b), at M-9.

95. Lynn J. Ed & Paul J.M. Bongaarts, *General Report*, in STUDIES ON INTERNATIONAL FISCAL LAW: 51ST CONGRESS OF THE INTERNATIONAL FISCAL ASSOCIATION, NEW DELHI 1997, *supra* note 83, at 21, 43.

96. VIITALA, *supra* note 92, at 81.

Second, according to the definition of a resident in the OECD Model,<sup>97</sup> a CIV that takes the form of a pass-through entity would easily be excluded from the definition of a “resident” because it is not liable for taxes in the residence country.<sup>98</sup> By contrast, if a CIV is in principle liable for taxes but the country where it is established does not in effect impose tax, the OECD suggests treating such CIV as a resident of that country “because the CIV is subject to comprehensive taxation in that State.”<sup>99</sup> However, the OECD further notes that some contracting states may not treat such CIVs as residents of that country for treaty purposes.<sup>100</sup>

To put the OECD position in terms more familiar from the paradigm cases: the OECD suggests that a pass-through vehicle in Paradigm Case 1.1 may not be treated as a resident of the country where it is established. It also suggests that an SPC in Paradigm Case 1.2 would be treated as a resident of such country. However, the treatment of these vehicles is still not certain.

Third, the definition of beneficial ownership perhaps poses the most difficult issue in the application of the treaty.<sup>101</sup> The OECD Model requires a CIV to be a beneficial owner of capital gains<sup>102</sup> as well as dividends<sup>103</sup> and interest<sup>104</sup> in order to enjoy tax treaty benefit. To satisfy the beneficial ownership requirement, the managers of the CIV must have discretionary powers to manage the assets generating such income.<sup>105</sup> However, most countries are reluctant to recognize a fund to be the beneficial owner of such incomes because the income is mandatorily distributed or passed through to the investor, rather than remaining in the CIV pursuant to the managers’ discretion.<sup>106</sup>

In sum, the existing studies have tried to award treaty benefits to CIVs, but they have not found fundamental solutions under the existing rules. Moreover, the existing literature merely suggests the principle that there should be relief to investors when a fund fails to receive treaty benefits. However,

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97. Article 4 section 1 of the OECD Model defines the resident of a contracting state as “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.” See OECD Model 2010, *supra* note 65, art. 4, § 1.

98. The OECD CIV Report and the Commentary on Article 1 of the OECD Model support the same position. *Commentaries on Model 2010*, *supra* note 49, para. 6.11, at C(1)-6.

99. *Id.* para. 6.12, at C(1)-7.

100. See *id.* para. 6.13, at C(1)-7; see also Ed & Bongaarts, *supra* note 95, at 44, 45.

101. Ed & Bongaarts, *supra* note 95, at 45.

102. See OECD Model 2010, *supra* note 65, art. 13. Although the language of Article 13 does not contain this beneficial ownership requirement, it is hard to doubt that such requirement is also applicable to capital gains. See Ed & Bongaarts, *supra* note 95, at 45.

103. See OECD Model 2010, *supra* note 65, art. 10.

104. See *id.* art. 11.

105. OECD, *Commentaries on Model 2010*, *supra* note 49, para. 6.14, at C(1)-7.

106. See Ed & Bongaarts, *supra* note 95, at 45–46.

these studies have fallen short of making detailed proposals with respect to what such relief should involve.

## 2. Existing Rule for Non-CIVs

Non-CIVs often involve multiple-tier structures with various legal entities. Investment portfolios are generally less diversified than CIVs, and they are also generally subject to less strict regulations.<sup>107</sup> These characteristics distinguish non-CIVs from CIVs. Thus, a separate study is required for the question of whether PEFs, hedge funds, trust-types, or corporate-types of investment vehicles are entitled to treaty benefits and, if so, how to treat them.<sup>108</sup>

Nevertheless, there remains a shortage of studies on the issue, save for the OECD reports on real estate investment trusts (REITs),<sup>109</sup> sovereign wealth funds,<sup>110</sup> and the recent discussion draft on non-CIV funds.<sup>111</sup> Given the dearth of relevant research and the lack of rules applicable to non-CIVs, the existing three-prong test, which requires a fund to be a legal person, a resident, and the beneficial owner of the foreign income it receives,<sup>112</sup> still needs to be applied. However, under this rule, most non-CIVs are not entitled to treaty benefits even where some or all their investors would qualify if the investment were held directly.

Few existing studies have attempted to discuss this issue. Some have argued that the investors, not the fund, should be treated as beneficial owners of the income,<sup>113</sup> and the source country should deny the alleged residency of the fund.<sup>114</sup> Others have proposed to treat a fund as a conduit and disregard

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107. See, e.g., Kim, *supra* note 8, at 443.

108. See *id.* at 447.

109. See generally OECD, TAX TREATY ISSUES RELATED TO REITs: PUBLIC DISCUSSION DRAFT (2007), <https://www.oecd.org/ctp/treaties/39554788.pdf> [<https://perma.cc/MSP8-7BLF>].

110. See generally OECD, DISCUSSION DRAFT ON THE APPLICATION OF TAX TREATIES TO STATE-OWNED ENTITIES, INCLUDING SOVEREIGN WEALTH FUNDS (2009), <http://www.oecd.org/ctp/treaties/44080490.pdf> [<https://perma.cc/6NY8-TFYG>].

111. See OECD, DISCUSSION NON-CIV EXAMPLES, *supra* note 28, at 1–2.

112. OECD, CIV REPORT, *supra* note 26, at R(24)-2.

113. See, e.g., STEF VAN WEEGHEL, THE IMPROPER USE OF TAX TREATIES: WITH PARTICULAR REFERENCE TO THE NETHERLANDS AND THE UNITED STATES 91 & n.214. (1998).

114. See OECD, PARTNERSHIP REPORT, *supra* note 25, at R(15)-9; cf. MICHAEL LANG, THE APPLICATION OF THE OECD MODEL TAX CONVENTION TO PARTNERSHIPS: A CRITICAL ANALYSIS OF THE REPORT PREPARED BY THE OECD COMMITTEE ON FISCAL AFFAIRS 40–41 (2000).

it under the substance-over-form doctrine of domestic tax law.<sup>115</sup> Although such studies try to overcome the current limitation by using one of the three prongs of the existing rules, none of them suggest a coherent and all-encompassing approach covering all three requirements.

### 3. *Paradigm Cases in Bilateral Jurisdictions: Country of Source and Country of Residence*

Despite these flaws, the existing rule generally works if the fund investment structure spreads across only two countries—in a bilateral situation—and tax neutrality between direct investment and indirect investment is accomplished. This is not a surprising result when one recalls that the existing international tax rules and principles were initially developed based on bilateral solutions.

In our paradigm cases, the border may exist in the following three scenarios: (1) between the target company and the SPC (Paradigm Case 2.1), (2) between the SPC and the pass-through vehicle (Paradigm Case 2.2), and (3) between the pass-through vehicle and the investors (Paradigm Case 2.3). To simplify the analysis, let us assume there is a tax treaty between Country A and Country B, and both countries have a tax system treating a pass-through entity as a non-taxable entity.

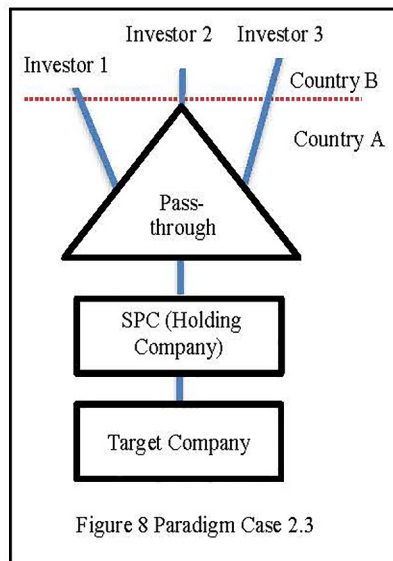
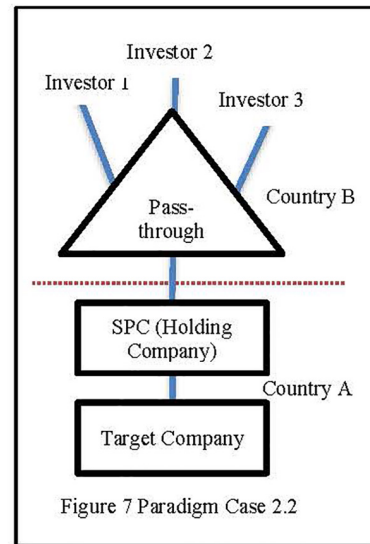
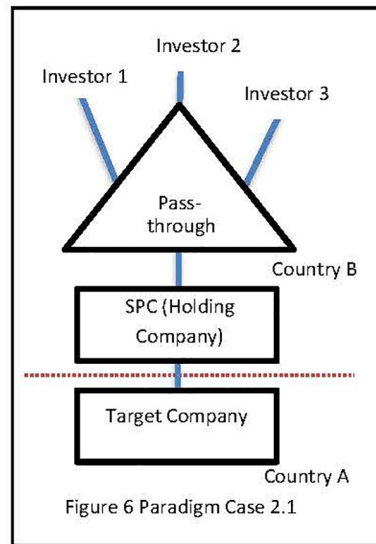
In Paradigm Cases 2.1 and 2.2, it is not certain whether the SPC or the pass-through entity are entitled to the treaty benefits discussed above. However, such a problem is not critical in these two cases. As long as the pass-through entity and the SPC are not subject to entity-level taxation in domestic tax, all investors behind the investment vehicle are the residents of Country B, where the pass-through vehicle has been established.<sup>116</sup> As a result, there remains no further international tax consequences between the pass-through vehicle and the investors. Therefore, international tax issues—such as which country has tax jurisdiction for certain income arising from the target company; whether the source country could withhold tax on such income; how much the tax rate would be; et cetera—would be resolved by tax treaty.<sup>117</sup> In addition, the tax consequences between the

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115. See, e.g., *Aiken Indus., Inc. v. Comm’r*, 56 T.C. 925, 925 (1971). Some commentators see this case as an example of invoking judicial doctrines under domestic law, while others see this as a teleological interpretation of tax treaties. With respect to the former argument, see WEEGHEL, *supra* note 113, at 61–62. With respect to the latter argument, see René Matteotti, *Interpretation of Tax Treaties and Domestic General Anti-Avoidance Rules—A Skeptical Look at the 2003 Update to the OECD Commentary*, 33 INTERTAX 336, 347–49 (2005).

116. See OECD, PARTNERSHIP REPORT, *supra* note 25, at R(15)-8, -13 to -14.

117. See Andrew P. Morriss & Lotta Moberg, *Cartelizing Taxes: Understanding the OECD’s Campaign Against “Harmful Tax Competition,”* 4 COLUM. J. TAX L. 1, 27 (2012).



pass-through entity and the investors remain basically domestic matters.<sup>118</sup> In most cases, there exists no additional tax liability or consequence incurred between them due to the partnership tax regime. In other words, the tax consequences of Paradigm Cases 2.1 and 2.2 are the same as when each investor in Country B directly invests in the target company in Country A. This means there exists tax neutrality between direct investment and indirect investment.

Moreover, Paradigm Case 2.3 does not involve the treaty entitlement problem of investment vehicles. Cash flow from the target company to the pass-through vehicle remains a domestic tax matter.<sup>119</sup> However, the SPC or pass-through vehicle gets either disregarded for tax purposes or labeled as a non-taxable entity.<sup>120</sup> The income received by the SPC and pass-through vehicle would be attributed to the investors abroad,<sup>121</sup> which entails international tax analysis, such as withholding taxes and treaty application. However, because the target company, SPC, and pass-through vehicle are in the same jurisdiction, Country A will be considered a source country regardless of the international tax implications. The tax treaty between Country A and Country B will thus be applicable. The tax consequences for the investors in Country B are the same as they would be in the case where such investors directly invest in the target company in Country A.

In short, the investors in Country B in Paradigm Cases 2.1–2.3 would be in the same tax position as they would be in the case where such investors directly invest in the target company in Country A. That leads to the conclusion that there would be neutrality between direct and indirect investment in a bilateral structure.

### *C. Problems in Multinational Structure*

In the multinational setting, at least three countries are involved: the country where the target company is established (source country), the country where investors are located (residence country),<sup>122</sup> and the country where the investment vehicle is located. To simplify the analysis, I will assume the income distributed by the target company is in the form of passive income, such as dividends and capital gains. The analysis here will follow the flow

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118. See Jeffrey M. Colon, *Foreign Investors in U.S. Mutual Funds: The Trouble with Treaties*, 35 VA. TAX REV. 483, 525 (2016).

119. See *id.*

120. See Birmingham & Bandoblu, *supra* note 43, at 18.

121. See Kim, *supra* note 8, at 421, 424–25.

122. Having assumed that there are more than three investors in the paradigm cases, it is possible that each investor would be in three different countries to diversify the country of residence as well. However, unless it is necessary, the analysis on the investor level will be rendered for one jurisdiction among them.



of cash, starting from the target in Country A through the pass-through entity in Country B to the investors in Country C.<sup>123</sup>

The first problem in a multinational setting is treaty shopping. The analysis of tax structures in a multinational setting is different from that in bilateral setting in two ways. First, there could be multiple tax treaties potentially available in the structure, unlike in a bilateral setting. Those tax treaties are not identical, and they may offer different treaty benefits to investors. As a result, investors may be motivated to choose a more favorable tax treaty. Second, it is neither possible nor practical to assume that each country has an identical domestic tax law for pass-through taxation. That leads to a possibility that, although an investment vehicle is in substance fiscally transparent or a business conduit, it can be treated as an entity that can claim treaty benefits. The combination of these two variations gives rise to the potential for treaty shopping.

In addition to the treaty shopping, two additional problems loom large in a multinational setting. One is the lack of transparency in tax information that occurs in small-island tax havens, such as the Cayman Island, Bermuda, and the British Virgin Islands (BVI).<sup>124</sup> The other problem is the hybrid mismatch opportunity posed by European intermediary jurisdictions, such as Luxembourg, the Netherlands, and Belgium.<sup>125</sup> Traditionally, the three types of jurisdictions, which offer tax information secrecy, hybrid mismatch opportunities, and treaty shopping, are collectively called tax havens because often a tax haven offers more than one opportunity at the same time.<sup>126</sup> However, the lumped terminology of a tax haven does not help to analyze each type of problem accurately, considering that the function of the three opportunities is different from each other.

### *1. Paradigm Case 3.1: Country Where Pass-Through Vehicle Is Located*

Ironically, this case may be the least tax-motivated transaction. In the single jurisdictional frame, Paradigm Case 1.1 is, in effect, tax-motivated because it uses a vehicle not subject to entity-level taxation. However,

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123. I also assume that the residence country of investors has a worldwide tax system of international taxation, where its resident is subject to tax on all its active income earned abroad or domestically.

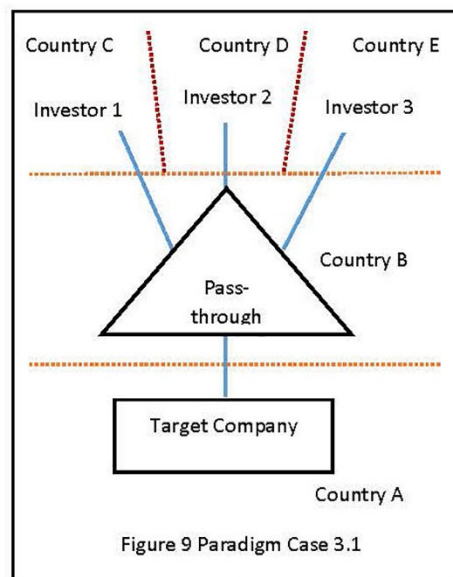
124. See Johannesen & Zucman, *supra* note 24, at 66–68.

125. See *id.*

126. See, e.g., *id.*

once a pass-through tax regime is given, the function of this vehicle in multinational jurisdictions becomes mainly financial.<sup>127</sup> In fact, the use of a pass-through vehicle is desirable to pool investor capital from multiple countries to fund a project in a third country.<sup>128</sup> This tactic can be beneficial for shareholder-level diversification and, in some cases, for achieving threshold levels of capital to fund a project. Furthermore, it may make sense to locate an intermediary capital-pooling entity in a third country unrelated to the shareholders or the location of investment. This is not about avoiding residence country taxation so much as avoiding extra tax cost.<sup>129</sup>

Whatever the financial motive, the tax consequence of Paradigm Case 3.1 is nonetheless very different from that of Paradigm Cases 1.1 in a single jurisdiction or 2.1 in bilateral jurisdictions. I will analyze Paradigm Case 3.1 with two scenarios: one with a tax treaty between Countries A and B and the other without one.



127. See, e.g., MARPLES, *supra* note 15, at 3–4 & 3 n.8.

128. See Kim, *supra* note 8, at 443.

129. It is intended not to bring on “extra” tax cost relative to aggregate tax cost if each investor just held investment in the source country directly without pooling capital.

*a. When There Is a Tax Treaty Between Two Countries*

Let us assume that in Paradigm Case 3.1, an investor is a resident of Country C, which happens to have a tax treaty with Country A. Country A also has a tax treaty with Country B, where the pass-through vehicle is located. Whether the pass-through entity is entitled to treaty benefits under the tax treaty between Countries A and B depends on the traditional three-prong test: whether the pass-through entity is a person, a resident, and a beneficial owner of the income it receives.<sup>130</sup> In a multinational structure, it is not certain, again, whether the pass-through entity is entitled to treaty benefits, particularly under the residency requirement.<sup>131</sup>

Assuming that Country B provides a pass-through tax regime for the pass-through vehicle, it is more likely that the pass-through entity is not entitled to the treaty benefits. The problems arise at this point as to the investors. Some source countries treat such a case as a non-treaty case and apply their domestic tax laws, mostly at a much higher tax rate than the usual domestic tax rate or treaty rate.<sup>132</sup> Had the investor in Country C invested in a target company in Country A directly, the investor would have been entitled to treaty benefits under the tax treaty between Countries A and C. However, when an investor invests in the target company through a pass-through vehicle in Country B, the investor is put in a worse position by not being entitled to any treaty benefits because of the bilateral structure of the treaty arrangements. This result harms the goal of tax neutrality between direct investment and indirect investment.

However, such a policy—treating this scenario as a non-treaty case—has a logical flaw. If the source country denies treaty benefits to the pass-through entity because it is a fiscally transparent entity, it means that the source country does not treat the pass-through entity as a taxpayer on the income. In that case, the source country should have determined who the real taxpayer is instead of just dropping this case from further tax analysis.

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130. OECD, CIV REPORT, *supra* note 26, at R(24)-2.

131. See *supra* notes 98–100 and accompanying text.

132. For example, even if treaty benefits will be available to reduce the withholding tax on payments of U.S. source income made to foreign pass-through or hybrid entities, the United States may deny such benefits and tax the income at a full 30% withholding tax unless the recipients furnish sufficient documentation to prove that they are the beneficial owner. See I.R.C. § 894(c) (2012); 26 C.F.R. §§ 1.1441-1, -5 (2017).

*b. When There Is No Tax Treaty Between Two Countries:  
Small-Island Tax Havens and Tax Secrecy*

In the second scenario of Paradigm Case 3.1, no tax treaty exists between Countries A and B. Typically, Country B is a small-island tax haven, such as the Cayman Islands, Bermuda, BVI, et cetera. These countries have few tax treaties with the rest of the world and have a pass-through tax regime, exempting foreign-source income from taxation.<sup>133</sup> Most importantly, these countries provide strong forms of secrecy.<sup>134</sup>

If Country A treats the pass-through entity as a fiscally transparent entity, the problems are basically similar to those where the pass-through entity is not entitled to treaty benefits in the first scenario. Some source countries treat such a case as a non-treaty situation and just apply their domestic laws, mostly at a much higher tax rate than the usual domestic tax rate or treaty rate. However, the same logical flaw exists here,<sup>135</sup> and, again, the goal of tax neutrality between direct taxation and indirect taxation cannot be achieved.

What is worse in the second scenario is that Country A, and even Country C, is not likely to be able to figure out who the real taxpayer is due to the nontransparency of Country B. These countries provide strict bank secrecy laws, making it nearly impossible for foreign countries to identify investors

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133. For example, the Cayman Islands does not have a tax treaty with any country, nor does it levy corporate income tax or any type of direct taxation on income earned offshore. See OECD, GLOBAL FORUM ON TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES: CAYMAN ISLANDS 2017 (SECOND ROUND) 24 (2017), [https://read.oecd-ilibrary.org/taxation/global-forum-on-transparency-and-exchange-of-information-for-tax-purposes-cayman-islands-2017-second-round\\_9789264280168-en#page1](https://read.oecd-ilibrary.org/taxation/global-forum-on-transparency-and-exchange-of-information-for-tax-purposes-cayman-islands-2017-second-round_9789264280168-en#page1) [<https://perma.cc/E7X5-YRMS>]; TAX JUSTICE NETWORK, FINANCIAL SECRECY INDEX 2018: NARRATIVE REPORT ON CAYMAN ISLANDS 13 (2018), <https://www.financialsecrecyindex.com/PDF/CaymanIslands.pdf> [<https://perma.cc/39TB-GLSV>].

134. See, e.g., William J. Moon, *Regulating Offshore Finance*, 72 VAND. L. REV. 1, 24, 48 (2019). To understand how the Cayman Islands' local laws are designed to protect banking privacy, see OECD, *supra* note 133; TAX JUSTICE NETWORK, *supra* note 133. The Tax Justice Network releases the Financial Secrecy Index of various countries and full data on each country in the list, available at <http://www.financialsecrecyindex.com> [<https://perma.cc/4MBP-NWNE>].

135. If the source country treats the pass-through entity as a fiscally transparent entity, it means that it does not treat the pass-through entity as a taxpayer on the income, so it should determine who the real taxpayer is first. If the real taxpayer is a resident of Country A, it would be a round-tripping case, where the income is derived through an offshore non-CIV that is not a resident of the source country but such income is attributed to a resident of the source country. If, however, the real taxpayer is a resident of Country C, which happens to have a tax treaty with Country A, it is not clear whether the treaty between Countries A and C would be applicable. If it is not applicable, investors in Country C would be put in a worse position than the one they would be in had they invested in a target company in Country A directly.

in the vehicles domiciled in their jurisdiction.<sup>136</sup> Had Country B entered into tax treaties with Country A or C containing a tax information exchange provision, Country A or C might invoke that provision to seek tax information relating to the vehicle. However, at present, Country B has not entered into such tax treaties with the rest of the world.

To overcome the lack of a treaty network with jurisdictions like Country B, the OECD Global Forum Working Group on Effective Exchange of Information released the Model Tax Information Exchange Agreements (TIEAs) in 2002.<sup>137</sup> These model agreements allow international cooperation for exchanging tax information between competent authorities.<sup>138</sup> There are currently more than 500 TIEAs, and the United States has entered into TIEAs with most of the small-island tax havens.<sup>139</sup> However, the scope of information exchange is mostly limited to specific requests relating to an already-initiated tax investigation. As such, the TIEAs are still not effective tools for exchanging broader information, such as a financial accounting or identity of investors in the vehicles domiciled in Country B.

## 2. *Paradigm Case 3.2: Country Where Holding Company Is Located*

### a. *Treaty Shopping*

When an SPC or holding company is interposed in a jurisdiction—Country B—different from the jurisdictions of investors and the target company, Country B almost always has an extensive treaty network. It also almost always provides a holding company with a tax regime to maximize treaty benefits. Therefore, Paradigm Case 3.2 exists as a more tax-oriented structure in a multinational setting. Country B is often called a “conduit jurisdiction.”<sup>140</sup> The distinction between a real tax avoidance case and a business conduit case becomes blurred here.

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136. See Moon, *supra* note 134, at 43.

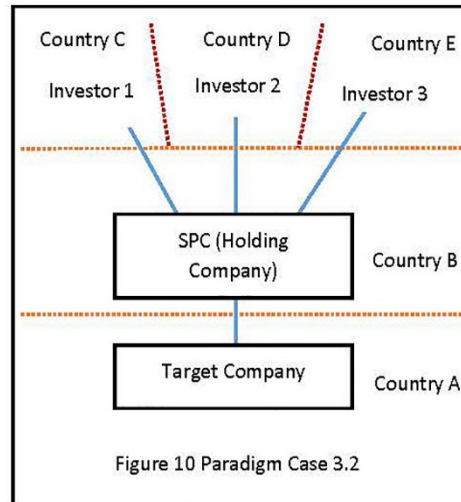
137. OECD, TAX INFORMATION EXCHANGE AGREEMENTS (TIEAs), <http://www.oecd.org/ctp/exchange-of-tax-information/taxinformationexchangeagreementsticias.htm> [https://perma.cc/GQ44-ZQH8].

138. See *id.*

139. See *id.*

140. See Javier Garcia-Bernardo et al., *Companies Use These Countries to Reach Tax Havens*, U.S. NEWS (Jul. 25, 2017, 10:55 AM), <https://www.usnews.com/news/best-countries/articles/2017-07-25/these-countries-are-conduits-for-the-worlds-largest-tax-havens> [https://perma.cc/JMQ6-9YB5].

It would be fair to assume in Paradigm Case 3.2 that there is a tax treaty between Countries A and B. Typical examples of Country B are Belgium, the Netherlands, Luxembourg, Ireland, and Mauritius, all of which offer more favorable tax treaty benefits than the direct investment model.<sup>141</sup> Treaty shopping is a form of terminology used to describe the behavior of investors that select those countries with favorable tax treaty benefits.<sup>142</sup>



Whether the holding company is entitled to treaty benefits depends on the three requirements under the traditional rule: that is, again, whether it is a person, resident, and beneficial owner of the income it receives. In contrast to the pass-through entity in the Paradigm Case 3.1, the SPC is a corporation subject to comprehensive taxation in Country B. As a result, it is more likely to meet the first two requirements: status as a legal person, and as a resident of Country B.<sup>143</sup> However, as the SPC is a conduit, it is not certain whether it is entitled to treaty benefits, particularly given the beneficial ownership requirement.

Until the late 1980s, countries were generous in admitting such holding companies as beneficial owners of income received from the source

141. Ilan Benshalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method*, 28 VA. TAX REV. 619, 648 (2009); *Tax Treaties*, TAX JUST. NETWORK, <https://www.taxjustice.net/topics/corporate-tax/tax-treaties/> [https://perma.cc/J969-24XK].

142. Grady, *supra* note 72, at 627.

143. See OECD, CIV REPORT, *supra* note 26, at R(24)-2.

country.<sup>144</sup> However, most countries, especially source countries whose treaties with the conduit jurisdiction are at issue, became reluctant to recognize such holding companies as beneficial owners of the income.<sup>145</sup> Furthermore, the OECD report on the use of conduit companies<sup>146</sup> and the Commentaries on the Articles of the OECD Model implied that granting treaty benefits to a holding company that is merely a conduit may be inconsistent with the object and purpose of the tax treaty.<sup>147</sup>

*b. Hybrid Mismatch that Eliminates a Holding Company's Tax Liability*

Treaty shopping is widespread in international tax practice. It is relatively easy for governments and tax professionals to understand. However, the holding company regime in intermediate jurisdictions has been mysterious, except to a handful of experts. It is quite rare to see materials that explain such regimes. This lack of understanding has been a major obstacle in analyzing the overall tax consequences of non-CIV transactions. Therefore, it would be useful to introduce how the actual holding company regime works in the real world.

One of the most popular holding company regimes is the *société de participation financière* (SOPARFI) of Luxembourg.<sup>148</sup> This regime offers a “participation exemption” that eliminates domestic entity-level tax on dividends and capital gains received from its subsidiary if the SOPARFI

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144. See OECD, *Double Taxation Conventions and the Use of Conduit Companies*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 2010, *supra* note 25, at R(6)-1, R(6)-2 [hereinafter OECD, CONDUIT REPORT]. The OECD Conduit Report was originally adopted by the OECD Council in 1986 to deny treaty benefits for an entity “with the main or sole purpose of obtaining treaty benefits which would not be available directly to such [entity].” *Id.* Countries were especially willing to make this designation when the holding company had discretionary power to manage the investment independent from the investors.

145. See *id.* at R(6)-2 (explaining that the tax advantages that a conduit company enjoys is detriment to the source country).

146. See generally OECD, CONDUIT REPORT, *supra* note 144.

147. OECD, *Commentaries on Model 2010*, *supra* note 49, para. 12, at C(10)-3.

148. Julien Bieber, Gaëlle Auger & Linda Taing, *Private Equity Structuring in Luxembourg—Key Tax Aspects*, in 38 TAX PLAN. INT’L REV. 11, 12–13 (2011). For the holding company regime in Luxembourg, thanks to Johan Léonard (N.Y.U. School of Law, LL.M. in International Taxation 2014). This Part could not have been completed without his helpful comments and explanation. Interview with Johan Léonard, Partner, NautaDutilh, in N.Y.C., N.Y. (Feb. 21, 2014).

holds 10% or more ownership in the subsidiary.<sup>149</sup> It also provides flexible, thin capitalization rules<sup>150</sup> and hybrid instruments.<sup>151</sup>

Assuming Country A in Figure 10 is Belgium and Country B is Luxembourg, the dividend distributed by the target company is also subject to a 0% withholding tax rate under the Belgium-Luxembourg tax treaty.<sup>152</sup> As such, the tax on the SOPARFI's income is not triggered in the source country.

Furthermore, tax obligations cannot be triggered on the income repatriated by the SOPARFI to its foreign investors, such as in the United States. SOPARFIs have to comply with a flexible thin capitalization rule, which requires a debt/equity ratio of 15% equity to 85% debt,<sup>153</sup> or alternatively 1% equity, 14% interest-free loan usually in the form of Convertible Preferred Equity Certificates (CPEC), and 85% interest-bearing loan, which is usually in the form of Preferred Equity Certificates (PEC).<sup>154</sup> If the debt ratio exceeds the above-mentioned ratio, interest on that excess debt will be treated as dividend subject to Luxembourg's 15% withholding tax.<sup>155</sup> However, as long as the specified debt/equity ratio is met, all repatriation of returns on investment to the investors is not subject to Luxembourg withholding tax under domestic tax law, regardless of the treaty benefits between Luxembourg and the residence countries of investors.<sup>156</sup>

Going back to the 85:15 debt/equity ratio, or the alternative 1% equity/14% CPEC/85% PEC capital structure, both CPECs and PECs are hybrid instruments. From the U.S. perspective, PEC and CPEC are both equity,

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149. Bieber, Auger & Taing, *supra* note 148, at 12. Participation exemption does not exempt tax on interest income from a loan extended to the subsidiary. However, that interest received can be effectively offset by interest payments out of interest-bearing loans to the shareholders, as long as the SOPARFI retains a small amount of taxable margin at 8 ~ 20 basis points (bps), or 0.08 ~ 0.2%, and only such small margin will be subject to the normal Luxembourg corporate tax rate—29.22%. Interview with Johan Léonard, *supra* note 148.

150. When a company is financed through a mixture of debt and equity, it often prefers debt to equity because interest payments are deductible whereas dividends are not. Thin capitalization rules aim to administer an adequate level of debt/equity ratio and deny deduction of certain interest payment of a company, if a company is financed through a relatively high level of debt compared to equity. See Mitchell A. Kane, *A Defense of Source Rules in International Taxation*, 32 YALE J. ON REG. 311, 344 (2015).

151. Bieber, Auger & Taing, *supra* note 148, at 12–13. See generally Omri Marian, *The State Administration of International Tax Avoidance*, 7 HARV. BUS. L. REV. 1 (2017).

152. Agreement for the Avoidance of Double Taxation and the Regulation of Certain Other Matters with Respect to Taxes on Income and Fortune, Belg.-Lux., art. 10, § 1, Sept. 17, 1970, 870 U.N.T.S. 12503.

153. Marian, *supra* note 151, at 28.

154. See OGIER, LUXEMBOURG: STRUCTURING AND FINANCING PRIVATE EQUITY AND VENTURE CAPITAL TRANSACTIONS (2017), <https://www.ogier.com/media/brochures/ogier-structuring-and-financing-private-equity-and-venture-capital-transactions.pdf> [<https://perma.cc/8KZC-N5AH>].

155. Marian, *supra* note 151, at 28.

156. See *id.*



not debt, while from the Luxembourg perspective, both PEC and CPEC are debt, the return of which is interest and deductible, although there would be no return for CPEC because it is an interest-free loan.<sup>157</sup> One caveat is that CPEC is considered as equity only for the purpose of the 85:15 debt/equity ratio in Luxembourg.<sup>158</sup>

The last puzzle of the capital structure is the 1% equity, the dividend payment on which is in principle subject to 15% Luxembourg withholding tax, unless there is a more favorable tax treaty between Luxembourg and the residence country of investors who receive dividend. However, such tax again can be eliminated by using “alphabet classes of shares.”<sup>159</sup>

In sum, in Figure 10, there is no remaining tax liability in the whole picture, except corporate tax of the target company to the source country Belgium, income tax of the investors in their own residence country the United States, and the Luxembourg corporate income tax of the holding company with respect to the interest income, which is not exempt under the participation regime.

However, this final amount paid to Luxembourg is nominal.<sup>160</sup> By providing hybrid mismatch in back-to-back structure, the holding company is, in effect, not liable to pay tax on the income it receives.<sup>161</sup> It pays a nominal amount

157. The benefits of the hybrid nature of PEC and CPEC are not limited to Luxembourg taxation. Because the residence countries of investors, such as the United States, usually provide more favorable tax treatment to dividend income than interest income, it is more beneficial for investors' tax position as well. *See* Bieber, Auger & Taing, *supra* note 148, at 13. The equity treatment of the hybrid instrument would be considered as benefits from the investors' standpoint in the multinational fund investment structure. However, considering that such investors would have held plain equity in a direct investment situation, investors are motivated to hold such hybrid instrument to neutralize their tax position in the residence country in indirect investment.

158. OGIER, *supra* note 154.

159. To be specific, if, for example, a SOPARFI is supposed to receive income annually from its subsidiary for ten years and it should repatriate corresponding income to its foreign investors, it issues ten classes of alphabet stock, Class A through Class J, and liquidates a whole stock of one class annually in turn, instead of paying dividend to investors, until the stocks are exhausted. Because such partial liquidation is not subject to Luxembourg withholding tax, and because the life span of PEFs is around a decade, this strategy will effectively eliminate the withholding tax on the dividend income.

160. Assuming that investors invest \$100 in the holding company, \$85 of which would be in the form of PEC. If the holding company extends a back-to-back loan by using such PEC to the target company at the interest rate of 10%, it should retain at least 8 bps margins, so the interest rate of PEC would be 9.92%. Hence, only \$0.068 (0.08% of \$85) is annually subject to Luxembourg income tax, not to mention the various mechanisms to eliminate tax on the inbound and outbound cash flow. \$0.068 is very small figure even if we conservatively assume the rate of return at the level of the holding company as \$10 (10% of \$100).

161. *See, e.g.,* Marian, *supra* note 151, at 38.

on the small spread under the name of “income tax” to Luxembourg, but in substance, this amount is more like a “fee” for the service and system that Luxembourg provides, not an income tax.<sup>162</sup> Omri Marian recently demonstrated that this small spread depends on the “face amount” passing through Luxembourg from source country to residence country, not on the income.<sup>163</sup> To attract more investors and money flow through Luxembourg, the fee is even discounted if the gross amount flowing through Luxembourg increases.<sup>164</sup>

*c. When the Treaty Benefits Are Denied*

In the above example, the holding company is, in effect, not liable to pay tax on the income it receives. The only exception is a small taxable amount in proportion to the face amount flowing through the country where it is located.<sup>165</sup> Because this nominal tax is, in substance, a fee rather than income tax, it is fair for some source countries to argue that such a holding company would not be entitled to the treaty benefits under the treaty between Countries A and B because it is not the beneficial owner of the income.

The problems arise at this point, just as in Paradigm Case 3.1. There is no coherent rule or practice in the current international tax regime when the tax treaty between Countries A and B is not applicable. Some source countries treat this situation as a non-treaty case and apply their domestic laws.<sup>166</sup> They mostly do so at a much higher tax rate than the usual domestic tax rate or treaty rate.<sup>167</sup> However, once the tax authorities of the source countries deny the treaty benefits, they do not care about the further tax consequences.<sup>168</sup> Issues exist with respect to whether the source country should find a true beneficial owner of the income, recast the transaction

162. *Id.* at 29.

163. *See id.* at 38.

164. *See id.* at 37–38.

TABLE 3 – MARGINS CHARGED BY LUXEMBOURG	
Face Amount Financed through Luxembourg (in EUR millions)	Taxable Margin
< 25	0.25%
25 to 187.5	0.125%
187.5 to 500	0.09357%
500 to 1,250	0.0625%
1,250 to 6,250	0.03125%
> 6,250	0.015625%

*Id.* at 38.

165. GUSTAFSON, PERONI & PUGH, *supra* note 18, at 311.

166. *See* Birmingham & Bandoblu, *supra* note 43, at 18.

167. *See, e.g., id.* at 19.

168. *See* Rebecca M. Kysar, *Interpreting Tax Treaties*, 101 IOWA L. REV. 1387, 1419–20 & 1420 n.205 (2016).

accordingly, and think about the tax consequences according to the recast transaction.

The OECD Commentary suggests as a solution that if the holding company is denied the status of beneficial owner, the beneficiary who is a resident of a third country, Country C, will be able to enjoy the treaty benefits under the tax treaty between the source country, Country A, and the third country, Country C, if there is such a treaty.<sup>169</sup> Although the OECD Commentary does not mandate the provision of treaty benefits between the payer and the beneficial owner, this position may serve the goal of tax neutrality between direct investment and indirect investment.

It is fair to ask, however, whether it is legitimate to pursue tax neutrality by applying a treaty between Countries A and C here. Clearly, Paradigm Case 3.2 is more likely to be related to tax avoidance by claiming more favorable benefits under the treaty between Countries A and B. Some might argue that such a tax-avoiding transaction deserves a tax position that merely denies treaty benefits with no further analysis. This position would, in effect, operate as a penalty on investors.

Nevertheless, such an argument is incomplete and perhaps a bit irresponsible. In the case of domestic tax law, if transactions are challenged by tax authorities and recast into a legitimate transaction, subsequent tax adjustment, taking into account the identity of the beneficial owner of the income derived from the transaction, is followed.<sup>170</sup> The final tax liability would be heavier than the original transaction in most cases, although that is not always the case.<sup>171</sup> But once it is determined that there is a tax avoidance, tax consequences are determined based on such a recast transaction in a logical and coherent way.<sup>172</sup> The lack of such subsequently adjusting rules ex ante in international tax is a huge defect as a complete system.

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169. See OECD, *Commentaries on Model 2010*, *supra* note 49, para. 12.2, at C(10)-4; para. 11, at C(11)-8; para. 4.2, at C(12)-2.

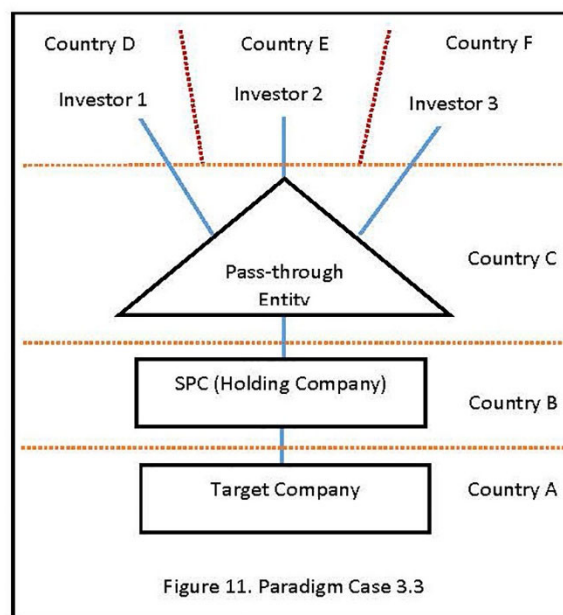
170. Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465, 475 (2011).

171. Sometimes the recast transaction results in similar or even lesser tax liability than the original transaction does. However, the change of tax liability in a less severe way is a factor to determine whether there is tax avoidance in the first place. *Id.* at 475–76.

172. See *id.* at 475–76, 483. As a matter of fact, the domestic tax codes have penalty provisions, so the risk of less severe tax liability could be mitigated by the imposition of tax penalty provisions. Scott D. Michel, Zhanna A. Ziering & Young Ran Kim, *U.S. Offshore Account Enforcement Issues*, 16 J. TAX PRAC. & PROC. 49, 50 (2014).

### 3. Paradigm Case 3.3: Combined Structure

The third paradigm case in a multinational setting is the combination of Paradigm Cases 3.1 and 3.2. This scenario may be the most realistic non-CIV structure as is shown in Figure 2. The problems are also compounded in this case.



First, the holding company is typically a conduit located in the intermediate jurisdiction.<sup>173</sup> The holding company is not likely to pay the entity-level taxation in effect to Country B. This lack of payment eliminates tax consequences on inbound and outbound cash flow, and it converts the character of income to get a more favorable tax treatment in the investor countries.<sup>174</sup> Furthermore, there is almost always a very favorable tax treaty between Countries A and B. The treaty benefits under the treaty between Countries A and B are, in most cases, more favorable than the treaty benefits under the treaty between Countries A and D. Moreover, there are often multiple layers of holding companies in multiple jurisdictions.<sup>175</sup> Those holding companies

173. See OECD, *Commentaries on Model 2010*, *supra* note 49, at C(23)-4.

174. See *supra* Section III.C.2.

175. See *supra* Figure 2.

are designed not to trigger taxes, and some are used to advance third-party loans other than shareholder loans.<sup>176</sup>

Second, the pass-through vehicle is designed for pooling capital from investors in various countries. Sometimes the pass-through vehicle is established in the same country as some or all investors. Sometimes, however, the pass-through vehicle is established in a different country from that of investors. In the latter case, it is most likely to be a small-island tax haven that provides a pass-through tax regime, a hybrid entity, exemption from tax on foreign source income, and confidentiality.<sup>177</sup> However, Country C is not likely to have a tax treaty with any of the remaining jurisdictions in Figure 11, which breaks the chain of bilateral tax treaties.

In Figure 11, the only production of services and goods happens in the target company in Country A, the source country. The capital for the investment in the target company mostly comes from Countries D, E, and F, except for certain third-party loans. It flows through to Country A. The return arising out of the target company also flows through the vehicles until it reaches investors in Countries D, E, and F. Hence, the whole structure of this non-CIV may, in essence, be accomplishing what would have been accomplished by an indirect investment in a single or bilateral setting—that is, the structure does not trigger any substantial taxes in the middle of the cash flow.

After all, investors often achieve more favorable tax consequences than the tax-neutral benchmark if the tax planning explained above is successfully respected by all relevant countries.<sup>178</sup> However, many tax authorities, especially in source countries, have been challenging such preferential tax consequences of investors by attacking the residency of holding companies or pass-through vehicles.<sup>179</sup> Once they challenge the treaty benefits, tax authorities usually recast the transaction as a non-treaty case, where investors would receive much worse tax consequences than the tax-neutral benchmark. Appendix A briefly shows such results in hypothetical problems.<sup>180</sup>

Furthermore, even if the treaty benefits are not challenged by tax authorities, another problem harms tax-neutral consequences for investors. That is, investors may not use foreign tax credits for the withholding tax paid to

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176. See, e.g., Wells & Lowell, *supra* note 23, at 543–44.

177. See generally Benshalom, *supra* note 141, at 647–48.

178. See, e.g., Grady, *supra* note 72, at 627–28.

179. See LANG, *supra* note 114, at 40–41 (explaining the tension that typically arises between a source and residence country).

180. See *infra* Part VII.

source countries because they are not technically taxpayers liable to such withholding tax.<sup>181</sup> For example, the tax on the dividend income withheld by Country A, the source country, cannot be credited in Country B or C as a foreign tax credit (FTC).<sup>182</sup> This tax on the dividend income cannot be credited because the pass-through entity or holding company is not liable for any taxes to Country B.<sup>183</sup> The investors in Countries D, E, or F are not likely to claim FTC, either, because from the residence country's perspective, the eligible foreign tax for FTC would be the one paid to Country C, or Country B at best, not the one to Country A.<sup>184</sup> This FTC problem also harms tax neutrality in multinational fund investments.

In sum, international tax law does not see the whole structure due to the restriction imposed by the bilateral structure of tax treaties. The source country focuses on the tax analysis with its most adjacent jurisdiction and determines whether the tax treaty between them would be applicable. It does not further analyze matters beyond that point, such as who will be the real taxpayers of the income and what the tax rules should be for them. The residence country focuses on tax rules for repatriating the offshore money.<sup>185</sup> However, there is no overarching approach linking the whole level of taxation under a comprehensive ex ante rule.

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181. GUSTAFSON, PERONI & PUGH, *supra* note 18, at 309.

182. *Id.* at 310.

183. *See, e.g., id.*

184. There are examples of these FTC problems in South Korea. Korean investors in a Korean mutual fund invested in Brazil through a wholly-owned U.S. LLC. National Tax Service [NTS], International Tax Resource Management Office-335 (July 16, 2010) (S. Kor.). The U.S. LLC established a wholly-owned corporate subsidiary in Brazil to invest in the real estate in Brazil. *Id.* The Brazilian subsidiary paid dividend to the U.S. LLC after withholding 15% tax. *Id.* Since the U.S. LLC checked the box to elect to be disregarded for U.S. tax purposes, it cannot claim direct FTC against such withholding tax, which should be available to the Korean investors instead. *Id.* However, Korean tax authorities held that Korean investors may not claim FTC against such withholding tax paid to the Brazilian government, thereby creating a double taxation problem where neither the U.S. LLC nor the Korean investors in U.S. LLC could claim FTCs. *Id.* In contrast, if Country C is the United States, the investor in Country C is likely to claim FTC. GUSTAFSON, PERONI & PUGH ET AL., *supra* note 18, at 309–10.

185. For example, controlled foreign corporation (CFC) rules and passive foreign investment company (PFIC) rules are anti-deferral regimes, aiming to eliminate the economic benefit of deferring U.S. taxes on the foreign-source income until they are repatriated to the United States. I.R.C. §§ 951–65, 1291–98 (2012). For general introduction and overview of the CFC and PFIC, see GUSTAFSON, PERONI & PUGH, *supra* note 18, at 485–93. The Proposal discussed in Section IV.D also intends to tax foreign-source income on a current basis by relying on the pass-through tax system, so both the Proposal and the anti-deferral regimes share the same position in terms of timing perspective. However, as the CFC and PFIC is a top down approach, it has limitations on figuring out the overall structure of the cross-border investment all the way down to the source country if blockers are interposed in the middle of the structure.

Therefore, the investors in non-CIVs structure the transactions too aggressively to exploit the limit of bilateral solutions and sometimes achieve substantially lower tax liability than the tax-neutral benchmark. However, when the source countries challenge the transactions ex post, the tax burdens increase exponentially because the source countries do not consider multinational dimensions of their tax policy.<sup>186</sup> Either case is not desirable.

Under the current bilateral approach, each country, where any vehicle is located, should count and be eligible to exercise tax jurisdiction in principle, even though some intermediary jurisdictions are not exercising it but are merely severing as a blocker of the cash-flow and tax information for international tax purposes. However, the vehicles in such jurisdictions would have been just disregarded or ignored for tax purposes under the pass-through tax regime in domestic tax law. Does every country have enough reason to claim to exercise tax jurisdiction on the investment by non-CIVs just because it is an international transaction? If not, it is time to revisit the existing rules and suggest a new approach fit for a multinational setting.

#### IV. ENGINEERING PASS-THROUGH RULES FOR MULTINATIONAL FUNDS

The previous Part examined the inadequate rules and practices of international taxation for multinational fund investments. To overcome the limited bilateral approach, major trading countries and international organizations have studied and introduced multilateral approaches. This Part reviews those efforts and introduces the Proposal for non-CIVs.

##### A. OECD Partnership Report

The OECD's first effort to address the problem concerning multinational fund investments took place in the 1990s.<sup>187</sup> This approach was directed toward the different treatment of partnerships in an international context and the resulting double taxation or double non-taxation.<sup>188</sup>

Many countries treat partnership as fiscally transparent for tax purposes. However, some countries, such as Belgium and France, treat them as entities

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186. See *infra* Part VII.

187. See generally OECD, PARTNERSHIP REPORT, *supra* note 25.

188. See generally F.A. Engelen & F.P.G. Pötgens, Report on "The Application of the OECD Model Tax Convention to Partnerships" and the Interpretation of Tax Treaties, 40 EUR. TAX'N 250 (2000).

with legal personality and subject them to corporate income tax.<sup>189</sup> The OECD Partnership Report in 1999 focused on such “conflicts of qualification” of, and “conflict of income allocation” to, a partnership.<sup>190</sup> These conflicts represent instances where the source country and residence country interpret or apply a treaty to that partnership in different ways.<sup>191</sup> If an entity is not widely used in the civil or commercial laws of treaty partners, one country could treat the entity as a partnership while the other treats it as a company.<sup>192</sup> This outcome would lead, of course, to different tax results between treaty partners.<sup>193</sup> Focused on these types of issues, the Partnership Report emphasized a better coordination in the application and interpretation of some of the provisions of tax treaties.<sup>194</sup>

The Partnership Report first suggests that if a partnership is liable to tax in a country, it qualifies as a resident.<sup>195</sup> The partnership is thus entitled to treaty benefits. It then suggests entitling individual partners, but not the partnership, to the treaty benefits of the countries where partners are residents to the extent they are liable to taxation on their share of the partnership income in countries where the partnership does not qualify as a resident.<sup>196</sup> When discussing the conflicts of qualifications in greater detail, the Partnership Report suggests that a useful starting point for determining whether a partnership qualifies as a resident for treaty purposes is the principle in the domestic law that governs matters regarding how an item of income is taxed.<sup>197</sup>

Unfortunately, the Partnership Report failed to obtain full support from the OECD member countries. France, Germany, the Netherlands, Portugal, and Switzerland expressed reservations over the proposed changes to the OECD Model Tax Convention.<sup>198</sup> France noted that the proposed criteria of being liable to tax are not sufficient in addressing situations where the entity is hybrid in nature—the entity is partly treated as a taxable unit and partly disregarded for tax purposes.<sup>199</sup> It further disagrees with the conclusion that if treaty benefits to the partnership are refused, the partners would always be entitled to the treaty benefits by their own country of residence.<sup>200</sup> Lastly,

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189. See Jean Schaffner, *The OECD Report on the Application of Tax Treaties to Partnerships*, 54 BULL. FOR INT’L FISCAL DOCUMENTATION 218, 218 (2000).

190. OECD, PARTNERSHIP REPORT, *supra* note 25, at R(15)-3 to -4.

191. See *id.*

192. *Id.* at R(15)-6.

193. *Id.*

194. See *id.* at R(15)-7.

195. *Id.* at R(15)-14.

196. *Id.*

197. *Id.* at R(15)-31; see LANG, *supra* note 114, at 31.

198. OECD, PARTNERSHIP REPORT, *supra* note 25, at R(15)-57 to -62.

199. *Id.* at R(15)-57.

200. *Id.*



France asserted the “administrative difficulties” for implementing the proposed changes.<sup>201</sup> Such problems included the flow of information for partnerships, given that many partners may reside in different nations.<sup>202</sup> Germany shared similar concerns regarding administrative difficulties, noting that “[i]t is an extremely difficult task . . . to attribute the income subject to withholding tax to the partners, because the withholding agent does not know the often very complicated and sometimes even abusive arrangement between the partners on the division of profits (and losses).”<sup>203</sup>

Despite the criticism and reservations, the OECD Committee on Fiscal Affairs adopted the Partnership Report in 1999.<sup>204</sup> The proposed changes were reflected in the OECD Model Tax Convention in 2000.<sup>205</sup>

### B. OECD CIV Report

A decade after it released the Partnership Report, the OECD resumed the discussion on the cross-border investment using pass-through vehicles. This time, the discussion was focused on CIVs, such as mutual funds, and excluded non-CIV funds from its scope.<sup>206</sup> The OECD Model Commentary, followed by the adoption of the CIV Report, suggested roughly four possible provisions modifying the treatment of CIVs.<sup>207</sup> Two of them could be acknowledged as multilateral approaches.<sup>208</sup> Although these suggestions are limited to CIVs, they provide important insights for thinking about a new multilateral approach for non-CIVs.

The first suggestion is the purely proportional approach. It suggests that in the case where a CIV established in Country B receives income arising in Country A, the CIV shall be treated as a resident of Country B.<sup>209</sup> The CIV also may be considered the beneficial owner of the income it receives, but only to the extent that the beneficial interests in the CIV are owned by equivalent beneficiaries.<sup>210</sup> The equivalent beneficiaries include (1) a

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201. *Id.* at R(15)-58 to -59.

202. *See id.*

203. *Id.* at R(15)-59.

204. *Id.* at R(15)-1.

205. OECD Model 2010, *supra* note 65, art. 23A, para 4, at M-52.

206. *See* OECD, CIV REPORT, *supra* note 26, at R(24).

207. OECD, *Commentaries on Model 2010*, *supra* note 49, paras. 6.21 to .34, at C(1)-10 to -17.

208. *See id.*

209. *See id.* para. 6.21, at C(1)-10 to -11.

210. *Id.*

resident of Country B and (2) a resident of any other State, Country C, with which Country A has a tax treaty, who would be entitled under that treaty, or under the domestic law of Country A, to a rate of tax with respect to the particular item of income that is at least as low as the rate claimed under the tax treaty between Country A and Country B by the CIV with respect to that income had the investor received that income.<sup>211</sup>

The effect of this first approach is to achieve the goals of tax neutrality between direct investments and indirect investments through a CIV.<sup>212</sup> At the same time, it may prevent investors from abusing a CIV to achieve a better treaty position than through direct investment, by way of the rate comparison in the definition of the equivalent beneficiary.<sup>213</sup>

However, the CIV Report provides a second prong for the first suggestion, limited by bilateral solutions. If some states prefer the bilateral nature of tax treaties, they may not want to take all treaty-eligible investors, including those in a third country, Country C, into account.<sup>214</sup> In this case, the states “may prefer to allow treaty benefits to a CIV only to the extent that the investors in the CIV are residents of the Contracting State in which the CIV is established,” Country B.<sup>215</sup>

The second suggestion is to provide an ownership threshold for the treaty benefits. It provides that the purely proportional approach may “impose substantial administrative burdens as a CIV attempts to determine the treaty entitlement of every single investor.”<sup>216</sup> Hence, this suggestion considers the rationale that if a substantial portion of the CIV’s investors are treaty-eligible, a contracting state may decide that such CIV is not engaged in treaty shopping. Thus, if an amount is owned in the CIV above a certain ownership threshold by either equivalent beneficiaries or a resident of the country where the CIV is established, the treaty “benefits would be provided with respect to all income received by the CIV.”<sup>217</sup>

The two suggestions have their own distinctive merits. The former reinforces the principle of tax neutrality between direct investment and indirect investment. The latter simplifies the procedures. However, the purely proportional approach seems to be the most genuine multilateral approach. Nonetheless, even that approach does not entirely overcome bilateral solutions because in order for it to function in the multinational domain, there should be tax treaties in every part of the entire structure.

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211. *Id.* para. 6.21(b)(ii), at C(1)-10.

212. *Id.* para. 6.23, at C(1)-11.

213. *Id.* para. 6.24, at C(1)-11.

214. *See id.* para. 6.26, at C(1)-12 to -13.

215. *Id.*

216. *Id.* para. 6.27, at C(1)-13.

217. *Id.*

This approach may not work if a country without a tax treaty, such as a country favored to pose a pass-through entity, is interposed. In addition, it is also a sign of bilateral solutions that the technically applicable tax treaty is the one between the source country and the residence country of the immediate recipient of the income or CIV, although the benefits actually granted are from the treaty between the source country and the residence country of the equivalent beneficiaries. A true multilateral approach should be able to function in the multinational domain even if there is a missing link in the treaty network and even if there is no such device as an equivalent beneficiary clause.

### *C. OECD Non-CIV Discussion*

In 2016, as part of its BEPS project, the OECD began discussing non-CIV funds.<sup>218</sup> The discussion, which continues today as of 2019, remains focused on the treaty entitlement of non-CIV funds rather than their overall problems. However, the suggestions in the Public Discussion Draft from March 2016 (Non-CIV Discussion Draft) show much progress toward a multinational solution. This Article examines two suggestions that are relevant to a multinational solution.<sup>219</sup>

First, the Non-CIV Discussion Draft suggests that if (1) a non-CIV fund is treated as a transparent entity by the residence country of investors and (2) the investor is taxed directly on its share of the income derived through that non-CIV, treaty benefits with respect to that income will be generally available.<sup>220</sup> The benefits will be available at the level of investors under

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218. See, e.g., OECD, NON-CIV DISCUSSION DRAFT, *supra* note 28; OECD, BEPS ACTION 6 DISCUSSION DRAFT ON NON-CIV EXAMPLES, *supra* note 28.

219. OECD, NON-CIV DISCUSSION DRAFT, *supra* note 28, at 10. The Non-CIV Discussion Draft suggests five approaches relating to the limitation on benefits (LOB) provision as follows: (1) suggestion that treaty benefits be granted to regulated or widely held non-CIV funds; (2) suggestion relating to non-CIV funds set up as transparent entities; (3) suggestion that certain non-CIV funds be granted treaty benefits where a large portion of the investors would be entitled to the same or better benefits if they had received the income directly; (4) suggestion that the LOB should not deny benefits to a non-CIV resident of a State with which the non-CIV has a sufficiently substantial connection; and (5) suggestion of a “Global Streamed Fund” regime. See generally OECD, NON-CIV DISCUSSION DRAFT, *supra* note 28. The first suggestion has very limited scope as it applies only to regulated alternative investment funds, which is basically the same solution as the mutual funds. The third and fourth suggestions are either similar to the existing solutions in the CIV Report or repeat the existing bilateral solutions, which may not resolve the problems in a multinational setting. On the other hand, the second and fifth suggestions may be considered as multinational solutions.

220. See *id.* at 5–7.

the treaty between the source country and the residence country of the investors.<sup>221</sup> This transparent entity provision is expected to address not only the treaty-shopping concerns but also the hybrid mismatch problem.<sup>222</sup> Commentators suggest that a non-CIV should be able to elect to be treated as fiscally transparent for treaty purpose. However, such an election would be a matter of domestic law that requires a non-CIV to attribute its income to its investors.

An important strength of the transparent entity provision is that it confronts the limitation of the existing bilateral approach of treaty entitlement and proposes a multinational solution. However, the Non-CIV Discussion Draft does not seem to recommend this approach strongly due to a key practical difficulty: the approach requires the source country to be provided with all the relevant information concerning the investors in the non-CIV.<sup>223</sup> Many commentators argue that identifying the tax residence of the investors may not be possible “despite the evolving anti-money laundering legislation and tax reporting regimes.”<sup>224</sup>

The second noteworthy suggestion is a Global Streamed Fund (GSF) regime.<sup>225</sup> The key features of this approach are that investment income derived by a qualifying fund, a GSF, is exempted from any tax, including withholding tax, if the fund distributes 100% of its income on a regular basis.<sup>226</sup> Upon these distributions, the GSF should determine tax by the treaty between the source country and the residence country of investors.<sup>227</sup> The GSF should then pay the so-determined tax, including withholding tax payable to the source country, to its own residence country—the intermediate jurisdiction.<sup>228</sup> The fund-residence country would then remit the so-collected tax to the relevant countries, especially the source country.<sup>229</sup>

The GSF regime is also recommended to be elective, not mandatory.<sup>230</sup> It may be implemented by amending tax treaties between participating countries by requiring a GSF to apply the appropriate rate in relation to its distribution of the income relevant to this regime.<sup>231</sup> The Non-CIV Discussion

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221. *Id.* at 5. However, in the case of round-tripping, where the income is derived through a non-CIV that is not a resident of the source country and such income is attributed to the investors who are residents of the source country, such benefits are not available.

222. *See id.*

223. *Id.* at 6.

224. *Id.*

225. *Id.* at 10.

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.*

231. *Id.* at 11. It is also intended for closed-end non-CIVs rather than other types of funds. *Id.*

Draft expects that the proposal also address not only the treaty shopping concern but also the deferral concerns because a GSF would be required to distribute 100% of its income.<sup>232</sup>

Since the Non-CIV Discussion Draft was released in 2016, the OECD also has released another Discussion Draft on Non-CIV Examples.<sup>233</sup> It also has released comments received on the draft in February 2017.<sup>234</sup> As of September 2019, the final Non-CIV Report has yet to be published.

#### D. The Proposal for Non-CIV Funds

The bright side of these efforts is that the OECD is endeavoring to accomplish tax neutrality in multinational fund investment. For example, the GSF regime in the Non-CIV Discussion Draft suggests that as long as a fund distributes 100% of its income to its investors on a regular basis, its tax consequences would be eliminated.<sup>235</sup> The draft also suggests that the tax consequences for investors would be determined by considering only the source country and residence country.<sup>236</sup> However, the discussion regarding both CIV and non-CIV funds is limited to only the treaty entitlement issue. Tax treaties are an important source of international tax law. However, when the fund investment is spread across multiple countries, it is highly likely that at least some of the countries do not have treaty networks with other countries involved in the investment structure. Focusing on the treaty entitlement issue may resolve the treaty shopping issue, but that is only a partial solution to the overall problem in multinational indirect investment.

More importantly, the GSF regime gives intermediary countries the primary authority to determine the overall tax consequences.<sup>237</sup> It also grants them authority to collect taxes on behalf of the source and residence countries and to remit the tax to them.<sup>238</sup> This approach requests the source and residence countries to comply with the so-determined result.<sup>239</sup> However, considering

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232. *Id.*

233. OECD, DISCUSSION NON-CIV EXAMPLES, *supra* note 28.

234. OECD, COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFT: BEPS ACTION 6—EXAMPLES ON TREATY ENTITLEMENT OF NON-CIV FUNDS (2017), <https://www.oecd.org/ctp/treaties/Non-CIV-Examples-Compilation-of-Comments.pdf> [<https://perma.cc/KMQ8-L47Q>].

235. OECD, NON-CIV DISCUSSION DRAFT, *supra* note 28, at 11; *see supra* notes 225–32 and accompanying text.

236. OECD, NON-CIV DISCUSSION DRAFT, *supra* note 28, at 10.

237. *Id.*

238. *Id.*

239. *See id.*

that many aggressive tax planning techniques, such as treaty shopping, hybrid mismatches, and secrecy are mostly offered by intermediary countries, it is difficult to justify their primary taxing power in multinational fund investment.

Therefore, this Article offers the following new alternative Proposal for non-CIV funds. The Proposal is as follows: As long as a fund distributes 100% of its income to its investors and, as a result, eliminates any substantial tax liability in the intermediary jurisdictions other than to the source country and residence countries, such an investment scheme shall qualify for international pass-through taxation.<sup>240</sup> The investment fund would be able to make the election to be treated in this manner. By doing so, the source country and residence country shall together determine whether the fund is qualified for such international pass-through taxation.<sup>241</sup> The source country and residence country shall also collect taxes as if the investment was made directly from the residence country to the source country. Therefore, multinational indirect investors may achieve tax-neutral consequences as if they invested directly. Intermediate countries are required to cooperate in the process.

The end result of the Proposal would be similar to that of the OECD's approach. However, the Proposal may serve as a more effective alternative, as it grants primary tax authority to source countries and residence countries that are entitled to such tax, rather than the intermediary countries interposed between them, which have been contemplated as the origin of many existing problems.

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240. There is potential pushback on the 100% distribution requirement—such a requirement may create another cliff effect for taxpayers and suggesting lowering the threshold to, for example, 90% equivalent to the 90% distribution rule for domestic SPCs or adopting a proportional pass-through rule in proportion to the distribution amount. However, the OECD is concerned about lowering the threshold from 100% because investors may defer recognition of income on which treaty benefits have been granted if a 100% distribution is not required. *Id.* at 11. Considering there is not a good reason to retain the funds in the intermediary, taxpayers can easily avoid such a cliff effect.

241. The process will be initiated only if the investment fund makes the election to be treated as a pass-through entity. The election should be filed with tax authorities in both the source country and the residence country. If the two countries come up with different answers, a dispute resolution mechanism should be available. The mutual agreement procedure (MAP) in Article 25 of the OECD Model has been developed vigorously these days as part of the BEPS Project, and, thus, it would be a good resource for the Proposal, as well. *See* OECD, MAKING DISPUTE RESOLUTION MECHANISMS MORE EFFECTIVE, ACTION 14: 2015 FINAL REPORT, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT (2015), [https://read.oecd-ilibrary.org/taxation/making-dispute-resolution-mechanisms-more-effective-action-14-2015-final-report\\_9789264241633-en#page1](https://read.oecd-ilibrary.org/taxation/making-dispute-resolution-mechanisms-more-effective-action-14-2015-final-report_9789264241633-en#page1) [<https://perma.cc/F456-47GA>]. More details on how the source country and residence country would cooperate would be the task of a future project.

## V. IMPLEMENTATION: THE CASE OF PRIVATE EQUITY FUNDS

The purpose of the Proposal toward the international tax system is to ensure pass-through taxation in appropriate cases. In the previous Part, this Article argued that, to date, the international tax regime has not provided an established pass-through tax rule or partnership tax rule, mainly because of the prevalence of bilateralism. However, the traditional practice of bilateralism in the international taxation sphere is not the only obstacle to implementing a pass-through tax regime. Even if the Proposal as a multilateral approach is implemented, two further prerequisites will be required: (1) the provision of information on investment by non-CIVs<sup>242</sup> and (2) the exchange of such information among relevant tax authorities. This Part examines what information the non-CIVs should provide with relevant tax authorities and how, and with whom, the tax authorities would then share that information. It also shows that there is a unique implementation opportunity of the Proposal in the case of PEFs.

*A. Prerequisites for the Proposal**1. Provision of Information on Investment*

The first prerequisite is to obtain information on the investment of a particular non-CIV. The necessary information includes the overall structure of the non-CIV in question and the identity of investors. Thus, the most important concern is whether the relevant tax authorities may institutionally obtain such information and whether the non-CIV and its investors would be willing to cooperate with tax authorities to provide such information.

*a. Regulatory Permission*

First, it will be necessary to devise solutions to regulatory and contractual difficulties faced by the relevant parties. Non-CIVs might still be unwilling to provide such information to the extent that they are bound by confidentiality obligations toward their investors.

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242. This is a third-party information reporting, because the taxpayers in a non-CIV investment are the investors, not the non-CIV itself; just like the taxpayers in a partnership investment is the partners, not the partnership. For the importance of third-party information reporting by business firms in tax administration, see generally Leandra Lederman & Joseph C. Dugan, *Information Matters in Tax Enforcement*, 2020 BYU L. REV. (forthcoming 2020).

One may find the confidentiality excuse is similar to the long-lasting argument of Swiss banks against becoming more transparent, relying on their Bank Secrecy Law.<sup>243</sup> However, Swiss banks' resistance against transparency has relented in the face of the recent global changes toward enhanced transparency on tax information.<sup>244</sup> The new institutional regime for international taxation toward transparency, such as Automatic Exchange of Information (AEOI) and the U.S. Foreign Account Tax Compliance Act (FATCA), discussed in Subsection A.2, made Switzerland abandon its Bank Secrecy Law and cooperate to provide tax information of its bank customers to the customers' residence countries.<sup>245</sup>

Furthermore, the European Union (EU) has devised a directive, known as DAC 6, that imposes mandatory disclosure requirements for an intermediary entity and its advisers to report cross-border arrangements with tax-avoidance hallmarks, discussed in Section III.C, as from June 25, 2018.<sup>246</sup>

This Article argues that this new global regime will contribute to conditions under which the non-CIV industry is more likely to overcome regulatory and contractual hurdles and become more transparent. Before the emergence of the new regime, it was a legitimate question to ask whether the non-CIV industry was ready and willing to voluntarily become more transparent. However, the new regime, particularly the FATCA, applies to the extended category of financial institutions, which include not only traditional banking industry, but also alternative investment entities, such as PEFs and hedge funds.<sup>247</sup> Therefore, the transparency for non-CIVs is expected to become mandated soon, and it is hoped that the contribution of this Article to the new regime will be several improvements applicable to non-CIVs.

#### *b. Provision to Source Country*

A caveat of the new regime is that it requires financial institutions, including non-CIVs, to provide tax information regarding structure and investor identity. Institutions must provide this information to either the jurisdiction where the financial institution is located or the jurisdiction where the taxpayers maintain residency.

All the while, the Proposal requires non-CIVs to provide information to the source country jurisdictions. Thus, in addition to the current reporting requirement to the residence country imposed by FATCA and FATCA-like

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243. Stuart Gibson, *Swiss Bank Secrecy—Their Lips Say Yes, but Their Eyes Say No*, FORBES (Apr. 5, 2017, 1:18 PM), <https://www.forbes.com/sites/taxanalysts/2017/04/05/switzerland-their-lips-say-yes-but-their-eyes-say-no/#35732b3f5783> [<https://perma.cc/B7JZ-RDL6>].

244. *See id.*

245. *See infra* Section V.A.2.

246. Council Directive 2018/822, 2018 O.J. (L 139/1) 1.

247. *See* Treas. Reg. § 1.1471-5(e)(4)(i)(C) (2018).



laws, the Proposal needs additional domestic legislation that requires non-CIVs to report relevant tax information to source countries as well.

## 2. *Exchange of Information*

For an accurate tax analysis, relevant tax information should also be shared among all relevant tax authorities in a timely manner. Thus, the second prerequisite of the Proposal is the exchange of information (EOI) collected among relevant tax authorities for accurate and consistent tax administration throughout.

Fighting offshore tax evasion has become a top priority of international tax policy in recent decades. After going through the LGT Bank affair<sup>248</sup> and the UBS scandal,<sup>249</sup> the EU and the United States, the two most important voices in international tax law, realized they were vulnerable to offshore tax evasion and were losing enormous tax revenues as a result. They also realized that they had not fully caught up with the techniques used by their domestic citizens of using offshore vehicles to “round-trip” or “circulate” funds. In addition, the global financial crisis in 2007, which was caused by the reckless practices of certain financial institutions, offered an opportunity to implement a more active regulatory policy. It also triggered a global discussion regarding overall transparency in the financial industry, from which a new regime for international taxation is emerging.

A couple of important developments are worth noting, including the Global Forum on Transparency and Exchange of Information for Tax Purposes

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248. In 2008, Heinrich Kieber, a former employee of LGT Truehand, a trust company affiliated with LGT Bank in Liechtenstein, stole customer data and provided it to tax authorities throughout the EU and to the IRS under a newly enacted whistleblower provision. See Lynnley Browning, *Banking Scandal Unfolds Like a Thriller*, N.Y. TIMES, Aug. 14, 2008, at C8.

249. In 2007, Bradley Birkenfeld exposed the tax avoidance strategies of UBS, where UBS advised the U.S. taxpayers to establish foreign shell entities, which then opened offshore accounts at the UBS based on the position that such offshore accounts need not be withheld at the rate for the U.S. taxpayers nor be disclosed to the IRS. Joshua D. Blank & Ruth Mason, *United States National Report on Exchange of Information* 2–3 (N.Y.U. Law & Econ. Research Paper Series, Working Paper No. 14-22, 2014); see Treas. Reg. § 1.1441-1; Itai Grinberg, *The Battle over Taxing Offshore Accounts*, 60 UCLA L. REV. 304, 325–26 (2012).

(Global Forum)’s initiative for AEOI,<sup>250</sup> the U.S. FATCA,<sup>251</sup> the OECD’s BEPS project,<sup>252</sup> and the EU’s various implementation measures.<sup>253</sup>

*a. EOI System*

The exchange of tax information is not a new system. To enforce domestic tax law fully and fairly, access to tax information from other countries is critical.<sup>254</sup> Therefore, bilateral tax treaties have included EOI clauses since World War II.<sup>255</sup> Among various forms of EOI—including “upon request,” “spontaneous,” and “automatic” EOI (AEOI)—the default rule for EOI has been EOI upon request.<sup>256</sup>

However, EOI upon request has not been sufficient to fight against offshore tax evasion.<sup>257</sup> It has not provided information on non-compliant cases in a timely manner due to the bureaucratic procedures for request.<sup>258</sup> Furthermore, it has not been sufficient for tax authorities to detect noncompliant cases in the absence of previous indications of noncompliance.<sup>259</sup>

To overcome the limitations of the EOI upon request, AEOI is considered as an alternative. After several attempts,<sup>260</sup> AEOI finally obtained momentum in the late 2000s, under the auspices of the Global Forum, when tax transparency became the priority of the international tax policy.<sup>261</sup> Since 2009, the Global Forum has pressured its member states to adopt broader

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250. See generally *Global Forum on Transparency and Exchange of Information for Tax Purposes*, OECD, <http://www.oecd.org/tax/transparency/> [<https://perma.cc/64SK-YV59>].

251. See generally *Summary of FATCA Reporting for U.S. Taxpayers*, IRS (Jan. 29, 2019), <https://www.irs.gov/businesses/corporations/summary-of-fatca-reporting-for-us-taxpayers> [<https://perma.cc/4H4Q-RYE3>].

252. See generally *International Collaboration to End Tax Avoidance*, OECD, <http://www.oecd.org/tax/beps/> [<https://perma.cc/D7NH-Q5CW>].

253. See, e.g., Dario Paternoster, *General Tax Policy*, EUR. PARLIAMENT (May 2019), <http://www.europarl.europa.eu/factsheets/en/sheet/92/general-tax-policy> [<https://perma.cc/5434-V7CD>].

254. Grinberg, *supra* note 249, at 313.

255. *Id.* at 313–14.

256. OECD, *Commentaries Tax Convention*, *supra* note 49, para. 9.1, at C(26)-5; see Grinberg, *supra* note 249, at 314–15. To be specific, Article 26 of the OECD Model requires EOI upon request, permits automatic EOI, and forbids fishing expedition. See generally OECD Model 2010, *supra* note 65, art. 26, at M-62.

257. See Grinberg, *supra* note 249, at 313–17.

258. See *id.* at 315–17.

259. See *id.*

260. The efforts to adopt AEOI by the EU and the OECD had been frustrated by the resistance of several countries, such as Austria, Belgium, Luxembourg, and Switzerland. *Id.* at 314–15.

261. Michel, Ziering & Kim, *supra* note 172, at 76–77.

EOI provisions in accordance with the OECD standard.<sup>262</sup> One of the outcomes was the revision of the Convention on Mutual Administrative Assistance in Tax Matters (MAAC) in 2010, in which 126 jurisdictions were participating as of November 2018.<sup>263</sup> Although the revised MAAC did not set AEOI as an obligation, it provides a legal basis and a platform for AEOI to be implemented multilaterally.<sup>264</sup>

With the success of the revised MAAC, along with the enactment of the U.S. FATCA in 2010, AEOI has been met with widespread political support since 2012. In 2014, G20 leaders and finance ministers endorsed AEOI as the “new single global standard.”<sup>265</sup> In 2014, the OECD released the Common Reporting Standard (CRS) for AEOI on financial account,<sup>266</sup> calling on governments to obtain detailed account information from their

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262. The Global Forum now includes 154 member states with 12 observers, making it the largest tax group in the world. *Global Forum on Transparency and Exchange of Information for Tax Purposes*, *supra* note 250.

263. Stafford Smiley, *Mutual Administrative Assistance in Tax Matters*, 40 J. CORP. TAX’N 21, 21 (2013). For a chart listing participating jurisdictions, see OECD, JURISDICTIONS PARTICIPATING IN THE CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS STATUS (2019), [https://www.oecd.org/ctp/exchange-of-tax-information/120718Article%2026-ENG\\_no%20cover%20\(2\).pdf](https://www.oecd.org/ctp/exchange-of-tax-information/120718Article%2026-ENG_no%20cover%20(2).pdf) [<https://perma.cc/WL7M-JNMX>]. The United States signed the MAAC in 2010, which was submitted to the Senate for ratification in 2012. Patrick Temple-West, *Senator Paul Stirs Business Ire Over Blocking of U.S. Tax Treaties*, REUTERS (Apr. 28, 2013), <https://www.reuters.com/article/usa-tax-treaties/senator-paul-stirs-business-ire-over-blocking-of-u-s-tax-treaties-idUSL2N0AJFS320130428> [<https://perma.cc/B859-2NUT>]. However, the Senate has yet to ratify it along with other tax treaties, mainly due to the strong opposition by Senator Rand Paul, a Republican from Kentucky. *Id.*

264. Although the focus of the EOI system is moving to the AEOI, EOI upon request still matters because the current AEOI system is limited to financial account information, whereas EOI upon request is available to all kinds of tax information. Hence, the Global Forum is also working to enhance EOI upon request. OECD, GLOBAL FORUM ON TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES, TAX TRANSPARENCY: 2014 REPORT ON PROGRESS 31 (2014), <http://www.oecd.org/tax/transparency/GFannualreport2014.pdf> [<https://perma.cc/3RPB-7G94>].

265. *OECD Delivers New Single Global Standard on Automatic Information*, OECD (Feb. 13, 2014), <https://www.oecd.org/g20/topics/taxation/oecd-delivers-new-single-global-standard-on-automatic-exchange-of-information.htm> [<https://perma.cc/D3JB-RDHS>].

266. Rick Mitchell, *Practitioner Sees Possible Negative Effect on Banks as U.S. Hesitates on Global Standard*, DAILY TAX REP. (BNA) (Oct. 29, 2014). CRS is modeled on the U.S. FATCA. *See id.*; *see also* Rick Mitchell, *Switzerland Signs OECD Agreement On Automatic Tax Information Exchange*, DAILY TAX REP. (BNA) (Nov. 19, 2014). The OECD later adopted the full and comprehensive report on the CRS. OECD, STANDARD FOR AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION IN TAX MATTERS (2014), [https://read.oecd-ilibrary.org/taxation/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters\\_9789264216525-en#page1](https://read.oecd-ilibrary.org/taxation/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters_9789264216525-en#page1) [<https://perma.cc/A4XE-7L95>] [hereinafter THE STANDARD].

financial institutions and to exchange that information automatically with other jurisdictions on an annual basis.<sup>267</sup> The rationale behind the CRS is to generate advantages arising from “process simplification, higher effectiveness and lower costs for all stakeholders concerned.”<sup>268</sup> As of April 25, 2019, 105 countries have signed a multilateral instrument to implement the AOI with the CRS.<sup>269</sup> The first AEOI among the group of 49 countries began in 2017, and the subsequent group of 51 countries, including Switzerland, followed in 2018.<sup>270</sup>

Ironically, the United States has not committed to any multilateral instrument requiring AEOI, such as MAAC and CRS MCAA.<sup>271</sup> However, the United States has undertaken AEOI since 2015 pursuant to FATCA and relating intergovernmental agreements with other jurisdictions,<sup>272</sup> which will be discussed below.

#### *b. U.S. FATCA*

Congress enacted FATCA in 2010 to combat offshore tax evasion.<sup>273</sup> FATCA requires that foreign financial institutions (FFIs) and other foreign entities receiving payments from U.S. sources undertake a series of steps to identify accounts held by U.S. persons and report information regarding those accounts on an annual basis to the IRS.<sup>274</sup> It is noteworthy that FATCA sets a category of “investment entity” in the definition of FFI and includes alternative investment vehicles, including PEFs, in that category.<sup>275</sup> Failure to comply could subject the affected institution to a series of 30% withholding tax on certain U.S. source income.<sup>276</sup>

267. See THE STANDARD, *supra* note 266, at 13, 15.

268. *Id.* at 11. The Standard further provides guidance on IT solutions relating to data safeguards and confidentiality standards and the transmission and encryption for secure transmission of information under the CRS. *Id.* at 17.

269. OECD, SIGNATORIES OF THE MULTILATERAL COMPETENT AUTHORITY AGREEMENT ON AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION AND INTENDED FIRST INFORMATION EXCHANGE DATE (2018), <http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/MCAA-Signatories.pdf> [<https://perma.cc/YD9Q-QEWK>].

270. OECD, AEOI: STATUS OF COMMITMENTS (2018), <http://www.oecd.org/tax/automatic-exchange/commitment-and-monitoring-process/AEOI-commitments.pdf> [<https://perma.cc/WPF8-C4GN>].

271. See *id.*

272. *Id.*

273. *Summary of FATCA Reporting for U.S. Taxpayers*, *supra* note 251.

274. See Foreign Account Tax Compliance Act, Pub. L. No. 111-147, 124 Stat. 97, 97–99 (2010).

275. Young Ran (Christine) Kim, *Considering “Citizenship Taxation”: In Defense of FATCA*, 20 FLA. TAX REV. 335, 362 (2017); see Treas. Reg. § 1.1471-5(e)(4)(i)(C) (2017).

276. *Summary of FATCA Timelines*, IRS, <https://www.irs.gov/businesses/corporations/summary-of-fatca-timelines> [<https://perma.cc/D43S-X6L4>] (last updated June 5, 2018). Such withholding tax has been imposed on fixed or determinable annual or periodic (FDAP)

One concern that has arisen is whether FFIs can provide financial information to the United States pursuant to FATCA without violating their own domestic banking and privacy laws, as well as the terms of their contractual relationships with their clients.<sup>277</sup> To address this issue, the United States suggested an alternative approach to the implementation of FATCA by entering into inter-governmental agreements (IGAs) that would allow FFIs to comply with FATCA obligations without violating the laws of their residence countries.<sup>278</sup> Starting with the United Kingdom in 2012, more than 100 countries, including major trading partners as well as bank secrecy jurisdictions, such as the Cayman Islands and Switzerland, have signed or initialed agreements with the United States.<sup>279</sup>

The major criticism of FATCA in the early phase was that it unilaterally imposed extraterritorial obligations on FFIs solely for the benefit of the United States.<sup>280</sup> Even after the U.S. government committed to enter into IGAs to solve issues caused by the unilateral and extraterritorial nature of FATCA, and even after the FATCA obtained global political support as momentum for AEOL, many practitioners and government officials complained about the complex compliance procedure.<sup>281</sup>

Notwithstanding such criticism, FATCA has provided momentum for global AEOL. In addition to the AEOL work by the OECD, FATCA spurred

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income since July 1, 2014. *Id.* Withholding tax on gross proceeds from the sale or disposition of any property that gives rise to FDAP income began January 1, 2019. *Id.*

277. See Tracy A. Kaye, *Innovations in the War on Tax Evasion*, 2014 BYU L. REV. 363, 364–65; see also Grinberg, *supra* note 249, at 336.

278. See Grinberg, *supra* note 249, at 336–37; Kaye, *supra* note 277, at 366.

279. Ian Bone, *FATCA: Compliance by Foreign Jurisdictions*, WOLTERS KLUWER (June 14, 2017), <https://ct.wolterskluwer.com/resource-center/articles/fatca-compliance-by-international-jurisdictions> [<https://perma.cc/GT96-UUUH>]; Michel, Ziering & Kim, *supra* note 172, at 72. As of February 23, 2017, ninety-six countries—including major trading partners as well as tax secrecy jurisdictions, such as Bermuda, BVI, Cayman Islands, Isle of Man, Guernsey, Panama, Hong Kong, and Singapore—have signed IGAs with the United States. Kim, *supra* note 275, at 361. “Seventeen countries, including China, have initiated IGAs, and a couple of other countries are in discussions with U.S. authorities about entering into IGAs.” *Id.* See *IGA Status*, TAX NOTES, <https://www.taxnotes.com/FATCA-expert/IGA-status> [<https://perma.cc/9Z7X-PUQ3>], for the current IGA status.

280. Grinberg, *supra* note 249, at 336.

281. See, e.g., *Hillis v. Canada* (Att’y Gen.), [2016] 2 F.C. 235, 238 (Can.). For the costs and negative collateral consequences of FATCA, see generally Shu-Yi Oei & Diane Ring, *Leak-Driven Law*, 65 UCLA L. REV. 532, 601–08 (2018).

similar legislation in various jurisdictions.<sup>282</sup> Such FATCA-like legislations and agreements are expected to be integrated in the platform of AEOI arranged by the Global Forum.<sup>283</sup>

In conclusion, FATCA appears to have triggered an irreversible trend toward AEOI. Thanks to the emergence of this new regime in international taxation, this Article may safely assume the enhanced level of EOI and multilateral cooperation in tax administration for the Proposal.

### *c. EU ATADs and DAC6*

Building upon the recent developments discussed above, such as the OECD BEPS project and AEOI, the European Commission (EC) also has been adopting various measures designed for its member states. Two measures worth noting with respect the Proposal are the Anti-Tax Avoidance Directives (ATADs)<sup>284</sup> and the DAC6.<sup>285</sup>

The EC adopted the Anti-Tax Avoidance Package in 2016 to ensure harmonized implementation of the OECD BEPS project within the EU.<sup>286</sup> The Package includes a proposal for an Anti-Tax Avoidance Directive (ATAD 1)<sup>287</sup> and the amendment to the Directive on mutual assistance to apply AEOI to country-by-country reporting.<sup>288</sup> Thereafter, the EC adopted ATAD 2 in 2017<sup>289</sup> as an amendment to ATAD 1 in order to combat the hybrid mismatch problem in the EU, including those demonstrated in Subsection III.C.2.b.<sup>290</sup>

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282. See John McCann & Angela Nightingale, *Tax Information Sharing, the Rise of "FATCA-esque" Agreements*, 94 AIMA J. 71, 71–72 (2013), for examples in the United Kingdom and France.

283. See Grinberg, *supra* note 249, at 380–82.

284. See generally Council Directive Proposal for Amending Directive (EU) 2016/1164 as Regards Hybrid Mismatches with Third Countries, COM (2016) 687 final (Oct. 25, 2016).

285. See generally Council Directive 2018/822, *supra* note 246, at 1.

286. *The Anti Tax Avoidance Directive*, EUR. COMM'N, [https://ec.europa.eu/taxation\\_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive_en) [<https://perma.cc/Z75M-FLV3>]; see Rita de la Feria, Editorial, *Harmonizing Anti-Tax Avoidance Rules*, 26 EC TAX REV. 110, 110 (2017).

287. See generally Council Directive Proposal for Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, at 3, COM (2016) 26 final (Jan. 28, 2016).

288. Council Directive Proposal for Amending Directive 2011/16/EU as Regards Mandatory Automatic Exchange of Information in the Field of Taxation, at 2–4, COM (2016) 25 final (Jan. 28, 2016).

289. Council Directive 2017/952, 2017 O.J. (L 144) 1, 1–2 (EU).

290. Substantively, ATAD 2 applies to four categories of hybrid mismatches: (1) “that result from payments under a financial instrument;” (2) “that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment, including as a result of payments to a disregarded permanent establishment;” (3) “that result from payments made by a hybrid entity to its owner, or deemed between the head office and permanent

The second Directive on the AEOI was further amended in 2018.<sup>291</sup> As from June 25, 2018, the so-called DAC6 calls for the mandatory disclosure of information by intermediary entities in the multinational fund structure, and in some cases taxpayers, on potentially aggressive tax planning schemes, many of which are criticized in Section III.C.<sup>292</sup> Furthermore, the DAC6 imposes a mandatory EOI on so-called reportable cross-border transactions among EU member states to crack down the tax abusive schemes.<sup>293</sup> However, the question remains whether the EU will allow the United States to be privy to this collected information through other channels for the AEOI.

*d. Rationale for EOI as a Prerequisite*

In the new regime oriented toward enhanced transparency discussed above, the tax information is usually obtained by a jurisdiction where non-CIVs are located. Alternatively, this information is sometimes obtained by a jurisdiction of an investors' residence country at first hand. The information is more comprehensive than that currently available to the source country, such that exchanging the information through EOI upon request and AEOI would theoretically help to implement the Proposal.

However, there are more important reasons why the Proposal needs EOI as a prerequisite. If the Proposal just relies on the information available through EOI, the inevitable time lag between the income distribution and information provision would significantly delay the tax analysis, which

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establishment or between two or more permanent establishments;" and (4) "double deduction outcomes resulting from payments made by a hybrid entity or permanent establishment." *Id.* at 3.

291. See generally Council Directive 2018/822, *supra* note 246.

292. See *id.* at 2; Fionnuala Lynch, *Insight: DAC 6—New EU Tax Disclosure Rules: Cause for Concern?*, BLOOMBERG BNA (Aug. 8, 2018), <https://www.bna.com/insight-dac-6new-n73014481548/> [<https://perma.cc/6CZC-BBXG>]. An intermediary that is subject to the reporting obligation includes advisory firms, such as accounting firms and law firms, which is in line with the movement to combat the aggressive tax planning by enforcing professional ethics of the tax advisers. See generally Heather M. Field, *Aggressive Tax Planning & The Ethical Tax Lawyer*, 36 VA. TAX REV. 261 (2017). Member states must put DAC6 into effect by December 31, 2019, but a retrospective element exists that calls for member states to consider potential reportable transactions that occurred on or before June 25, 2018. ALLEN & OVERY, DAC6—MANDATORY DISCLOSURE TAX REPORTING, WHAT DOES IT MEAN FOR YOU?, (2018), <https://www.aohub.com/aohub/publications/dac6-mandatory-disclosure-tax-reporting?nav=FRbANeucS95NMLRN47z%2BeeOgEFcT8EGQ71hKXzqW2Ec%3D&key=BcJlhLtdCv6/JTDZxvL23TQa3JHL2AIGr93BnQjo2SkGJpG9xDX7S2thDpAQsCconWHAwe6cJlrrH1E07STCrUKIYbf2%2B19> [<https://perma.cc/RH6M-HX7C>].

293. See Council Directive 2018/822, *supra* note 246, at 4.

should be done at the time of distribution. Hence, the Proposal requires the source country to be provided with tax information and initiate the analysis of tax consequences of the non-CIV investment when a target company in the source country distributes income to upper level entities. Such tax information includes offshore tax information that is not originally subject to its tax jurisdiction. Under the Proposal, the information may be timely provided during the process of the tax analysis done by the source country. However, the accuracy of information collected would be limited if there are no means for the source country to verify such information by comparing it with the information on the same transaction obtained by the residence country. Therefore, as a prerequisite for the Proposal, implementation requires comprehensive information-sharing in addition to the current AEOI requirements.

For this purpose, the drawback of the time lag between the income distribution and information sharing could be alleviated because the information sharing is essential not just for initiating the tax analysis by tax authorities but for verifying the tax compliance. If the information provided by taxpayers to a source country turns out to be inaccurate in the later stage when tax authorities verify it with the shared information, then tax authorities would need to reassess the relevant tax and collect the deficient tax amount. Such rectification might be cumbersome, but the systematic process for improvement will surely improve taxpayers' compliance with the Proposal.<sup>294</sup>

#### *B. The Case of Private Equity Funds: Administrable Number of Investors*

A potential criticism of the Proposal is that it is not practical for source and residence countries to administer the tax consequences of multinational investment funds because not all relevant information concerning investors may be available to the source countries.<sup>295</sup> Before the world was equipped with operational AEOI and FATCA, this information was not available because it was relating to offshore entities and accounts that were beyond tax sovereignty of a country. Pursuing such information meant extraterritorial exercise of tax sovereignty. In the new regime toward transparency, however, that concern has been alleviated.

But even if we assume that we are going to live in a world equipped with the second prerequisite—operational AEOI—it is not certain that such a system would consistently or reliably identify investors behind

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294. The risk of noncompliance still exists if the only effective way to collect tax in the Proposal is by withholding tax. However, such risk is not unique to the Proposal but rather applies to the overall withholding tax system in international tax.

295. See OECD, DISCUSSION NON-CIV EXAMPLES, *supra* note 28, at 5.



non-CIVs for at least two reasons. First, given that the investment structure of many non-CIVs covers multiple jurisdictions, information shared piece by piece—or country by country—does not necessarily provide a complete picture including all relevant investors and ultimate beneficial owners. Second, AEOI and FATCA apply to financial institutions only, while certain entities in the chain of non-CIV investment structure are often non-financial business entities, such as a corporation, a partnership, or a hybrid entity, which are not included in traditional definitions of financial institutions and are therefore not likely to be subject to the obligation to provide information to tax authorities under those systems.<sup>296</sup>

Such problems of identifying taxpayers could be solved to the extent that the Proposal requires non-CIVs to provide such information not only to the residence country but also to the source country. However, commentators still assert practical difficulty for some types of non-CIV funds in identifying the tax residence of their investors and thus their inability to provide such information to source country.<sup>297</sup>

To illustrate the viability of the Proposal, this Article offers a unique implementation opportunity for the Proposal in the case of PEFs by showing that PEFs have an administrable number of investors to identify their residence country.

PEFs, which are essentially privately held partnerships, are a representative example of the non-CIV. PEFs use investment structure similar to that of CIVs, but PEFs' structure are largely more complex than that of CIVs because it contains "multiple layers of pass-through entity and corporate-type special purpose vehicles spread across multiple jurisdictions."<sup>298</sup> They are less transparent to the public than FDI and CIVs, and the information is less available even to the domestic regulatory agencies because reporting requirements have been limited.<sup>299</sup> That is why the OECD first discussed CIVs in its discussion on international indirect taxation and then moved on to non-CIVs, such as private equity.

However, if the administrative authorities tried to obtain information on the individual investors behind the investment vehicles, it would be easier to do so for PEFs than for CIVs. This is because PEFs tend to have only

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296. See OECD, NON-CIV DISCUSSION DRAFT, *supra* note 28, at 6.

297. The Non-CIV Discussion Draft illustrates that a securitization company "may not be in a position to identify who its bondholders" are in a fund of funds "where a financial institution invests in a CIV on behalf of its own clients." *Id.*

298. Kim, *supra* note 8, at 446.

299. See *supra* note 33 and accompanying text.

a handful of high-profile investors, which rarely change during the lifetime of a fund,<sup>300</sup> while CIVs generally have many more, including private retail investors. Based on the author's empirical research through the U.S. Securities and Exchange Commission EDGAR database<sup>301</sup> and PitchBook database,<sup>302</sup> the average number of total limited partners (LPs), who are not managing funds but rather investing in a cross-border private equity fund, for the past ten years is fifty-seven.<sup>303</sup> This is a considerably smaller and more manageable number than the average 34,411 investor units listed per mutual fund.<sup>304</sup>

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300. See TALMOR & VASVARI, *supra* note 33, at 187.

301. EDGAR stands for the "Electronic Data Gathering, Analysis, and Retrieval" system. *Important Information about EDGAR*, SEC (Feb. 16, 2010), <https://www.sec.gov/edgar/aboutedgar.htm> [<https://perma.cc/6DCW-BY8Y>]; see *EDGAR Company Filings*, SEC, <https://www.sec.gov/edgar/searchedgar/companysearch.html> [<https://perma.cc/LH7H-J822>] (providing accessibility to company filings).

302. PitchBook is a software-as-a-service (SaaS) Company, offering private market data not available in the S&P 500 Index, Moody's, and EDGAR. See *Pitchbook Continues on Path to Become One-Stop-Shop for Private & Public Financial Market Data with Launch of Intraday Market Data*, PITCHBOOK (Apr. 24, 2018), <https://pitchbook.com/media/press-releases/pitchbook-continues-on-path-to-become-one-stop-shop-for-private-public-financial-market-data-with-launch-of-intraday-market-data> [<https://perma.cc/Q2UJ-SWWJ>]. It is specialized in PEFs, venture capital, mergers and acquisitions, and IPO. See *id.* It sources fund-related data primarily from private reporting to itself by limited partners. PITCHBOOK, *PITCHBOOK BENCHMARKS: PRIVATE EQUITY & VENTURE CAPITAL DATA THROUGH 1Q 2017*, at 4 (2017), <https://pitchbook.com/news/reports/4q-2017-pitchbook-benchmarks> [<https://perma.cc/5MZF-JE5S>]. It also collects data from Form D filings with the Securities and Exchange Commission (SEC), which are a type of exemption that companies may employ in the offering and sale of securities without the requirement of registration for such with the SEC. Email from Peter Leslie, Account Manager, PitchBook, to Young Ran (Christine) Kim, Assoc. Professor of Law, S.J. Quinney Coll. of Law, (Mar. 1, 2018, 6:06 AM & 2:01 PM MDT) (on file with author). See 17 C.F.R. § 230.501 (2018), for Form D filings.

303. I generated a list of 303 private equity funds that engage in cross-border investment for the past ten years as sample for this research. First, I limit the vintage year to the range of January 1, 2008–February 16, 2018, and ran a search for all "Buyout," "PE [Private Equity] Growth–Expansion," and "Diversified PE" funds in the PitchBook database. Then I excluded the following funds: (1) funds that did not have any investors known to the Pitchbook, (2) funds that do not offer any geographical indication, (3) the country where the fund is domiciled and the country where the fund makes investment were identical—to ensure the funds are engaging in cross-border investment, and (4) funds in the promotion stage or the early investment period that are still selling securities to the investors.

The above search rendered 763 funds, for which PitchBook offers detailed information of some investors known to PitchBook, including the identity of investors and their commitment amount. However, because PitchBook data primarily relies on the private reporting by investors, it does not offer the total number of investors in a particular fund. That information is available at EDGAR database thanks to its Form D filings. So, I compared the initial result obtained from PitchBook with figures available in Section 14 of Form D and excluded funds that did not have Form D filings listed on the EDGAR database. This left 303 funds remaining. Further research methodology is on file with the author.

304. According to the reports for year 2017 published the Investment Company Institute (ICI), 56.2 million households out of the total of 126.2 million households in the United

More detailed information on the identity of the investors is currently available for about fifteen investors in PEFs, which is about 27% of the above fifty-seven average investors.<sup>305</sup> Furthermore, information on the commitment and investment amount of a particular investor is also available for about twelve investors in PEFs—that is, about 21% of the above fifty-seven average investors.<sup>306</sup>

FIGURE 12. AVERAGE NUMBER OF LPS



The missing detailed information might be obtainable through the newly enhanced exchange of tax information system, such as FATCA, AEOI, and DAC6. The global efforts to enhance tax transparency and the exchange

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States owned mutual funds. See DANIEL SCHRASS & MICHAEL BOGDAN, INV. CO. INST., PROFILE OF MUTUAL FUND SHAREHOLDERS, 2017, at 5 fig.1.1 (2017), [https://www.ici.org/pdf/rpt\\_17\\_profiles17.pdf](https://www.ici.org/pdf/rpt_17_profiles17.pdf) [<https://perma.cc/U6QX-ZW78>]. To find the average number of households per mutual fund, the number of owning households is multiplied by 6, the mean number of mutual funds owned by U.S. households, and then divided by the number of funds in the United States, 9,799.

$$\frac{(\text{owning Households}) \times (\text{mean number of funds owned})}{\text{Total number of funds}} = \frac{(56,200,00) \times (6)}{9,799} = 34,411$$

*Id.* at 13 fig.1.6; EUROPEAN FUND & ASSET MGMT. ASS'N, WORLDWIDE REGULATED OPEN-ENDED FUND ASSETS AND FLOWS: TRENDS IN THE SECOND QUARTER OF 2018 tbl.7 (2018), [https://www.efama.org/Publications/Statistics/International/Quarterly%20International/180928\\_International%20Statistical%20Release%20Q2%202018.pdf](https://www.efama.org/Publications/Statistics/International/Quarterly%20International/180928_International%20Statistical%20Release%20Q2%202018.pdf) [<https://perma.cc/9RGT-F47Z>]; INV. CO. INST., 2017 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE INVESTMENT COMPANY INDUSTRY 242 app. A (57th ed. 2017), [https://www.ici.org/pdf/2017\\_factbook.pdf](https://www.ici.org/pdf/2017_factbook.pdf) [<https://perma.cc/HR82-33A2>].

305. Data on file with the author and available upon request.

306. *Id.*

of information, in addition to these empirical findings, further may make the Proposal more promising and administrable.

## VI. CONCLUSION

The basic goal of a pass-through tax regime is tax neutrality between direct and indirect taxation. Tax neutrality is generally accomplished in the domestic tax system. However, tax neutrality failed in the international tax system, particularly in multinational settings. Current international tax regime results in either over-taxation or under-taxation for investors in multinational investment funds.

Thus, this Article offers the Proposal of making pass-through taxation work in multinational jurisdictions. Suppose that a fund distributes 100% of its income to its investors, and as a result, it eliminates any substantial tax liability in the intermediate jurisdictions other than country of source and residence. In this scenario, such an investment scheme would qualify for international pass-through taxation. The difference between the Proposal and the OECD's approach is that the Proposal gives primary tax authority to the source country and residence country rather than intermediary countries. Furthermore, this Article shows the prospect of implementing the Proposal in the case of PEFs, inspired by PEFs' unique features promoting administrability of the Proposal.

This Article fills the gap in international tax scholarship, which lacks the systematic analysis in foreign indirect investment. However, there are many issues in cross-border fund investment that are not fully addressed in this Article, such as deferral of income and allocation of tax jurisdictions among relevant countries. Moreover, the global community needs to improve the EOI system to apply it to fund investments. All those topics are future research topics that can be built upon the ideas of this Article.

VII. APPENDIX A: EXAMPLE COMPARING THE TAX ANALYSIS OF  
DIRECT INVESTMENT AND INDIRECT INVESTMENT

Assumptions

- Tax treaty between Country A and Country B: 0% withholding (WH) tax on dividend, 10% WH tax on interest.
- Tax treaty between Country A and Country D: 15% WH tax on dividend, 12% WH tax on interest.
- Country B provides holding company regime similar to Luxembourg. Country C provides offshore pass-through tax regime similar to the Cayman Islands. Tax amount payable to Countries B and C is nominal enough to be ignored.
- Country D has a worldwide tax regime with FTC and will apply a 35% tax rate on the foreign source income, except for dividend and capital gains, which it will tax at a 20% rate. It also provides a special tax regime for a tax-exempt organization (EO), which exempts tax on interest, dividends, and capital gains but imposes tax on unrelated business taxable income (UBTI). Assume income received by an EO is not UBTI.
- If Country A determines that it is a tax avoiding transaction, it will deny treaty benefits between Countries A and B and apply domestic tax law, the maximum tax rate of which on dividend and interest of nonresident is 30%.

Problem 1: Target company in Country D distributes 100 of dividend.

- Direct investment between Country A and Country D
- Indirect investment (treaty between Countries A and B is applicable, not challenged by Country A)
- Indirect investment (treaty between Countries A and B is not applicable, challenged by Country A)

	A	B	C	D	Total worldwide tax liability
a. Direct	100 div @ 15% WH =	-	-	100 div income @ 20% = 20	20
Investment	15			(FTC 15)	
				Tax payable to D = 5	
				If EO,	15
				Tax payable to D = 0	
b. Indirect	100 div @ 0% WH = 0	0	0	100 div income @ 20% = 20	20
Investment				(No FTC)	
(treaty				Tax payable to D = 20	
shopping)				If EO,	0
				Tax payable to D = 0	
c. Indirect	100 div @ 30% WH =	0	0	70* div income @ 20% = 14	44
investment	30			(No FTC)**	
(challenged				Tax payable to D = 14	
by A)				If EO,	30
				Tax payable to D = 0	

\* Only 70 will be considered as taxable income from Country D's perspective under the bilateral approach.

\*\* No FTC is allowed as to the tax paid to Country A for the purpose of income tax in Country D under the bilateral approach.

**Problem 2:** Target company in Country D distributes 50 of dividend and 50 of interest, but the character of such income will be recharacterized when Country B distributes such income for the tax purposes of Country D. Assume that only 5 will be characterized as interest, and the remaining will be characterized as dividend.

	A	B	C	D	Total tax liability
a. Direct	50 div @ 15% WH = 7.5	-	-	50 div income @ 20% = 10	27.5
Investment	50 int @ 12% WH = 6			50 int income @ 35% = 17.5	
	Total tax payable to A = 13.5			(FTC 13.5)	
				Tax payable to D = 14	
				If EO,	13.5
				Tax payable to D = 0	
b. Indirect	50 div @ 0% WH = 0	0	0	Gross income = 95	24.75
Investment	50 int @ 10% WH = 5			90** div income @ 20% =	
(treaty applied)	Total tax payable to A = 5			18	
				5* int income @ 35% = 1.75	
				(No FTC)***	
				Tax payable to D = 19.75	
				If EO,	5
				Tax payable to D = 0	
c. Indirect	50 div @ 30% WH = 15	0	0	Gross income = 70	44.75
Investment	50 int @ 30% WH = 15			65** div income @ 20% =	
(challenged by A)	Total tax payable to A = 30			13	
				5* int income @ 35% = 1.75	
				(No FTC)	
				Tax payable to D = 14.75	
				If EO,	30
				Tax payable to D = 0	

- \* Only 5 out of the total income received is characterized as interest.
- \*\* In the indirect investment where the treaty between Countries A and B is applicable, only 95 out of 100 is taxable income from Country D's perspective, and 90 out of 95 is dividend. In the indirect investment where the treaty is not applicable, only 70 out of 100 is taxable income from Country D's perspective, and 65 out of 70 is dividend.
- \*\*\* No FTC is allowed as to the tax paid to Country A for the purpose of income tax in Country D under the bilateral approach.

Analysis

- a. represents a simple FDI scenario, not involving a fund vehicle.
- b. represents treaty shopping scenarios. Compared to a., a taxpayer is paying less tax, and the residence country is likely getting more revenue, while the source country is losing its revenue.
- c. represents ex post, unilateral adjustments by source country. The taxpayer has to pay too much tax and the source country is collecting too much tax, compared to both a. and b. How the residence country's revenue would be changed is not certain.